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Fiscal Policy in Poland under Transition

Andrzej S. Bratkowski (ed.)
Marek Dąbrowski
Małgorzata Antczak
Marcin Łuczyński
Krzysztof Połomski

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Editor:

CASE - Center for Social & Economic Research
00-585 Warszawa, Bagatela 14
tel/fax (48-2) 628 65 81; tel/fax (48-22) 29 43 83

Introduction

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Chapter I: Short History of Economic Transition in Poland
(Marek Dąbrowski)

1. Situation of the Polish economy in late 1980s.

The Polish economy in late 1980s represented a typical case of a reformed socialist economy, similarly to Yugoslavia and Hungary. Economic system was partly centrally planned and partly market governed with very ineffective macroeconomic control and with enterprises not interested in profit maximization. The foundations of this socialist market (or rather semi-market) system were created mainly in 1981-1982 as a result of big economic reform debate in 1980 - 1981. The concrete institutional and regulatory solutions were a product of political bargaining and compromises between advocates of different reform proposals[1]. The specific political conditions of the Martial law also affected the eventual shape of 1982 economic reform.

The most important element of this reform included:

- limited autonomy of state-owned enterprise (SOE) maintained by the institution of employee self-management and partial elimination of intermediate organs and organizations;
- abolishing the traditional central plan targets and replacing them by the so-called "operational programs" and "government orders" for selected group of products; central allocation of selected basic raw materials, semi-products and foreign currencies were maintained;
- partial liberalization of domestic prices;
- partial demonopolization of foreign trade; a system of retention quotas for part of foreign exchange earnings from export was introduced;
- limited and controlled opening for domestic private sector and small-scale foreign investments;
- some liberalization of state enterprise financial system and individual wage setting

Although a lot of minor modifications were adopted in the next five years a general logic of that economic system remained unchanged until 1987.

The macroeconomic equilibrium and discipline was the point where the Poland's situation differed significantly from the situation of Hungary. Inflationary processes combined with shortages were a quite normal phenomenon in Poland in the 1980-s. Serious macroeconomic disbalances in Poland had their origins in early 1970s when First Secretary of the Polish United Workers Party Edward Gierek and Prime Minister Piotr Jaroszewicz forced a very intensive modernization of the Polish industry and a

[1] The Balcerowicz's group proposal was the most radical among many other being subject of debate. However, even this project did not go beyond the borders of market socialism (because did not propose privatization of public sector).

consumption boom. Both were financed, to significant extent, through large scale foreign borrowing what led to a dramatic balance of payment crisis in the end of this decade. This period bring also creation of basic elements of the very extensive and expensive system of social protection. Wage explosion after the August 1980 strikes (that gave a foundation for the "Solidarity" movement) combined with continued price control devastated completely the state budget and consumer market. Polish economy in the Summer and Autumn 1981 was in the situation of the repressed hyperinflation. Authorities had to rely on the wide scale rationing of basic food and industrial consumer products.

Under the Martial Law in February 1982 the large scale administrative price adjustment took place which decreased the real size of monetary overhang and market shortages but did not eliminate them completely. The quite substantial market shortages, coupon system (especially for meat products) and open inflation ca. 15-20% per year became a standard picture of this decade. Unfortunately, the process of creating excessive social obligation of the state was continued especially in relation to a pension system (including many branch and professional privileges).

Inflationary processes accelerated in the Fall of 1987 when the government of Zbigniew Messner announced the so-called Second Stage of Economic Reform including "price-income operation". It was an attempt of a typical administrative price adjustment implemented finally at the beginning of 1988. The long political discussion as well as the referendum in November 1987 contributed to a big market panic. The macroeconomic effect of this operation was additionally undermined by a strong wage pressure (two waves of strikes - in April-May and in August 1988).

Messner's government started in 1988 some institutional and structural reforms such as deconcentration of many SOEs, transforming monobank system into two-tiers banking system, merging some branch industrial ministries into single Ministry of Industry.

2. Beginning of market reforms and near-hyperinflation (October 1988 -August 1989)

The last pre-democratic government of Mieczysław Rakowski had some important achievements in the liberalization and institutional sphere. It contributed, among others, to a significant liberalization of new entries, including private ones (the Law on the Economic Activity from December 23, 1988), to the liberalization of foreign trade and foreign exchange market, to the limited liberalization of foreign direct investments. This government finally liquidated the intermediate organizations grouping SOEs (trust and associations). It also introduced corporate income tax and tried to start the privatization process. Unfortunately, this last attempt was unsuccessful because unclear rules and techniques preferring so-called *nomenklatura* prevailed [Błaszczyk and Dąbrowski, 1993].

Despite the above achievements, the lack of macroeconomic stability became the weakest point of the policy of M. Rakowski's government. Already, The Program of a Consolidation of the National Economy, a key policy document of this cabinet, neglected the role of monetary and fiscal discipline. The state budget for 1989 was accepted with a big deficit. During the next months, the macroeconomic situation further deteriorated (see - chapter II). This was caused by a number of factors: populist tendencies raised during the "round table" negotiations, instability affected by the electoral campaign as well as an across the board indexation of wages forced through by "Solidarity" Independent Trade Union and the National Council of Trade Unions (OPZZ). Earlier, in January 1989, Parliament passed the Law on Salaries in the State Budgetary Sphere which guaranteed the rising level of parity indexation of salaries starting from 97% in 1989 to the finally targeted 106% of wages in enterprise sector in the end of 1992[2] .

The government decision of April 17, 1989 regarding the increase of the minimum procurement prices of agricultural products and influenced by the forthcoming election campaign contributed to the final collapse of the state budget in the mid of 1989. The National Bank of Poland played at this time an absolutely passive role financing the budget deficit through an unlimited and interest-free credit to the government. A huge monetary overhang combined with a partially administrative price control lead to a total deficit of goods on the domestic market. The price and wage freeze introduced in July 1989 only strengthened the market panic.

In this situation the "marketization of a food economy" - the freeing of prices and elimination of the rationing system - was decided by the Rakowski government on August 1, 1989. The decision itself was absolutely necessary. However, it came a few months too late and was accompanied by pro-inflationary monetary, fiscal and wage policies. The huge subsidies still existed although they were stabilized in nominal terms. All employees and pensioners received 100 % income compensation for inflation. The minimum procurement prices increased once again. The official exchange rate was extremely overvalued and the interest rate was extremely negative in real terms. The inflation jumped to the level of 39,5% in August and 54,8% in October 1989. A big shortage of many products still existed at this time on both the consumer and producer markets.

3. First measures taken by Mazowiecki's government (September - December 1989)

The government of Tadeusz Mazowiecki, the first post- communist government in Poland, which was appointed on 12 September 1989, inherited an economy in a state of near-hyperinflation and regulatory chaos. A month later Vice Prime Minister and Minister of Finance Leszek Balcerowicz presented a comprehensive program of economic transformation. This document was made up of two key components: an anti-inflationary stabilization program and a program of fundamental institutional reforms including privatization.

[2] This law function in 1990 only when the wage level in enterprise sector was kept under the relatively tough control. In 1989, in the near-hyperinflationary situation, government could not catch up the nominal wage level in the enterprise sector. Starting from the Spring 1991 this law was suspended in the every year budget. Finally this law was replaced by another regulation in the end of 1994.

The drama of the economic situation forced the government to focus, in the first instance, on a stabilization package. However, this does not mean that systemic reforms have been neglected. In the last quarter of 1989, preparations were made for the introduction of a stabilization and liberalization program which was enacted on January 1, 1990. In the meantime, some transitory emergency measures were taken. From October 1, 1989 most of the subsidies to food products and to some intermediate inputs were eliminated. Starting in September 1989, the NBP began to tighten the money supply, to increase the nominal interest rate and to depreciate the exchange rate against the US $ both in nominal and real terms. This policy enabled to almost completely close the huge gap between official and free-market exchange rate by the end of 1989. In October 1989 the wage indexation in the enterprise sphere became limited.

4. Stabilization and liberalization program (January 1990).

The stabilization and liberalization program introduced from January 1, 1990 and drawn up in consultation with the International Monetary Fund, consisted of five major components:

1) Restrictive monetary policy, most clearly expressed by a drastic reduction in the money supply as well as the establishment of a high interest rate (exceeding inflation in real terms from March 1990). This move was accompanied by a law regulating credit operations by introducing interest rate adjustments in all credit agreements that were made in the past. The law also restricted the so called `preferential credit'.

2) Elimination of the budget deficit, predominantly through further drastic reductions in subsidies for food, raw materials, production input, energy carriers as well as the removal of tax exemptions. Substantial budget surplus was achieved in the first three quarter of 1990.

3) Further liberalization of prices (since January 1990 ca 90% of prices were determined by the market) as well as a significant increase of prices still under administrative control, for example, fuels and energy, transportation tariffs, housing rents and pharmaceuticals. Some other price deregulation steps were taken during 1990 (e.g. a liberalization of coal prices from 1 July 1990). Housing rents were only partly deregulated in 1994.

4) Introduction of a current account convertibility of the Polish currency, linked with its considerable devaluation and the emergence of a single exchange rate. The exchange rate was stabilized on the level 9500 zł per 1 US $ as a nominal anchor[3]. The exchange rate policy was accompanied by liberalization in foreign trade (elimination of import quotas, most of export quotas, unification and decreasing of tariffs). Despite these significant steps the relative level of tariffs was still rather high in the first half of 1990 (see - table I.1.). Some export quotas and export taxes, especially in the raw materials and energy industry as well as

[3] It was kept on this level until the devaluation in the mid of May 1991. From October 1991 the preannounced scrawling peg formula was adopted which worked until today.

in agriculture, were also preserved. Further import tariff liberalization as well as the removal of most of export barriers came in the third quarter of 1990. Most tariffs became temporary, either totally suspended or radically decreased. From the end of 1990 a strong political pressure to return to trade protectionism rose first from agricultural lobby, later also from industrial lobby. In Spring 1991, several custom rates for agriculture products were increased. From August 1, 1991 all custom tariff were doubled. After the Association Agreement with EEC was signed by Polish government in December 1991 (followed by free-trade agreement with EFTA and creation of CEFTA) import tariff policy became more stable.

5) Restrictive income policy manifested mainly in the elimination with the end of 1989 of general wage indexation in the enterprise sector introduced in July, 1989 and the introduction of severe taxation penalties on wage increases (so-called *popiwek*[4]), a policy that allowed only a modest growth of wages with respect to price increases (the index ratio was the following: 0.3 in January 1990, 0.2 from February - April, 0.6 in May and June, 1.0 in July and 0.6 since August). During next years excess wage taxation was gradually relaxed[5] (especially after December 1992) and finally abandoned in the end of 1994.

Table I.1: Evolution of Import Tariff Structure (based on average frequency, including suspended tariff and tariffs on duty-free tariff quotas) - percentage rates

Group of commodities	I.1989	VIII.1990 to VIII.1991	VIII.1991	XII. 1993
All commodities	18.3	5.5	18.4	19.0
Agriculture products	17.2	4.0	26.2	26.2
Industrial products	18.7	...	16.3	17.0

The objectives of the above program were: to stifle high inflation and to eliminate shortages; to open the economy to domestic and foreign competition; to deregulate the majority of commodity markets; to liberalize the structure of prices and to bring it closer to the free market; to break down the wage indexation policy; to make state budget balanced and stable. In general the operation was meant to create a macroeconomic basis for the microeconomic restructuring.

[4] *Popiwek* was introduced in 1982 and existed during all period of 1980s though the detail construction of this instrument and even formal name of tax were change almost every year.

[5] Many technical aspects of this tax were changed permanently. The most important change was connected with moving from controlling the total wage bill of enterprise to the average wage (it happened from January 1, 1991).

Authors of 1990 stabilization and liberalization policy expected rather moderate output decline and quick recovery - already in the second half of 1990. It was probably the biggest intellectual miscalculation done during preparation of this program [see - Gomułka, 1995]. Although this forecasting mistake did not have any direct influence on effectiveness of stabilization and liberalization outcome it created very nervous political atmosphere around Balcerowicz's program. When the output decline in the beginning of 1990 occurred to be higher than forecasted and expected recovery did not come a big pressure for government and National Bank of Poland started to rise to look for possible ways of reactivation of national economy. It led to the serious mistakes in macroeconomic policy (see below). Politicians and economist did not realize in that moment that output decline is not a specific Polish phenomenon but common feature for all the transition economies. Moreover, looking from the historical perspective it is now clear that the output decline in Poland was the smallest one among transition economies.

Most of the stabilization and liberalization objectives were achieved but not all to the same extent. The most spectacular success was connected with immediate elimination of market shortages. Demonopolization of the Polish economy also proceeded in a quite fast way, mainly due to very liberal rules of market entry for the new private firms and due to a massive import liberalization in the second half of 1990[6]. Polish economy is probably one of the most competitive among the transition countries. Unfortunately, the indexation rules and mentality in the income and social policy were not overcome. It happened partly because the struggle with inflation was never fully successful (see below and chapter II). Also the budget surplus occurred to be only a temporary phenomenon (see - chapter IV).

5. The first wave of institutional reforms (Fall of 1989 to the Fall of 1991)

The Balcerowicz program has not been limited to a macroeconomic stabilization and extensive liberalization but also included a lot of important institutional reforms. As we have noted, the Mazowiecki government did not start from the zero point in this respect. It inherited a partially reformed economic system with numerous relicts from the planned economy but also with a number of market- type institutions and mechanisms (or at least their beginnings). During the entire post-war period Poland maintained a predominant private sector in agriculture and a limited private sector in commerce, services, transport, construction, etc.

The 1980s were marked by a steady growth of the private sector. A significant rise in its growth occurred in 1989 and next years, after the Rakowski's government removed the majority of administrative barriers preventing private firms from entering the market. 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 GDR, Czecho-Slovakia and the Soviet Union.

[6] In the first half of 1990 import was limited not only by moderate import tariffs but mainly by the undervalued exchange rate of złoty [see - Zieliński, 1994].

Two first democratic governments (the Mazowiecki government from September 1989 to December 1990 and the Bielecki government from January to December 1991) implemented a set of important institutional reforms.

Aside from the ones previously mentioned, (for example; price liberalization, convertibility of the złoty) we should mention the following:

1) Creation of an uniform tax policy for all ownership sectors of the economy, removal of a significant number of allowances, exemptions and special benefits from the tax system, reduction of top bracket tax rates for direct taxes. The second stage of the tax reforms started from the Summer of 1991 and included the introduction of the personal income tax from January 1, 1992, the new law on corporate income tax (adopted in March 1992 but working retrospectively from January 1, 1992) and of the value added tax (VAT) from July 5, 1993.
2) Introduction of a customs law corresponding to EEC standards from January 1, 1990.
3) Extensive public finance reform including abolishing almost all extra-budgetary funds and introduction of the new budget law (from January 1, 1991).
4) Acceptance of a new anti-monopoly legislation (March 1990), creation of an anti-monopoly office (April 1990), breakup of state-owned enterprises in a number of industries (meat, sugar, grain, cement, coal, energy, energy generating machine, mining, internal trade, construction, commodity transport, bus transportation, public utilities and other).
5) Liquidation of all cooperative associations (January 1990) as well as the conglomerate RSW `Prasa-Ksiazka-Ruch' (March 1990), which belonged to the old United Polish Workers Party (PZPR). Most of this conglomerate was privatized in 1990-1991.
6) Liberalization of building rental laws by the abolition of administrative allotment of usable spaces (May 1990) what contributed to speeding up a small privatization (see point 14).
7) Updating of the Civil Code, Civil Behavioral Code, legislation governing land use (Autumn 1990). Among others, this changes speed up the formation of a real estate market, helped to develop collateral lending, improved the execution of civil contracts, removed unequal treatment of state and private contractors. Together with the updated state enterprise law (see point 10) they allowed SOEs to sell out or rent redundant assets what contributed both to speeding up the small privatization (see point 14) and to restructuring many SOEs (see section 10).
8) Improvement of the procedures governing the tax collection system (possibility of tax execution from SOEs - March 1990); establishing the fiscal police (Law on Fiscal Control Offices from September 1991, started to act in February 1992).

9) Acceptance of new legislation governing the insurance of persons and property which allows for commercialization and demonopolization of the insurance sector (July 1990).

10) Update of legislation governing socialized enterprises, giving them greater independence (with giving the full responsibility for selection mangers to the worker councils); accompanied by simultaneous tightening of rules governing so called rehabilitation actions and bankruptcy procedures against SOEs (March 1990).

11) Abolition of all remaining forms of trade not based on free market principles, termination of rationing, ending of traditional central planning (from the end of 1989).

12) Speeding up the reorganization of the banking sector and updating the banking law. It was done in several steps. The most significant changes to the banking law, introducing the Western European norms of bank behavior and accounting, were adopted in September 1991 but after the Presidential veto were reconfirmed by parliament in March 1992. Many new private owned banks are being formed in 1989-1991 including some with foreign investment.

13) Strengthening the independent position of the National Bank of Poland (NBP). The same legislative initiative which changed the banking law changed also the Law on NBP giving the Governor of NBP a personal stability. His or her candidature is proposed by President and must be accepted by Sejm for six years period without a possibility to fire him or her earlier (apart the case of resignation or criminal prosecution). Unfortunately, the NBP is not fully independent from Sejm which must accept the monetary program each year. There is also practice that budget law for the specific years may set a limit of government financing by the central bank (not only as maximum entitlement for government to borrow but also as minimum obligation for NBP to buy treasury bills as happened in 1994).

14) Speeding up of the "small" privatization, especially in retail and wholesale trade, in road transport, construction, services. Practically, this process was finished until the end of 1991.

15) Creation of a legal and institutional basis for the "large" privatization. This process only started in the Fall of 1990. However, it was accelerated in 1991 (especially it concerns the so-called liquidation privatization).

16) Acceptation of the Law on Securities Market and Mutual Funds (March 1991); opening the Warsaw Stock Exchange in April 1991.

17) Acceptation of the new Foreign Investment Law eliminating most of licentioning and allowing a free repatriation of profit and invested capital (July 1991).

18) Implementation of the system of local self-government and the reintroduction of municipal ownership abolished in 1950 (May 1990). The new budget law separated from January 1, 1991 the single state budget (incorporating also former *voivod*, i.e. regional budgets) and local budgets. Communes and

municipalities have their own taxes. They participate in some central taxes, and receive both so-called general subsidies as well as target subsidies from the state budget. They can receive also revenues from their own economic activity. Generally speaking, the level of financial autonomy of local self-government is not high what is connected with rather limited tasks delegated to communes and municipalities. They do not include, for example, the primary education and most of health services. The basic rules of game are changed very often.

6. Social policy reforms

Period of 1989-1991 bring also attempts to reform the social safety net. Some of the reforms have been continued later. The most important steps in this sphere adopted so far include:

1) The new Employment Law (December 1989) creating a network of employment offices and introducing unemployment benefits. Unfortunately, the established eligibility criteria were too liberal and the level of benefits - too high. This legislation had to be corrected many times - in 1991, 1992 and 1994 - mainly by tightening the definition of unemployee, relating benefits to the minimum wage in the national economy not to the recent wage received by the individual person, and by limiting period of benefits to 12 months after a registration.

2) The Group Lay-Off Law (from December 1989) that enabled the rationalization of employment in enterprises. However, this law created very high financial burden for enterprises (obligation to pay compensation equal very often three months salary).

3) The reform of the pension system implemented in several changes. The Law on Pension Revalorization from October 1991 was the most important step in this process. The attempt to return to the insurance character of the pension system, i.e. to reestablish linkage between period and size of contribution to the pension fund and the level of pension benefits, was the first target of this reform. It was achieved only partly after many legal complications connected with the Constitutional Court (CC) decision about unconstitutionality of many new regulations (CC treated the elimination of branch and professional privileges as the violation of citizen rights). The second target was connected with a general revaluation of old pension titles depreciated by inflation (so-called old portfolio problem) and establishing the regular wage-related indexation of the pension benefits. This part of reform was seriously miscalculated. It created enormous financial burden for the expenditure side of the budget (see - chapter VI). The continuation of relatively easy entry criteria, especially for the disability pensions of the so-called third group and for farmer pensions (traditionally financed in ca. 95% by the state budget) worsen additionally situation. Several drastic and politically unpopular adjustment steps were necessary in 1992 and 1993. Generally they were focused to slow down the pace of indexation process. Unfortunately, the Waldemar Pawlak government reversed partly this adjustment in the end of 1993 increasing the minimal benefits and the indexation coefficient.

4) The introduction of the decentralized system of social aid for the poor people from January 1991 (Law on Social Welfare System from November 1990).

5) The reform of family benefits system (legislation from December 1994, introduced from March 1995) which limited the eligibility of these benefits to families with low and middle income.

6) The reform of sickness benefits making situation of public and private sector equal as well as limiting the level of individual benefit to 80% of wage rate (from March 1995).

The list of urgent social policy reforms waiting for elaboration and implementation is still very long. It includes both some further adjustment measures (e.g. changing the indexation of pensions from the wage related to the price related, increasing the retiring age for women) and more fundamental systemic reforms such as general pension reform, introduction of health insurance, etc.

7. Modifications of macroeconomic policy from Summer 1990.

The end of second quarter of 1990 bring a general relaxation of a macroeconomic policy. The monetary policy started to be relaxed even earlier - in April 1990. This reorientation was caused by the will to reactivate the Polish economy after the deep output decline. Now there is evidence that the assessment of this decline, made at that time, was overestimated [Bratkowski, 1993]. The political arguments such as the forthcoming presidential election campaign and the pressure of the farmers lobby also played an important role. This relaxation gave a new, very strong inflationary impulse in the second half of 1990 and a rather limited reactivation in the output sphere. A rising inflationary pressure induced the NBP to start a monetary contraction. The adopted measures included three substantial increases of the refinancial interest rate (during the period since October 1990 to January 1991), the increase of the norm of required minimum reserves and the credit rationing for the state owned enterprises. This drastic package helped to stop inflation again.

The beginning of 1991 bring the new serious challenge for the macroeconomic policy connected with collapse of CMEA trade, the second wave of output decline and the post-stabilization fiscal crisis (see chapters II and III). Fiscal policy became for the next three years the central issue of stabilization attempts. Every budget law, budget provisorium or budget corrections until the first half of 1993 (i.e. September 1991, December 1991, February 1992, June 1992, November 1992 and February 1993) were connected with the drastic adjustment measures related mainly to the unemployment benefits, pension system, wages of budgetary sphere, subsidies, removing tax and import tariff exemptions, introduction the new special taxes (6% import surcharge in December 1992), improving tax collection and execution, housing programs, etc. Most of these steps were characterized earlier. General tax reform (see above) was gradually implemented.

The economic recovery and tax reform (especially introduction of VAT) improved the fiscal situation in the end of 1993 and in 1994. This fact contributed to the weakening of political interest in further fiscal adjustment in 1994, especially in the social policy sphere and even to the reversal of some earlier decisions (see above).

8. Further institutional reforms after 1991

After 1991 the pace of institutional reforms became much slower. Part of the adopted measures such as the tax reform or changes in the social legislation was described earlier. Some other steps worth to mention included:

1) The Law on Financial Restructuring of Enterprises and Banks (February 1993) which opened the decentralized process of debt renegotiation, debt trading, debt-to-equity conversion and bank recapitalization.
2) The Public Procurement Law (June 1994)
3) The housing reform (relevant laws from June and July 1994) deregulating partly the housing market, reintroducing the institution of condominium, and clarifying the property status of many apartments.
4) The new Foreign Exchange Law (effective from January 1, 1995) introducing the full current account convertibility *de iure* and opening possibility for full convertibility in the future (including capital accounts). The new law was followed by the official declaration of Ministry of Finance and NBP about convertibility of zloty according to Article 8 of IMF Articles of Agreement.
5) Denomination of the Polish złoty (from January 1, 1995).

The Waldemar Pawlak government took also in 1994 some decisions that mean reversal of some earlier liberalization and demonopolization reforms such as the introduction a system of compensation payments for imported agriculture products , creation of the administrative sugar oligopoly or compulsory concentration of co-operative banks into one big conglomerate under the state owned Food Economy Bank.

9. Large privatization

The Law on Privatization of State-Owned Enterprises was adopted by Sejm in July 1990. Large-scale privatization started in the end of this year. During 1991 and 1992 the so-called liquidation privatization[7] of small and medium size enterprises dominated. The so-called equity privatization (through corporatization and public offering or trade sale to the strategic investor) was rather slow. The latter became more intensive in 1993 and 1994. The earlier mentioned debt-to-equity swap became in 1994 the important method of privatization of some large enterprises. From the beginning of 1992 the former state agriculture farms are subject of liquidation process and privatization implemented by the special government agency.

The Mass Privatization Project based on investment funds organized by the state and later privatized through equal distribution of their shares to all adult citizens was discussed from Summer 1990 and presented first time for the public discussion in June 1991. However, it took almost two years of hot political controversies before the relevant law (Law on the National Investment Funds and their privatization) was

[7] That is the direct selling, renting or leasing of all the enterprise assets or their part.

adopted by parliament on April 30, 1993. The next one and half year took before this idea entered into the decisive implementation phase (the end of 1994). Finally 423 big and medium size enterprises are subjects of mass privatization and 14 or 15 national investment funds will be created.

The issue of reprivatization was not solved so far in Poland.

Poland is not a leading country in respect to the speed of large-scale privatization (like East Germany, Czech Republic and Russia). Mass Privatization Project is significantly delayed in comparison with many other countries. Nonetheless, ca. 60% of GDP in Poland is contributed already by the private sector[8]. It happened, to significant extent, due to a very successful small privatization and spontaneous development of the new private firms. Most of the known cases of large privatization have a rather good quality characteristics in respect to restructuring effects.

10. Main vehicles of the microeconomic restructuring

The microeconomic restructuring is going mainly in the decentralized way under the pressure of market forces. Removing subsidies and most of tax exemptions, tightening the credit policy, opening markets for domestic and external competition, intensive deconcentration and demonopolization, success of small privatization and very dramatic growth of the new private sector, moderate inflow of foreign investments became the main vehicles of this process.

As we mentioned in the previous section the new private and privatized enterprises represent far more market oriented behavior than traditional state sector in communist economies (even in their reform version). Privatization of the national economy in the wide sense (including the creation of new private firms) bring not only changes in the microeconomic behavior but also led to substantial changes of sector composition of GDP (decreasing share of industry and increasing share of trade and services).

The available empirical research [Dąbrowski, Federowicz, Levitas and Szomburg, 1992; Pinto, Belka and Krajewski, 1993; Belka, Estrin, Schaffer and Singh, 1994; and day-to-day observations show that also a part of state sector started a serious microeconomic adjustment. It happened mainly in industries open to a strong domestic and foreign competition and not protected by the state. Far less signs of adjustment can be observed in industries still remaining under the special umbrella of government protection. The coal industry is the best example here. Government sponsored restructuring programs such as a big reorganization of coal industry in the beginning of 1993 has bring a little progress in the real adjustment and rather contributed, through rebuilding strong intermediary structures, to the rising political bargaining with government.

[8] Statistical definition of the private sector covers also the co-operative sector. The last one was seriously reformed after 1989 and now its behavior, contrary to the previous communist experience, is in most cases similar to the typical private enterprises.

Chapter II: Macroeconomic Performance (Andrzej S. Bratkowski)

1. Economic situation in late eighties

After the economic collapse of 1979-82, resulting from the incapacity to continue servicing rapidly increasing foreign debt, the Polish economy recorded a period of growth in the years 1983-1988. However, as late as in 1987, GDP was some 2% lower than in 1978. Debt denominated in foreign currencies which was serviced only to a low extent continued to grow, finally reaching 40.8 billions USD in 1989. In 1989, in order to provide full foreign debt service (principal and interest) Poland would have needed to allocate 80% of its total revenue from export against convertible currencies.

In spite of the rapid decrease of real revenues recorded in 1982, shortages on the consumer goods market persisted over the entire decade, with open inflation amounting to ca 15% annually. In 1987 poor results in agriculture made the lack of market equilibrium all the more acute, thus contributing to inflation increasing to over 25% and further political destabilisation.

2. Macroeconomic destabilisation in 1988-1989

In 1988 the political situation caused rapid wages increase and the strengthening of negative trends recorded in 1987. During that year nominal wages rose on the average by more than 80% (however, the increase from December 1987 to December 1988 amounted to almost 150%). In spite of relatively good economic results in 1988, this increase both caused an inflation leap - to over 60% - and made shortages of goods even more acute (in 1988 real personal income rose by almost 14%, with GDP growth of ca. 4%).

Macroeconomic destabilisation accelerated sharply in 1989. The removal of administrative price controls as regards a majority of foodstuffs, relaxed control over wages and prices in the enterprises sector, significant wage increases in the budgetary sector and lower corporate income tax rates resulted in a rapid price increase, fall in real budgetary revenue and an increase in budgetary expenditure, leading to a very rapid growth of budgetary deficit and further increase in prices. As regards the annual average, wages rose by 292%, while in the budgetary sphere they grew by over 360%. During the same period consumer prices rose by 251%. The increase in prices and wages accelerated by the end of 1989, when prices clearly grew faster than wages. In December, 1989, wages in the enterprise sector exceeded the figures recorded in December, 1988, by almost 470%, while prices were 640% higher than a year before. The second half of 1989 saw an even more rapid increase in producer prices. The average annual index was 213% higher - i.e. less than CPI - while in December producer prices index exceeded CPI, recording a 653% increase.

The inflation was accompanied by an increase of credit for enterprises, which, however, was still lower than inflation (more than 185%). Over 1989 the interest rate continued to grow in a systematic manner - from 44% in the first quarter to 104.4% in

December, 1989. Nevertheless, over the entire period, the interest rate was lower than inflation rate. The increase in money supply (M2) was far more rapid than the increase in credit and amounted to ca 515%. The rapid rise was caused mainly by the devaluation of zloty (by more than 1000%). In 1989 (December 1989 to December 1988) money resources in zloty grew by only 190%, while the resources held in foreign currencies (to be more specific: liabilities of the banking system denominated in foreign currencies), in zloty terms, grew by 1655%. The increase in cash (except for cash held in banks) amounted to 290%. These figures should be adjusted taking into account the increase in the amount of convertible currencies held by the population and not registered by the banking system. The increase in foreign exchange resources in 1989 can be estimated to be at least 400 million USD, while the total level would amount to at least 1500 million USD, which corresponds to cash increase in zloty terms by more than 470%. The proportion of zloty resources in the registered total resources (without the non-registered foreign currencies) dropped from 77% in 1988 to less than 36% by the end of 1989.

High inflation, negative real interest rates and sharp depreciation of zloty contributed to a rapid increase in the profitability of companies, which grew by ca 40% over the entire year. In spite of that - as a result of Tanzi effect - real budgetary revenue decreased by 25%. Rapid growth of wage expenditure in the budgetary sphere was to a large extent offset by a fall in real subsidies and investment (by ca 17% in real terms). As a result, real expenditure also declined (by ca 5%), however, this decrease was far weaker than on the revenue side. Budget deficit was growing rapidly, mainly over the first six months of 1989, reaching in June 3275 milliard zloty, i.e. more than 30% of state expenditure. In the second half of 1989 the increase in deficit was much slower - by the end of the year the deficit amounted to 3579 milliard zloty and the proportion of deficit to budgetary expenditure fell to less than 10%.

Macroeconomic destabilisation caused a slow-down in economic growth. The official GDP growth index was +0.2%. It would seem, however, that the index underestimates the full extent of inflation - and in particular its influence upon real inventories. According to data supplied by Chief Statistical Office (GUS) industrial output decreased by some 0.5% while consumption fell by 1.3%, which, given the increase in real revenues signified further strengthening of disequilibrium on consumer goods market. Investment in fixed assets fell by 2.1% in real terms. Export, calculated at fixed prices, both settled in convertible currencies and in rouble, remained at previous year's level. In spite of a series of significant devaluation measures, the increase of internal demand resulted in the growth of import against convertible currencies and a deterioration of the balance of trade (according to data included in the balance of payments), from +1088 million USD in 1988 to +240 million USD in 1989.

3. Results of shock stabilisation and macroeconomic liberalisation of 1990

The release of a majority of prices from administrative controls, adjustment of government-controlled prices (mainly prices for energy which grew more than threefold) and another devaluation of zloty caused a leap increase in prices in January, 1990. Prices of consumer goods and services grew by 80%, while producer prices increased by 110%. In February and March the inflation rate was declining rapidly. Overall, in the first quarter of 1990, prices of consumer goods and services grew by 132%, while producer prices rose by 129%. Over the second quarter of 1990 prices of consumer goods and services were increasing at an average rate of 5.1% per month, while in the third quarter the rate was already 3.3%.

From February 1990 until the end of the year the increase of industrial producer prices was significantly lower than the CPI. Such proportions were caused by large price increases as regards regulated prices for certain consumer services (mainly prices of energy). This discrepancy resulted in numerous phenomena, the most significant of which was a very high difference between interest rates (which the National Bank of Poland usually maintained at a level exceeding CPI) and the rate of growth for producer prices.

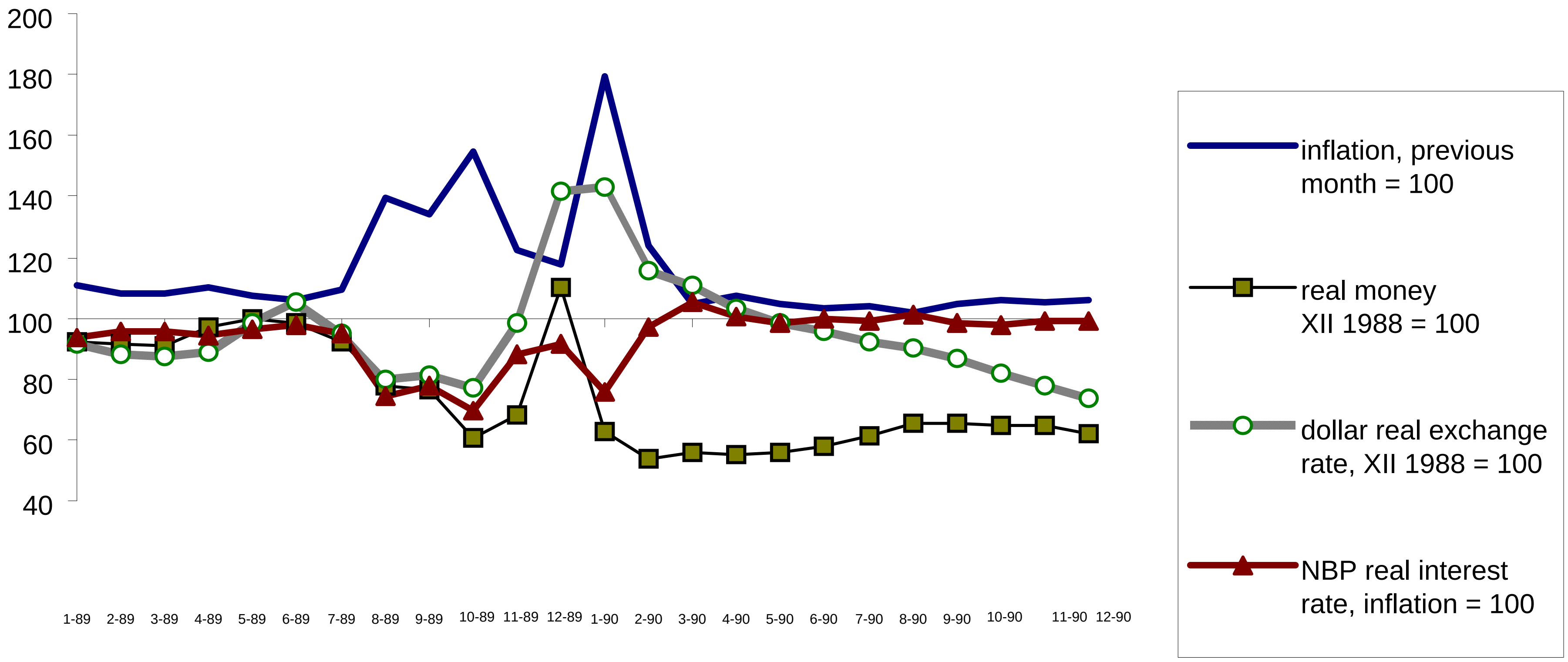
Shortages as regards both consumer goods and producer goods were eliminated as early as in January.

New principles of wage control, high nominal interest rate (432% p.a. in January, 1990), and the leap increase in prices cause a drastic drop in domestic demand. In the first quarter of 1990 real wages dropped by ca 30% - however, about 50% of this decrease could be explained by the closing of the gap between the income levels and supply of consumer goods, which used to exist over the previous years). The industrial production, however, also declined by some 30%. On the other hand, the falling domestic market demand, the real depreciation of zloty as well as liberalisation of foreign trade resulted in a rapid increase of export sales against convertible currencies (8% in the first quarter, 14% over the first six months of the year) accompanied by a sharp decline in import (20% and 30%, respectively). The increase in export sales made the drop in industrial output less acute, but a very large trade and current account surplus caused the money supply to start growing as early as in March, thus slowing down any further decrease in inflation.

In mid-1990 the refinancing rate was reduced to 34%. The tax on excessive wage increases was also relaxed. This resulted in a very rapid wage increase and - in spite of a stable dollar rate of exchange and suspension of a majority of customs duties - revived the inflation. In the fourth quarter consumer prices grew by more than 15%.

Export sales continued to grow at a rapid pace, however, by the end of the year the increase in import against convertible currencies grew even faster. This was mainly the result of a rapid increase in domestic demand, the appreciation of zloty and lowered customs rates. The reduction of raw material supplies from the Soviet Union, for which payments used to be settled in rouble, forced companies to import from the

Graph II.1: Basic monetary indicators, 1989-1990 years



countries belonging to the area of dollar settlements, partly contributing to the increase in import. Over the last two months of 1990 the trade surplus was reduced by more than 670 million USD, to attain the level of 2.2 milliard USD by year-end. In general, however, good results in foreign trade caused an increase in official reserves by almost 1.7 milliard USD, which contributed to a significant strengthening of confidence in zloty.

Similar to 1989, the financial situation of a majority of enterprises - except for a part of consumer goods industry and food processing - was very good, in spite of a rapid drop in production output. High inflationary profits and foreign exchange gains, as well as cautious wage policy pursued by companies over the first six months of the year allowed them to maintain the profit margins at ca 30%.

The policy of maintaining a fixed rate of exchange of dollar and reduction of customs tariffs resulted in a situation in which the rapid increase in demand over the second half of the year did not yield a significant influence upon production output. An intensified competition from imported goods and the increase of wage costs led to a drop in company profitability (which was very difficult to trace in statistical terms, due to the fact that profit and loss accounts were prepared in the incremental format). The rise in inflation during the last months of the year forced the National Bank of Poland (NBP) to increase the interest rate up to 55% in December, 1990.

Good financial situation of companies and a slower inflation rate permitted an increase in revenues of general government from 37.5% of GDP in 1989 to 46.8% in 1990, resulting in an increase in real revenue by ca 9%, in spite of the overall GDP fall. Real budgetary expenditures remained at levels similar to these recorded in 1989, largely improving the budgetary balance: after the first six months the budget surplus was recorded of more than 6.7 billion zlotys (more than 2% of GDP over the same period). In the second half of the year budgetary expenditures grew and the budget surplus started to decrease rapidly, in spite of continuing high tax revenues. By the end of the year the surplus amounted to 2.4 billion zloty, i.e. less than 0.5% of GDP.

A significant fall in the real income of population on the one hand and good budgetary performance on the other resulted in a situation in which the new legislation concerning social benefits (changes in the pension systems, unemployment benefits) was constructed in a way which strongly favoured persons receiving the benefits. The financial consequences of this legislation were not to become apparent until the next year.

In general, the reform programme did attain its principal objectives, i.e. macroeconomic stabilisation and liberalisation, even though the cost involved a fall in economic activity and consumption[9] and stabilisation objectives were implemented only in part. Inflation (December to December) dropped from 640% in 1989 to 250%, though some two-thirds of inflation over that period may be attributed to price adjustments of the first quarter. Gross Domestic Product and consumption decreased

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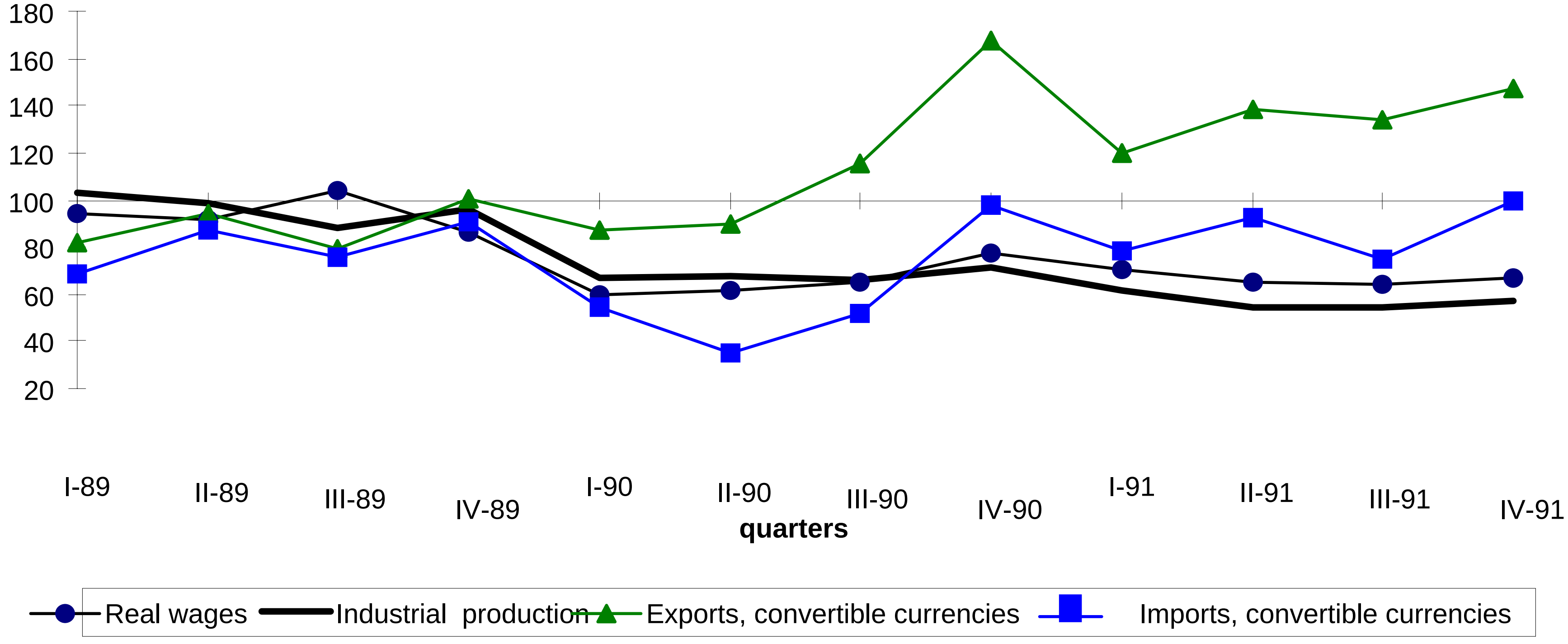
[9] After few years of economic transition there is a lot of evidence that the actual decline of industrial output, GDP, real consumption and real wages was smaller than officially recorded by the GUS. See - Bratkowski [1993] and Berg and Sachs [1992].

Graph II.2.: Basic macroeconomic indicators, 1989-1991 (IV quarter of 1988 = 1



by almost 12%, investment fell by ca 10%. The data, however, fails to take into account unregistered economic activity which developed very rapidly starting from mid-1990. Thus, the real decrease in GDP and consumption was probably slightly (by 3-4 percentage points) lower than the official figures.

4. Deterioration of the economic situation in 1991

During the first months of 1991 inflation accelerated still further, accompanied by a simultaneous drop in production output and a dramatic decline in financial results attained by companies. The sharp worsening of the economic situation was caused by several concurrent factors:

- the necessity of implementing a more restrictive macroeconomic policy after a period of excessive relaxation over the second half of 1990;
- collapse of export to the former CMEA members, after the introduction of settlements in convertible currencies;
- unfavourable political climate after presidential elections in fall 1989, resulting in a relaxation of financial discipline in companies.

Many directors of state enterprises and, above all, the trade unions, interpreted the presidential election loss of Prime Minister Tadeusz Mazowiecki in his race against Lech Wałęsa as a herald of a departure from reforms initiated in January, 1990. This led to an increased wage pressure, to which the directors yielded without much resistance, in view of the relaxation of macroeconomic policy in the second half of 1990, anticipating better access to credit, removal or at least relaxation of tax on excessive wage increases and devaluation of zloty. Such factors could allow companies to offset the increasing cost by way of price increase and higher sales volume. Even though these expectations proved to be false, they largely undermined the credibility of economic policy. In such a situation most decisive moves were required in order to restore the credibility of the reform programme.

Such decisions were indeed made. After the initial increase to 55% in December, the interest rate grew to 70% in January. Limits regarding maximum increase of credit granted by commercial banks were also introduced. In order to slow down the increase in prices and to strengthen financial discipline in companies, it was decided to maintain the fixed exchange rate, leading to a rapid drop in export sales profitability, given the increase in domestic prices.

The burden resulting from the excess wage tax grew sharply. The construction of this tax permitted companies to make use of the "non-realised" wage increase over the given year (in relation to the standard level defined by the government). Since in the first half of 1990 enterprises did not make full use of the wage increase limit which was free from this tax, wages paid out in the second half of the year could grow more than indicated by the governmental standard, without entailing tax liability. As a result, in January, 1991 wages in numerous enterprises were significantly higher than the defined standard, resulting in a dramatic increase of fiscal burden, due to the restrictively progressive tax structure.

Burdens resulting from the so-called dividend, i.e. tax levied on the value of the "founder's fund" of state enterprises also grew (the fund corresponds to the level of funds contributed by the state to the newly created state-owned enterprise). Since in 1990 fixed assets held by enterprises were not subject to revaluation, the value of founder's funds underwent significant depreciation. Such revaluation was operated in January 1991 and resulted in a sharp increase of tax liabilities, in spite of the fact that the tax rates themselves were lowered, especially in case of relatively new enterprises in which the founder's fund constituted a major part of company's own funds. In 1991 the average financial result after taxation was negative - net profitability dropped from 10.6% in 1990 to -1.3% in 1991.

Restrictive macroeconomic policy coincided with a dramatic drop in demand for Polish products in East European countries and increase in the cost of import. This in turn resulted from the transition to settlements operated in convertible currencies, leading to the removal of hidden subsidies to export production which had so far existed within the settlement mechanism. As a result, the volume of export to former CMEA members dropped by ca 50%. According to official statistics terms of trade index amounted to ca 0.90. It can be estimated that in 1991 this index was by 5 to 10 percentage points lower. The drop in the production output was strengthened by a strong decrease in intermediate demand. In 1990 companies often manufactured to stock, expecting a rapid recovery in the overall trade situation. In 1991 it became apparent that increase in demand is still a long way ahead. In this situation companies started divesting parts of unused manufacturing equipment and inventories. As a result about one-third of their total revenue in 1991 was generated by such sales.

A drop in production output, deterioration in terms of trade, increase of wages and cost of credit, as well as inflation which was far lower than by the end of 1989 and beginning of 1990 led to a sharp fall in profitability ratios. Profitability amounted to 29% in 1990, while in January it fell to 10% only to deteriorate even further over the next months. Very high fiscal burdens unrelated to the company revenue (excess wages tax and dividend) resulted in a situation in which a majority of companies showed negative earnings after taxation. The burdens were alleviated by selling excessive inventories, as well as by the sale or leasing of unused assets to the emerging private companies. In general, however, numerous state owned companies were capable of maintaining their liquidity only by using bank credit. During that period banks applied relatively liberal criteria to the assessment of company creditworthiness and new credit was often used to repay old debts. The high rate of interest on loans caused a very rapid increase of company indebtedness. Negative consequences of an excessively liberal credit policy became apparent over the next years when the budget was forced to provide additional sources for the recapitalization of the state owned banks, to make up for the losses incurred by the banks due to their non-performing assets.

Lack of perspectives indicating forthcoming improvement of the overall situation and bad financial position of companies forced them to initiate the process of gradual reduction of employment. The unemployment rate, which at the end of 1990 amounted to 6.3%, grew to 11.8% over the next twelve months. New regulations in the social sphere caused a significant increase in social benefit levels and permitted earlier retirement, resulting in a very rapid growth of the number of pensioners (by some 12%).

Over the three quarters of 1991 real wages kept decreasing at a significant pace. Even though an increase in real wages was finally registered in the fourth quarter of 1991, in December 1991 wages were 10% lower than a year before. In spite of that, real wages in terms of the entire year were almost 3% higher than in 1990, mainly due to an increase of remunerations in the budgetary sphere which - through an indexation mechanism, reacting with a certain in-built delay - reflected the rapid increase of wages in the enterprise sector recorded during the previous year. Non-wage revenues were growing far more rapidly. This concerned above all the (largely unrecorded) revenues from the economic activity carried out by small businesses in the private sector which was developing in the most dynamic manner. Social benefits were also growing very fast. In 1991 the average retirement benefit increased by 7% in real terms, while unemployment benefits totalled 7.9 billion zloty. As a result, in spite of a 12% drop in production and a 7.6% drop in GDP, consumption rose by 3.3% (excluding the so-called "grey" sphere).

In spite of a significant appreciation of zloty (the fixed rate of exchange set on 1st January, 1990 was changed in May, 1991, when zloty was devalued by 16.8%) export to countries outside the former CMEA was growing rapidly, which largely compensated for the drop in exports to the Eastern Europe. In 1991 foreign currency revenues from export increased by 17.5%. Import, however, grew much faster (at 46.9%), in spite of the increase of customs tariffs in mid-1991. As a result, the balance of trade was reduced to +51 million USD and official foreign currency reserves dropped by almost 1.2 milliard USD.

Following a period of large price increases in January and February, inflation decreased to a significant extent. Over the subsequent quarters of the same year it amounted to 25%, 11.7%, 6.1% and 9.8% respectively. The CPI (December to December) amounted to 60.4%. This permitted the NBP to reduce the interest rate (down to 59% in May and to 40% in October) and remove limits imposed upon incremental credit volume. Annual decrease in real money stock amounted to 8%, while the entire drop in the real stock value was recorded only during the first half of the year - in the second half of the year the real money stock grew by 1%.

In 1991 the budgetary situation strongly deteriorated. The rapid drop in revenue from company profit tax was only slightly compensated by increased revenues from other taxes. New legislative regulations, rapid rise of unemployment and the number of old age pensioners caused a very fast growth of social expenditure. The budget deficit amounted to 31 billion zloty, which corresponded to 3.8% of GDP. The position of the central budget was further impaired by the reform of the public finance system. Under the reform budgets held by local self-government ("gmina") were separated from the state budget. The reform made it more difficult to assess the real needs of the budgetary sphere. As a result, local budgets and extra-budgetary funds recorded a significant surplus and the total public sector deficit amounted to a mere 14.6 billion zloty, i.e. only some 1.8% of GDP.

5. Economic processes in 1992-1994

Starting from the fourth quarter of 1991, in 1992 and 1993 industrial output and GDP continued to grow. Similar to the situation in previous years, the level of economic activity constituted the result of two opposite trends: very rapid growth of the private sector (at 20-30% p.a.) and decline in the activity of the state-owned sector, even though far less dramatic than in 1990 and the first six months of 1991. The economic recovery of 1992 and 1993 was caused by four principal factors:

- the revival of the intermediate demand after the enterprises had disposed of excessive inventories in 1991;
- restructuring of the economy, reflected in the shift of assets from state owned enterprises to the private sector which was more skilful at adjusting its production to the requirements of the domestic and foreign market;
- increase of consumer demand related to the increase of budgetary expenditure;
- replacement of some imports by domestic production, as a result of higher customs barriers.

In 1992, however, the financial situation of companies kept deteriorating. Sales profitability, which in 1991 amounted to 4.8% (annual average) dropped to 2.2% in 1992. Further deterioration of profitability, in spite of an increase in output and protection against external competitors, was caused mainly by the high cost of credit servicing and the drop of revenues from the sale of old inventories. Slower wage increase permitted to cut down on the excess wages tax; dividend rates were also lowered. Thus, in spite of a drop in gross profitability, net profitability in 1992 amounted to -1.5% and remained almost at the 1991 level.

Due to the rapid increase in social expenditure, the budgetary situation in 1992 underwent further deterioration. This was caused mainly by an increase of unemployment (up to 13.6% at year-end) and rapid increase in the number of old age pensioners. Due to the drop in employment and an increased numbers of persons receiving various benefits, the total amount of payments from the budget in order to supplement pensions kept increasing, in spite of higher social insurance contribution. The cost of servicing the public debt was also growing.

Personal income tax, introduced in 1992, permitted to compensate for the loss related to lower revenues from profit tax, while increased consumption boosted revenues from indirect taxes and customs duties. Also the widening of turnover tax base and increasing of the turnover tax rates as well as higher import tariffs contributed to some revenue improvement. The increase of revenues was, however, far slower than the growth of expenditure, leading to a rapid increase of central budget deficit - up to the level of 69.1 billion zloty (more than 6% of GDP). The deficit of the entire public sector was slightly lower and amounted to 56.2 billion zloty.

In March 1992 was additionally devalued (apart from the preannouced crawling peg mechanism introduced in October 1991). High deficit, largely financed by NBP, as well as an accelerated devaluation of zloty slowed down the decrease of inflation rate. Over the period from December, 1991 until December, 1992, CPI amounted to 44.3%, while - due to a faster increase in money supply during the second six months of the year - inflation over the entire period was higher than in the second half of 1991.

In 1992 real money stock grew by over 9%, mainly during the last months of the year, along with a sharp rise of deficit that was financed by the NBP.

In spite of leap devaluations, the growth rate of export revenue was reduced to less than 10%. However, the growth rate of import was also lower (6%) and, as a result, the balance of trade improved slightly, reaching surplus of 512 million USD and net official reserves grew by 470 million USD.

The recovery in the production output and increase in public sector expenditure permitted the 1.5% growth of GDP and 5% increase in consumption. Investment growth was more modest and amounted to less than 3%.

These upwards economic trends continued also in 1993, with the growth in production output (5.6% on the annual basis), GDP (3.8%), consumption (5.1%) and investment (2.2%).

The situation in foreign trade, however, was not favourable. Export revenues dropped by 3%, while import increased by almost 18%. These developments were caused by several factors. In 1992 the crawling peg devaluation rate was far lower than price increase, hence the decrease in export profitability and an increase of import profitability (even though this trend was weakened by a further increase in customs duties and non-tariff instruments). Poor economic situation in Western Europe coupled with a rapid increase of domestic demand did not create conditions which would be favorable to export activity. These circumstances lead to the next extra devaluation decision in August 1993.

Nevertheless, in spite of the poor official foreign trade results, the level of foreign exchange reserves did not change. This was caused by an increase of private transfers and purchase of foreign currencies in bureaux d'echange. These phenomena were linked to a rapid development of non-registered export in cross-border trade - mainly with Germany and the former Soviet Union countries. Large purchases made by Russian "tourists" probably constituted the reason for the rapid increase of the "official" import - Poland started to fulfil the role of intermediary in trade between Russia and the West; statistical records registered only the level of Polish import related to this trade, without showing these goods which were then carried away from the country by the former USSR citizens.

The economic revival started to gradually improve the financial situation of enterprises. Profitability increased by 0.7 percentage point, while net profitability grew by one percentage point. Budgetary revenues, however, recorded only a minimum increase related to these changes.

An increase of revenue came mainly from personal income tax (increase of tax rates), revenues from VAT and excise tax, introduced in mid-1993, as well as from customs duties.

The growth in budgetary expenditure was slower than over the previous years. It was connected with decisions limiting the indexation of wages in the budgetary sphere and pension benefits. The rate of growth of the number of pensioners also slowed down. Expenditure related to unemployment benefits, however, kept increasing, with unemployment rate reaching 16.4% at year-end. Cost of public debt was also growing fast.

In general, the central budget deficit in 1993 amounted to 43 billion zlotys (2.8% of GDP), and was by almost 26 billion zlotys better than in the previous year. The entire public sector deficit was lower than the central budget deficit and amounted to 35.3 billion zlotys. Inflation rate was decreasing - December, 1993 to December, 1992 CPI amounted 37.6%.

Preliminary results for 1994 show further acceleration in economic growth. Industrial output increased by ca 12%, GDP grew by almost 5%. Consumption is estimated to have grown at ca. 3% and investment at 8%. Average wages grew by 1.7% in real terms, with average salary in the budgetary sphere recording a 3.5% decline. The average real pension grew by 3%. The growth in unemployment rates was put to a halt. An improved situation on foreign markets caused a very rapid increase of export revenue (by almost 25%) and growth of net official reserves by ca 1.9 milliard USD.

The financial situation of companies improved significantly, with profit margin at 5.1% and net profit margin at 2.3%. Budgetary expenditures and revenues kept increasing at a relatively similar rate. The central budget deficit amounted to 59 billion zlotys, which was equal to ca 2.8% GDP, similar to the situation during the previous year. Nevertheless, the CPI grew by 29.5% over the 12 months of 1994.

Chapter III: Budgetary Classification and Organization
(Andrzej S. Bratkowski)

1. Institutional structure of the budget

Until 1990 the public finance sector was composed of three principal segments, i.e. the state budget, extra-budgetary funds and extra-budgetary units.

The state budget consisted of the central budget, voivodes' budgets and local (city or commune) budgets. However, due to the strict administrative dependency of authorities at the voivodship and local level, this division was purely formal. Thus, for the purposes of this paper, voivodes' budgets will be treated as components of the central budget.

Extra-budgetary funds were used for the financing of separate tasks. In 1990 there were several dozen of such funds, the most important ones being the Social Security Fund, Farmers' Social Security Fund and Labor Fund. All funds had their own sources of revenue, i.e. compulsory contributions made to the funds or other payments. In a majority of cases, however, 50 to 100% of fund revenues were supplied as the central budget transfer.

Extra-budgetary units constitute entities having their own financial and organizational structure, which implement budgetary tasks and render their services in exchange for payment. Their revenue is also supplemented from the budget.

All transfers from budget to extra-budgetary funds and units have character of target grants.

A major reform of the budgetary system was implemented in 1991. Within the framework of this reform, local budgets, i.e. the budgets of the newly established local self-governments (introduced in 1990) were separated from the central budget. Local authorities took over a part of taxes and payments which had so far been flowing into the central budget. At the same time local authorities receive target and general grants from the central budget, for the implementation of certain specific tasks.

A majority of extra-budgetary funds were liquidated and their total number was reduced to 13. On the other hand, several new funds have been created since 1990. Extra-budgetary funds of local authorities have been also established.

Extra-budgetary units were divided into units belonging to the central budget and these owned by the local governmnets.

2. Classification of budgetary revenue and expenditures

Budgetary revenue and expenditures are classified by the section, chapter and paragraph.

Paragraphs, defining the type of revenue/expenditure, constitute the basic classification format. Paragraphs are then grouped into chapters, corresponding to types of organizational units and budgetary tasks. Chapters, in turn, are aggregated to form budgetary sections.

In addition to the above, the central budget is also divided into parts. This division corresponds to the chief budget holders (ministries and other government agencies). Separate parts exist for budgetary reserves and the financing of budget deficit.

The state budget is developed and adopted in the format which defines amounts allocated to parts and sections, while local budgets follow the section format (local authorities have the right to demand a higher degree of detail as regards the classification). Budget performance reports are made on paragraph basis.

During the period when an annual budget is performed, resources may be shifted from one part or section to another only if authorized by a legislative act. At their own discretion, budget holders may make decisions as to the shifting of resources amongst various chapters and paragraphs belonging to the same part and section.

3. Financing of the deficit and banking services

The central budget deficit may be financed from resources which have remained from the previous years (unused resources from previous years are transferred into the bank account of the central budget), from bank credit and government securities. The volume of government securities with a redemption period exceeding one year is defined in the annual budget. As regards short-term securities, the annual budget specifies only the authorized incremental annual debt resulting from such operations. New liabilities may concern both domestic and foreign entities. The budget specifies also the volume of deficit financing to be provided by the NBP (the annual budget may just set the maximum financing limit).

Banking services for the central budget are provided by the National Bank of Poland, while resources set aside for the financing of specific task or goals may be deposited in other banks. Other budgetary units may freely choose the bank at which their bank account is to be operated.

Local authorities have the right to issue securities, however, the cost of the servicing these securities over the given year must not exceed 10% of expenditure in the same year. Local authorities have the right to choose the bank which will operate their bank account.

Chapter IV: Basic Proportions in the General Government Sector in 1987-1993 (Andrzej S. Bratkowski)

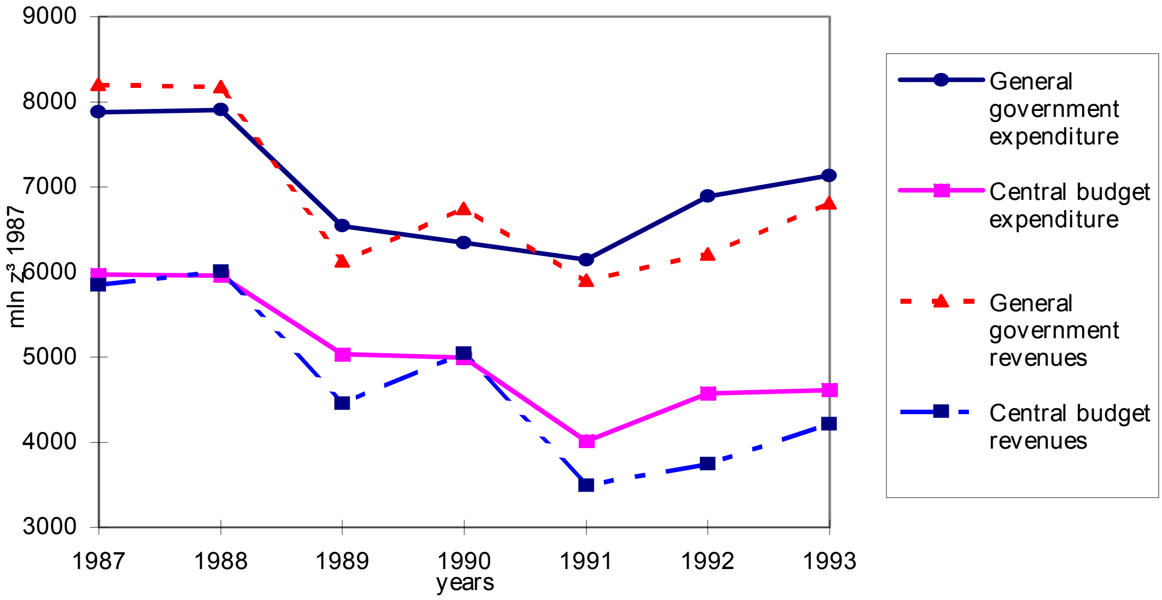
Formally speaking, the performance of the public finance sector during the years directly preceding systemic transformations was good. In 1987 and 1988 the consolidated public finance sector (general government) recorded surplus. The central budget decicit in 1987 amounted to a bare 0.8% GDP. The deepening macroeconomic disequilibrium in 1988 also did not hurt the budget. It was only in 1989 when the share of budgetary revenue in GDP fell from more than 50% to slightly over 37% as a result of high inflation, leading to a general government deficit of 2.5% GDP and the central budget deficit of 3.5%. It happened in spite of a simultaneous fall of total expenditure (of general government), from 48.6% to 40.1% of GDP.

Next year, 1990 saw a temporary improvement in the condition of the budget. This became possible due to high inflationary and devaluation profits taken over by the budget, due to the decreasing inflation rate (reversed Tanzi effect), increasing revenues both in terms of their share in GDP and in real terms. Real expenditure remained at a level close to the previous year's figures, in spite of their 6% increase in relation to GDP. As a result the budget recorded a surplus: 2.8% for general government and 0.4% for the central budget. The collapse on the revenue side recurred in the next year, with general government revenue dropping by 12.5% in real terms and central government revenue decreasing by almost 31%. In relation to GDP general government revenue decreased slightly (2.8 percentage point) while central government revenue dropped by 9 percentage points. Real budgetary expenditure decreased, while their share in GDP decreased only in the case of central government. Share of general government in GDP grew by 1.8 percentage points. The budgetary balance deteriorated rapidly, especially as regards to central government (-3.8% GDP). The remaining segments of general government generated a relatively large surplus, so that the overall result recorded by the general government was by 2% of GDP better.

In 1992 the budget deficit became even more acute, in spite of a certain rise in revenues (both in terms of their share in GDP and in real terms). This time, however, expenditure grew faster. As regards general government, expenditure exceeded the real level recorded over the three preceding years. Central government expenditure was growing almost equally fast, and in 1992, in terms of their share in GDP, they exceeded the level reached over the previous three years. In real terms - after the 1991 collapse - they were still some 9% lower than in 1989-1990. As a result of a rapid rise in expenditure, the central government deficit rose to 6% of GDP and general government deficit was at 4.9% GDP.

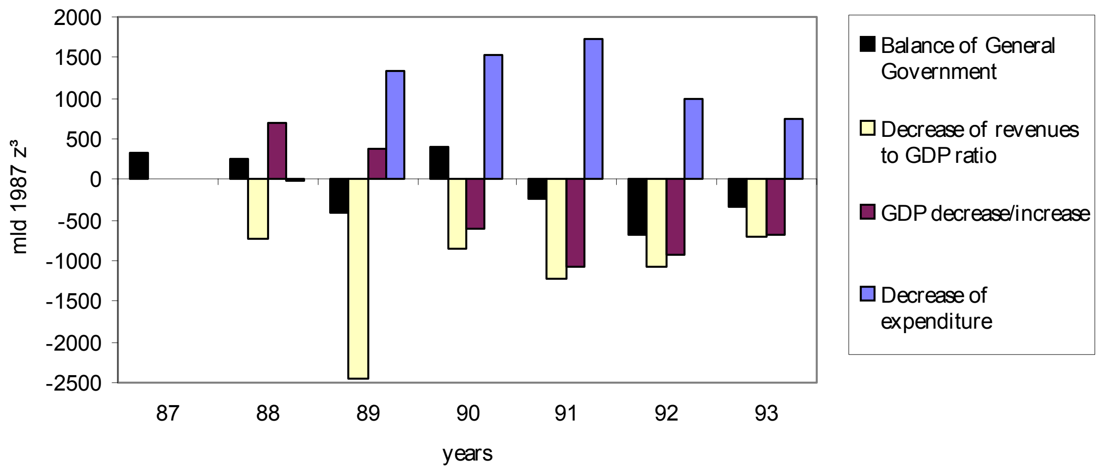
In 1993 expenditure continued to increase, however, at a slower rate. Due to a GDP growth their share in GDP slightly decreased. The increase on the revenue side slightly accelerated. This situation resulted in a reduction of the deficit down to 2.3% of GDP as regards general government and to 4.4% for the central government.

Graph IV.1.: Public revenues and expenditures in real terms



The public finance crisis was the result of both decrease of GDP and decline of the share of public sector revenues in GDP. The latter can be largely explained by a reduction of subsidies paid to enterprises, which constituted one of the major elements of market reform. The decrease in subsidies and liberalisation of economy, however, lead to a decrease of GDP. The second major factor contributing to the decline of GDP was the collapse of export to the former CMEA countries in 1991. The tax system was not adapted to the new economic situation, making the budgetary revenues very sensitive to changes in enterprise profit. Wage increases in enterprises as well as the drop in inflationary profits led to a rapid collapse of the revenues. The reform of the tax system (introduction of personal income tax and VAT) permitted the budget to gradually reconstruct its revenues.

Graph IV.2: Components of general government balance (in comparision with 1987)



Budgetary expenditures were reduced to a far lesser degree than budgetary revenues. This was a result of two major factors. First, there had been a significant increase of real wages in the budgetary sphere in 1989, which was difficult to go back upon (even more so since wages in this sphere were very low as compared to wages in enterprises during the period preceding the transformation). Second, social benefits and performances grew rapidly, due to both a decline in GDP and legislation introduced in 1990-1991 which was excessively favourable to persons receiving benefits (see graph IV.2: Components of general government balance - in comparison with 1987).

Chapter V: Public Debt - Size, Structure and Costs of Servicing (Andrzej S. Bratkowski)

The size and structure of the public debt is presented in table V.1. Public debt figures for 1987-1991 reflect both the real increase of public sector liabilities and the results of a more precise definition of these liabilities, in terms of formal, legal and quantitative parameters. For example, the obligation to maintain the real value of advance payments on motor vehicles accepted from prospective owners did not appear in the official reports until 1990, even though the liability was, in fact, incurred at a far earlier date. Another significant "unrecorded" part of the public debt was the liability arising due to the use of a part of foreign currency deposits for the financing of import purchases. The level of these liabilities was assessed precisely only at the end of 1990. Banks which had granted this loan in 1980s received a special government bond, denominated in dollars. The table V.1. presents also the estimated value of these bonds in 1989.

In 1992 the new government liability towards NBP arose that were connected with purchasing the so-called transfer rouble, resulting from the Polish export surplus in trade with the USSR in 1990. This item could actually be interpreted as a loan granted to the USSR, rather than as an element of public debt. In 1995 this claim was used in the settlement of Polish liabilities towards Russia.

Poland's public debt is strongly dominated by foreign loans. At the beginning of the analyzed period foreign debt accounted for 100% of the total public debt (except for these budget liabilities which at that time did not yet have a "formal" status but which could not have corresponded to more than 1% of foreign debt). Except for 1990, when the total suspension of foreign debt servicing caused a growth in the liabilities level by more than ten percent, the value of debt expressed in dollar terms continued to decrease slightly. The zloty value of this debt kept growing due to zloty devaluation.

The rapid rise in domestic debt began in 1989, as a result of financing the budget deficit, the "disclosure" of liabilities that had been incurred at an earlier stage but failed to be classified as such, and the fact that the budget incurred long-term liabilities which were not treated as budget expenditure and thus did not contribute to the budget deficit for a given year. The most significant liabilities of this last type included the restructuring bond issued to the banking sector (21 billion zloty in 1993) and the bond issued to the NBP in 1994, with the value of 15.8 billion zloty, in exchange for the use of a part of foreign exchange reserves for partial debt repayment (buy-back) to the London Club. Another factor contributing to the growth of domestic public debt was the increase of the nominal value of the dollar-denominated bond issued in 1991 in order to cover foreign exchange liabilities towards banks, incurred in 1989. On the other hand, amounts used for foreign debt service actually represented the conversion of foreign debt into domestic debt.

Domestic public debt in 1990-1993 grew by 318 billion zloty (see table V.2.).

Table V.1: Public debt, 1987-1994

	1987	1988	1989	1990	1991	1992	1993	1994
1. Total debt	12.919	19.684	306.440	528.879	647.242	966.773	1.326.272	1.377.973
1.1. Short term		713	14.284	21.329	69.348	149.211	204.263	245.375
1.1.1. Bonds and bills		0	0	0	13.718	85.673	155.365	230.361
1.1.2. Loans		713	14.284	21.329	55.631	63.538	48.899	15.014
1.2. Long term		18.969	292.156	507.550	577.894	817.562	1.122.009	1.132.598
1.2.1. Bonds and bills		0	35.542	51.945	60.045	84.162	157.492	436.300
1.2.2. Loans		18.969	256.614	455.605	517.849	733.400	964.517	696.298
Total debt as percent of GDP	82,6%	72,0%	280,6%	94,4%	80,0%	84,1%	85,1%	65,8%
2. Total domestic debt		1	41.285	68.369	126.635	242.149	359.063	507.317
2.1. Short term		0	5.743	8.293	54.544	129.476	179.811	245.364
2.1.1. Bonds and bills		0	0	0	13.718	85.673	155.365	230.361
2.1.2. Loans		0	5.743	8.293	40.826	43.803	24.446	15.002
2.2. Long term		0	35.542	60.075	72.091	112.673	179.252	261.953
2.2.1. Bonds and bills		0	35.542	51.945	60.045	84.162	157.492	242.246
2.2.2. Loans		0	0	8.131	12.046	28.511	21.761	19.707
of which NBP		0	5.743	17.063	37.545	116.478	139.304	187.729
of which current deficit finansing		0	5.743	0	24.671	35.979	28.348	17.165
3. Total foreign debt	12.918	19.682	265.155	460.511	520.608	724.624	967.209	870.657
3.1. Short term	439	713	8.541	13.036	14.804	19.735	24.452	12
3.1.1. Bonds and bills	0	0	0	0	0	0	0	0
3.1.2. Loans	439	713	8.541	13.036	14.804	19.735	24.452	12
3.2. Long term	12480	18.969	256.614	447.474	505.803	704.889	942.756	870.645
3.2.1. Bonds and bills	0	0	0	0	0	0	0	194.054
3.2.2. Loans	12480	18.969	256.614	447.474	505.803	704.889	942.756	676.591
Foreign debt as percent of exports	578%	471%	539%	446%	372%	329%	334%	211%

Table V.2: Increase of the public debt 1990-1993

Item	in bn zlotys	%
Total	318	100
Cumulative deficit	170	34
Negative foreign financing	10	3
Increase of current liabilities	13	4
Increase in the value of the dollar bond	68	21
Increase of long-term liabilities	38	12
Settlement of earlier liabilities and unidentified items	18	6

As a result, the share of domestic debt in the total public debt grew to 27% in 1993. In 1994 the share of domestic debt grew even further, reaching 37%, due to continued financing of budget deficit, provision of additional financing to banks and repayment of a part of debt to the London Club members. On the other hand this change in proportions was also caused by the reduction of foreign debt.

The drop in foreign debt was mainly the result of the reduction of debt towards the London and Paris Clubs. The reduction of debt towards the Paris Club had been agreed upon in 1991, however, in 1991-1993 the impact of the agreement was limited to interest repayment. Only when agreement with the London Club had been reached the implementation of the second stage of Paris Club agreement could begin and the impact of both agreements begun to bear an influence upon the Poland's balance of payments. This factor constituted the main reason for the reduction of debt from 45.33 billion USD by the end of 1993 to 35.8 billion USD by the end of 1994.

Due to the fact that public debt was dominated by foreign liabilities, the proportion of debt to GDP was subject to strong fluctuations, as a result of changes in the exchange rate of the US dollar. Hence the sharp increase of this proportion in 1989 and - after an equally sharp fall in 1990 - further decrease, in spite of the fact that domestic debt continued to grow and foreign debt was not subject to any significant reduction.

Official data on public debt fail to fully reflect financial obligations of the state. In 1992-1994 the indexation of pensions and wages in the budgetary sphere was reduced. These decisions have been questioned by the Constitutional Tribunal. In order to fully cover its obligations, the budget would need to spend an additional 100 billion old zlotys. Credit guarantees granted by the state are another "off-balance" item of budget liabilities. By the end of 1995 government guarantees amounted to 115.5 billion zlotys. According to a fairly general view, a majority of this amount would account for hidden subsidies which will have to be repaid at some point in time. In 1994 government guarantees grew by ca. 86 billion zloty. Even if only 50% of both obligations discussed above were taken into account, the public debt would increase by ca 10%.

Foreign debt is definitely dominated by medium and long-term credit. Some 60% of debt (Paris and London Club) bears interest rates which range below the market rates. As regards the remaining part of the debt, it is mainly composed of loans granted by international financial institutions. Some 70% of debt is subject to variable interest rates. The structure of debt as regards loans denominated in foreign currencies is unfavourable (strongly departs from the structure of export revenue); the repayment schedule, with a sharp increase in amounts falling due for payment after the year 2003, is also unfavourable. This debt structure makes it more difficult to run active debt management. The debt service cost to total debt ratio can be expected to deteriorate at a rapid pace.

Domestic debt was initially dominated by bank credit. Since 1991 the share of credit has been declining rapidly, in favour of government securities. Virtually the entire domestic debt with maturity periods exceeding one year is subject to variable interest rates. Short-term debt accounts for some 50% of domestic debt.

In 1987-1993 the share of debt servicing cost in GDP has doubled. In the years 1987-1989 foreign debt service accounted for more than 1.5% GDP. In 1989-1993 this share fell by 50%, due to the suspension of debt servicing and debt reduction. The cost of domestic debt servicing grew from 0% to 3% of GDP, over the period from 1990 until 1993. In 1994, debt servicing cost exceeded the central budget deficit. Inflation rate still bears an influence upon the cost of debt servicing. Real debt servicing cost has remained relatively low - the average rate in domestic debt service (except for the dollar bond) corresponded to mere two-thirds of inflation. This resulted from a large proportion of short-term treasury bonds in the total debt volume, as well as from the fact that in 1993 some 10% of debt were not being serviced (settlements with NBP on transfer roubles purchased by the Bank) or were subject to various forms of valorization (e.g. some settlements with banks). The effective cost of domestic debt service was still lower, since its significant part was financed by NBP and the profit from NBP is paid back into the budget.

Chapter VI: Manner of Financing Budget Deficit and Its Implications for the Monetary Policy and Inflation (Andrzej S. Bratkowski)

Until 1989 the deficit was financed exclusively by the NBP. In 1990 debt at the NBP related to deficit financing decreased. Starting from 1991 credit granted by NBP became anew the main source for the financing of deficit, satisfying almost 80% of budget requirements in this respect. In 1992 this share fell to 52%, to rise again in 1993, up to 65%. In 1994, 30% of deficit was financed by NBP.

The financing of deficit constituted a significant factor in money creation (see table VI.1).

Table VI.1: The ratio of deficit financing to M1 and M2 growth

Monetary aggregate	1991	1992	1993	1994
M2	35.2%	24.0%	19.2%	8.0%
M1	122.1%	133.4%	106.6%	66.1%

The principal reason for such a high proportion of the monetary financing of the budget deficit in 1991-1993 was the relatively weak political position of NBP and the lack of sufficient legal guarantees of its autonomy - the annual monetary program of the NBP is subject of Sejm approval. Poland's central bank is also under the permanent political pressure of parliament and government to increase credit supply and to decrease nominal interest rates.

The underdevelopment of the money market can be seen as another reason of the high share of monetary financing in the first years of transition. However, recently this factor cannot be seen as excuse for the continuing monetary financing. For example, the high share of deficit financing by NBP in 1994 seems to have been caused by the Ministry of Finance wishing to minimize debt servicing cost. (In 1994 money supply was rapidly growing, due to the increase of foreign exchange reserves and the entire banking system experienced excessive liquidity, which permitted the sale of sufficient amounts of government securities to the banks).

In 1989 budget deficit especially in the first half of the year became a principal cause of near-hyperinflation. The budget surplus in the first half of 1990 allowed to bring inflation to the level below 5% per month. Due to surplus net credit to governmnet did not contribute to a monetary expansion. The increasing official reserves and rising credit to commercial banks became the main factor of growing money supply especially in the second half of the year.

In 1991 and 1992 the net credit to government became a principal source of monetary expansion and therefore inflation [Bauc, Dąbrowski, Senator, 1995]. In

1992 the sharp rise in budget deficit was recorder in the fall of the year, and this deficit was mainly financed from NBP credit. In 1993 the deficit was largely limited, however, the share of NBP financing in the deficit grew. The latter factor contributed to a slow-down in the decrease of inflation rate in 1993, in spite of the fact that current account balance could slow down the increase of money supply. Another leap rise of NBP debt in December, 1993 and in September, 1994, caused high inflation to persist also in 1994 and in the beginning of 1995.

In 1991-1992 budget deficit accounted for ca. 45% of the increase of money supply. In 1993 this share fell to 29% and in 1994 it was 27%. The policy of Ministry of Finance in relation to the interest on treasury bonds had a very strong impact upon the market interest rate. It would seem that the extensive use of NBP financing by the Ministry of Finance in 1993 and 1994 was, amongst other things, aimed at decreasing interest rates on treasury bonds sold to commercial banks. The interest rate reduction policy had a negative influence upon savings. In 1994 NBP started to counteract these trends, by increasing rates on bonds offered in open market operations. Negative consequences of a lack of coordination as regards policies pursued by the Ministry of Finance and NBP were especially strong in the second half of 1994 when the sharp - and quite surprising - rise in foreign exchange reserves caused rapid increase in money supply. In spite of the creation of a joint Public Debt Management Committee in 1994, it would seem that different views held by NBP and the Ministry of Finance as regards monetary policy directions make the efficient functioning of this Committee very difficult.

The high share of short-term treasury bonds in public debt also constitutes a potential threat to the macroeconomic balance, in view of the introduction of floating exchange rate in May 1995 and broadening the convertibility of the Polish zloty. It would seem that the fact that the Ministry of Finance failed to accept the proposal to relieve non-financial entities from the obligation to re-sell foreign currencies (which according to NBP proposals constituted one of the elements contributing to an enhanced convertibility of zloty) results from the fear that foreign exchange deposits would compete with bank deposits and short-term treasury bonds in absorbing free financial resources of enterprises. The refusal to grant such a permission will lead to a situation in which company risk related to exchange rate fluctuations will be very high, the foreign exchange market will remain relatively shallow and NBP will have to apply intervention measures on the market in order to contain exchange rate fluctuations.

Chapter VII. Changes in the Size and Structure of Budgetary Revenue (Małgorzata Antczak)

1. Public sector (general government) revenue

The general government balance covers the central budget, extra-bdgetary funds, extra-budgetary units and local self-government budgets, which were separated from the central budget starting from beginning of 1991.

Table VII.1 shows public sector (general government) revenues in nominal terms, in real terms (using GDP deflator) and in relation to GDP. Data indicate that 1989 saw a rapid drop in revenues - both in real terms and in terms of their share in GDP (by 15 percentage points).

Table VII.1.: General government revenues in nominal terms (in bn zloty), as a percentage of GDP, and in real terms as compared to 1987.

Year	1987	1988	1989	1990	1991	1992	1993
Revenue	8196	13732	40996	261947	355758	518852	742204
%GDP	52.4	50.2	37.5	46.0	44.0	45.1	47.6
1987=100	100	99.7	74.7	82.3	72.0	75.8	83.1

Table VII.2: Central budget revenues in nominal terms (bn zloty), as share in GDP, and in real terms as compared to 1987

Year	1987	1988	1989	1990	1991	1992	1993
Revenue	5851	10089	29839	196078	210885	312775	459008
% GDP	37.4	36.9	27.3	35	26.1	27.2	29.5
1987=100	100	102.7	76.2	86.3	59.8	64	72

Sharp reduction of tax revenue constituted one of the major reasons for the collapse of the revenue side of general government and central budget which commenced in 1989 (in comparison to 1987 general government revenue fell by 24%). The reduction was partly due to a decrease of corporate income tax rates (to 40%). Nevertheless, the drop in the revenue was mainly due to the near-hyperinflation recorded in 1989 (Tanzi effect). After a temporary increase in 1990, 1991 saw a further decline in revenue. Starting from 1992 the revenues of both general government and central budget kept growing, both in real terms and in relation to GDP, however, they have never attained the 1987 and 1988 levels.

This was mainly due to the tax system reform, leading to a situation in which the personal income tax became a more significant source of budgetary revenue. The increase of revenue from personal income tax (alongside with higher social security contributions) compensated for losses resulting from a fall in revenues from the corporate income tax (in 1987-1989 the base corporate income tax rate was lowered from 65% - for the public sector - and 85% - for the private companies - down to 40%) and from turnover tax.

Personal income tax was introduced in 1992. This tax replaced the 20% payroll tax (formally two different taxes - one for state owned enterprises and co-operatives and second for private sector), wage equilization tax (for high and very high wage incomes), income tax for individual economic activity, and part of the agriculture tax (for the most profitable sectors of agriculture production). Tax rates applied to personal income amounted to 20%, 30% and 40%.

The introduction of VAT and excise tax in July 5, 1993, constituted the next step in the implementation of tax reform, leading to an immediate increase of tax revenue in GDP (see table VII.3).

The introduction of personal income tax which is also levied from employees in the budgetary sphere, old age pensioners and persons receiving disability pensions caused a purely "statistical" increase of central government revenue (doubling effect - both on revenues and expenditure side - amounting ca. 2% of GDP).

The increase of tax revenues was delayed due to the fact that in the newly developed sectors (certain services, small business) the collection of taxes was more difficult than in the shrinking sector of large state owned enterprises. Very often the tax administration was not fully prepared to undertake its activities under the new circumstances.

Table VII.3: Share of tax revenue (general government) in GDP

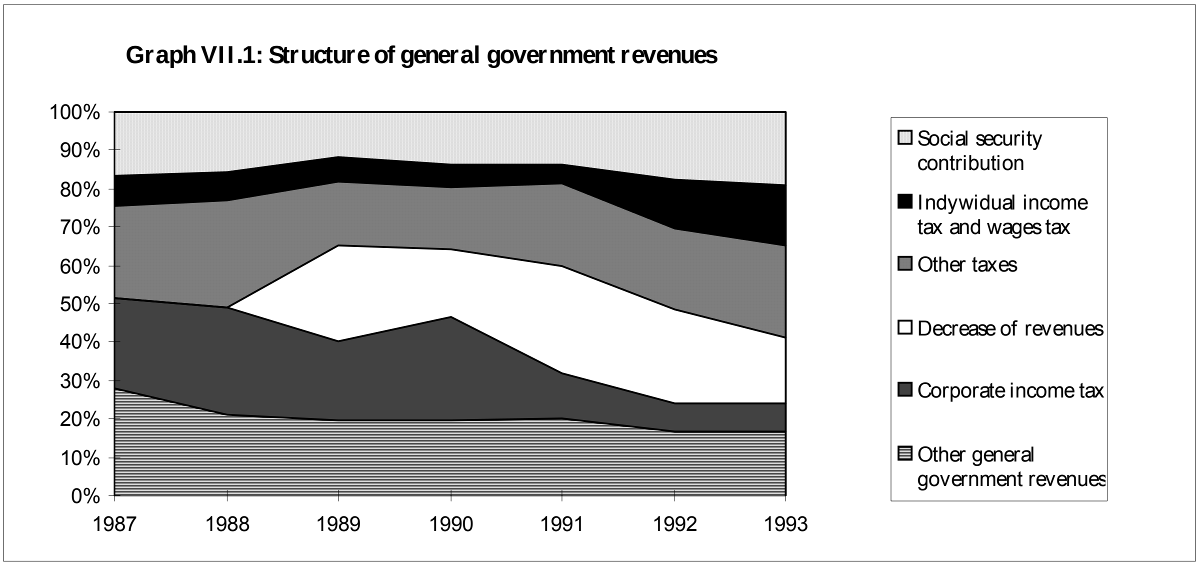
Year	1987	1988	1989	1990	1991	1992	1993
% GDP	29.1	31.7	21.8	27.7	23.4	24.4	26.9

The group of so-called "other taxes" was dominated by the excess wages tax. In 1990-1991 this tax caused a significant increase of the share of "other taxes" item in general government revenues (reaching as much as one-eighth of total revenue). Over the subsequent years the significance of "other taxes" was systematically decreasing.

After a drop in 1988-1989 non-tax revenues started to grow again in 1990. This was caused by higher revenues from customs duties, payments from the National Bank of Poland and higher revenue from social security contributions.

Privatization proceedings did not make a significant contribution to the total general government revenue, in spite of the permanent increase of their share in GDP and growth trend in real terms. A major role was played here by the so-called capital privatisation.

Graph VII.1 shows the proportion of various types of budgetary revenues, their influence upon general government revenue and changes in the proportion of the particular types of revenue in 1987-1993.



In performing an analysis of budgetary revenue it is useful to differentiate between "gross" and "net" amounts, i.e. the figures from which subsidies paid to enterprises have already been deducted. In 1987-88 some 40% of budgetary revenue was transferred back to the enterprises in the form of subsidies, thus reducing their financial burden and "net" contribution to the public sector revenue (see - table VII.4). The process of reducing such subsidies commenced in 1989.

Table VII.4: Budgetary subsidies for the financing of economic activity

Year	1987	1988	1989	1990	1991	1992	1993
% of general government revenue	22.5	24.2	23.5	12.6	8.7	4.8	3.9
% GDP	11.8	12.1	8.8	5.9	3.8	2.2	1.9

The above data indicate that the share of net budgetary revenue in GDP grew from 40.6% in 1987 to 45.7% in 1993. If CPI had been equal to GDP deflator (over the analyzed period), it could have been stated that the decrease of general government revenue by 10% GDP constitutes a "natural" consequence of the reduction in subsidies. In reality, however, prices of consumer goods grew faster (subsidies targeted mainly the suppliers of consumer goods and services). The increase of the share of budgetary transfers to households in GDP is also a "natural" consequence of a decrease in subsidies. This would mean, however, that in order to maintain budget equilibrium during the transformation period, other things kept equal, it would be necessary to increase the share of net budgetary revenue in GDP. It can be estimated that in such a situation the share of net budget revenue in GDP "should" grow by ca 3.5% GDP. Another natural reason for an increase of net revenue ("natural" meaning: necessary in order to maintain budget equilibrium) would be the fact that liberalization eliminates inefficient entities, thus leading to both an increase of necessary social protection and higher capability to shoulder the fiscal burden on the part of these entities which have not been eliminated from the economic scene. It would seem that without a significant reduction in the real level of average social benefits, even higher net increase of the budget revenues would be required in order to maintain budget equilibrium.

2. Revenue from direct taxation

In 1987 personal income tax (and wages equalisation tax) accounted for a fraction of a percent in the total budgetary revenue. Tax paid by enterprises constituted the source of ca one-fourth of the total general government revenue. In spite of a reduction in tax rates, inflationary profits permitted to maintain the share of the tax in the government revenue at a more or less stable level. However, in 1988 and 1989 the influence of inflation upon taxes was different from the impact of inflation in 1990.

In 1988 and 1989 real revenue from direct taxes was reduced due to the payment delays and thus real depreciation of nominal tax obligations (Tanzi effect). In 1989 this situation led to a decrease of real budget revenue, in spite of a sharp increase of enterprise profitability.

The high company profitability in 1990 was supported by a rapid increase in prices in the beginning of the year, which, given high inventories, allowed the sales prices to grow at a rate higher than the manufacturing cost. In addition to that, enterprises profited from foreign exchange windfall gains (as result of devaluation). Another factor supporting high profitability levels was the drop of the real wage cost leading to a reduction of labor costs. High inflation was accompanied by a negative real interest rate (until February 1990), permitting the companies to reduce debt (in the short run). At the same time the inflation rate slow-down caused an increase in the real value of collected taxes (reversed Tanzi effect). Revenues from corporate income tax in 1990 exceed the level of collection in any other year during the analyzed period, both in real terms and in relation to GDP.

With the profitability drop of 1991 the share of this tax in total revenue begun to decrease. The fall in company profitability in 1991 was caused not only by slower inflation. External reasons for the reduction in real revenue from direct taxation include the consequences of a decline in the industrial production and the worsening of the terms of trade as a result of the USSR breakup. Other factors having a negative impact upon the financial situation of companies included the high real interest rate in the first half of 1991.

The reduction of general government revenue from direct taxes resulted also from the reduction of tax rates imposed upon company profits. As we mentioned before in the beginning of 1989 the base tax rate was decreased to 40%. The massive use of tax exemptions especially in 1989 was another systemic reason leading to a decrease in tax revenues. The decline in the amount of taxes paid by companies constituted the major factor contributing to the decrease of tax revenues and accounted for an almost 10% decrease in budgetary revenue (see - table VII.5.)

Table VII.5: Share of corporate income tax and personal income tax in GDP

Year	1987	1988	1989	1990	1991	1992	1993
tax from enterprises	12.5	13.9	10.4	15.1	7.3	4.5	4.2
personal income tax	0.0	0.0	0.0	0.1	0.1	7.4	9.0

The introduction of personal income tax in 1992, together with the removal of the payroll tax, caused an increase of direct taxes in budgetary revenues. In case of central government this increase was slower, since 15% of personal income tax was transferred to the local budgets.

The impact of privatisation upon taxes paid by transformed companies remains unclear. It would be very risky to raise any conclusions about the negative impact of ownership transformations upon budgetary revenues. Table VII.6 presents the dynamics of budgetary revenues from the corporate income tax and from the three taxes - corporate income tax, dividend, excess wages tax - throughout the entire economy, as regards enterprises which have undergone capital privatisation.

Table VII.6: Tax revenues from companies

Taxes/period	1990	1991	1992
corporate income tax in the economy	100.0	63.8	60.7
corporate income tax from companies after capital privatisation	100.0	103.5	73.6
total tax in the economy	100.0	86.4	68.9
total tax from companies after capital privatisation	100.0	88.2	53.4

It turns out that in 1990-92 corporate income tax paid by these enterprises was reduced by almost 27 percentage points, while during the same period the revenue from all companies operating within the entire economy was reduced by some 40%. In case of the tax on capital (dividend) and excess wages tax, the share of companies which have undergone capital privatisation went down to zero in 1992, since these taxes did not apply to privatised companies.

3. Revenue from indirect taxes

Due to the changes introduced into the tax legislation the structure of indirect taxes kept changing over the entire period. Until 1991 indirect taxes included turnover tax and payroll tax. In 1991 the payroll tax was incorporated by the personal income tax. From January until July, 1993, turnover tax included a 6% import surcharge. In July, 1993, new categories of indirect taxes were introduced, namely tax on goods and services (VAT) and excise tax.

Until 1991 central budget revenues from indirect taxes kept decreasing in real terms (see - table VII.7). Except for the wages tax, their share in GDP started to increase from 1991. The lowest real value was reached in 1991 (in 1987 prices). In 1987 the average turnover tax rate amounted to 8.1% of sales value, while in 1988 it increased to 8.7% of sales value, resulting in a slight increase of tax revenue from this title. The reduction of revenue from indirect taxation in 1989 was caused by inflation, as well as, to a certain degree, by the drop in the effective turnover tax rate down to 8.4% of sales value. Turnover tax rate grew again in 1990. In 1991, as a result of a broadened tax base (larger number of taxpayers from whom this tax was levied) the adjustment of turnover tax rates and improved efficiency of tax administration, the share of indirect tax revenue in GDP started to grow.

Table VII.7: Central budget revenues from indirect taxes

Year	1987	1988	1989	1990	1991	1992	1993
% GDP	10.6	10.8	7.4	7.06	7.56	8.9	11.3
1987=100	100	106.6	73.3	56.8	56.5	68.7	90.7

Another source of the fall in turnover tax revenue was the popular practice of not disclosing the entire sales volume, which was encountered especially in small companies.

In 1992, after a period of fall, the share of indirect tax revenue in GDP increased, together with a further increase in real revenue. In 1993 real revenue from indirect taxes were still ca. 10% lower than in 1987 (after adjustment for the removed wages tax). However, in relation to 1992 these revenues grew by 22 percentage points, as a result of the introduction of VAT (which replaced turnover tax on July 5, 1993) and excise tax (covering alcohol, tobacco, fuels, cars, yachts, radio and TV equipment). Two base VAT rates - 22% and 7% - were introduced. Some products such as animal fodders, medicines, books and newspapers were exempt from VAT. VAT was levied on distribution, retail, services and import. It did not, however, cover export sales (zero rate). Tax collection became easier through monitoring and inspection at each stage of production. An additional advantage of the VAT system is the possibility of collecting data on the economic activity.

4. Other tax revenue and non-tax revenues

These two categories of revenue consisted mainly of the excess wage tax, dividend paid by state owned enterprises, customs duties and payments from the NBP. Dividend and excess wage tax accounted for the major part of such revenues in 1990 and 1991. In principle, the excess wage tax was intended to play the role of a macroeconomic stabilizer, not a purely fiscal instrument. In reality, it became very important as an instrument reducing the gap between average salaries in the budgetary sphere and in enterprises. It could be discussed whether the tax did fulfil the function of slowing down the overall wage increase.

Dividend was introduced in 1989, at the rate of 44% of the founder's fund value. In 1989, under hyperinflationary conditions, the real value of the fund (which was not revalued) dropped, leading to a decrease in dividend revenues of the central budget. In 1990 the book value of fixed assets (and therefore of founder's fund) was revalued 14 times but the dividend rate was reduced to 40%. In 1991 fixed assets were revalued again and dividend rate was reduced to 22% (this rate was applied until June 1992). In June 1992 it was further reduced to 10%, while in 1993 it remained at a stable level.

Since 1992 the significance of dividend and excess wages tax has constantly decreased. Payments from NBP also fell down with the decline of inflation, in spite of the increase of budgetary debt at the central bank.

Amongst non-tax revenue, major role was played by compulsory social security contributions made by economic entities, which amounted to ca 10% GDP over the entire period under analysis. In March 1992 social security contribution increased from 43% to 45% of gross wages.

5. Revenue from privatisation

Table VII.8 shows data on revenues from the privatisation. The privatisation process started in 1990 but the first revenue was received by the budget until 1991.

Table VII.8: Central budget revenues from privatisation

Year	**1991**	**1992**	**1993**
revenue from privatisation (bn of zloty)	1709.4	4844.4	7804.7
% GDP	0.2	0.4	0.5
% of revenues	0.8	1.5	1.7

Initially privatisation techniques were not geared towards an increase of budget revenue. Budget revenues from this source were treated as a by-product of the ownership transformation process. Only capital privatisation played a more significant role in generating state budget revenue. In 1991-92 revenues from liquidation (the type of privatisation carried out under two legislative Acts: State Enterprise Act and State Enterprise Privatisation Act) amounted to 0.3% of total budget revenues. This figure increased to 0.7% in 1993. Revenue from capital privatisation accounted for an annual average of ca 0.93% of total budget revenue. By the end of 1993 total privatisation revenue amounted to 14,358.5 bn zloty, of which 65% from the capital privatisation. Total revenues from liquidation amounted to some 4,916 bn zloty.

The use of privatisation revenue is not subject to any special restrictions.

Chapter VIII: Structure of Public Expenditure (Marcin Łuczyński and Krzysztof Połomski)

1. Size and structure of budgetary expenditure

Tables VIII.1-4 present the size, structure and share of public sector in GDP. The overall real decline of public expenditure in the years 1987 - 1993 amounted to 9.5%. During the discussed period real expenditure was falling in 1988-1991, with a sharp drop in 1991.

In terms of its share in GDP expenditure reached its lowest level in 1989. Starting from 1990 the share of budget expenditure in GDP has been continuously growing. The main reasons for the increase of expenditure share in GDP is the decline of GDP itself, accompanied by state attempts at maintaining the same level of services financed from the budget. In addition to that, new areas requiring more financial activity of the budget emerged during systemic transformations. These areas included the co-financing of social security benefits, with the share of transfers to social security system in the budget increasing almost four times, from 4.7% in 1988 to 20% in 1993.

Another consequence of the fall in GDP is the reduction of budgetary revenues forcing the government to finance the expenditure from public debt. This in turn causes higher cost related to debt servicing, clearly visible over the subsequent years. The increased expenditure on public debt service is especially striking as regards domestic debt, which has grown considerably since 1990.

The increase of expenditure in the above categories was linked to the shifting of resources from other parts of the budget. The most significant drop in real expenditure was recorded as regards subsidies for enterprises. In real terms, in 1993, such subsidies were more than four and a half times lower than in 1987. Their nature changed, from subsidies allocated on product basis (food, coal, children's clothing) to subsidies granted to specific entities (industrial restructuring, co-financing of investment intended to reduce energy consumption). To quote an example, the share of food subsidies in current budgetary expenditure fell from 17.1% in 1988 to 0.9% in 1990 and 0.0% in 1991.

Since 1989 the budget has seen a decline in the share of investment expenditure, accompanied with a rise of current expenditure. During the five years the share of investment in the total government expenditure fell almost three times (from 15% in 1988 to 6.5% in 1993).

To sum up, it should be stated that in 1987-1991 the real fall in budgetary expenditure was lower than the GDP decline. Budgetary resources on the expenditure side were shifted mainly from subsidies towards the social programs (see graph VIII.1. Structure of real general government expenditure, 1988=100).

Table VIII.1.: Revenues and Expenditures, 1987-1993

General Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	4.543,3	8.658,3	23.767,7	155.019,5	189.549,5	280.406,8	418.691,4
Corporate income tax	1.947,0	3.811,0	11.335,2	84.676,8	59.374,4	52.285,5	66.064,0
Individual income tax	7,2	10,2	12,8	445,9	1.153,6	84.875,3	140.417,0
Indirect taxes	2.412,0	4.257,9	12.117,1	57.525,0	84.465,3	103.099,0	177.493,5
of which: Wages tax	613,0	1.043,3	3.298,9	17.924,2	23.269,3	0,0	0,0
Other taxes	177,1	579,2	302,6	12.371,8	44.556,2	40.147,0	34.716,9
Other revenues	3.647,6	5.073,2	17.228,5	106.927,8	164.499,3	233.601,1	311.125,0
of which:							
Social security contributions	1.375,8	2.147,1	6.572,4	44.143,1	67.839,1	121.389,0	168.443,0
Revenues from privatisation	0,0	0,0	0,0	0,0	1.709,0	4.844,0	12.388,0
Total revenues	**8.195,9**	**13.722,5**	**40.996,2**	**261.947,3**	**355.758,2**	**518.851,9**	**742.204,4**
Expenditure							
Capital	1.230,3	2.029,5	5.260,3	26.836,0	29.679,5	39.296,0	50.951,0
Current	6.648,4	11.251,9	38.501,1	219.510,1	340.744,0	535.740,0	726.590,0
Expenditure on goods and services	1.350,6	2.252,8	8.245,5	54.118,6	131.966,0	194.932,4	262.258,3
Wages and salaries	590,8	1.035,4	4.944,4	28.871,4	60.323,1	94.360,7	128.174,3
Other purchases of goods and serv	759,8	1.217,4	3.301,1	25.247,2	71.642,9	100.571,7	134.084,0
Interest payments	276,0	467,0	1.692,0	7.035,2	9.789,0	32.091,0	59.153,0
Domestic	0,0	0,0	0,0	2.421,2	2.641,0	20.327,0	47.499,0
Abroad	276,0	467,0	1.692,0	4.614,0	7.148,0	11.764,0	11.654,0
Subsidies to enterprises	1.841,1	3.319,3	9.642,0	32.920,6	31.122,3	25.003,0	28.927,5
Pensions and disablement benefits	1.262,1	2.105,3	7.865,7	48.020,1	102.031,0	168.083,0	197.634,0
Other transfers to households	645,3	1.008,3	3.859,3	23.092,0	39.472,0	63.457,0	114.113,0
Remaining transfers	1.273,2	2.099,2	7.196,6	54.323,6	26.363,7	52.173,6	64.504,2
Total expenditure	**7.878,7**	**13.281,5**	**43.761,4**	**246.346,1**	**370.423,5**	**575.036,0**	**777.541,0**
Deficit/surplus	**317,2**	**441,0**	**-2.765,2**	**15.601,2**	**-14.665,3**	**-56.184,1**	**-35.336,6**

Central Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	4.543,3	8.658,3	23.767,7	155.019,5	163.173,7	246.155,0	369.621,4
Corporate income tax	1.947,0	3.811,0	11.335,2	84.676,8	53.761,4	50.620,0	62.572,0
Individual income tax	7,2	10,2	12,8	445,9	814,4	72.261,0	119.424,0
Indirect taxes	2.412,0	4.257,9	12.117,1	57.525,0	77.604,2	103.099,0	177.493,5
of which: Wages tax	613,0	1.043,3	3.298,9	17.924,2	16.408,2		
Other taxes	177,1	579,2	302,6	12.371,8	30.993,7	20.175,0	10.131,9
Other revenues	1.306,7	1.430,4	6.071,6	41.058,0	46.002,3	66.460,0	89.329,0
Revenues from privatisation					1.709,0	4.844,0	7.804,0
Total revenues	**5.850,0**	**10.088,7**	**29.839,3**	**196.077,5**	**210.885,4**	**312.775,0**	**459.008,4**
Expenditure							
Capital	942,6	1.579,6	4.069,6	21.636,0	16.788,0	19.501,0	24.778,0
Current	5.030,6	8.430,6	29.617,5	172.165,3	225.070,0	362.388,0	477.645,0
Expenditure on goods and services	1.314,7	2.154,7	8.100,6	56.011,5	103.511,0	144.539,0	183.130,0
Wages and salaries	510,3	890,7	4.268,2	24.817,0	45.667,0	68.374,0	90.910,0
Employer contribution	193,5	296,5	1.460,6	9.814,7	14.823,0	23.178,0	30.040,0
Other purchases of goods and serv	610,9	967,5	2.371,8	21.379,8	43.021,0	52.987,0	62.180,0
Interest payments	276,0	467,0	1.692,0	7.035,2	9.789,0	32.091,0	59.610,0
Domestic	0,0	0,0	0,0	2.421,2	2.641,0	20.327,0	47.499,0
Abroad	276,0	467,0	1.692,0	4.614,0	7.148,0	11.764,0	11.654,0
Subsidies to enterprises	1.841,1	3.319,3	9.642,0	32.920,6	25.851,0	24.926,0	21.063,0
Other transfers to households	358,5	350,9	980,6	7.591,3	6.141,0	10.624,0	19.214,0
Transfers to extra-budgetary funds	506,0	889,2	3.918,9	26.032,6	43.718,0	90.093,0	119.416,0
Transfers to other levels of budget	121,4	200,9	863,3	7.486,2	17.682,5	23.739,0	30.199,0
Remaining transfers	612,9	1.048,6	4.420,1	35.087,9	18.377,5	36.376,0	45.013,0
Total expenditure	**5.973,2**	**10.010,2**	**33.687,1**	**193.801,3**	**241.857,0**	**381.889,0**	**502.422,0**
Deficit/surplus	**-123,2**	**78,5**	**-3.847,8**	**2.276,2**	**-30.973,0**	**-69.115,0**	**-43.413,6**

Table VIII.2.: Revenues and Expenditure 1987 = 100

General Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	100,0	113,4	78,1	87,9	69,2	73,9	84
Corporate income tax	100,0	116,5	87,0	112,0	50,6	32,1	31
Individual income tax	100,0	84,3	26,6	159,5	265,7	14.111,9	17.890
Indirect taxes	100,0	105,1	75,0	61,4	58,1	51,2	67
of which: Wages tax	100,0	101,3	80,4	75,3	62,9	0,0	0
Other taxes	100,0	194,7	25,5	179,9	417,1	271,4	179
Other revenues	100,0	82,8	70,5	75,5	74,8	76,7	78
of which:							
Social security contributions	100,0	92,9	71,4	82,6	81,8	105,6	112.
Revenues from privatisation	100,0						
Total revenues	100,0	99,7	74,7	82,3	72,0	75,8	83.
Expenditure							
Capital	100,0	98,2	63,9	56,2	40,0	38,2	38,
Current	100,0	100,7	86,5	85,0	85,0	96,5	100,
Expenditure on goods and services	100,0	99,3	91,2	103,2	162,0	172,8	178,
Wages and salaries	100,0	104,3	125,0	125,8	169,3	191,2	199,
Other purchases of goods and serv	100,0	95,4	64,9	85,6	156,3	158,5	161,
Interest payments	100,0	100,7	91,6	65,6	58,8	139,2	196,
Domestic							
Abroad							
Subsidies to enterprises	100,0	107,3	78,2	46,0	28,0	16,3	14,
Pensions and disablement benefits	100,0	99,3	93,1	98,0	134,0	159,4	143,
Other transfers to households	100,0	93,0	89,3	92,1	101,4	117,7	162,
Remaining transfers	100,0	98,1	84,4	109,9	34,3	49,1	46,
Total expenditure	100,0	100,3	83,0	80,5	78,0	87,4	90,
Deficit/surplus							

Central Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	100,0	113,4	78,1	87,9	59,5	64,9	74,
Corporate income tax	100,0	116,5	87,0	112,0	45,8	31,1	29,
Individual income tax	100,0	84,3	26,6	159,5	187,5	12.014,6	15.215,
Indirect taxes	100,0	105,1	75,0	61,4	53,3	51,2	67,
of which: Wages tax	100,0	101,3	80,4	75,3	44,4	0,0	0,
Other taxes	100,0	194,7	25,5	179,9	290,2	136,4	52,
Other revenues	100,0	65,2	69,4	80,9	58,4	60,9	62,
Revenues from privatisation							
Total revenues	100,0	102,7	76,2	86,3	59,8	64,0	72,
Expenditure							
Capital	100,0	99,7	64,5	59,1	29,5	24,8	24,
Current	100,0	99,8	87,9	88,1	74,2	86,2	87,1
Expenditure on goods and services	100,0	97,6	92,0	109,7	130,5	131,6	127,
Wages and salaries	100,0	103,9	124,9	125,2	148,4	160,4	163,4
Employer contribution	100,0	91,2	112,7	130,6	127,0	143,4	142,4
Other purchases of goods and serv	100,0	94,3	58,0	90,1	116,8	103,8	93,4
Interest payments	100,0	100,7	91,6	65,6	58,8	139,2	198,1
Domestic							
Abroad							
Subsidies to enterprises	100,0	107,3	78,2	46,0	23,3	16,2	10,5
Other transfers to households	100,0	58,3	40,9	54,5	28,4	35,5	49,2
Transfers to extra-budgetary funds	100,0	104,6	115,7	132,5	143,3	213,1	216,5
Transfers to other levels of budget	100,0	98,5	106,2	158,8	241,5	234,1	228,2
Remaining transfers	100,0	101,8	107,7	147,4	49,7	71,0	67,4
Total expenditure	100,0	99,8	84,2	83,5	67,1	76,5	77,2
Deficit/surplus							

Table VIII.3.: Revenues and Expenditure as percent of GDP

General Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	29,1	31,7	21,8	27,7	23,4	24,4	26,9
Corporate income tax	12,5	13,9	10,4	15,1	7,3	4,5	4,2
Individual income tax	0,0	0,0	0,0	0,1	0,1	7,4	9,0
Indirect taxes	15,4	15,6	11,1	10,3	10,4	9,0	11,4
of which: Wages tax	3,9	3,8	3,0	3,2	2,9	0,0	0,0
Other taxes	1,1	2,1	0,3	2,2	5,5	3,5	2,2
Other revenues	23,3	18,6	15,8	19,1	20,3	20,3	20,0
of which:							
Social security contributions	8,8	7,9	6,0	7,9	8,4	10,6	10,8
Revenues from privatisation	0,0	0,0	0,0	0,0	0,2	0,4	0,8
Total revenues	**52,4**	**50,2**	**37,5**	**46,8**	**44,0**	**45,1**	**47,6**
Expenditure							
Capital	7,9	7,4	4,8	4,8	3,7	3,4	3,3
Current	42,5	41,1	35,3	39,2	42,1	46,6	46,6
Expenditure on goods and services	8,6	8,2	7,6	9,7	16,3	17,0	16,8
Wages and salaries	3,8	3,8	4,5	5,2	7,5	8,2	8,2
Other purchases of goods and serv	4,9	4,5	3,0	4,5	8,9	8,7	8,6
Interest payments	1,8	1,7	1,5	1,3	1,2	2,8	3,8
Domestic	0,0	0,0	0,0	0,4	0,3	1,8	3,0
Abroad	1,8	1,7	1,5	0,8	0,9	1,0	0,7
Subsidies to enterprises	11,8	12,1	8,8	5,9	3,8	2,2	1,9
Pensions and disablement benefits	8,1	7,7	7,2	8,6	12,6	14,6	12,7
Other transfers to households	4,1	3,7	3,5	4,1	4,9	5,5	7,3
Remaining transfers	8,1	7,7	6,6	9,7	3,3	4,5	4,1
Total expenditure	**50,4**	**48,6**	**40,1**	**44,0**	**45,8**	**50,0**	49,9
Deficit/surplus	**2,0**	**1,6**	**-2,5**	**2,8**	**-1,8**	**-4,9**	**-2,3**

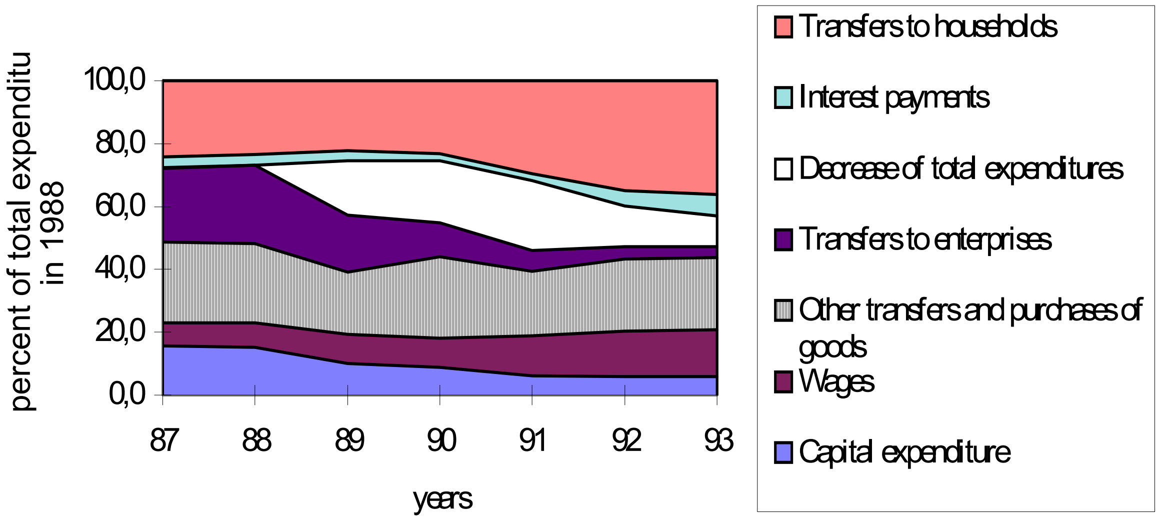
Central Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	29,1	31,7	21,8	27,7	20,2	21,4	23,7
Corporate income tax	12,5	13,9	10,4	15,1	6,6	4,4	4,0
Individual income tax	0,0	0,0	0,0	0,1	0,1	6,3	7,7
Indirect taxes	15,4	15,6	11,1	10,3	9,6	9,0	11,4
of which: Wages tax	3,9	3,8	3,0	3,2	2,0	0,0	0,0
Other taxes	1,1	2,1	0,3	2,2	3,8	1,8	0,7
Other revenues	8,4	5,2	5,6	7,3	5,7	5,8	5,7
Revenues from privatisation	0,0	0,0	0,0	0,0	0,2	0,4	0,5
Total revenues	**37,4**	**36,9**	**27,3**	**35,0**	**26,1**	**27,2**	**29,5**
Expenditure							
Capital	6,0	5,8	3,7	3,9	2,1	1,7	1,6
Current	32,2	30,8	27,1	30,7	27,8	31,5	30,7
Expenditure on goods and services	8,4	7,9	7,4	10,0	12,8	12,6	11,8
Wages and salaries	3,3	3,3	3,9	4,4	5,6	5,9	5,8
Employer contribution	1,2	1,1	1,3	1,8	1,8	2,0	1,9
Other purchases of goods and serv	3,9	3,5	2,2	3,8	5,3	4,6	4,0
Interest payments	1,8	1,7	1,5	1,3	1,2	2,8	3,8
Domestic	0,0	0,0	0,0	0,4	0,3	1,8	3,0
Abroad	1,8	1,7	1,5	0,8	0,9	1,0	0,7
Subsidies to enterprises	11,8	12,1	8,8	5,9	3,2	2,2	1,4
Other transfers to households	2,3	1,3	0,9	1,4	0,8	0,9	1,2
Transfers to extra-budgetary funds	3,2	3,3	3,6	4,6	5,4	7,8	7,7
Transfers to other levels of budget	0,8	0,7	0,8	1,3	2,2	2,1	1,9
Remaining transfers	3,9	3,8	4,0	6,3	2,3	3,2	2,9
Total expenditure	**38,2**	**36,6**	**30,8**	**34,6**	**29,9**	**33,2**	**32,3**
Deficit/surplus	**-0,8**	**0,3**	**-3,5**	**0,4**	**-3,8**	**-6,0**	**-2,8**

Table VIII.4.: Structure of Revenues and Expenditure

General Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	55,4	63,1	58,0	59,2	53,3	54,0	56,4
Corporate income tax	23,8	27,8	27,6	32,3	16,7	10,1	8,9
Individual income tax	0,1	0,1	0,0	0,2	0,3	16,4	18,9
Indirect taxes	29,4	31,0	29,6	22,0	23,7	19,9	23,9
of which: Wages tax	7,5	7,6	8,0	6,8	6,5	0,0	0,0
Other taxes	2,2	4,2	0,7	4,7	12,5	7,7	4,7
Other revenues	44,5	37,0	42,0	40,8	46,2	45,0	41,9
of which:							
Social security contributions	16,8	15,6	16,0	16,9	19,1	23,4	22,7
Revenues from privatisation	0,0	0,0	0,0	0,0	0,5	0,9	1,7
Total revenues	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Expenditure							
Capital	15,6	15,3	12,0	10,9	8,0	6,8	6,6
Current	84,4	84,7	88,0	89,1	92,0	93,2	93,4
Expenditure on goods and services	17,1	17,0	18,8	22,0	35,6	33,9	33,7
Wages and salaries	7,5	7,8	11,3	11,7	16,3	16,4	16,5
Other purchases of goods and serv	9,6	9,2	7,5	10,2	19,3	17,5	17,2
Interest payments	3,5	3,5	3,9	2,9	2,6	5,6	7,6
Domestic	0,0	0,0	0,0	1,0	0,7	3,5	6,1
Abroad	3,5	3,5	3,9	1,9	1,9	2,0	1,5
Subsidies to enterprises	23,4	25,0	22,0	13,4	8,4	4,3	3,7
Pensions and disablement benefits	16,0	15,9	18,0	19,5	27,5	29,2	25,4
Other transfers to households	8,2	7,6	8,8	9,4	10,7	11,0	14,7
Remaining transfers	16,2	15,8	16,4	22,1	7,1	9,1	8,3
Total expenditure	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Deficit/surplus as % of revenues	3,9	3,2	-6,7	6,0	-4,1	-10,8	-4,8
subsidies /revenues	22,5	24,2	23,5	12,6	8,7	4,8	3,9

Central Government	1987	1988	1989	1990	1991	1992	1993
Revenues							
Taxes	77,7	85,8	79,7	79,1	77,4	78,7	80,5
Corporate income tax	33,3	37,8	38,0	43,2	25,5	16,2	13,6
Individual income tax	0,1	0,1	0,0	0,2	0,4	23,1	26,0
Indirect taxes	41,2	42,2	40,6	29,3	36,8	33,0	38,7
of which: Wages tax	10,5	10,3	11,1	9,1	7,8	0,0	0,0
Other taxes	3,0	5,7	1,0	6,3	14,7	6,5	2,2
Other revenues	22,3	14,2	20,3	20,9	21,8	21,2	19,5
Revenues from privatisation	0,0	0,0	0,0	0,0	0,8	1,5	1,7
Total revenues	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Expenditure							
Capital	15,8	15,8	12,1	11,2	6,9	5,1	4,9
Current	84,2	84,2	87,9	88,8	93,1	94,9	95,1
Expenditure on goods and services	22,0	21,5	24,0	28,9	42,8	37,8	36,4
Wages and salaries	8,5	8,9	12,7	12,8	18,9	17,9	18,1
Employer contribution	3,2	3,0	4,3	5,1	6,1	6,1	6,0
Other purchases of goods and serv	10,2	9,7	7,0	11,0	17,8	13,9	12,4
Interest payments	4,6	4,7	5,0	3,6	4,0	8,4	11,9
Domestic	0,0	0,0	0,0	1,2	1,1	5,3	9,5
Abroad	4,6	4,7	5,0	2,4	3,0	3,1	2,3
Subsidies to enterprises	30,8	33,2	28,6	17,0	10,7	6,5	4,2
Other transfers to households	6,0	3,5	2,9	3,9	2,5	2,8	3,8
Transfers to extra-budgetary funds	8,5	8,9	11,6	13,4	18,1	23,6	23,8
Transfers to other levels of budget	2,0	2,0	2,6	3,9	7,3	6,2	6,0
Remaining transfers	10,3	10,5	13,1	18,1	7,6	9,5	9,0
Total expenditure	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Deficit/surplus as % of revenues	-2,1	0,8	-12,9	1,2	-14,7	-22,1	-9,5

Graph VIII.1: **Structure of real general government expenditure, 1988 = 100**



2. Classic government services (administration, defence, public security, justice, science)

Classic government services can be divided into three main categories: public security and justice, national defense and general public services. The last group includes administration, science and fundamental research, excluding higher education.

In a majority of cases classic government services were financed directly from the central budget. Local budgets were used to finance local self-government administration and - to a low extent - public security forces, i.e. local guards, a kind of local police (their cost was included in administrative expenditure). Local authorities were granted the right to create such services in 1991, with the introduction of new legislation on local self-government.

The share of administrative expenditure financed from local budgets in the total expenditure incurred by the budgetary sphere on classic government services ranged from 9% to 11.5%.

Total budgetary expenditure on classical government services was dominated by current expenditure. In the years 1987-1990 the share of investment expenditure continued to decline from 8% in 1987, fluctuated around 5% in early 1990s and fell to 4.9% in 1993.

Table VIII.5 shows that real expenditure on classical government services was declining. If we adopt 1987 as the base year, the real drop in expenditure amounted to 9.5%. The share of this type of expenditure in total expenditure was also decreasing (except for 1990). In 1987-1993 this decrease amounted almost 2 percentage points of total expenditure. This decline was strongly neutralized by an increase of the share of such expenditure (as well as of overall budget spending) in GDP. This situation reflected the attempts made by the state to maintain the same level of real expenditure on general public services, in spite of the fall in GDP.

Table VIII.5: Current expenditure on classic government services (1987-1993):

Year	1987	1988	1989	1990	1991	1992	1993
in bn zlotys	808	1352	2160	4225	27636	66892	92907
in bn zlotys, 1987	808	844	779	732	727	712	731
share in the total expenditure (%)	13.76	13.50	12.54	14.26	12.25	11.63	11.94
share in GDP (%)	4.77	4.56	3.57	4.67	5.44	5.86	5.96

Changes in the volume of real expenditure on general public services were accompanied by significant structural modifications. Expenditure on national defense was drastically reduced - in comparison with 1987 the real defense expenditure in 1993 fell by 45% (see - table VIII.6). The fall in expenditure was especially strong in 1991 as a result of curbing budgetary spending which was necessary due to the fall on the revenue side. It should be borne in mind, however, that prior to the reform defense used to constitute the public service sector of special interest for the state. Given the changes in geo-political situation the reduction seems to be well justified.

Table VIII.6: National defence expenditure (1987-1993):

Year	1987	1988	1989	1990	1991	1992	1993
bn zlotys	467	742	2118	13599	17129	24318	32156
bn zlotys 1987	467	463	377	353	261	259	253
% GDP	2.76	2.50	1.79	2.30	2.08	2.13	2.06
share in budgetary expenditure	7.95	7.41	6.29	7.02	4.68	4.23	4.13

The cuts in defence expenditure allowed the government to increase the financing of other classical government services. Expenditure on public order and safety grew by ca 15% in real terms (see - table VIII.7). Its share in total budget expenditure increased from 3.337 to 3.72%, with the exception of 1991, when a drop in the level of financing was recorded, due to a fall on the revenue side.

Expenditure on administration and science grew a lot (see - table VIII.8). As regards science, it is difficult to assess the actual change in real expenditure, since the data available for the 1980s seem not to take into account all institutions supporting the development of science and technology (e.g. various R&D institutes operating within the specific industrial branches). Thus, these data cannot be compared with figures for 1991-1993. Starting from 1991, with the establishment of the National Scientific Research Committee, which introduced clear criteria for the financing of scientific work, the system became more transparent, both as regards finance and in terms of particular scientific issues under research. The lack of reliable data forces us to limit the analysis to the years following 1991. Compared to 1991, expenditure on science in 1992 and 1993 fell in real terms. Current expenditure on science fell by 35%, along with a decreased share of this type of expenditure in GDP and in overall budgetary spending.

Table VIII.7: Expenditures for public order and safety (1987-1993):

Year	1987	1988	1989	1990	1991	1992	1993
bn zlotys	198	322	1192	7977	11491	20170	28939
bn zlotys 1987	198	201	212	207	175	215	228
% GDP	1.17	1.09	1.01	1.35	1.39	1.77	1.86
share in budgetary expenditure	3.37	3.22	3.54	4.12	3.14	3.51	3.72

Table VIII.8: Expenditure for administration and science (1987-1993):

Year	1987	1988	1989	1990	1991	1992	1993
bn zloty	142	288	914	6059	16253	22404	31812
bn zloty, 1987	142	180	162	157	247	238	250
% GDP	0.84	0.97	0.77	1.02	1.97	1.96	2.04
share in budgetary expenditure	2.42	2.88	2.71	3.13	4.44	3.90	4.09

The other type of expenditure included in the general public services - the administration - recorded an opposite trend. The difficult position of the budget seemed to have no bearing on administrative expenditure. In the critical year 1991 this type of expenditure grew the most. As a result, in 1987-1993 real current expenditure on general public services (science and administration) increased by 76%, with its share in GDP growing from 0.84% to 2.04%. It would seem as if the overall fiscal crisis did not concern the state administration. As regards this type of public services, expenditure rose both in real terms and as regards its share in the overall budget and GDP.

Structural changes entailed modifications in the proportion of expenditure on general public services. In 1987 the proportion of expenditure on national defence / public order & safety / general public services was as 1.000 / 0.304 / 0.424. By 1993 the resources were distributed in an almost level manner: 1.000 / 0.989 / 0.900.

An analysis of current expenditure clearly indicates an increase of share allocated to wages and wage-related payments. This trend indicates protection of employees in the sphere of classical government services. This is the most visible in administration, where real wages rose the most.

3. Public social and cultural services

Social services include education and higher education, health services, arts and culture, sports, tourism and recreation. During the period under discussion, social expenditure went through two distinct periods (see -table VIII.9). The first one, from 1987 until 1990, saw annual increases in real expenditure on such services. This expenditure group dominated the budget and had a decisive impact upon its shape. Social services expenditure reached its peak level in 1990, both in real terms and as regards the share in GDP and overall budget spending. In 1990 current financing of social services accounted for 33.57% of total budget expenditure. 1991 saw a sharp decline in real expenditure on such services.

In 1991-1993 real expenditure remained at a fairly stable level. Its share in total budget expenditure was slowly decreasing and in 1993 the current expenditure in this area accounted for 19.98% of the total budgetary expenditure, which corresponded to ca 10% of GDP. The years 1991-1993 constituted a period of relative stabilization as regards the financing of social services. In 1993 real current budgetary expenditure on social services decreased by 10.7%, as compared to the situation in 1987.

Table VIII.9: Current expenditure on social services (1987-1993):

Year	1987	1988	1989	1990	1991	1992	1993
bn zlotys	1369	2320	9197	65066	81938	113981	155455
bn zlotys 1987	1369	1448	1635	1687	1247	1213	1223
% GDP	8.08	7.83	7.77	11.00	9.94	9.98	9.98
share in budgetary expenditure	23.32	23.17	27.30	33.57	22.37	19.82	19.98

The gradual increase of current expenditure on social services was caused mainly by the rising wage cost in this sphere. The pattern of real wages increase is similar to the trend depicting current expenditure on social services. Real wages grew gradually, reached their maximum by the end of 1989, then started to decline rapidly. In 1989 real wages in the health service amounted to 150% of real wages in 1987.

Wages in education, culture, sports and tourism followed a similar trend, growing by 151%, 126% and 116%, respectively.

The increase in wages resulted from political pressures exerted by trades unions. Faced with the threat of strikes, the government increased salaries. This process reached its final apex in the Law on Salaries in the State Budgetary Sphere, dated 31st January, 1989, which tied salaries in the budgetary sphere to wages in the material sphere. This Law was never fully implemented (see - chapter I). Starting from 1991 the Law was regularly suspended, and therefore in 1990-1993 real wages in the budget sphere, especially in health services and education, kept declining.

In spite of the above, the share of wages and wage-related payments in current expenditure kept increasing. This may indicate that the financial policy over the entire period under discussion was geared towards the protection of income earned by employees in the budget sphere rather than ensuring an appropriate quality of social services and benefits.

Budget difficulties had the strongest impact on these social services which are oriented towards leisure and recreation. In 1993 real expenditure on arts and culture, as well as on sports and tourism was 41% lower than in 1987. It was connected with partial privatization and commercialization of these spheres. Nevertheless, the savings were not very high and accounted for, respectively, 0.4% - 0.5% and 0.12%-0.15% GDP as well as 1.5% - 0.8% and 0.43% - 0.24% of total budget expenditure.

Current expenditure on education and higher education was virtually unchanged. Its share in the total budget expenditure amounted to 10%, except for 1989 and 1990 when it reached 13% and 14.5%, respectively. With the rise of the share of budget expenditure in GDP, the share of expenditure on education was also growing, to reach 5% in 1993. Detailed data is presented in the table below.

Table VIII.10: Current expenditure on education and higher education (1987-1993):

Year	1987	1988	1989	1990	1991	1992	1993
bn zlotys	607	1010	4342	28250	38909	52776	77875
bn zloty, 1987	607	630	772	732	592	562	613
% GDP	3.58	3.14	3.67	4.78	4.72	4.62	5.00
share in budgetary expenditure	10.34	10.09	12.89	14.58	10.62	9.18	10.01

In 1993 current expenditure on health services, as compared to 1987, fell by 16.13%. Similar to the overall expenditure on social services, health expenditure grew in real terms until 1990, to remain at a more or less stable real level after the drop in 1991. Amongst health service expenditure the strongest growth dynamics was displayed by medicines and wages which begun to increase their share in the total amount allocated to health services. In spite of that, starting from 1991, the average real wages in health service kept decreasing (see data in table VIII.11). This in turn caused a deterioration of a quality of provided services, accompanied with a general dissatisfaction of employees in this sector. Starting from 1992 the share of health service expenditure in GDP kept decreasing.

Table VIII.11: Current expenditure on health services (1987-1993):

Year	1987	1988	1989	1990	1991	1992	1993
bn zloty	648	1093	4015	32617	37815	54828	69072
bn zloty, 1987	648	682	714	847	576	584	543
% GDP	3.83	3.69	3.39	5.52	4.59	4.80	4.43
share in total expenditure	11.03	10.92	11.92	16.86	10.32	9.53	8.88

4. Budget expenditure on the social security system

The process of transformations of the Polish pension system, from social-based into insurance-based, commenced in 1968. Under the new system the chief criterium for the granting of retirement benefits will be the payment of adequate contributions and their amount [Golinowska, 1995].

The Social Security Fund was fully separated from the budget in 1987. Farmers' retirement pension fund was created as a separate entity in 1990. The budget started making contributions to social security benefits granted to farmers right from the moment when this group became entitled to benefit from the retirement pension system (i.e. from 1978).

Table VIII.12: State budget transfers to social security system, in bn zloty:

Year	1987	1988	1989	1990	1991	1992	1993
Social Security Fund	117.7	199.0	1272.0	8819.0	22060.0	49508.0	66052.1
Farmers' Retirement and Disability Pension Fund	111.7	195.7	1046.6	7500.0	13621.3	22472.5	30850.0
Total subsidies to social security	229.4	394.7	2318.6	16319.0	35681.3	71980.5	96902.1
Current state budget expenditure	5030.6	8430.6	29617.5	172165.3	225069.6	362388.6	480367.0
Share of subsidies in current budget expenditure (%)	4.6	4.7	7.8	9.5	15.8	19.9	20.1
Share of subsidies in GDP (%)	1.39	1.36	1.98	2.71	5.30	6.30	6.20

The table VIII.12 shows the increase of budgetary tranfers to the pension system. The share of transfers doubled over the period of two years (1990-1991), while in 1993 it already accounted for 20% of current budget expenditure. The budget pays social security contributions to the Social Security Institution (ZUS) with respect to employees in the budget sphere. In 1992 subsidies and contributions accounted for a total of ca 30% of current budget expenditure.

The major reason for the increase in subsidies was an exceptional rise in the number of pensioners, which was not accompanied by an adequate increase of revenue from contributions. Quite to the contrary - the rise in numbers was accompanied by a decline in contributions paid in by employers.

In 1989-1992 the group of pensioners (retirement and disability pensions) grew by almost 1.9 million persons, while during the eighties the annual incremental figures amounted to some 200 thousand persons. This phenomenon was caused by a poor situation on the labor market, prevailing from the end of 1989, which constituted an incentive to participate in early retirement schemes or to arrange for the granting of disability benefits.

5.Other social programmes

In 1987-1992 budget expenditure on social services and performances did not record a sharp decline. The real value of such services and benefits continued to increase, even though incremental amounts were lower each year. In 1992 the services recorded a real fall by some 3-4%.

State expenditure on social services includes culture, education, health care and social aid.

Economic transformations caused a drastic change in the structure of expenditure, i.e. even though its real value remained at the same level, the allocation of resources to various services was largely modified. In 1990 expenditure on culture and recreation was cut by 25% and expenditure on education fell by 5%. At the same time resources were shifted towards social welfare services, covering both social benefits and unemployment. In 1990 unemployment-related expenditure accounted for almost 50% of the total social welfare expenditure. Over the subsequent years this proportion grew to 70 - 80% of total social welfare spending.

Table VIII.13: Current expenditure on social welfare (from state and local budgets, in bn zloty)

Year	1988	1989	1990	1991	1992
Social welfare	75.6	450.8	7632.2	16378.1	33062.7
% GDP	0.2	0.4	1.3	2.0	2.9
Payments from Labour Fund	-	-	3702.0	12630.0	22827.0

As shown above, over the four-year period the share of expenditure on social welfare in GDP grew more than ten times, up to 3% of GDP. Together with transfers to social security system, welfare-related expenditure accounted for over 42% of all social expenditure. For the sake of comparison, in 1988 such expenditure accounted for only 9% of the total social expenditure.

Along with the drop in the value of price subsidies on consumer goods, various types of social benefits were introduced, to compensate for the increase of rent charges, housing cost or medicines. These benefits make up for the losses incurred by poor family budgets as a result of price subsidy removal. The share of various benefits is difficult to assess, however, together with unemployment benefits, they are estimated to account for more than a dozen percent of the total social expenditure of state budget and local budgets.

Chapter IX: Budget Results in 1994 and Future Perspectives (Andrzej S. Bratkowski)

In 1994 the budgetary situation did not undergo any significant changes in comparison with 1993. Both revenues and expenditure rose slightly in real terms, however, their increase was slower than GDP growth, thus the share of budget in GDP will probably slightly decrease. The deficit reached 57.4 billion zloty and its share in GDP will be similar to the 1993 figures. In spite of a relatively low deficit, no significant progress has been made as regards inflation rate.

Negative trends in the budget expenditure structure persisted, even though at a slower pace. The increase of fiscal burdens (among others, higher personal income tax rates - 21, 33 and 45%) caused a clear slow-down in the development of small private companies.

Draft budget for 1995 anticipates large growth of real revenues and expenditure; however, expenditure is expected to rise at a more rapid pace, hence the deficit is planned to reach 88 billion zloty. It is already certain that assumed inflation targets adopted for the 1995 budget (17%) will not be met. In spite of that, the budgetary performance recorded so far indicates that the final budget result in 1995 will not be better than has been planned for [Misiąg, 1995].

The plan assumes significant growth in subsidies paid to enterprises and as regards wages in budgetary sphere. If these plans are implemented, inflation may not only rise beyond the planned level but it may well exceed 1994 figures. In 1994 and 1995 no major systemic changes were introduced, neither to the functioning of the budget itself, nor to the social policy (mainly pension system) and social services financed from the budget (education, health services).

Unless a reform of social performances and services is undertaken, expenditure related to these items will continue to grow at a rapid pace, entailing a gradual increase in the budget deficit. Debt service cost will also grow, not only as a result of an increase in debt value but also due to the interest rate paid on the debt.

High fiscal burdens imposed upon the economy threaten to slow down economic growth. Unless a significant rise is recorded as regards foreign investment in 1995 and 1996, investment financing problems will become even more acute, especially taking into account the fact that the investment revival witnessed in 1994 focused upon capital-intensive branches of the heavy industry. Slower economic growth might, in turn, make it more difficult for the government to sell its bonds on international capital markets and as a consequence impair the servicing of foreign debt after the year 2000, when debt repayment to the Paris Club is scheduled to grow to a significant extent.

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Table of Contents