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# 11            The Government Budget and the Economic Transformation of Poland

Alain de Crombrughe and David Lipton

Poland's budgetary position shifted dramatically from 1989 to 1991. A large deficit emerged in 1989, there was a huge swing to surplus in 1990, and a deficit reemerged in 1991. These shifts resulted, first, from the collapse of the Communist fiscal system and, then, from the macroeconomic and structural forces set in motion by the economic transformation process.

Poland's fiscal system, designed during the Communist period primarily as an instrument to reallocate resources, collapsed when macroeconomic pressures mounted in 1989. The Communist government was unable to cope with falling revenues or to reduce sufficiently the budgeted subsidies and social spending, and a large budget imbalance (of about 7 percent of GDP) resulted. The deficit was financed by central bank credit, which contributed to an avalanche of money printing and, by August 1989, an explosive inflation.

The Solidarity government began the economic transformation by launching a program of stabilization and liberalization at the beginning of 1990. This program produced a huge budgetary correction, about 10 percent of GDP in 1990, as the profitability of enterprises was restored and subsidies were cut drastically (see app. table 11A.1). Over time, however, the stabilization correction eroded, mainly because the process of economic transformation had unfavorable effects on the management of the budget. The liberalization of economic activity produced qualitative and quantitative changes in the nation's tax base and changes in spending priorities. For example, enterprise profits taxes, which had been a major source of revenues, fell as a result of the decline of the state enterprise sector. In addition, pressure mounted for improvements in public services and increases in social safety net spending.

At the same time, budget management has been constrained by financial

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realities. Since the economic transformation began, the government's room to maneuver has been restricted by the need to avoid budget deficits of a scale that would jeopardize the effort to stabilize prices and the exchange rate. So far, the government has avoided a budgetary erosion of dangerous proportions, although the emergence of a deficit has prevented a decisive victory in the anti-inflation battle. The deficit reached about 4 percent of GDP in 1991, and, as a consequence, the government was unable to reach its aim of bringing inflation down to 1–2 percent per month. Nonetheless, the deficit was financed by the banking system without a loss of monetary and financial control.

With the anti-inflation battle always in the foreground, Poland's post-Communist governments have begun major reforms of the fiscal system. Poland is now creating a fiscal system better suited to a modern, market economy, with much less emphasis on directing the allocation of resources. The new priorities must be to support macroeconomic stabilization and foster the development of a market economy. In time, the reform of the fiscal system will include tax reform, a reevaluation of spending priorities, civil service reform, the revamping of social insurance programs, and the creation of a public investment program.

This paper explores the challenge of managing budgetary policy during Poland's transition to a market economy. The focus is on the case of Poland, but much of what is discussed has been or will be faced by other countries in Eastern Europe and the newly independent states of the former Soviet Union.<sup>1</sup>

The paper begins with a description of the shortcomings of the Communist fiscal system. This is followed by an examination of the effect of the economic transformation on the budget and an explanation of the budget swings that have taken place since the economic transformation began. The next section describes the role of the budget in a market economy and discusses the major changes that will be necessary to fulfill this role. Finally, the paper offers some comments about how budget targets can be set in the transition to a market economy and illustrative targets for the main budgetary aggregates in the short and long run.

### **11.1 The Breakdown of the Communist Fiscal System**

During the Communist period, the government budget was primarily an instrument for resource reallocation. Under this approach, fiscal policy was used differently than in market economies, where policymakers aim to support macroeconomic balance and to provide public goods. Budget policy under Poland's Communist governments involved the administration of turnover taxes, enterprise profits taxes, tax reliefs, and subsidies to support an extensive system of

1. For descriptions of fiscal developments and budgetary policy issues in Hungary, Romania, and Czechoslovakia, see Boote and Somogyi (1991, 21–24), Demakis and Khan (1991, 26–27), and Aghevli, Borensztein, and van der Willigen (1992, 10–11).

consumer and producer price controls. In fact, neither the tax nor subsidy schemes were fixed regimes (i.e., with established parameters on which economic agents can base their decisions), as is the case in the West. In practice, taxes and subsidies were negotiated, with enterprises seeking to achieve their desired level of post-tax-cum-subsidy profits and the government seeking to maintain price controls and clear commodity markets.<sup>2</sup>

Although Poland's governments had sought other budgetary objectives, maintaining macroeconomic balance was not among them. The tax system was managed to achieve incomes policy objectives, targeting the growth of state enterprise wages and then using these wages as the base for social insurance benefits and government-sector wages. Although the state investment budget included some infrastructure projects executed by government ministries, it was designed primarily to channel resources to state enterprises, to support their industrial investment projects and profitability.

Thus, a complicated network of resource transfers rested on a shaky foundation, Poland's very narrow tax system. The tax system relied primarily on turnover taxes and the enterprise profits tax (see app. table 11A.2). These two taxes provided revenues of about 23 percent of GDP in the mid-1980s, roughly two-thirds of all state budget revenues. Most of the turnover-tax revenues were from three products (gasoline, alcohol, and tobacco), and the base was not broad; in fact, exemptions were plentiful.

The macroeconomic effects of budget policy on aggregate demand were not given much consideration. This was possible because the prevalence of price controls and subsidies bottled up domestic imbalances and the lack of exchange rate convertibility restricted the spillover of imbalances into economic relations with the rest of the world. When the macroeconomy started to veer off course, budgetary policy was not adjusted.<sup>3</sup> During the buildup of the imbalances in 1988 and 1989, real wages in state-owned industry rose by 28 percent. Since this was far in excess of productivity gains, enterprise profitability slumped. This slump produced a corresponding decline in government tax revenues in 1989. As the revenue crisis materialized, spending was not reduced sufficiently, mainly owing to an effort to maintain enterprise profitability and consumer price controls in the face of growing aggregate demand.

Ultimately, the government was unable to bring about an adequate fiscal adjustment. In August 1989, the last Communist government raised food prices by 150 percent. This was a last-ditch attempt to strengthen the budget and also to prepare the way for a greater role for market forces. Meaningful

2. Balcerowicz (1989) explained that, in Poland, the governmental authorities "heavily tax enterprise gross profits but then channel them—to a large extent in an arbitrary way—back to enterprises. . . . The problem is that a great deal of fiscal assistance flows to enterprises in financial difficulties, and that practically all such enterprises are bailed out."

3. Poland's earlier episode of macroeconomic imbalances, in 1981 and 1982, led to a harsh budgetary adjustment and a sharp reduction in real wages under conditions of martial law. For a general discussion of the reasons why budgets in socialist economies turn toward deficit during periods of economic reform, see Kornai (1992, 337–43).

fiscal adjustment, however, would have required the rethinking of many related policy areas—including consumer and producer price controls and the operation of the trade and exchange system—something the Communist reformers were politically and technically incapable of doing. The budget deficit for the year was about 7 percent of GDP. Since almost all the budget finance came from loans from the banking system, the deficit led to a huge increase in base money and fueled Poland's hyperinflation.

## **11.2 The Economic Transformation and the Budget**

### **11.2.1 The Stabilization Correction**

The first Solidarity government launched a stabilization and liberalization program at the beginning of 1990. The measures introduced at that time produced a nearly 10 percent budgetary correction that year (see app. table 11A.1) and resulted in a surplus of about 3 percent of GDP. This stabilization correction resulted mainly from the following four aspects of the program.

First, the liberalization of economic activity—the freeing of prices and the liberalization of domestic and international trade—gave the government the opportunity to cut subsidies to consumers and enterprises sharply. With prices set by supply and demand, the government no longer had to intervene with subsidies to maintain desired price levels. Instead, enterprises were expected to manage their own profit positions. In the course of the budget crisis of 1989, subsidies had been reduced to about 12½ percent of GDP from the 16 percent level that had prevailed in the mid-1980s (see app. tables 11A.3 and 11A.4). The 1990 liberalization measures permitted a sharp cut in explicit subsidization to about 7 percent of GDP. The effort to slash explicit budget subsidies continued in 1991, with subsidies falling to only 4 percent of GDP.

Second, the stabilization program restored enterprise profitability. The most important factor in the restoration of enterprise profitability was the reversal of the real wage increases that had occurred in 1988 and 1989. These real wage increases were unwarranted in the sense that they far exceeded productivity growth. To a degree, however, the measured increases in real wages were symptomatic of the growing excess of aggregate demand. Wages were rising in comparison with controlled prices, but these controlled prices were increasingly irrelevant, as the availability of goods at official prices diminished. In 1990, the real wage dropped by 27 percent in 1990 in comparison with the previous year. In part, wages fell back into line with productivity, and, in part, price liberalization led to the comparison of wages with prices that more closely reflected the scarcity and value of goods and services.

Another factor in restoring profitability was the establishment of a unique, convertible exchange rate. Convertibility removed the long-standing antiexport bias of the old exchange rate system and permitted many Polish enterprises to be competitive in world markets. Yet another factor was the one-time increase

in enterprise taxation resulting from nominal asset revaluation. The rapid inflation and nominal devaluation (and their effects on asset values) in early 1990 created taxable profits. In 1990, enterprise profits taxes rose by 4 percent of GDP to reach 14 percent, a level that exceeded even those of the mid-1980s (see app. table 11A.2).

Third, Poland was able to reduce substantially its external debt service burden. Shortly after taking office in September 1989, the new government stopped making interest payments on medium- and long-term external obligations and announced its intention to seek a permanent reduction of Poland's debt service burden. Much of Poland's debt service had been rescheduled during the 1980s, but, in September 1989, the government sought debt forgiveness. In early 1990, official creditors agreed to a generous rescheduling of debt service falling due that year and, in early 1991, to a permanent 50 percent reduction of all eligible debt. Poland continues to negotiate with commercial bank creditors for comparable treatment of their claims.

The immediate effect of Poland's debt service reduction was cash-flow relief for the budget and reduced pressure on the monetary system and balance of payments. In the short run, the cessation of interest payments permitted Poland to reduce debt service payments to \$0.7 billion in 1990 from \$1.6 billion the year before (a reduction of about 1½ percent of GDP).<sup>4</sup> The rescheduling provided relief not only for the balance of payments but also for the budget. This resulted from the reduction in inflationary finance that had been funding government purchases of foreign exchange for debt service.<sup>5</sup>

Fourth, state budget support for investment reached an all-time low. Many investment projects were stopped in 1990, and there were almost no new government investment projects. Budgetary expenditures for investment, which had fallen by 1½ percent of GDP in the two years prior to the reforms, dropped another ½ percent of GDP to about 3½ percent (see app. table 11A.3).

### 11.2.2 The Transformation and Emerging Budgetary Pressures

The effects of the stabilization effort were not all positive. While the positive effects dominated at first, certain effects placed a greater burden on the budget from the outset. The sharp decline in production, employment, real wages, and retail sales in the state sector depressed the level of tax revenues linked to those

4. For years, because of earlier reschedulings, Poland had been paying only a fraction of the nearly \$7 billion of interest and principal falling due. The 1990 payments represented a smaller fraction than in earlier years.

5. In addition to cash-flow relief, the permanent 50 percent reduction in Poland's debt burden has probably eliminated Poland's debt overhang (presuming that the debt reduction granted by official creditors is followed by a comparable deal with commercial bank creditors). Had debt service merely been rescheduled rather than permanently reduced, doubts would have remained regarding the government's ability to generate the resources for debt service in the future (when the rescheduled obligations would fall due). The risk of a renewal of inflationary finance and renewed balance-of-payments problems would have made it all the more difficult for the government to reestablish its creditworthiness.

activities. Turnover taxes and wage-related taxes combined fell by 3 percent of GDP. Moreover, some modest compensation for subsidy cuts was extended to the population in the form of income support, rising government expenditures on health (related to purchases of medicine), and changes in social insurance benefits (primarily for housing).

As Poland's program of transformation has progressed, several aspects of the process have had important and sustained negative effects on government revenue and have forced the government to constrain its spending tightly. In most cases, these negative effects stem from the nature of the post-Communist transformation and are undoubtedly important factors in other countries in transformation.

### *Revenues*

The most important development was the reversal of the initial improvement of enterprise profits and profits taxes. In 1991, enterprise profit tax revenues fell by 7½ percent of GDP to a level well below what had prevailed in the mid-1980s. With a tax system heavily dependent on this particular revenue source, the effect on total revenues was large and not easily remedied.

The fall in enterprise profits taxes can be traced to three aspects of the transformation process.

First, by its very nature and design, the liberalization of prices and economic activity exposed the fact that an important segment of Poland's capital stock would prove unprofitable in an environment of market-determined prices. The pattern of capital accumulation had been shaped by central planning and, then, supported by subsidies, low energy prices, and the protected CMEA market. The low value (and in some cases worthlessness) of much of this capital was exposed by the liberalization of the economic environment. Over the long term, new investment will lead to a reorientation of the capital stock and will support new business activities (for the most part private business activities). New capital will provide a basis not only for economic growth but also for the collection of corporate profits taxes. In the short run, however, the fall in the profitability of old capital has had a direct, negative effect on enterprise profit tax revenues.

Moreover, the enterprise profit tax system has not been effective in collecting revenues from new private businesses. Poland is now accumulating profitable "new capital" in thousands of new private businesses, mainly in the service sector, but also in manufacturing, transport, distribution, and construction. So far, however, the share of taxes paid by the private sector has not risen with its growing share in total business activity (see table 11.1).

Second, wage pressures reemerged in late 1990 and were not adequately resisted. As mentioned earlier, the fall in the measured real wage at the outset of the program had contributed to the restoration of healthy profit levels. By late 1990, workers began to seek a greater share of these profits in the form of wage increases, and state enterprise managers for the most part did not resist. As a result of the absolute absence of central authority over state enterprise

**Table 11.1 Poland: Shares of the Tax Burden, 1991**

	Socialized Sector	Private Sector
Total sales	72.4	27.6
Total taxes paid	90.2	9.8

*Source:* Central Statistical Office, Warsaw.

*Note:* The data cover the 20,700 largest employers (with 50 or more employees in construction and industry and 20 or more in other sectors), and the period is the first three quarters of 1991. These data undoubtedly lead to an understatement of the role of the private sector in sales (because of the employment cutoff level) and an overstatement of the share of taxes paid by the private sector (because of tax avoidance by small enterprises). Figures given are percentages of total.

managers, there were no effective owners to oversee management decisions and no effective resistance to wage increases within the industrial structure.

The government was aware that the prevalence of state ownership and decentralized decision making would lead to weak control over enterprise costs, particularly wages. For this reason, the government instituted a tax-based incomes policy aimed at curbing wage growth at the beginning of 1990. The instrument of policy was an excess wage tax, under which wage payments above a putative norm would give rise to a tax liability for the enterprise equal to several times the excess of wage payments.

One inherent difficulty with this type of policy is establishing the level of the wage norm. Poland's excess wage tax was not binding in the first half of 1990 because real wages remained below the preset norm. This left room for untaxed wage increases later on that were not fully warranted by macroeconomic circumstances or the financial position of particular state enterprises. In the second half of the year, when the wage norm was binding in most cases, many enterprises chose to raise wages and pay the tax.

Wages began to rise in the fourth quarter of 1990, and enterprise profits and profits taxes began to fall accordingly. There was also automatic upward pressure on budget-sphere wages and pensions, which were linked to industrial wages. The rising trend of wages continued in 1991. In retrospect, it was unrealistic to place too much weight on a tax-based incomes policy; the incentive problems of the state enterprise sector could not be rectified by a tax on excess wages.

In fact, the real culprit in the wage saga is the sluggishness of the privatization program. The Polish Treasury technically remains the sole owner of most large state enterprises. Of course, the government no longer has the will or the mechanisms to exert direct influence over state enterprise behavior. Until enterprises are commercialized and privatized, industry will remain in the hands of state enterprise managers and their labor councils, neither of which are subjected to much outside scrutiny. In this transitional state, enterprise managers have no particular incentive to seek to make a profit, apart from an

ill-defined motive to accumulate some resources for investment. The main consequence of higher profits is higher profits taxes; therefore, enterprise managers find ways to spend their resources and avoid profit tax liabilities.

This failing has had important consequences for the budget and, thus, for the management of the macroeconomy. When viewed from the vantage point of the consumer, wage growth in 1991 does not seem excessive, as it was only slightly higher than the increase in the consumer price index. When viewed from the vantage point of enterprise profitability, however, the situation was actually grave. Wages rose by 24 percent more than producer prices in 1991 and contributed to the sharp fall in profitability in that year.<sup>6</sup>

The third blow to profit tax revenues was the scrapping of the CMEA (Council for Mutual Economic Assistance) trading system at the end of 1990. Under this system, the Soviet Union and the East European countries had exchanged goods on the basis of a clearing arrangement denominated in the unit of account called *transferable rubles*. The decision to end this system coincided with a crippling balance-of-payments crisis in the Soviet Union, related to the collapse of its political and economic system. In the midst of the crisis, the Soviet Union was unable to provide an effective foreign exchange system or payments mechanism for its enterprises. Thus, trade between Poland and the Soviet Union collapsed, as did trade between the Soviet Union and the rest of Eastern Europe. Poland's exports to the Soviet Union under the clearing arrangements fell by 92 percent in 1991 (as only transitional transactions occurred as the system was wound up), and very little of the trade was converted to a hard currency basis.<sup>7</sup>

The Soviet trade shock brought on a profound collapse of profits and profits taxes in Polish industry. The principal effect of the trade collapse was the sharp drop in the demand for exports from those enterprises with traditional links to the Soviet economy. The effect on the enterprise sector was broader, however, because real zloty input prices (for oil, natural gas, electricity, and iron ore) rose universally. This increase in input costs need not have been borne entirely by profits, for the real product wage could in principle have fallen to absorb part of the shock. But, as mentioned above, the real product wage rose sharply, and, as a result, enterprise profits and profits taxes declined sharply for much of the Polish state enterprise sector in 1991.<sup>8</sup>

Another feature of the transformation that lowered budget revenues was the sharp reduction in import tariffs that constituted part of the strategy to liberalize external trade. Tariff revenues fell in early 1990, fortunately coming at a

6. Consumer prices rose by 60 percent in 1991, while producer prices rose by 36 percent. The difference is accounted for by the sharp increase in the relative price of services.

7. For a description of trade developments with the former CMEA countries and an analysis of the quantification of trade between Poland and the Soviet Union, see Rodrik (chap. 18 in this volume).

8. For a detailed analysis of the effects of the CMEA collapse on Polish industry, see Berg and Sachs (1992).

time when the budget had been strengthened by the stabilization correction. The tariff system was revamped in July 1991, and tariffs were set at an average level of about 15 percent. Revenues in 1991 were 1.7 percent of GDP, down about 1/2-1 percent of GDP from the mid-1980s.

The privatization program, on the other hand, was expected to provide greater support for the budget. Little was expected from this source in 1990 because it was necessary to put privatization legislation through Parliament and design a privatization program before collecting revenues. The program was expected to be under way in 1991, however, so the 1991 budget included an estimate of Z1 15 trillion (about 1.5 percent of GDP) from privatization revenues. The privatization effort was intended to include many components, including initial public offerings (IPOs) and auctions of shares for individual enterprises, a mass privatization program to distribute ownership claims to the population via investment funds, and a sectoral privatization program aimed at the restructuring and sale of enterprises in key industrial sectors. The elements of the privatization effort that were expected to provide revenues for the state were the sale of enterprises through IPOs and auctions. In the end, these two elements turned out not to be practical avenues for privatization, and revenues turned out to be well below initial expectations.

### *Expenditures*

The most important change in the pattern of budget expenditures arising from the economic transformation is in the area of social safety net spending. Unemployment, virtually unknown in Poland before 1990, rose steadily after the program began in 1990. An extrabudgetary labor fund was created to administer an unemployment scheme and a job retraining and relocation program. The government initiated the unemployment scheme with high replacement rates (70 percent for the first three months), no time limitations on benefits, and broad eligibility criteria. In 1991, the expenditures of the labor fund rose to 1.4 percent of GDP, as the rate of unemployment rose to 12 percent by the end of the year (see app. table 11A.5).<sup>9</sup> Unemployment should decline over the course of the transformation, but, as in any market economy, frictional unemployment will remain, and an appropriate social insurance scheme must be maintained.

Social security benefits paid by the social insurance funds—sickness, maternity and family benefits, and pensions—also increased sharply. This resulted mainly because the government inherited from the Communist period a social

9. Group layoffs from state enterprises account for less than 25 percent of the registered unemployment in 1990 and 1991. The rise in registered unemployment was probably accelerated by the fact that the initial unemployment benefit scheme adopted in 1990 was generous and did not have as eligibility criteria that individuals were job leavers or were engaged in an active job search. In early 1992, the scheme was revised, benefit eligibility was limited, and the government began to strike individuals from the unemployment rolls (for further discussion of this subject, see Berg and Sachs 1992).

security system with comprehensive and universal benefits. In time, this system must be reformed to make it suitable to the conditions of a market economy and sustainable from a fiscal point of view. In the first two years of the economic transformation, however, the government attempted to maintain the comprehensiveness of the social security benefits carried over from the Communist period. Where real benefits had been allowed to erode through the lack of inflation adjustment, the government revalued benefit packages. Where the link of pensions to the average industrial wage had been allowed to slip, the government restored a stronger link. Expenditures of the two social insurance funds rose to 14.2 percent of GDP in 1991 from 10.7 percent of GDP in 1989. Rising public expectations about social insurance benefits have made it difficult to contain benefit levels and the scope and coverage of benefits.

### **11.3 The Budget in a Market Economy**

As Poland's market economy takes hold, the government will have to reassess its role in Polish economic life. There is a continuing demand for modern and effective public services. In addition, the social insurance system is facing mounting demands from many segments of the population asking for greater income support and social protection. As mentioned earlier, unemployment benefits will remain a permanent feature of Poland's market economy, even after the temporary budget burden of transitional unemployment has passed.

In addition, new demands for budget resources will arise from the need to overcome the heritage of the Communist system. To meet them, the government will have to reform its own administration and trim the size of the overstuffed civil service. At the same time, the government will have to revamp the civil service wage structure to overcome the heritage of egalitarianism and to attract qualified staff. In addition, the government will have to develop a public investment program to build a modern infrastructure, clean up the environment, and recapitalize the banking system.

To create a revenue base that will make all this possible, Poland will need to complete the ambitious tax reform agenda that has already been drawn up. Finally, the tax system will have to be supported by an improved system for budget finance that removes the dependency of the budget on banking system credit. The following subsections describe briefly these long-run imperatives of budgetary reform.

#### **11.3.1 The Public Investment Program**

To modernize its infrastructure, which at present is not adequate for a growing, capitalist economy, Poland must develop a public investment program. Billions of dollars of investment are required to upgrade transport and communications systems alone. In addition, the Communist economy produced extensive environmental degradation, which has led to adverse effects on health and the quality of natural resources. Estimates of the environmental cleanup costs

vary, but they range as high as the Ministry of Environment's estimate of \$260 billion.

The abundance of public investment needs and the shortage of budgetary resources mean that public investment criteria, now virtually absent, must be developed. The many potential projects must be evaluated and compared, and a selective public investment program must be drawn up that is based on a careful assessment of rates of return. In all likelihood, public investment expenditures in the state budget will have to rise from about 2 percent at present to 6–7 percent of GDP.<sup>10</sup> This range would not be atypical for a country with a similar income level (even ignoring Poland's particular environmental problems). The financial implications of boosting the level of public investment by this magnitude will be discussed in the section on budget finance. But it is clear that a sustained increase in public investment can be managed only by some combination of an improvement in government savings, domestic bond finance, and substantial recourse to external finance.

Unfortunately, Poland, like other countries in the region, does not have a tradition of a well-defined public investment program based on sound economic selection criteria. In the Communist past, investment expenditures in the state budget were devoted only in part to building infrastructure and more often to channeling resources to particular industries and sectors to finance enterprise investments. In fact, no distinction was drawn between the provision of public goods and private goods in the selection of state-funded investment. Moreover, when the state has chosen to fund investments, there have been no clear and acceptable procedures for the evaluation of the return on these investments. Interestingly, in 1990, when the new government considered which of the unfinished investment projects to complete, the only data available were the nominal amounts spent to date (without correction for inflation) and the total expenditures required for completion. No rate-of-return calculations were made at the outset, nor were calculations made regarding the return on project completion. In order to develop an effective public investment budget with an adequate spending level, the government must develop investment evaluation rules that are based on concepts of public goods provision and appropriate rate-of-return requirements.

### 11.3.2 Commercial Bank Rehabilitation

Poland will probably have to recapitalize some of its state commercial banks in order to privatize them. Attempts to privatize banks that do not have an adequate capital base may prove impossible and will certainly not lead to a strong banking system. Thus, recapitalization will have to come first. If this is carried out in connection with privatization, the budgetary contribution will

10. Public investment by local and municipal authorities amounted to about 1 percent of GDP in 1991. General government investment of 6–9 percent of GDP is in line with what is found in comparable developing countries.

not be wasted by a continuation of inappropriate state enterprise management.

The budgetary burden of the recapitalization is likely to be modest, but not inconsequential. The government is now in the process of preparing nine large state commercial banks for privatization. The banks have been audited, and estimates of bad loans in their portfolios range from 10 to 30 percent. Nonetheless, the financial position of the banks is still in flux because the underlying condition of the state enterprise borrowers has not stabilized. Thus, the market value of these banks is not yet known and will not be known until the large state enterprises are either closed or privatized. When the state commercial banks are privatized, some estimation of their market value will emerge, but in all likelihood certain banks will not have an adequate capital base to make privatization possible.

Recapitalization could take many forms, but one illustrative possibility would be to place government bonds at these banks to strengthen their assets positions. In this case, the annual budgetary effect of the recapitalization effort would be the interest burden of the bond placements. The domestic portfolio of the banking system stood at Z1 170 trillion at the end of 1991 (or about 18 percent of GDP). A recapitalization effort equivalent to only 10 percent of this portfolio would involve the placement of bonds of about 1.8 percent of GDP. The magnitude of the interest burden stemming from bond placements of a recapitalization would depend on interest rate developments. If stabilization efforts succeed in bringing the interest rate down to 25 percent per annum, the recapitalization could add Z1 4 trillion (or 1/2 percent of GDP) to budget expenditures.

### 11.3.3 Social Spending

Poland has begun to reform its social insurance system, which was designed during the Communist period and, thus, embodied the strong Communist preference for care for the social needs of all citizens. Polish society continues to place a high priority on the government's role in social support, but this priority must now be weighed against others. In the coming years, the government may want to shift its emphasis away from the "care" of social needs and toward the creation of "opportunities" for the Polish people. This will require less support in the form of social insurance and more support for education and the creation of human capital. Moreover, the development of the market economy will require that social insurance spending be sustainable from a fiscal point of view and be structured so as to minimize the disincentives and distortions for the population.

### 11.3.4 Tax Reform

Poland has begun a process of fundamental tax reform.<sup>11</sup> The reform has several aims. First, the new tax system will be less distortionary, mainly be-

11. For a more detailed discussion of tax reform issues, see Gordon (chap. 9 in this volume).

cause the selectivity and exemptions of the old tax system will be replaced by broadly based taxes. Second, the new tax rates and tax bases will be sufficient to generate the revenues needed to support an acceptable level of spending. This is of paramount importance in light of the many competing demands for government resources and the need to limit budget deficits to levels that can be financed in a noninflationary manner. Third, the new tax system will be more fair. Private and state enterprises will be treated alike, and all individuals' incomes will be treated uniformly under the personal income tax.

In brief, the taxes inherited from the Communist period will be replaced with several broadly based taxes modeled on Western tax systems. In January 1992, the government introduced a personal income tax, expected to raise about 5½ percent of GDP in revenues. A value-added tax has been designed to replace the selective turnover-tax system, but it has not yet been passed by Parliament because of political conflicts over the question of whether construction and agricultural value added should be exempt. In the meanwhile, the base for the turnover tax has been broadened as a stopgap measure. The reformed company profits tax is now comparable to those used in the West.

The authorities expect that the introduction of the new taxes will in time lead to a substantial recovery of tax revenues as a fraction of GDP. In the short run, however, there will be an inevitable loss of revenues, stemming from the difficulties of taxpayer education and tax administration.<sup>12</sup> The personal income tax administration relies on a system of estimated tax payments to collect revenues from the hundreds of thousands of new, private businesses. The procedures are unfamiliar in the Polish context and difficult to enforce.

### 11.3.5 Budget Finance

The main source of budget finance in Poland has been credit from the banking system, which has led for the most part to the monetization of budget deficits. An important goal of budget policy, therefore, will be to limit the reliance of the budget on the banking system to amounts of credit that are consistent with low rates of inflation, declining in time to European levels. Because the economic transformation relies so heavily on the maintenance of a stable macroeconomic climate, its success depends on giving the inflation goal top priority and shaping budget deficit targets accordingly.

At the end of 1991, high-powered money in the banking system amounted to Z1 89 trillion, or about \$8 billion. To bring the rate of inflation down toward European levels (or at least to the neighborhood of 10 percent per annum), high-powered money could be allowed to grow by about Z1 9 trillion, or about 1 percent of GDP, per year to accommodate the rise in nominal money de-

12. A recent journalistic account quoted the head of Poland's tax inspection office, who explained that he was "still trying to figure out all the ways that people can evade [the new personal income tax]. I don't think we will replenish the budget overnight. Germany has 11,000 tax inspectors, France has 16,000, and Poland has 1,524" (Battiatà 1992).

mand.<sup>13</sup> Setting the amount of banking system credit granted to the government with this limitation in mind will make the low inflation target attainable.

This does not imply that the budget deficit must be limited by the credit available from the banking system. In light of Poland's investment and environmental cleanup requirements and the need for improved public services and social insurance benefits, over the next several years the government may need to accept budget deficits that exceed the amount of credit from the banking system. The first step toward making this possible is to develop a domestic bond market.

To date, Poland does not have a functioning bond market. The government issued bonds in late 1989 as it attempted to reduce the inflationary effect of the budget deficit in preparation for the introduction of the Balcerowicz program. At that time, inflation was running at more than 20 percent per month, and there were great uncertainties about the government's ability to introduce a suitable economic program. The bonds carried very high yields to maturity (to improve their acceptability), and the government incorporated conversion options, under which the bonds could be used to buy assets in future privatizations and to pay future taxes. In the end, the bond sale amounted to only a small fraction of 1 percent of GDP, and the instruments did not provide a suitable basis for establishing a functioning domestic bond market. Since mid-1991, the central bank has begun to create a market for short-term Treasury bills that it auctions to commercial banks as an instrument for monetary absorption. Although this instrument represents an improvement in the management of monetary policy, its use has been limited, its term is four to twenty-six weeks, and the bills are held only by commercial banks.

It should be possible for the government to issue longer-term bonds—without conversion options or other novelties—that can be sold to the nonbank public and form the basis for a domestic bond market. This should be achievable, given the low initial level of domestic government debt and the lack of financial assets for the nonbank public (i.e., alternatives to savings deposits in state commercial banks). There should be little difficulty or fiscal risk in selling bonds equivalent to 1–2 percent of GDP per year, as is done in many other countries around the world. After all, provided that economic growth in Poland resumes at even a modest rate, borrowing on this scale would not lead to a rising debt-to-GDP ratio.

Budget finance could also be augmented from foreign funds. Uncertainties regarding Poland's economic prospects will probably continue to restrict access to commercial credits in the West in the coming years, and access will improve only gradually. Therefore, Poland's external borrowing strategy may have to focus on multilateral and bilateral official credits, such as World Bank

13. Of course, if inflation were brought down to a low level, the real demand for money might be somewhat higher and the base for the inflation tax greater.

loans to support sectoral adjustment efforts, the public investment program, and the environmental cleanup activities.

Quantitatively, the most important potential source of external finance may be export credits and credit guarantees from Western export credit agencies. Poland already has commitments from Western governments for credits exceeding \$8 billion, very little of which has been used to date. And it is likely that additional commitments could be secured from Western export credit agencies because of their desire to support the exports of their domestic companies. To date, there have been many obstacles to the utilization of export credits, including the reluctance of the government to guarantee state enterprise borrowing for projects of uncertain return. Moreover, few export credits have gone to support the budget because of the paucity of capital import requirements among the investment expenditures included in the state budget.

During the transition to a market economy, it should be possible to make much greater use of export credits for budget support. An ambitious public investment program would increase the scale of capital imports by the public sector. But more important, the government can channel to the budget much of the finance extended by export credit agencies in connection with nongovernment imports. The government can assist Polish enterprises in importing capital equipment from the West to obtain export credits but also require that a large portion of the imports be paid for by these enterprises out of their own funds. In essence, by not passing along foreign finance to Polish importers, the finance can be diverted to support the budget.

## **11.4 Targets for Budgetary Aggregates**

### **11.4.1 The Long Run**

An illustration of long-run budgetary targets can give an idea of the direction and magnitude of the budgetary changes still required in Poland over the coming decade. Of course, future policy choices and macroeconomic developments will have a direct bearing on the desirability of any particular budget target. Nonetheless, this subsection presents a view intended to take into account the many demands for budgetary resources and financing constraints facing the government.

First, it will be necessary to boost government revenues to the neighborhood of 30 percent of GDP (see table 11.2).<sup>14</sup> This level of revenues is lower than what was consistently collected by the state budget in the mid-1980s and

14. The numerical examples that follow refer to the state budget and exclude the extrabudgetary funds and local governments. It is presumed that the division of responsibilities between the state budget and the extrabudgetary funds and local governments is not changed again, that the extrabudgetary funds are placed on a self-sustaining basis, and that the local government budgets are balanced.

**Table 11.2** Poland: Budget Aggregates

	1991	Target Budget
Revenues	23.4	30.0
Current spending	24.9	27.0
Government saving	-1.5	3.0
Investment	1.9	6.0
Surplus (minus indicates deficit)	-3.3	-3.0

*Source:* Ministry of Finance, Warsaw.

*Note:* Figures given are percentage of GDP.

would represent a scaling back of government claims on the resources of the economy.<sup>15</sup> However, revenue levels of even 30 percent of GDP will represent a substantial recovery from the 1991 level of 23 percent of GDP. A recovery of revenues of this scale is necessary to support the expenditures that Poland will need to make. This should be possible once tax reform is complete and transitional losses have been overcome. Moreover, the intrusion of government via the tax system will be greatly reduced in comparison with the Communist period because tax reform will eliminate most of the arbitrariness and selectivity of the tax system.

Second, current expenditures will have to be kept to about 27 percent of GDP. This limit would represent a decline in expenditures of about 8 percent of GDP compared to the mid-1980s but is consistent with the reorientation of government activity away from subsidization and resource reallocation. The need to improve education and health services, to raise civil service salaries, and to reform social safety net programs will make this limit difficult to attain. On the other hand, this level would represent an increase in current spending of more than 2 percent of GDP in comparison with the compressed spending level experienced in 1991.

Achieving these targets for revenues and current expenditures would reverse the pattern of government dissaving that emerged in 1990 and 1991. The main reason to aim for government savings of about 3 percent of GDP is to provide the resources for an enhancement of public investment expenditures. If public investment is boosted to the neighborhood of 6 percent of GDP, half the amount could be financed by government saving and the rest by government borrowing. As argued above, the Polish government need not attempt strictly

15. Total revenues of the state budget averaged about 39 percent of GDP over the period 1983–86 and then declined to about 35 percent of GDP over the period 1987–88. To compare these data with the target proposed in the text, it is necessary to adjust for the fact that, in the 1980s, state budget revenues included certain funds that were collected by the state and then transferred to local governments. Beginning in 1991, local governments were allowed to retain revenues to cover local expenditures, and in that year these governments retained revenues of about 3½ percent of GDP.

to balance the budget in the next decade. There are limits, however, to the amount of budget finance that can be achieved in a noninflationary manner, and there are limits to the amount of public debt that can be taken on. It is reasonable that the government could run budget deficits of about 3 percent of GDP over the coming decade without adverse consequences. Domestic bank credit, domestic bond sales to the nonbank public, and foreign credits could each provide finance equivalent to about 1 percent of GDP.

#### 11.4.2 The Short Run

The transition to a sustainable budget position is proving difficult for Poland. As these difficulties stem from the nature of the transformation process, the Polish experience may be instructive for other countries attempting the transformation to a market economy.

For some years, revenues are likely to remain below an acceptable long-run target. The revenue base remains weak because the state sector remains in crisis and the private sector has not yet become the predominant force in many areas of the economy. And revenue collection remains weak because tax reform is not yet complete and will involve transitional revenue losses and because tax administration is still being improved.

Similarly, expenditures are difficult to control during the transition. Some of the remnants of the old system, such as subsidies, have not been fully jettisoned. Some elements of the economic transformation, such as the transitional surge in unemployment, place temporary burdens on the budget. And the population is eager for rapid improvements in public services and expanded social benefits.

In weighing budget choices during the transition, the government's financing constraints dictate what is an acceptable budget deficit. Budget financing must be guided by the stabilization objective because of the importance of a stable climate to nourish the new private sector. To create such a climate, the government will have to reduce domestic inflation toward European levels. As explained above, this will require limiting budgetary recourse to banking system credit to about 1 percent of GDP. There is some greater leeway in the areas of domestic bond finance and foreign finance in the short run. Domestic bond sales could probably reach 2 percent of GDP or so if a concerted effort were made to develop the instruments and the market.<sup>16</sup> Foreign finance could provide another 1–2 percent of GDP, combining what might be available from the IMF, the World Bank, and export credit agencies.

The 1992 draft budget has been at center stage in Poland's political arena for most of the first half of 1992. The government put forward a draft budget

16. Of course, domestic borrowing on this scale inevitably places pressure on the nongovernment sector, by depriving it of much of the available domestic financial savings and, thereby, bidding up interest rates. This pressure must be weighed against the transitional pressures limiting budget revenues and elevating budget expenditures.

calling for a deficit of 5 percent of GDP.<sup>17</sup> This deficit is near the upper bound of what might be financed in a noninflationary manner. For this reason, political attitudes toward the draft budget have proved to be a litmus test on Poland's anti-inflation program.

To reach its target, the government has proposed measures both to boost revenues and to curtail expenditures. Among the measures to boost revenues, the turnover tax has been extended to previously exempted goods, such as food, clothing, and construction materials. Modifications in social security contributions, some public-sector price increases, and the new personal income tax are also expected to play a positive role. Among the measures to curtail spending, the revaluation of pensions would be postponed, family allowances and disability pensions would be restricted, and housing subsidies to cooperatives would be cut.

To keep the deficit below 5 percent of GDP over the next two years will require emergency efforts to boost tax revenues by several percentage points of GDP from the low level of 23 percent of GDP collected in 1991. Tax revenues must be raised quickly toward the level that must be restored over the long run. Several options (beyond what is already being proposed by the government) might be considered.

One option is to introduce a value-added tax with an elevated tax rate for two years or so. The elevated rate would compensate in part for the transitional losses of switching from the turnover tax. Another option would be to tax the enterprise sector more heavily. The tax burden on this sector accounted for most of the fall in revenues in 1991, and it is doubtful that revenues can be substantially restored unless more revenues flow from the enterprise sector. Recent signs point to some recovery in production and to continued strong exports. Thus, it should be possible to restore in part the tax contribution of the enterprise sector, even though important segments of the state enterprise sector remain in crisis.

In the long run, the answer to the enterprise taxation question is to privatize and introduce a new company profits tax. In the short run, the *dividenda*, a tax on enterprise capital assets, could play a role. State-owned enterprises are prone to profits tax avoidance, which is less of a problem with a capital tax. The *dividenda* is unpopular and has been reduced, not increased, in the past two years, mainly because it cannot be evaded. The *dividenda* will be paid by healthy enterprises. Unhealthy enterprises that do not pay should suffer sanctions, in the form of either wage controls or outright intervention.

On the expenditure side, reducing the budget deficit will require an aggressive effort to eliminate or sharply reduce remaining subsidies. And social in-

17. The budget as presented does not take into account the implications of two decisions of Poland's constitutional tribunal invalidating limitations that had been placed on the growth of pensions and budgetary-sphere wages in the course of 1991. The effect of these decisions will oblige the government to make expenditures equivalent to at least 4 percent of GDP. At present, it remains unclear whether these expenditures will be made in 1992 or later.

surance benefits, health, pension, and education must be contained to a level consistent with a reasonable budget position, until the revenue system begins to perform adequately.

## 11.5 Conclusion

Poland faces the immense task of reorienting the role of government in the economy to support its emerging market economy. To facilitate this transition, the government will have to support allocative efficiency, invest in and supply public goods, and provide an appropriate social safety net. To play these new roles effectively will require sweeping tax reform, a reevaluation of spending programs, the development of a public investment program, a comprehensive privatization effort, and the development of improved techniques for budget finance. These tasks are being undertaken in the difficult environment of economic transformation. If Poland is to sweep away the remnants of the Communist fiscal system, it must shoulder the burden of the enduring costs of the Communist period (such as pollution, bankrupt banks and state enterprises, and inadequate infrastructure). This will prove a difficult agenda because, at the same time, Poland's government must fulfill its most important new function, to provide a stable macroeconomic environment.

## Appendix

**Table 11A.1 Poland: Budget Summary, 1987-91 (in percentage of GDP)**

	1987	1988	1989	1990	1991 (est.) <sup>a</sup>
Total revenue	34.3	35.6	29.7	32.5	22.8
Turnover tax	10.6	10.9	8.8	6.5	6.6
Profit tax	11.5	12.9	9.7	14.0	5.8
Other	12.1	11.9	11.2	12.0	10.4
Total expenditure	37.8	37.0	35.7	31.9	27.3
Wages, goods, services	12.9	12.4	13.4	14.7	12.2
Subsidies	15.4	16.0	12.5	7.1	3.7
Transfers to social funds	1.5	1.5	2.3	3.3	4.7
Investment	5.6	5.3	4.1	3.6	1.9
Other	2.5	1.8	3.3	3.2	4.7
State budget balance	-3.5	-1.4	-5.9	.6	-4.5
Extrabudgetary funds					
balance	2.7	1.4	-1.2	2.1	-.5
Local government balance	...	...	...	...	.5
General government:					
Revenue	48.2	49.0	41.8	44.6	37.4
Expenditures	49.0	49.1	48.9	41.9	41.8
Balance	-.8	-.0	-7.1	2.7	-4.4

(continued)

**Table 11A.1** (continued)

	1987	1988	1989	1990	1991 (est.) <sup>a</sup>
Financing	.8	.0	7.1	-2.7	4.4
Change in arrears	.0	.0	1.9	-.3	.9
Domestic banks	.0	.0	5.0	-2.6	4.4
Other domestic financing	.0	.0	.5	.1	.0
Foreign financing	.0	.0	-.3	-.7	-.1
Other	.8	.0	.0	.7	-.9

Sources: The 1991 *Statistical Yearbook of Poland* and the Ministry of Finance.

<sup>a</sup>Local government operations were excluded from the state budget for the first time in 1991. In 1991, local government revenues and expenditures amounted to 3.5 percent of GDP.

**Table 11A.2** Poland: Budget Revenue, 1987-91 (in percentage of GDP)

	1987	1988	1989	1990	1991 (est.) <sup>a</sup>
<i>Total revenue</i>	34.3	35.6	29.7	32.5	22.8
Tax revenue	31.5	33.4	26.0	30.2	20.6
Turnover tax	10.6	10.9	8.8	6.5	6.6
Profit tax	11.5	12.9	9.7	14.0	5.8
Dividends	.0	.0	1.7	2.1	1.2
Payroll tax	3.6	3.5	3.3	3.0	1.8
Excess wage tax	.3	.7	1.7	1.4	2.9
Foreign trade taxes	2.4	2.0	.0	.6	1.8
Other	3.0	3.4	.8	2.5	.5
Nontax revenue	2.8	2.2	3.7	2.4	2.2
Privatization	.0	.0	.0	.0	.2
Profit transfers	.5	.5	.7	1.6	.7
Other	2.2	1.7	3.0	.7	1.3
<i>Memorandum Items</i>					
Tax revenue	31.5	33.4	26.0	30.2	20.6
From socialized sector	29.3	31.0	23.6	28.1	20.0
From nonsocialized sector	2.2	2.4	2.5	2.1	.6

Sources: The 1991 *Statistical Yearbook of Poland* and the Ministry of Finance of Poland.

<sup>a</sup>Local government operations were excluded from the state budget for the first time in 1991. In 1991, local government revenues and expenditures amounted to 3.5 of GDP.

**Table 11A.3** Poland: Budget Expenditures, 1987-91 (in percentage of GDP)

	1987	1988	1989	1990	1991 (est.)
<i>Total expenditure</i>	37.8	37.0	35.7	31.9	27.3
Current expenditure	32.2	31.7	31.6	28.3	25.3
Science and culture	.6	.8	.7	.6	.9
Education	3.6	3.4	4.3	4.7	3.5
Health, sport, tourism	4.0	3.9	4.2	5.0	4.7
Administration	.8	.7	.8	.9	.7
Justice, police, defense	3.9	3.6	3.3	3.6	3.1

**Table 11A.3** (continued)

	1987	1988	1989	1990	1991 (est.)
Subsidies	15.9	16.0	12.5	7.1	3.7
Transfers to social funds	1.5	1.5	2.3	3.3	4.7
Financial costs	.1	.1	1.3	2.0	1.7
Other	1.8	1.7	2.0	1.2	2.4
Capital expenditure	5.6	5.3	4.1	3.6	1.9
<i>Memorandum items</i>					
Salaries	3.0	3.0	4.3	4.1	4.9

Sources: The 1991 *Statistical Yearbook of Poland* and the Ministry of Finance of Poland.

Note: Local government operations were excluded from the state budget for the first time in 1991. In 1991, local government revenues and expenditures amounted to 3.5 of GDP.

**Table 11A.4** Poland: Budget Subsidies, 1987-91 (in percentage of GDP)

	1987	1988	1989	1990	1991 (est.)
<i>Total subsidies</i>	15.9	16.0	12.5	7.1	3.7
Subsidies to the population	10.0	10.0	8.1	3.8	2.3
Foodstuffs	3.4	4.9	3.6	.2	.0
Meat products	.8	1.4	1.1	.0	.0
Dairy products	1.4	2.1	1.5	.2	...
Cereals	.9	.9	.5	.0	.0
Consumer goods	.7	.4	.2	.1	.1
Coal and coke	.7	.4	.2	.0	...
Private agriculture inputs	1.0	.9	.9	.2	.0
Passenger transportation	.8	.8	.9	.4	.3
Housing	3.6	2.5	2.4	2.7	1.7
Medicine (imported)	.3	.5	.1	.0	.0
Books	.0	.0	.0	.0	.0
Other subsidies to private agriculture	.1	.1	.1	.1	.1
Subsidies to enterprises	5.9	6.0	4.4	3.3	1.4
Inputs and transportation	1.0	1.1	3.2	1.5	.5
Coal	.9	1.0	3.2	1.5	...
Transfers of goods	.0	.0	.0	.0	...
Foreign trade	2.5	2.2	.2	.0	.0
Socialized agriculture	.6	.5	.2	.1	.0
Other subsidies to enterprises	1.0	.3	.1	.9	.6
The banking system	.0	1.2	.0	.0	.0
Other economic units	.8	.7	.6	.8	.3
Road maintenance	.4	.3	.3	.3	.0

Sources: The 1991 *Statistical Yearbook of Poland* and the Ministry of Finance of Poland.

**Table 11A.5** Poland: Operations of Extrabudgetary Funds, 1987-91 (in percentage of GDP)

	1987	1988	1989	1990	1991 (est.)
Total revenues	16.9	16.6	16.9	17.9	15.7
Direct revenues	13.9	13.4	12.0	12.1	11.0
Transfers from state budget	3.0	3.2	4.8	5.8	4.7
Social Insurance Fund	10.1	9.1	9.7	9.5	12.0
(of which transfers)	(.7)	(.7)	(1.3)	(1.5)	(2.4)
Social Insurance Fund for Farmers	.9	.9	1.1	1.4	1.6
(of which transfers)	(.7)	(.7)	(1.0)	(1.2)	(1.5)
State Labor Fund	.1	.1	.1	.8	1.3
(of which transfers)	(.1)	(.1)	(.1)	(.6)	(.8)
Central Fund for Development of Science and Technology <sup>a</sup>	1.2	1.4		1.4	...
(of which transfers)	(.0)	(.2)	(.1)	(.0)	
Foreign Debt Service Fund <sup>a</sup>	1.2	1.2	1.0	1.6	...
(of which transfers)	(.0)	(.0)	(.9)	(1.5)	
Export Development Fund <sup>a</sup>	.0	.0	1.0	1.3	...
(of which transfers)	(.0)	(.0)	(.0)	(.0)	
Other	3.1	3.9	2.9	2.0	.8
(of which transfers)	(1.5)	(1.5)	(1.5)	(1.1)	.0
Expenditures	14.2	15.2	18.1	15.8	16.2
Social Insurance Fund	8.3	8.4	9.7	8.5	12.4
Social Insurance Fund for Farmers	.9	.9	1.0	1.3	1.7
State Labor Fund	.1	.1	.1	.6	1.4
Central Fund for Development of Science and Technology <sup>a</sup>	.9	1.4		1.1	...
Foreign Debt Service Fund <sup>a</sup>	1.2	1.0	3.2	1.5	...
Export Development Fund <sup>a</sup>	.0	.0	.9	1.0	...
Other	2.8	3.5	2.2	1.9	.8
Balance	2.7	1.4	-1.2	2.1	-5
Social Insurance Fund	1.9	.7	-.1	1.0	-4
Social Insurance Fund for Farmers	.0	-.0	.1	.1	-.0
State Labor Fund	.0	.0	.0	.2	-.1
Central Fund for Development of Science and Technology <sup>a</sup>	.3	.0		.3	...
Foreign Debt Service Fund <sup>a</sup>	.1	.3	-2.1	.1	...
Export Development Fund <sup>a</sup>	.0	.0	.1	.3	...
Other	.4	.4	.7	.1	-.0

Sources: The 1991 *Statistical Yearbook of Poland* and the Ministry of Finance of Poland.

<sup>a</sup>Liquidated in 1991.

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## Comment Michael P. Dooley

The paper by Alain de Crombrughe and David Lipton provides a frontline account of the enormous difficulties faced by governments in transition economies. Their focus on the fiscal implications of the transition is consistent with the traditional view that monetary stability is necessary for the transition and that the fiscal deficit is the fundamental determinant of monetary growth.

The transitional “fiscal” problem is easy enough to identify, but I am less convinced that privatization and the reform of tax and spending programs are an adequate response to the problem. Although their paper provides a valuable description of a number of important determinants of the fiscal position, two factors stand out. On the revenue side, the inherited tax system relied heavily on a profits tax on state-owned enterprises. As the central government lost control over the enterprises, labor has protected its income in the face of falling output at the expense of profits. On the expenditure side, reduced spending on price supports and capital expenditures has been partially offset by rising expenditures for the social safety net.

The authors emphasize the positive role that privatization could play in dealing with the current situation. The revenues from privatization might help balance the budget in the short run, but, perhaps more important, private ownership would provide market discipline for wage demands. The importance of better corporate governance is underlined by the access of state-owned enterprises to credit. It is not hard to imagine that, once profits have been squeezed, labor might continue to press wage and employment demands, resulting in increased losses covered by borrowing from state-owned domestic banks.

The difficulty with privatization as a policy response to this dilemma is that it is hard to find a case where the pace of privatization is not much slower than expected. A part of the problem might be that the central government does not clearly own all the property rights that go along with the sale of a firm.

The enactment of a broadly based income or value-added tax is also a reasonable policy prescription, but like privatization one that takes considerable

time to yield the significant share of national income needed to match government expenditures. Thus, a significant amount of foreign assistance may be necessary in order to reduce the government's resort to the inflation tax.

In the interim, it may be necessary to recognize that workers in state-owned enterprises are government employees and that state-owned commercial banks are a part of the fiscal system. It seems obvious that some restraints must be placed on the economic behavior of these institutions during the transition.

## Discussion Summary

*Mark Schaffer* pointed out a puzzle in the Polish budget statistics. He noted that the payroll tax fell by over a third in 1991 even though real wages rose. *David Lipton* responded that the payroll tax is collected primarily from the state sector and that the number of state-sector employees fell in 1991. However, Lipton noted that the decline in workers can explain only a portion of the revenue collapse.

*Andrew Berg* asked whether the authors' reported revenue estimates for 1991 include arrears. Lipton did not know, but Schaffer said that a quick comparison of the numbers in the paper with the numbers in the *Polish Statistical Bulletin* suggests that the numbers in the paper are actual receipts. Schaffer added that there are substantial arrears associated with the excess wage tax.

*Kalman Mizsei* contrasted the "bad news" that the Polish government has had difficulty collecting taxes with the "good news" that government expenditure is less than 40 percent of GDP. He said that indirect taxes can be used to make up the temporary shortfall between expenditures and receipts. Mizsei said that such stopgap measures would be needed only for two years.

Lipton noted that the government will face difficulty restraining spending. He said that social benefits, which were pared back in 1991, could explode in 1992. The threat comes from a pair of constitutional tribunal decisions in which the 1991 cutbacks were declared unconstitutional. Lipton concluded that, if the government can hold the line on spending, then the remaining degree of freedom will be foreign official finance coming from the World Bank, the European Bank for Reconstruction and Development, and already committed but unutilized export credits. He said that the availability of these sources for one or two years might put Poland in a position where some of the longer-term adjustments to the budgetary position can take hold.

Lipton also discussed the government's labor policy. He said that, in negotiations with labor, the government should discuss the costs of the high real wage instead of publically acting as if Poland does not have a real wage problem. He suggested that the current government effort indirectly to lower the real wage with a nominal devaluation will fail because the policy was developed without the cooperation of labor.

Berg criticized the authors' proposal that the dividenda tax be used in the short run. Berg recommended that a higher payroll tax be used instead. He said that the dividenda tax is arbitrary because it depends on unreliable official measurements of each firm's capital stock.

Lipton defended the temporary dividenda tax. He noted that the dividenda tax is nondistortionary because it is based on an input that is fixed in the short run. Moreover, he emphasized that the healthy state enterprises are capable of paying the dividenda tax since they have a lot of financial resources at their disposal that they are carelessly spending on excess wage payments and other unnecessary expenditures.

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