

Conclusions for The Economic Policy

Despite the current cyclical economic upturn, Poland has not managed to narrow the gap between her and the EU15 in terms of employment and participation rates, although other countries in the CEE region have. Consequently, the Polish labour market of 2006 is in a similar position with respect to other EU member states to that of 2002. In all age groups the share of economically active and working people is much smaller, whereas unemployment is much higher.

Continued good economic performance in the forthcoming years is likely to bring Poland closer to the EU15, however, total and rapid convergence of social welfare levels will not be achieved without complex structural and institutional reforms. One factor which makes it easier to address these challenges is good economic situation. Hence, in the Conclusions, we focus on actions intended to bring rapid increase in labour productivity and wages and we complement them with the key tenets of a policy aimed to boost labour supply and employment in the long term.

Macroeconomic stabilisation policy, labour supply and demand

As demonstrated in Part I, for the last dozen years, the Polish labour market has been greatly impacted by macroeconomic shocks and economic fluctuations. In this respect, reallocation shocks have been of major importance as they lead to changes in the structure of labour supply and demand and made considerable structural maladjustments between expectations of new and restructured companies and labour supply. At the same time, the macroeconomic policy-mix pursued during that period exerted a mixed influence on the economy. Monetary policy resulted in the fall of inflation expectations, in the reduction and stabilisation of inflation at a low level, and – what comes with it – in the effective decrease in real exchange rates which in the long term should boost investment and create new jobs. Notwithstanding the above, the period of excessively restrictive monetary policy which took place at the beginning of this decade probably deepened (but not caused) the economic slowdown of 2001-2002, thus contributing to lasting unemployment hysteresis.

In general, the impact of monetary impulses on the labour market has not been as great as that of broadly understood fiscal policy. This is so because as much as the public sector deficit has been under control throughout the last dozen or so years and its fluctuations contributed only marginally to fluctuations of aggregate demand and output, it was permanent in nature and all fiscal impulses that we have identified – apart from one – had a negative effect on labour supply and employment. The main reason for the above state of things was the increase in social transfers to people in the economically productive age at times of downturn financed by the reduction of productive government expenditures or by the increase in deficit or debt. The first alternative could be observed in 1998-2000, when increased transfers were financed by the contraction of government investment, whereas the second – in 2001-2002, when the public finance balance, which had been left unreformed, deteriorated. Thus, it can be assumed that in both cases fiscal impulses had an adverse impact on the accumulation of capital, labour supply and employment.

The social policy model adopted in Poland determines above all the long-term trends which have been visible in the Polish labour market since the beginning of the 1990s. The arguments delivered in Part I, which further support the conclusions presented in the previous issue of *Employment in Poland*, prove that labour supply and employment have been at an invariably low level throughout the period of transformation in the economically productive age group of 55+ (and in some cases of 50+), who can only count on the easily available social transfers, including in particular early retirement and pre-retirement benefit schemes. Although in the conditions of improved economic performance employment increases and unemployment decreases for younger age groups, the oldest labour market participants – similarly to previous years – are highly inclined to withdraw from it earlier than in other European countries, including the NMS8. This means that the employment gap between Poland and the EU will not be bridged in the long term without a necessary review of the passive labour market policy directed at people in the immobile age, especially that other EU countries have seen far-reaching reforms in this respect which gradually increase the effective retirement age, irrespective of it presently being higher by 5-7 years than in Poland. The analysis of participation and employment trends among the elderly during the period of strong economic revival in 2003-2006 clearly confirmed the appropriateness of recommendations included in the previous issue of *Employment in Poland* which indicated that failure to implement reforms in the area of social transfers would lead to Poland being a country with one of the lowest employment rates in Europe. The moment that unemployment falls to its natural level, i.e. within the next 2-3 years given the current dynamics, companies are bound to face a firm supply barrier in the labour market resulting from an effective limitation of labour resources to people aged 55 and less. Consequently, total output generated by the economy as well as wealth of households will be lower, whereas wages of those in employment will have to be burdened with higher taxes which are indispensable to finance the extensive benefit system. In other words, early withdrawals from the labour market lead to, firstly, lower income from work for the young and prime-age populations (i.e. those bringing up children), and secondly, relatively lower retirement benefits for the elderly which are financed by levies imposed on the young generation of workers. If the average period of participation in the labour market in Poland was extended to match that typical for other EU countries, both the average amount of retirement benefit and the living standard of the elderly could be increased and the tax burden imposed on working households could be cut down. The latter would, in turn, open up new implementation opportunities for an effective pro-family policy and it would favour the increase of one of the lowest reproduction rates in Europe.

The above remarks prove that it should be a priority for macroeconomic policy to stabilise public finances above all through the re-shaping of the social policy so that a smaller flow of transfers would be directed to people in the pre-retirement age. In other words, it is necessary to reduce social expenditures in areas where they affect labour supply in an adverse manner, namely those which are intended to finance consumption of people in the economically productive age. In the long term, decreasing public expenditures would allow not only to reduce deficits, which would create better conditions for a flexible anticyclical fiscal policy and lead to increased public investment and productivity of government expenditures (e.g. on research and development), but also to lower taxes thus improving capital and labour supply. It seems that that it would be particularly justified to introduce mechanisms which lower taxes imposed on lowest-income workers (e.g. through higher tax relief for work related expenses) and pro-family allowances for young workers with children. The implementation of structural reforms in public finances would favour the pursuit of a neutral monetary policy. This aspect of the policy-mix requires particular attention so that past achievements consisting in relatively low interest rates, low inflation expectations and low inflation would be sustained. The social cost of disinflation including slightly higher unemployment in 2001-2002 has already been paid and therefore another increase in price dynamics would be a proof of extravagance. On the other hand, however, more attention and insight ought to be given to mechanisms of transmission of monetary impulses and of propagation of supply and demand shocks in the Polish economy in order to minimise the risk of overly restrictive or expansive monetary policy adopted in response to inappropriately identified aggregate disruptions. For exactly the same reasons, the coordination of fiscal and monetary policies should be strengthened to make Poland's accession to the Euro zone possible within a relatively short time horizon. This would, in turn, allow for a decrease in the market evaluation of risk and return on Polish T-bonds and – what comes with it – in real interest rates, which would positively affect investment and decrease the public debt servicing cost in Poland.

Investment, real convergence and international migration

In Part I, we have demonstrated that although the last between ten and twenty years were a period of rapid closing the development gap between Poland and the EU-15 countries, the average output growth rate was lower than that necessary to keep up with the other CEE group. In other words, although Poland has been developing at a relatively fast rate, if we look at the initial level of wealth, it becomes apparent that the Czech Republic, Slovenia, Hungary and particularly the Baltic states have been developing even faster thus improving their relative position with respect to Poland. Based on the above diagnosis, it can be claimed that the reason for such state of things was Poland's relatively lower growth dynamics of total production factor productivity which was partly due to the fact that the level of capital equipment of labour was initially lower in Poland than in the other NMS8 – relatively more industrialised and urbanised. Consequently, despite relatively low investment rates, the contribution of accumulation in Poland was greater than, for instance, in the Czech Republic, Hungary, Slovenia and Estonia. Nevertheless, even if we bear in mind these differences, the fact that Poland's average TFP growth rate in 1994-2006, which amounted to less than 4 per cent per year, was much lower than that of Slovakia (6 per cent) and the Baltic states (7-9 per cent), and marginally higher than that of countries which were considerably richer at the point of departure, such as Hungary, the Czech Republic and Slovenia (3-3.5 per cent), is bound to have substantial consequences on the overall assessment of Poland's economic potential. This is so because as much as in the short term increased capital accumulation or labour input per capita may lead to changes in the level of GDP per capita, it is exclusively the TFP dynamics that determines the real level of wealth in the long term. Hence, it is a priority for the economic policy to increase this dynamics by at least 2 percentage points annually. It should be emphasised at this point that, conversely to some occasionally voiced concerns, there is no choice between labour and growth. On the contrary, the popularly called non-employment economic growth, i.e. a situation where high labour productivity dynamics is obtained at the cost of increased unemployment, is only temporary as a response to economic slowdown. In medium term, it leads to increased return on capital which in turn entails an acceleration of investment and labour demand and – what comes with it – a decrease in unemployment. Such situation could be observed in Poland in 2000-2006. Therefore, the task of increasing the average productivity dynamics in the long term should be regarded as a challenge to improve the convergence rate of living standards between Poland and Western Europe. In the long term, higher TFP variation rate must lead to faster dynamics of equalizing the real wage levels in Poland and the UE15. As demonstrated in Part III, it is exactly differences in living standards and wage levels that constitute the primary motive for Polish international migration. Hence, the intensity of economic migration from Poland – including permanent migration – can only be curbed by way of closing the income gap between Poland and the other EU countries.

From the macroeconomic perspective, this means that the primary challenge for the national economic policy is to build a regulatory environment and infrastructure which would favour fast accumulation of physical and human capital as well as a dynamic increase in the productivity of the above two production factors. As for the regulatory framework, it is necessary to enhance privatisation, deregulate the economy and remove bureaucratic barriers inherited from the past wherever they hinder the opening and operation of businesses and especially investment. A number of independent rankings on economic freedom and competitiveness drawn up by different institutions indicate that in these respects Poland comes after most EU countries. Reservations are pronounced in particular with respect to the lengthiness of judiciary procedures, high cost and lengthiness of investment procedures, excessive state bureaucracy in business, including lengthy registration and firm setting up procedures, legislative inflation and overregulation, especially in tax law. The simplification of the regulatory framework, which hinders business activity and increases business costs, including in particular decreasing the number of procedures and shortening the time necessary to start investment (including construction and

infrastructure investment), is bound to increase the capital accumulation dynamics and labour demand. The successes of other CEE countries, especially of Slovakia and the Baltic states, in attracting foreign investment, as well as the example of Special Economic Zones operating in Poland allow for a conclusion that by commonly applying certain tax instruments, such as low and simple taxes on corporate income (since recently applicable also in Poland), accelerated amortisation and investment concessions (applied, for instance in Estonia), favour the accumulation of capital and the creation of new productive jobs. In this context, the role of the central government and local governments is essential, especially when it comes to constructing road and railway networks, developing land intended for investment and performing IT infrastructure – wherever they cannot be provided by the private sector, increasing outlays on research and innovations and increasing the quality of human capital.

As for the last of the above-mentioned tasks, our recommendations included in the previous issue of *Employment in Poland* remain fully valid. We stress the necessity of paying more attention than in the past to the development of young people's ability to think creatively and independently as well as to reason logically and we call for the promotion of science education and attempts at increasing the number of graduates with scientific and technical degrees. The increase in labour supply of engineers and scientists is particularly important, if we think about a model of long term development for Poland. It is the development of the innovation potential in Poland through modern and market-oriented research and development centres established by private companies that is expected to bring the highest returns in the future. As the gap between Poland and better-developed countries will be levelled out, the mechanism of growth based entirely on imitation and comparative benefits derived from lower labour costs will diminish. The development of R&D centres as well as of the highest-productivity sectors of the economy is conditioned on the one hand by appropriate tax regulations and infrastructure support on the part of the national and local authorities, and on the other, by sufficient labour supply of people with relevant qualifications. Since the consequences of the implementation or failure to implement reforms of the educational system in Poland will only become visible after many years, this problem should be considered now when the scale of deficiencies in this area has not fully come to light. It is worthwhile to consider the introduction of both a mandatory A-level examination in mathematics as well as preferential treatment of those secondary education graduates who decide to take scientific and technical university courses – one example of this attitude is the initiative of the city of Wrocław which has started a special assistance programme targeting this group of graduates.

Internal migration, work commuting, infrastructure and urbanisation

The analyses discussed in Part II devoted to regional labour markets provide an additional dimension to the discussion on the necessity of increasing the average economic growth rate as well as the labour productivity dynamics. We indicate that one indisputably positive phenomenon of the recent years is no increase in differentiation between voivodeships and poviats (and in some aspects even a marginal decrease) and the progressing modernisation and restructuring of agriculture which has been occurring throughout Poland (although with different intensity). At the same time, however, in a large number of subregions, there have been some barriers to productivity, especially to the productivity of industry, as well as to enterprise development. This fact places the permanence of the recent positive labour market developments in some subregions under a question mark. The absence of rapid labour productivity growth is particularly evident in peripheral areas located far from the largest urban centres, whereas the largest agglomerations – together with the surrounding areas – achieve relatively high growth dynamics in the above respect. It seems that although different levels of infrastructure and human capital are of great importance here, it is the mere benefits the metropolises bring that are the main differentiating factor, namely the existence of a large, compact market which allow companies to achieve the scale effect on their operations, including in particular access to the benefits of a large local labour market.

In international comparison, Poland distinguishes herself by low level of urbanisation and a small number – for a rather large and populous country in the European context – of large cities. What is more, the largest and most dynamic Polish agglomerations, such as Warsaw (1,700,000 inhabitants in the city / approx. 2.5 million in the entire agglomeration), Łódź (approx. 770,000 / 1.3 million), Kraków (approx. 757,000 / 1.5 million), Tricity (approx. 750,000 / 1 million), Wrocław (approx. 635,000 / 1 million) and Poznań (568,000 / 1 million) are relatively small not only in relation to the agglomerations of Paris (9.8 million), London (7.2 million) and Berlin (5.1 million) but also to those of Manchester (2.5 million), Hamburg (2.7 million) and Milan (4.3 million). Hence, compared with the other EU countries, a much smaller share of the Polish population lives not only in cities but above all in the largest urban agglomerations. Consequently, the growth potential of *Development centres* and of the surrounding *Suburbs* is smaller than it could be. This, in turn, undermines the development potential of the entire country the dispersed population of which can hardly benefit from the spill-over and diffusion effects of large agglomerations. In the context of the above analysis, we can conclude that the priorities of the social and economic policy should include extending support to the existing *Development centres* and enhancing factors that facilitate immigration from other, relatively poorer and peripheral regions to *Development centres*.

The research analysis presented in Part III persuades that the process of dynamic urbanisation in the conditions of rapid economic growth is largely natural. Internal migration, similarly to international migration, is clearly determined by economic factors and therefore, Poland's current acceleration of economic growth rate, especially in large urban centres, should be associated with the intensification of migration movements from the relatively less-developed areas, particularly from *Towns* and to some extent from regions from *Former state farms* and *Low-productivity agriculture*. These movements will be further reinforced by populous cohorts of young and

relatively well-educated people entering the labour market as these people are much more spatially and professionally mobile than the average population. This flow could possibly be relatively smaller due to the increased intensity of international migration in the recent period, which does not necessarily translate into decreased outflows from peripheral regions. However, even now, in all large agglomerations, one comes across considerable structural barriers which prevent rapid increases in the number of their populations, although they would in fact be of great benefit to these agglomerations and to the social and economic development of the entire country. The above-mentioned barriers have to do above all with the (non-)availability of accommodation – both for purchase or rent, and they result mainly from the absence of detailed spatial development plans, from low supply of land intended, for residential development for which local governments are responsible, as well as from lengthy investment procedures. Consequently, the number of residential construction projects and of delivered buildings is rather scarce. This situation should be remedied by both the central government (simplification of relevant regulations, strengthening of public services charged with state-financed construction) and by local and self-government authorities (spatial development plans, sale of land for development and of council flats to individuals). Another serious obstacle is the lack of economic incentives to build and offer accommodation for rent. In the latter case, the problem is the excessive protection of tenant interests in relation to that of real property owners. Consequently, some houses and flats remain unoccupied irrespective of the large market demand for residential premises, and some (especially those managed by districts) are rented at below market rates to people who are marginally involved in the labour market. In this context, it is worthwhile considering two possibilities: firstly, that of diminishing the extent of protection offered to tenants who fail to pay rent and other charges, and secondly, that of abandoning such protection in the case of newly-constructed flats intended for rent.

Since, as stressed in Part III, migrants are usually young people and internal migration largely depends on such factors as going to university in a different city, it seems that the process of urbanisation could also be enhanced by increasing access to university education in large urban centres to students from other regions. This could be achieved through increased numbers of full-time day students as well as of places available in halls of residence and student houses. Infrastructure deficiencies and financial problems faced by public universities are mainly due to the abolishing of cross-financing of day studies by extramural students. Remedies to these problems should be sought either in increased public expenditures on tertiary education or in greater co-financing by students themselves. Whatever the measures, they should aim to increase the accessibility of university studies in large urban centres, including the largest agglomerations, because the urbanisation process could thus be enhanced and Poland's dynamics of accumulation of human capital – which is currently one of the lowest in the EU – could be increased.

The removal of barriers which are at the root of insufficient supply of accommodation in *Development centres* and *Suburbs*, as well as the development and improvement of transport infrastructure (especially railways) to allow large numbers of people to commute to work relatively cheaply and quickly (up to 1 hour) from more distant areas, would surely boost rapid economic growth and wage levels not only at the local but also at the national level as a result of diffusion and spill-over effects. As for peripheral areas which are located too far from *Development centres* to commute – even with the best transport infrastructure, their key objective should consist above in developing the nearby *Towns*. If this condition is not met, it can hardly be expected that the gradual depopulation of these regions will be halted in the long term. Only if strong, attractive growth centres are created within such peripheral areas, positive outcomes can be achieved for the surrounding areas. As evidenced by the extent of positive impact exerted by the existing *Development centres*, in Poland, *poviats* can greatly benefit from the proximity of dynamically developing regions. Nevertheless, if such medium-size cities as Szczecin, Bydgoszcz and Toruń, Olsztyn, Białystok and Lublin were to take on the role of regional centres, it would be necessary for them to implement appropriate policies in the areas of investment and education and to focus on pro-development objectives rather than on increasing consumption and living standards of the current generation. This concerns in particular the use of EU structural funds, both those intended for the development and revitalisation of infrastructure as well as those meant to enhance the accumulation of human capital within regions. In the conditions of increased availability of such funds, or even of their relative excess, it is essential that they not only be spent but effectively channelled to support projects with high social and economic rates of return. This issue is of particular importance in the context of urban centres of relatively smaller populations which are not as attractive to investors as larger agglomerations.

Economic regulations, taxes and shadow economy

Another topic that we have looked into in this issue of *Employment in Poland* is unregistered work and non-observed economy. Although work in NOE has both positive and negative consequences for the economy, it seems that in the literature on the subject there prevails an opinion that the reduction of NOE by including parts of it in the official sector of the economy is generally justified from the economic point of view. This is so because companies operating in the shadow economy have much smaller potential development opportunities than companies operating in the official economy. They do not have access to external financing, they cannot insure their assets or use marketing services. What is more, they are not in the position to fully benefit from scale effects due to considerable diffusion of their businesses. As for workers engaging in undeclared work in companies which operate in the official economy, although they evade taxation, they are also excluded from most mechanisms which guarantee basic social security to people employed officially (e.g. paid annual holiday and maternity leaves, sick leaves, retirement and pension coverage, etc.).

Having analysed determinants of participation in unregistered employment, we indicate that the sources of non-observed economy should be sought not only in excessive state fiscalism but also in overly burdensome economic regulations which are in total disregard of social expectations. In other words, people engage in undeclared work in the first place when access to official employment is limited and in the second place when it is financially unattractive. In view of the above reasons, the only method to reduce the size of NOE is essentially by applying recommendations intended to improve the dynamics of economic growth and labour productivity, namely by eliminating bureaucratic barriers and cutting taxes. Moreover, the reduction of the shadow economy may be further enhanced, if law regulations are loosened wherever their rigorousness reaches levels which commonly induce entrepreneurs to conceal their businesses or to employ workers without registering them. The above pertains above all to labour law the liberalisation and tightening of which seems to decrease and increase the shadow economy respectively. By way of example, let us mention the obligations to register and complete tax returns when employing people to help in households and farms. In some cases, these obligations may constitute a greater barrier to official employment than the amount of tax itself. From a broader perspective, it can be stated that the promotion of more liberal forms of employment and the liberalisation of the labour code would be a great advantage to all companies which employ workers on an intermittent and irregular basis, in accordance with the fluctuating demand for their services or products (e.g. renovation teams, small-scale gastronomy, etc.).

For similar reasons, solutions which directly limit labour demand among lowest-wage workers should be replaced by solutions which increase such people's net wages without increasing the gross labour costs. In this context, high average tax rates, which effectively encourage low-productive workers to engage in unregistered work, are of particular significance. Thus, NOE can be reduced through, for instance, the introduction of a high revenue earning cost, which effectively increases tax progression right at the beginning of the tax scale without increasing the burden imposed on employers hiring low-productivity workers. From the economic perspective, the above solution is more viable than some suggested measures which limit employers' ability to adjust offered wages to the actual employee productivity levels. Of course, one condition which must be met in order to implement the above solution is the public finance reform and – what comes with it – a fiscal consolidation. As argued above, the reform of public finance which would involve a reduction of social transfers directed to people in the economically productive age, would have a strong pro-employment effect. If it was supported by concurrent changes in the tax system, its likely outcome would consist in the reduction of undeclared work and of NOE. Therefore, if the authorities implemented and pursued a coordinated macroeconomic and pro-development structural policy at the national level, it might be expected that both the number of people working in NOE as well as the output generated in the informal sector would be decreased without any loss in total output or employment.