New Europe Economic Dossier aims to provide a structural view on the evolution of the various countries in the region, highlighting the main achievements and the open challenges. Each issue is dedicated to a specific country and includes an analysis of the economic situation plus an interview to a leading figure for the future of the country. The dossier is edited by the New Europe Research Network of UniCredit.

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Poland: excellent results at the test to join europe

Before Poland's entry into the European Union in May of last year, many western observers were concerned that Polish industry would find it hard to compete with efficient western European producers who had more capital and better management at their disposal. Furthermore, Poland's budget would be burdened by contributions to the EU. Some even spoke of a negative "accession shock" for the new members states.

In the event, there was an accession shock for Poland, but it has turned out to be almost entirely positive. Polish firms have sharply increased their exports to the EU, as have Polish farmers. Unemployed Polish workers have found new jobs in western Europe, particularly in the three countries (Great Britain, Ireland and Sweden) which have not imposed restrictions on the free movement of labour. Looking at the wider picture, the growth gap between "New Europe" and "Old Europe" is expanding rather than diminishing.

Why were the pessimistic commentators so wrong? A major reason seems to have been their underestimation of the extent of the institutional change which has occurred in countries such as Poland since the fall of Communism. Commentators extrapolated from the experience of the "southern enlargement" of the 1980s, which included Greece, Spain and Portugal in the Union. These countries' institutional framework was indeed found to be lacking on accession. Commercial laws did not protect investors or creditors well, tax and licensing services were highly inefficient, and so on. And the countries of the Mediterranean enlargement did indeed suffer an economic slowdown after EU accession.

Commentators assumed that if the so-called "Club Med" countries had had such difficulties in adapting to the Union, the countries of the "eastern enlargement" would have far greater ones. After all, the eastern countries had two additional handicaps: they were much poorer relative to the EU average than the southern countries had been at the time of their accession, and they had spent four decades under Communism, which had devastated large areas of their human, social and physical capital.

At the fall of Communism, much of the legal and skills infrastructure of capitalism did not exist. Management under market conditions was completely unknown just 15 years ago. Whole professions necessary for the proper functioning of capitalism, such as that of judges in commercial courts or accountants (as opposed to bookkeepers) had simply disappeared. Property rights were often undefined, tax systems unsuited to an economy based on private property, and corruption was rife in the state administration. Finally, it was believed that Poland was littered with former communist enterprises which had the wrong capital stock in the wrong place and with a labour force unwilling to adopt western work practices.

What the pessimists did not take into account was that Poland (together with the rest of Central and Eastern Europe) underwent an institutional "retooling" during those 15 years which put it roughly on a par with the EU average in terms of institutional quality, and possibly somewhat ahead of the "Club Med" countries in this regard, not just as they had been at the time of their accession, but even as they are today. And just as the retooling of German industry after the War gave it a certain edge over its competitors, so Poland has been achieved institutions which are often better than those of some old member states.

The extent of the "institutional retooling" that Poland has undergone was also due to the EU requiring the accession countries (as they then were) to implement almost the whole of the so-called acquis communautaire of EU laws before they joined the Union. This was not the case with previous enlargements, and although resented at the time by some as an unfair additional burden it has, in the event, on balance significantly helped to upgrade Polish institutions. Indeed, Poland was one of 10 countries which improved its institutions most during 2003-4 according to the World Bank's *Doing Business 2005*.

We can see the impact of the institutional changes that have occurred in the country since the fall of Communism by looking at the World Bank ranking in *Doing Business*. Here we find that a new business can be set up much faster in Poland than in the Club Med countries (31 days vs. an average of 75 days) and even than in Germany (45 days). Labour market rigidities are lower than in almost all the old member states, excepting Belgium, Britain and Ireland. Even firings are easier than (or as easy as) in all the old member states excepting Belgium, Britain, Denmark and Ireland. Comparisons of a wider set of institutional indicators in Poland, the "core" EU, the United Kingdom and the countries of the "southern enlargement" is given in Table 1. As can be seen, for some Poland performs remarkably well, for others quite poorly.

Moreover, the relatively good quality of institutions is not limited to the direct (microeconomic) environment of business. Institutions aimed at ensuring macroeconomic stability have also performed quite well. This is particularly true of the independent central bank, but also of institutions determining fiscal policy. Poland, alone among EU member states, has a limit on its public debt/GDP ratio written into its Constitution (this ratio must not exceed the Maastricht reference value of 60% of GDP). While there was considerable concern two years ago that this limit might be breached, requiring massive cuts in public expenditure, this danger has receded, and it appears that Polish politicians may have learned their lesson not to sail too close to the wind. The presence of the constitutional limit has become all more important for Poland because of the far reaching softening of the EU's Stability and Growth Pact (SGP) which occurred in March of 2005. This means that Poland cannot rely on external fiscal discipline being enforced on it via the SGP.

Other dimensions along which Poland is quite well placed include corporate taxes, pensions, the banking sector and the level of education. The corporate and "entrepreneurial" tax rates are 19%, which has already induced a competitive response in Germany. The state pension system was reformed in the late nineteen nineties, so that it will be "funded" for all new entrants into the labour force, and some 2/3 of existing employees. This puts Poland (and Hungary which introduced a similar reform two years earlier) ahead of all other OECD countries, bar none.

In common with the bulk of central and eastern Europe (excluding the Commonwealth of Independent States) the banking sector has been almost entirely privatized through sale to foreign banks, which has largely transformed the efficiency of the sector. Again, only the UK has a similar, though still lower, ratio of participation by foreigners in its banking sector. An often used indicator of a country's human capital stock is given by the percentage of 20-24 year olds who have completed secondary education. In Poland the figure is 90%, com-

1.MACROECONOMIC DATA AND FORECASTS

	2003	2004f	2005f	2006f	2007f
Nominal GDP (million Zloty)	814.9	883.7	942.9	1,021.2	1,105.6
Real GDP yoy, (%)	3.8	5.3	4.6	5.2	5.0
Inflation (CPI) yoy, Dec (%)	1.7	4.4	1.5	3.3	3.0
Unemployment rate (%)	20.0	19.1	17.8	16.4	15.8
Exchange rate /eop	4.72	4.08	3.78	3.75	3.70
Interest rate (Basic), avg of Dec	5.25	6.50	5.50	6.00	5.25
Current Account/GDP (%)	-2.2	-1.5	-0.2	-1.1	-1.7
FDI/GDP (%)	2.0	2.5	3.2	3.9	4.6
Public Debt/GDP (%)	45;3	43.6	41.9	41.3	39.7
Budget Balance/GDP (%)	-4;0	-4.8	-3.8	-3.0	-2.3
Total External Debt/GDP (%)	45;2	47.7	37.9	35.7	34.0

* considering the Pension Found as part of the State sector
Sources: Central Bank, Central Statistical Office, Bank Pekao Research Division

pared to an EU 15 average of 72% and a “Club Med” average of 64%, and Polish pupils score highly on UN tests of average mathematical ability.

Studies have shown that catch-up by poorer countries with richer ones occurs within groups of countries which are sufficiently similar institutionally. As we have seen, the quality of Poland’s institutions is quite similar to that of the EU, so it should not come as a surprise that convergence is proceeding satisfactorily, and that far from inhibiting it, EU accession has facilitated the process.

European Union accession has the potential of accelerating growth in the whole Union through a better allocation of factors of production, which should flow to where they are most scarce. This involves an eastward flow of physical and financial capital and high quality institutions and a westward flow of labour and human capital. However, people with specific “market friendly” skills, such as management, will also move East. At present, some 300,000 OECD citizens are resident in Poland, a similar figure to the number of Polish citizens resident in other EU countries.

Understanding the centrality of such cross-border movements in the basic factors of production is essential if Europe is to achieve any of the goals of the Lisbon strategy. Countries which inhibit such reallocation by limiting the flow of labour, loose out on these gains. This may be particularly the case of Germany, which has the potential to be the biggest beneficiary of enlargement, but is depriving itself of the opportunity by severely limiting the flow of human capital from new member states. Germany’s gains from enlargement have therefore been limited to those flowing from the export of capital, capital goods and management skills (through FDI by German firms).

Much remains to be done in Poland in terms of improving the institutional framework for business activity. This is the best way for a poor country to achieve faster wage growth without undermining it competitiveness on world markets, and Polish authorities seem to be more aware than some in Western Europe of the importance of institutional competition between member states in the enlarged EU.

FACTORS OF INFRASTRUCTURAL COMPETITIVENESS

	Registering Property		Getting Credit	Protecting Investors	Enforcing Contracts		Closing a Business		
	Time (days)	Cost (% of property value)	Cost to create Collateral (% of income per capita)	Disclosure Index (the higher the better)	Time (days)	Cost (% of debt)	Time (years)	Cost (% of estate)	Net Recovery Rate (cents on the dollar)
United Kingdom	21.0	4.1	0.1	7.0	288.0	15.7	1,0	6.0	85.8
France, Germany, Italy	87.0	3.8	1.4	5.3	549.7	13.3	1,4	11.3	46.8
Greece, Portugal, Spain	43.7	9.4	17.0	5.7	213.3	14.8	1,8	8.0	66.3
Poland	204.0	1.6	1.2	4.0	1,000.0	8.7	1,4	18.0	68.2

Contrasto

Intervew with Danuta Huebner Regional policy commisioner

Some Western observers expected industries in Poland and in the other new Member states of the EU to have serious problems in facing competition from the more advanced incumbent members. How has the first year of Poland's membership gone in this regard?

Poland's first year in the EU has gone extremely well. Rising exports, a falling trade deficit and an appreciating zloty are hardly suggestive of problems with competitiveness. Of course, the Polish economy was largely exposed to competition well before accession – trade was mostly liberalised (with some exceptions for agrarian products). Still, the accession removed some barriers (certificates, custom borders, recognition of technical standards etc). This seems to have benefited Polish firms, perhaps in part because of the high share of SMEs, for which such barriers are of greater significance then for large Western firms. We have seen particularly large increases in exports to the EU of agricultural products, coal and steel, and metal products. Also worth noting – as the Ministry of Economy recently pointed out – is the rise in exports to other new EU Member states which joined at the same time as Poland.

There were fears that there would be quick consolidation and concentration on the Polish market, but this has not materialized – the number of SMEs has remained stable while, at the same time, their average size increased.

It is said that Poland's success in the EU so far is likely to lead to calls for a reduction in EU structural funds, which are mainly paid for by rich older members. As Regional Policy Commissioner how do you see this debate developing?

Yes, there is a debate. The Commission thinks there are solid grounds for an ambitious cohesion policy not only in new Member states but in the whole EU. In fact, those who call for a reduction in funding say they want to concentrate EU funds more on poorer, new Member states. But, in practice, if funds are cut, all countries are likely to suffer. In the longer term, I hope that Poland will be successful in using the funds and will therefore need less support in future. Meanwhile, there remains tremendous scope for EU funds to help promote real convergence between PL and the rest of the EU.

POLAND IS FAR FROM MAKING BEST USE OF ITS HUMAN RESOURCES. WE NEED TO FACILITATE LABOUR SUPPLY AND TACKLE DISINCENTIVES IN WAGE BARGAINING. THE CHALLENGE IS TO COMBINE RESTRUCTURING AND PRODUCTIVITY GROWTH WITH A RISING EMPLOYMENT RATE.

What are the main economic challenges facing Poland at present?

First, labour market performance. With only a little over half the working-age population actually working, Poland is far from making best use of its human resources. We need to facilitate labour supply and tackle disincentives in wage bargaining and tax/benefit system. The challenge is to combine restructuring and productivity growth with a rising employment rate.

Secondly, it will require determination to implement Poland's convergence programme under the framework of the Stability and Growth Pact – especially as far as reform of public finances is concerned. This is also essential from the point of view of co-financing the implementation of cohesion policy in Poland.

Another challenge I would particularly like to highlight is the need for Poland to put into place a coherent national development strategy for the 2007-2013 period, when it will become a major beneficiary of EU structural funds. I hope Poland will set an example of how the funds can be used to promote growth and employment.

Why do you think that, in contrast to other new Members states, FDI flows into Poland failed to pick up after accession?

Greenfield FDI has continued to increase, while FDI associated with privatization has fallen. A lack of progress on restructuring and privatization may be one factor, though of course privatisation tends to become more challenging after the most attractive enterprises have been floated. FDI as a whole does now seem to be picking up. In 2004, USD 7.86 billion of foreign capital flowed into Poland – a 23% increase over 2003 and the highest level since the record year of 2000.

You are on record as a defender of tax competition. Is tax competition really important for attracting business to Poland?
Tax policies are important. There are many different ideas around as regards the best model, and that might differ between countries. So I am a defender of tax competition in the sense that I believe we must avoid rigid harmonization. And no doubt there is room for improvement in Poland's tax system (e.g. transparency). However, let us be under no illusion that low corporate tax rates (or narrow tax bases) alone would do a great deal to attract business. Firms have to worry about profits before they worry about corporate taxes, and there are many other, more important factors – including infrastructure, the labour market, skills and the regulatory environment to name just a few.

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Do you think that the far reaching watering down of the Stability and Growth Pact in March was a good thing for Poland?
It is not correct to call it a far-reaching watering down. The reform of the SGP adds useful flexibility in places, while strengthening surveillance of fiscal policies and making the system more credible. Remember that, although many additional factors may now be taken into account, the additional margin for manoeuvre is rather small, temporary and still subject to the judgement of the Commission and the Council. 3% deficit and 60% debt remain the key thresholds. So, yes, it's good for the EU and good for Poland. One specific element is that Poland's pension reforms might be favourably taken into consideration when it comes to taking a decision on ending the current excessive deficit procedure.

Do you think Poland would benefit from early entry into the eurozone?
Poland is already benefiting enormously from the expectation that eurozone entry will occur, and from the improvements in the economic policy framework that have made this a realistic prospect. Poland will benefit from entry at the right time, when the well-known criteria on public finances, exchange rate stability, inflation and interest rates are satisfied. I hope that is sooner rather than later.