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Is Rapid, Long-term Economic Growth in Poland likely?

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Summary

There are good reasons to assume that in the longer term Poland's economic growth will be unimpressive at best. This pessimistic judgement, however, does not reflect a sceptical evaluation of Poland's potential, but rather an evaluation of the merits of the current international economic order. More particularly, it reflects a critical assessment of the perceptions dominating the economic policies of the EU and its major countries. ‘The Polish problem’ is part of a larger problem: the wrong course taken by the EU itself. That course, however, is consistent with the evolution of the global economy which began with the abolition of the Bretton Woods system. It is only to be hoped that at some time the current global trends will be reversed. *Alles ist moeglich.* Until then, however, growth in Poland - and in the EU – can be expected at best to be unspectacular.

Alles ist moeglich ('everything is possible') runs the slogan of the Austrian State lottery. In the same vein, rapid long-term economic growth in Poland is also possible, yet hardly probable.

1. Can something be learned from recent fast-growth experiences?

In recent decades, it has been only China and a number of south-east Asian countries that have continued to experience rapid growth. Controversy, however, rages over the nature of growth in that region. For the proponents of liberalism, Asia's success is indisputably the outcome of the large and ever-expanding scale of economic freedom. For many others, that self-same success has much more to do with active government involvement. Furthermore, Asian economic growth is quite often associated with a specific 'Asian' mentality. All in all, it is rather difficult to draw constructive conclusions from the Asian experience. An analysis of that experience would call for an extensive discussion of facts: a time-consuming and seldom constructive undertaking.

With an economy that has grown rapidly since the early 1990s, Ireland may seem a less problematic case. However, Ireland is a specific case. Lessons from the Irish experience can hardly apply to Poland. Ireland is a small country (with a population roughly equal to that of greater Warsaw) which - owing to its low corporate taxes - has become an international tax haven[1]. Ireland's performance cannot be replicated in Poland, if only because a single low-tax area in Europe fully meets the current needs of internationally mobile firms. Moreover, even if Poland were to outbid Ireland in terms of corporate income tax (currently levied at a rate of 12.5% on all activities, excepting manufacturing where it is 10%), the inflow of capital eager to take advantage of the lower Polish tax rate would - given the country's size - be relatively less significant. Furthermore, the 'old' EU would probably object to such a radical decrease in the tax rate. In any event, Poland would never be able to win the tax stakes in competition with much smaller accession states, such as Malta, Cyprus or Slovakia.

Other recent instances of rapid growth are far from encouraging. In the 1990s the boom in the United States was impressive, yet relatively short-lived. What is more, it saddled the private sector with gigantic debts which, according to reliable analyses, will ultimately give rise to grave problems.

Of course, in the search for principles suited to guiding Poland's rapid growth over the long term, one could take a step further back in time to the 'golden age' of capitalism (1950-70), when growth was rapid and stable, full employment was coupled with low inflation, public finances were balanced and public debt was very low (at least when compared to that of today). However, the events of that period bear little relevance to our day and age.

First, the international economic order at that time was entirely different. Under the Bretton Woods system, exchange rates were essentially fixed and capital flows were both regulated and restricted.

Secondly, although the volume of international trade actually grew more rapidly than in recent decades, the tariff and non-tariff 'barriers' to that trade, set up by sovereign states, were incomparably larger than today.

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[1] There is no denying, however, that Ireland made the best of capital inflows and EU transfers (e.g., by upgrading education).

Thirdly, industrial policies and public ownership were on a much larger scale than would be tolerated today.

2. EU membership has not produced miracles in the past

The future of the Polish economy must be seen in the context of Poland's entry into the EU. It is generally assumed that EU enlargement will be conducive to the acceleration of growth in 'old' and new member states alike. Many experts have quantified that assumption in numerous studies. In most instances, however, they would appear on closer scrutiny to have simply *postulated* higher growth rates under an 'accession scenario'. The reasons for the 'membership rent' being 2 percentage points – as opposed to zero percentage points - are never properly justified. In my opinion, there is every reason to believe that EU membership will not accelerate growth in Poland to any significant degree. This opinion is based on two facts related to EU performance:

1) Economic growth in the entire EU (and its earlier incarnations) has been quite anaemic - at least since the early 1980s.

2) On entering the EU, none of the low-income countries, except Ireland, recorded marked and sustained acceleration of growth[2]. Relative p.c. GDP in Greece declined for many years after the country's accession, while it grew very slowly in Spain and Portugal. More recently, growth in the low-income EU member countries has been only fractionally higher than in the EU core[3].

To date, EU membership has not brought about rapid and sustained real convergence of the low-income countries. Similarly, despite massive transfers, low-income regions in individual EU countries have frequently failed to catch up with their more affluent counterparts. The economic gap between southern and northern Italy has increased, while the gap between the eastern and western parts of Germany has hardly narrowed[4].

Thus, EU experience suggests that: (a) future EU growth rates will be rather low; (b) Poland's growth rate will - in the longer term - be close to that of the EU. Needless to say, these simple extrapolations of past regularities bear qualification, if only because the EU itself has undergone radical change.

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[2] In actual fact, convergence of Greece, Spain and Portugal slowed down *after* accession: 'Greece experienced much slower growth after joining the EU in 1981 than in the decades before'...'Spain's growth rate was not much affected by EU membership. Most of its catching-up with the EU core was achieved before accession'... 'Portugal's income had converged with the EU until 1974 when its growth was interrupted by the democratic revolution at home and the world economic crisis abroad'. (Dauderstaedt, 2001, see also Łaski and Roemisch, 2003). It is worth noting that Ireland's acceleration only took place in the 1990s. Ireland's membership did not bring about any acceleration during the first 15 years (1973-1989).

[3] Over the period 1992-2002 the average GDP growth rate was 2.4% in Greece, 2.3% in Portugal and in Spain 2.7%, while the EU-15 as a whole grew at a rate of 2%.

[4] In 1952 the p.c. GDP of southern Italy (Mezzogiorno) amounted to 64% of the p.c. GDP for the rest of the country. In 1999 that ratio stood at 54%. (Boltho, 2001). Convergence of the former GDR came to a halt around 1995. In the second half of the 1990s the GDP of the former GDR grew at 1.5% p.a.: a lower rate than in the former Federal Republic. In 1995 labour productivity in the former GDR was 36% lower than in the former Federal Republic; by 2001 the labour productivity gap had narrowed to 31.5 % (Ragnitz, 2001).

3. EU "deepening" is associated with growth slowdown

Following the radical changes in the 1990s, the common market became reality. The last remaining barriers to the free movement of capital (still enforced and actually applied in the early 1990s) have since been removed. At the same time, the scope of traditional industrial policies pursued by individual national states has been radically curbed. Broadening the range of private economic liberties has been associated with the restrictions imposed on national macro-economic policies (as epitomised first by the Maastricht Treaty and then by the Stability and Growth Pact).

Changes in the Union's mode of operation have not brought about any acceleration of growth. On the contrary, as is quite obvious now, those very changes have contributed to a slowdown in growth over recent years. The benefits of a huge common market, common regulatory institutions, common external trade policy, common monetary policy and common currency, as well as fiscal policy guided by a common set of rules, have proved an illusion. Admittedly, it is possible to claim that the EU economy is still in the process of adjusting to new conditions. Once that period of adjustment is over, the changes instituted would - so the argument goes - be capable of generating spectacular improvements in EU economic performance.

In my opinion, this is but another illusion. No butterfly is ever likely to emerge from that chrysalis. Growth in the EU will remain anaemic - and growth in Poland will hardly be any faster. If anything, things may well get worse: the reason being that some of the changes in the EU economic system have unleashed destructive tendencies that will be impossible to control, let alone reverse.

4. Liberalisation is coupled with counterproductive trends in wage and fiscal policies

Given the free movement of capital and a liberal foreign trade regime the national balance of labour and business interests is irreparably upset - with labour's position progressively weakening. International competition (real, though often still only potential) strengthens the position of business. Labour, successfully blackmailed, accepts unfavourable changes in terms of both wages and conditions of work (e.g. 'flexibilisation'). Naturally enough, high unemployment (which tends to be aggravated by unreasonable and usually untimely austerity of fiscal and monetary policies) helps the business sector to achieve its goals. Under such circumstances, the rise in labour productivity is no longer closely matched by a rise in real wages.

On the same principle, the business sector[5] extorts tax concessions from national governments. This gives rise to international tax competition. Naturally, tax competition is not restricted to taxes on profits. Taxes on personal incomes also become less progressive

[5] The term 'business' denotes firms of all kinds: both small and large, local and international, mobile and immobile. Large, mobile international firms are the main beneficiaries of the ongoing tax reforms. Small, local firms quite often lose out. Lowering tax rates tends to be combined with 'broadening' the tax base: in short, phasing out specific regulations and tax privileges that benefit small local firms. (See Devereux, Grifith and Klemm, 2002). Interestingly enough, the share of foreign firms in Ireland's corporate profits rose from 48.5% in 1990 to 90% in 1999. The share of wages in the Irish GDP fell from 60 to 50% over the same period. (See O'Hearn, 2001).

(‘flattened’). At the same time, pressure builds up to reduce the employers’ portion of the mandatory social security contributions (‘non-wage labour costs’). Overall, a drop in tax rates on corporate income contributes, via a diminishing share of public sector revenues in the GDP, to constant tensions in public finances. As a consequence, pressure builds up in favour of cutting public spending and social transfers (e.g. pensions).

From the macro-economic point of view, both tendencies (a drop in the share of labour share and a drop in the shares of public sector revenues and expenditures) have well-defined consequences:

First, the growth in domestic consumer demand weakens. This is a direct outcome of:

(a) A rise in the saving propensity in the private sector due to a falling share of wage income in the GDP and to a lower rate of progression of personal income tax;

b) Differentials in the impact of simultaneous cuts in both public taxation and spending (i.e. Haavelmo-type effects).

Secondly, overall GDP growth falls hostage to the foreign business climate. The dependence of national economies on the international business climate, however, reinforces the pressure to cut costs at home. This, in turn, reinforces the tendency for labour productivity to outpace real wages. At the same time, it intensifies the outsourcing of certain segments of labour-intensive production to low-wage countries.

Thirdly, subordination of domestic wage policy to the needs of external competitiveness hits the domestic demand for services (e.g. housing) which are not internationally tradable and hence need not compete on the world market. (Restraints on wages in the tradable sector cannot be effective without corresponding restraints on wages in the service sector). In fact, since non-tradable services account for the lion's share of the overall private consumption, the stagnation of demand for those services - which is a by-product of increased external competitiveness - ultimately depresses overall GDP growth and employment.

5. Germany: a paragon of "bad dynamics"

The economic performance of Germany is a paragon of ‘bad dynamics’ set in motion by misguided wage and fiscal policies. The systematic decline of the share of wages in the GDP, coupled with cuts in public sector spending and taxation, pushed the German economy into its current stagnation (starting in 2001)[6]. In international terms, however, the German economy is unrivalled - as evidenced by its gigantic trade surpluses[7]. This does not reduce German paranoia over the country’s loss of competitiveness which underlies further ‘reforms’ aimed at further cuts in costs (i.e. in wages and the employers’ share in their employees' social security contributions). Certainly, Germany's aggressive policy cannot be a matter of indifference to its EU partners: German economic aggression will be resisted. Other EU

[6] The share of wages in the German GDP fell from 56.8% in 1992 to 53.6% in 2002. The GDP share of public sector expenditure fell, over the same period, from 63.7% to 57%, and the share of public sector revenues from 59% to 53.3%.

[7] In 1994 (earlier statistics refer only to foreign trade of the former Federal Republic) the German trade surplus was € 39 billion (about 2.2% of the GDP). By 2002 that surplus had risen to € 126 billion (6% of the GDP). Surplus on foreign trade trade in goods and services (national accounts) was a ‘mere’ € 83 billion in 2002 - equivalent to 4% of Germany’s GDP.

countries will be compelled to subordinate their wage and fiscal policies to the requirements of international competition - with predictable consequences for employment and overall GDP growth. Ultimately, ‘bad dynamics’ is becoming a typical feature of the whole EU economy. The ‘German disease’ has already proven highly contagious. Its clearest symptoms are to be observed in Slovakia. Poland is catching it too. The corporate income tax rate in Poland has been systematically reduced (to 19% at present) and the idea of a flat tax on personal incomes has been haunting the public debate. One Polish government after another has dismantled successive legal provisions restricting labour market ‘flexibility’. The battle over the reduction of non-wage labour costs is as intense as in Germany. And all this has occurred while increases in real wages trail far behind impressive increases in labour productivity.

6. Can Poland compete with China?

For many years now, Poland has followed (and sometimes even led) the general trends set in Germany. In actual fact, Poland does not have any alternative. Firms operating in Poland will succeed in their demands for still more cuts in taxes and non-wage costs (by threatening to pull out of the country). Of course, this will further weaken domestic demand and make the growth of GDP (and profits) dependent on the international market. On that market, however, domestic products will not only have to compete with products from other EU countries, but they will also have to compete with standard goods produced in other countries, such as China, where labour costs are but a fraction of those in Poland.

Theoretically, withstanding Chinese competition would require that wages be reduced to Chinese levels: a dramatic absolute cut in real wages. Of course, in such a situation, domestic demand for both tradable goods and services would have to decline correspondingly. In effect, GDP would fall, not rise.

7. Ukraine, Romania and Bulgaria are becoming more attractive than Poland

This apocalyptic vision of future developments can, of course, be disputed; for instance, by factoring in transportation costs which can afford protection to at least some segments of domestic manufacturing. In the long term, however, transportation costs are also likely to drop. Secondly, it can be argued that Polish wage levels are still much lower than those in the ‘old’ EU. This factor should thus be conducive to shifting production from the ‘old’ EU to Poland rather than to still more exotic and remote countries in Asia where labour skills may still be a little bit lower. This trend has undeniably been set in motion. However, the importance accorded it would appear exaggerated - if only because wage levels in the Ukraine, Romania and Bulgaria are even lower than in Poland. It would thus make more sense to shift production to those countries rather than to Poland in the first place.

Once again, as the labour skills improve in extremely cheap locations, there will be no reason (other than transport costs) to locate standard goods manufacture in Poland rather than in the Ukraine or Asia. At the time of writing, a number of foreign firms which settled only a couple of years ago in Hungary are already relocating to Asia and/or Romania. Moreover, in the ultimate analysis the overall cost-to-benefit ratio of foreign direct investment in low-wage locations need not always be positive. Foreign investment may raise the GDP, but not necessarily the national income. This is borne out by the current experience of Hungary and the Czech Republic where large proportions the profits generated by foreign-owned firms are repatriated[8].

8. The likelihood of Poland becoming a technological leader

These unfavourable tendencies can perhaps be offset, if domestic firms using local labour with specific skills and producing non-standard ('hard to imitate'), high-value-added goods were to emerge on a large scale. In other words, a desirable development would be the emergence, on a massive scale, of firms that enjoy oligopolistic positions internationally, yet depend heavily on local suppliers and local human capital. Such a development is contingent upon the proper promotion of science, technology and education: areas that have been grossly neglected in Poland[9].

Intensification of R&D activities does not, of itself, guarantee much, all the more so as an outflow of the best ideas and most creative personnel can be expected to follow in its wake. Besides, it would be necessary to create conditions conducive to the 'incubation' of firms capable of reaping rents on international market. Incubation is, admittedly, a costly, complex and risky process. In the initial stages of the process, prospective firms should perhaps be given a chance to earn rents on the domestic market. There is, however, no quick or simple answer or generally applicable solution to achieving that aim. In any case, whereas protecting prospective firms was permissible in the era of national industrial policies, it would hardly be tolerated in the EU today. (This holds all the more true for a large country such as Poland where, unlike smaller countries such as Finland or Estonia, it would not suffice to support just a couple of 'flagship firms').

9. Maintenance of price competitiveness may require own currency

In more realistic terms, not too much attention should be paid to Poland's hypothetical metamorphosis from a country dominated by solid traditional activities into a nation on the cutting edge of technology penetrating foreign markets with unique high-value-added products. Needless to say, domestic products will undergo constant improvement and sell at better prices, but essentially they will continue to be primarily exposed to price competition. In this context, it is useful to reflect on an eventual adoption of the euro.

In assessing the wisdom of giving up the national currency, a good starting point is Poland's experience over the past 15 years; it has shown that the Polish economy is highly susceptible to shifts in the exchange rate. Real depreciation of the zloty helped to restrict both the trade and current account deficits thus supporting an overall acceleration in growth, while real appreciation tended to have the opposite effect. To all intents and purposes, it is quite reasonable to expect this regularity to prevail in the foreseeable future.

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[8] The same applies to Ireland where national income is about 20% lower than the GDP.

[9] R&D expenditures in Poland are miserably low (0.7% of GDP in 2000) in comparison to the developed countries (e.g. 2.5% in Germany). In real (at purchasing power parities) per capita terms, R&D expenditures are some 10 times higher in Germany and about twice as high in the Czech Republic.

Adoption of the euro would thus deprive the Polish economy of the possibility of adjusting relatively painlessly to unfavourable developments in foreign trade. In particular, it would no longer be possible to weaken the national currency and so correct a decline in the external competitiveness of traditional products (or have it correct itself): something which cannot be ruled out. The inevitable outcome would be a relatively deep and protracted recession.

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