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Fiscal Policy in Poland from Perspective of the EU Member State

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Summary

Fiscal policy in Poland faces challenges both in the view of the critical position of public finance in the recent years and the UE accession. The Polish economy performance in the Union, when assessed from the perspective of the participation in the euro area, requires not only the fulfilment of the nominal convergence criteria as expected but, first of all, the real convergence.

Fiscal policy evolution in Poland should aim at its more intensive use in the stable economic growth management at the introductory stage, preceding the entry to the monetary union as well as, and even more, after becoming its member – in addition to common, supranational monetary policies. This evolution parallel to the accomplishment of the economy's transformation at the macro and micro level would also determine an optimal speed of the country's inclusion into the successive, ever more advanced forms of integration.

1. Fiscal Versus Macroeconomic Policy

Fiscal policy is one of the main components of macroeconomic policy. By the same, its aims and tasks have been considered in the double context. Firstly, it is the core of fiscal policy as such, secondly, its consistency with the monetary policy. In the case of the conutry's accession to the economic and finally also to the monetary union, it is the second approach which requires an evolutionary treatment of the fiscal policy role. After the introductory period of derogation in the monetary union membership, it is just the national fiscal policy task to overtake the responsibility for the country's stable economic growth within the euro area.

1.1 Fiscal Policy Aims and Tasks

The core of fiscal policy are the government decisions on the size of public expenditure and its financing by taxes, loans or money issue. More specifically, this policy is shaped by the choices to what extent public finance is expected to fulfil its traditional functions – allocative, distributive and stabilizing. The indicators of the fulfilment of these particular functions have been, respectively, the effectiveness of the use of resources, equality in income distribution and smoothing the changes in the rate of economic growth. The transmission of these functions to stable growth management finds its way in theory and empirical studies. The results of theoretical analyses have been different depending on the concepts of functioning of the mechanisms of economic stabilization and growth according to the different schools of economic thought.

In fuller Keynesian approach, IS-LM model, negative multiplier effects of fiscal consolidation are partially offset by the lower domestic real interest rates and currency depreciation (McDermont and Wescott, 1996: 728-729). In the currently dominating neoclassical growth theory fiscal policy does not affect the economic growth in the long run. The main trade-off in this policy has been between stabilizing the output and distortions in the economic performance due to tax policy and public expenditure (Blanchard, Fischer, 1994). Reducing public finance deficits puts in motion additional mechanisms of transmission through an increase of private sector's wealth and expectations; and these mechanisms may dominate negative Keynesian multiplier effects on demand and economic activity.

Tanzi and Zee (1997), invoking the recently ever more popular in the world of science – endogenic growth theory, point out that fiscal policy might and should play its role both in macroeconomic instability reductions in the short run and promotion of economic growth in the long run, mainly through increasing neutrality of taxation, human capital accumulation and diminishing income inequalities. The authors came to these conclusions on the base of the comprehensive literature review, covering also empirical studies on the major aspects of fiscal policy impact on economic growth.

The results of these studies show, *inter alia*, that the relationship between taxation and growth appears to be much weaker than expected by theory. Plainly remarkable has only been a negative impact of the often changes of the tax system increasing the uncertainty of investment and, by the same token, affecting it negatively „ ... if the optimal tax regime changes from one period to the next, there would be uncertainty as to whether the government would maintain the same regime over time" (Tanzi and Zee, 1997: 193). There is also a significant and negative correlation between growth and uncertainy about the levels of public revenue, expenditure and budget deficits.

Public expenditure may affect growth more by its structure than its level – through the private sector productivity improvement (public good effect). In endogenic growth theory the attention has been focused on public infrastructure i.e. public services supplementing the private sector performance. The particular role is assigned to R & D expenditure improving human capital[1]. However, the empirical evidence does not lead to unanimous conclusions on public expenditure effects on productivity of the private sector. A positive example in this respect of the extremely advantageous influence of public expenditure on infrastructure on the private sector productivity brings i.a.the analysis of the US economy performance (Tanzi and Zee, 1997: 190).

A controversial issue is also the relationship between income distribution and economic growth. Traditionally, income distribution aiming at its equalization leads to a loss of aggregate output. This loss might eventually dominate the advantages of the reduction in income inequality. (In a dynamic approach – it is the increasing marginal cost in the form of the output increase lost as the consequence of taxation impact on reducing savings of the wealthier social groups). However, Tanzi and Zee (1997: 197-199) point to the controversial validity of this opinion in the light of several strands of research.

One of them argues that redistributive taxation and the expenditure that it finances are a form of social insurance over an economic agent's lifetime against certain types of risk for

[1] In assessing the impact of public expenditure on productivity in the private sector three aspects of this influence should be underlined i.e. necessity to finance these expenditure – reducing pivate savings, the rate by which

which private insurance is not available. Redistributive income policies may then stimulate risk taking and the output growth although it unnecessarily leads to greater equality in the after-tax income distribution.

Another strand underlines the importance of different aspects of financial market imperfections for economic growth. The aim of redistributive income policies would be then to increaase incomes of the poor individuals beyond a certain threshold, enabling them to contribute to the output growth. Such policy could substitute a perfect but, in fact, non-existing financial market in its role of the loan supplier against the future earnings of the poor members of society.

The still another strand of literature does concentrate on an idea that income distribution does affect political outcomes and policy through the voting process. Representatives of this strand referring to the standard median-voter theorem point out that the greater inequality in income, the higher will be the voted level of taxation. „A poorer median voter faces a lower tax price of public expenditure than a richer one" (Tanzi and Zee, 1997: 199). Major income inequality may then result in a stronger increase in taxation and its negative consequences for economic growth.

An assessment of fiscal policy impact on stable economic growth is even more complex when considered in terms of the public sector constraint as safe macroeconomically and with the view of the interactions of fiscal and monetary policies along their impact on the rate and the path of economic development.

According to conventional wisdom, a most synthetic determinant of public sector equilibrium in the long run has been intertemporary budget constraint (the sum of the discounted future primary budget surpluses should be equal to the current public debt) (Blanchard and Fischer, 1994). Of fundamental importance would then be fiscal discipline reflected in the adequate primary surpluses attained in the successive years. The desired level of these surpluses would be the lower, the lower is the value of the real interest rate in public debt service above the real rate of economic growth. One of the synthetic measures of the state budget creditworthiness is also its net wealth. This measure is the sum of the public debt ratio to the GDP, the ratio of the primary public sector surplus/deficit to the GDP discounted by the interest rate (the difference between the real interest rate in public debt service and the rate of real economic growth) and measurable Treasury wealth, i.e. offcial currency reserves (Guidotti, Kumar, 1991: 12-13).

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improvement of productivity in the private sector stimulates private savings and complementarity and substitutability of public and private expenditure (Tanzi and Zee, 1997, p. 188-189)

1.2 Fiscal and Monetary Policy

The best relative efficiency of fiscal and monetary policies with perfect international capital mobility and depending on the exchange rate regime is given by Mundell-Fleming model. With the fixed exchange rate, the balance of payments management is assigned to monetary policy, while fiscal policy should be focused on the internal equilibrium. Under float the roles of these both policies are reversed. Monetary policy appears to be more efficient for stable economic growth, whereas fiscal policy becomes responsible to a larger extent for the balance of payments. Tightening fiscal policy increases domestic savings and would lower the domestic real interest rate and generate real currency depreciation. This would lead to the growth of domestic investment on the one side and to an improvement of the current account balance on the other side as a result of reduced domestic demand and the weaker exchange rate. However, such results do not likely appear and usually they do not appear in the case of higher risk of investment in a given country. A fiscal consolidation contributes to a reduction of the risk premium and domestic currency appreciation. Such a trend would be generated according to the predictions of portfolio balance models with the effects of the stock-flow implications of the initial current account imbalance. A permanent fiscal consolidation will imply a permanent increase in net foreign assets and an appreciation of the long-run real exchange rate (MacDonald, 1997: 9).

In a parallel strand of theoretical analysis – the impact of changes in fiscal policy on the real equilibrium exchange rate - it is assumed generally that an increase in public expenditure directed mainly to non-tradables would increase their relative price in terms of tradables and thus appreciate the real equilibrium exchange rate.

This hypothesis has been questioned, *inter alia*, by Balvers and Bergstrand (2002). They analyze the implications of the differences in public expenditure between countries for the real equilibrium exchange rate with a model of two countries' representative consumers' behavior. They find out the relationship among the real exchange rate, relative private and public consumption per capita, and the relative output of tradables and non-tradables.They extend Frankel and Razin (1996) analysis of the relationship between government expenditure and the real exchange rates. In their approach, government spending influences the private sector and the real exchange rate essentially through two channels. These are: the resource withdrawal – of the impact similar to negative supply shock with its final effects depending on the share of tradables and non-tradables in government consumption, and consumption-tilting – which depends upon the characteristics of the utility function (complementarity versus substitutability between private consumption and government consumption). Empirical evidence for a group of the OECD countries comparative to the United States presented by Balvers and Bergstrand confirms that government spending influences the real equilibrium exchange rate in the medium term through both these channels with the impact being approximately equal, whereas private and public consumption are complements in utility (Balvers and Bergstrand, 2002: 2,3)[2]. Thus, changes in public spending should be neutral for the real equilibrium exchange rate.

The validity of the hypothesis on the major impact of public expenditure on the real exchange rate through the relative price changes of non-tradables in transition countries has not been confirmed, *inter alia*, by the analysis of Egert and Lahreche-Revil (2003). The authors perceive the likely causes of this in the considerable reduction in public expenditure in these countries. This has resulted in restraining public expenditure mainly to the remunerations of public administration reflected in households' consumption (p.20).

The implications of fiscal policy for the balance of payments are also controversial. These controversies concentrate on generating net savings in the public sector and in the private sector, and on the mutual relationship (substitutability versus complementarity) between the increase or reduction of net savings in each sector against the other.

The one extreme view belongs to the economists of the New School of Cambridge from 1970's. According to them, the private sector would be totally neutral in this respect[3]. Opposed to this view is the Ricardian equivalence principle of the public debt and of the private sector obligations and, going in line with it, the concept of the neutral public debt of Barro (Buiter, 1979: 1-2). Between them one may find less extreme, eclectic standings.

At the background of the discussion there is the concept of the twin deficits – in the public sector and in the balance of payment current account. The relationship between the both deficits could be traced, *inter alia*, in the changes of domestic absorption implied by the changes of the public sector deficit or in the likely increase in the interest rates generated by the public sector borrowing requirements and influencing also domestic currency appreciation. The dominating impact of the one or another of these trends will depend, *inter alia*, on money supply increase. These relationships as explaining the similar direction of the changes of the twin deficits in Poland are invoked by Lipiński (1999: 37-49). However, he and also Orłowski (1999) doubt in a closer relationship between the twin deficits in Poland, if

[2] Also Karras (1994) on the basis of empirical evidence ascertains the complementarity of public and private consumption.

understood as attainment of zero balance in the current account through the elimination of the fiscal deficit. Indeed, considerable capital requirements relative to potential domestic savings in the majority of countries in transition, with Poland being included, would rather contradict the hypothesis about the fiscal consolidation as leading to a major improvement in the balance of payments current account[4].

Optimal monetary and fiscal policy mix is also not free of controversions. Different views refer, firstly, to the role of fiscal policy and its influence on the economy as it was mentioned above and, secondly, to the rules of monetary policy – taking into account the real GDP and unemployment, next to the fundamental inflation target. The proponents of the inflation target - as the only rule in monetary policy - perceive the role of fiscal policy mainly in its impact on economic agents on the supply side (e.g. changes in the marginal rax rates or in different rules governing the public sector). According to the advocates of conducting monetary policy also with regard to the real variables (Taylor, 1997), fiscal policy supplements monetary policy in its influence on the real GDP mainly through the automactic stabilizers, changes in tax revenue and expenditure on compensations for the unemployed.

In the case of monetary policy reduced only to the inflation target, it is possible to compensate such a „crippled" policy with the increased activity (discretionary actions) in fiscal policy. However, its changes have to be then relatively intensive to get the desired effects on the real output.

The opponents of such a use of fiscal policy (Issig, 2000) point to the wrong assumption – fundamental for the paradigm of the coordination of fiscal and monetary policies – as it were possible by fiscal policy to substantially change the aggregate demand in the right time. The presumed anticyclical effects of fiscal policy often appear to be, *de facto*, procyclical because of delays and uncertainty about its actual influence on the economy. Moreover, potentially asymmetric effects make once increased public expenditure rigid especially with regard to employees' remunerations in the the public sector and social transfers. An additional argument would be the so-called non-Keyensian effects, it is, *inter alia*, a decrease in private consumption in response to growing public expenditure.

In Poland, since 1999, the fundamental trade-off in monetary policy – stability (real growth) of the GDP versus reducing inflation - has been definitely directed towards the

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[3] According to the law of Say to which these economists referred, this sector would be neither net lender nor net borrower for the rest of the economy.

[4] More on this subject: Gotz-Kozierkiewicz (2002)

stabilization of the price level in spite of high potential costs of this process for the economy[5]. These costs have been additionally increased through the omissions in the inflation target in the particular years and subperiods (in terms of its actual implementation). Even in the cases when the results achieved were only casual they were, nevertheless, accepted as the credible indicator for the past and, consequently, for the next period – as long as reducing inflation appeared to be better than expected.

The one-way approach in the chosen strategy of the price level stabilization, with the almost regular attainment of „a positive margin" in the achieved inflation target seems especially missed in the transition country relatively large in terms of its geographical area and population, and with the low relative foreign trade to the GDP ratio. In such an economy in which real adjustments have been interplaying with nominal changes and with different instensity and, so more, interchangeably in different periods, the well-balanced control of inflation, conducive to the real adjustments and not impairing the economic growth in the short and in the longer run, appears to be an extremely complex task.

Excessive concentration on the too narrowly perceived and, in addition, permanently „overshooted" in practice, inflation target as it happened in Poland, especially in 1999-2000, contributed to tightening the field of maneouvre in fiscal policy in the period since 2000. It would be difficult not to agree with the reproach that this policy did not rise to the occasion in its macroeconomic role in the second half of the 1990's and even more in 1998-1999[6]. Nevertheless, the breakdown of the economic growth in 2001-2002, together with the achieved ahead of time and unexpected for its scale reduction in inflation, became a „trigger" of the crisis in public finance in Poland just before its accession to the EU.

2. Role of Fiscal Policy in the European Economic and Monetary Integration

Fiscal policy coordination in the countries within the single currency area is considered – next to the symmetry of shocks and flexible labour market – one of the major theoretical assumptions of the successful performance of an optimum currency area. This coordination is supplementary to the supranational monetary policies and fiscal policy – although left to the authorities of the individual member countries, nevertheless, subordinated to the requirements

[5] Also Griffith and.Pujol (1996) point to these costs in the form*, inter alia*, of prolonged changes in relative prices, slow restructuring of enteprises and relatively deeply rooted indexation practices.
[6] More on this subject: Gotz-Kozierkiewicz (2000).

based on the expectations that public finance should not destabilize the national economies and, as a consequence, the economy of the European Community.

Such an interpretation of coordinating fiscal policies has been imposed by the Union rules, with the regulations of the Maastricht Treaty and the Stability and Growth Pact being included. An element of fiscal coordination has also been the common budget aiming at the redistribution of public revenue among member countries. This arrangement, important on the ground of theory, but rather modest in the until now practice of the EU, makes even more essential the role of national public finance in its influence on the economy of the member country. In the most concise approach it means that the field assigned to the fiscal policies of the EU member countries would be the result of the combination of the restraints coming from the coordination of their policies at the level of the Community with the augmented expectations – to overtake by the fiscal policy the tasks of macroeconomic policies in the individual countries at their joining also the monetary union.

It is just the fiscal policy which is responsible for the ability of the economy of each of the member countries to absorb potential asymmetric shocks disturbing from time to time stable economic growth. This task means a partcicular „enlargement" of the role of public finance in smoothing the effects of the business cycles, next to its other traditional, allocative and distributive functions. According to this approach, fiscal policy should become a „counterbalance" for real changes, mainly of the rate of exchange and domestic demand in their influence on the rate of economic growth and the balance of payments.

The country public finance sector prepared for this role would require its consolidation going beyond the typical budget constraint and public debt stability measure as they are conventionally defined. Not less important would also be the capabilities of the economy as the whole to be adjusted to its functioning within the monetary union. Public finance is only a part of an economy. Therefore, the situation of public finance cannot be reasonably approached seperately from the other potential circumstances of stable economic growth.

Such an approach to the public finance and fiscal policy role has been reflected in the EU documents starting with the Treaty of Rome to the European Central Bank Statement on Exchange Rate Issues Relating to the Acceding Countries published at the end of 2003. These documents show clearly the major premises of formulating the country's strategy – a path to fulfil the final conditions to become a member of the Economic and Monetary Union. It allows to divide this path into the successive stages with also desigining the role and place of public finance and fiscal policy in the context of economic processes as a whole. The right introduction of macroeconomic policies into the schedule must be a task for the country authorities.

Within the UE one may distinguish the threefold status of the individual member country:

- a participant in the UE before entering the ERM-2,
- a participant in the ERM-2,
- a member of the montery union.

Each of the above forms of the country engagement into the institutional framework as foreseen for the Community has been characterized by different minimum requirements to be fulfiled and different restraints implying the compliance with the common rules. It also refers to public finance and fiscal policy.

The status of the country - member of the UE before entering the ERM-2 - as of the state with a derogation in terms of the introduction of the euro as common currency requires to treat the national economic policy as a matter of „common interest" (Art. 99 of the Maastricht Treaty) and a „subject to a number of multilateral surveillance procedures embedded in the EU policy framework" (Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries, 2003: 1).

More specifically, the formulations of the ECB document refer to the member country approach towards its exchange rate policy as a subject of common interest and persuance of the price stability as the primary objective of monetary policy. Formal duties of the country referring to public finance at this stage of membership consist in contribution to the common Union budget (with an entitlement to transfers from this budget conditional on the compliance with the procedures foreseen by the Union) and harmonizing the country tax system in accordance with the Union rules. Fiscal consolidation at this stage – a compliance with the target limits – public sector deficit at 3 percent of the GDP and public debt at 60 percent of the GDP two years at least before the accession to the monetary union – determines formally prospects of joining the ERM-2.

The minimum two year period in the ERM-2 covers a more comprehensive test for the economy of the country as a candidate to the monetary union – of the stable and credible level of the exchange rate, interest rate and inflation next to the compliance with the fiscal limits. A formal starting up of this period is to be decided by the country authorities when they recognize the economy ready to successfully pass the test of its performance under the conditions imitating, although not to the very end, the status of being a member of the euro area. At this stage the economy is formally tested for its nominal macroeconomic convergence and conditioned on the test results - the country likely gets its „pass” to the monetary union.

The only formal procedure at this stage consists in fixing the central exchange rate of national currency against the euro and maintenance of the fixed – though relative flexible – exchange rate regime within the fluctuation margins +/- 15 percent. For a country with the former float, like in Poland, the change in the exchange rate regime would mean its certain formal stiffening and by the same, less autonomic monetary policy and shifting the emphasis to fiscal policy.

The formal qualification to become a member of the monetary union opens a period in which the chances for stable and well-balanced growth depend mainly on that, how far nominal convergence would also mean the real compatibility of the national economy with the rest of the euro area. In other words, a potential success, it is successful economic performance under the new conditions would depend, first of all, on that if and to what extent the attainment of the nominal convergence criteria, necessary for the accession to the monetary union, is compatible with the real convergence in the period before the accession and in the union perspective.

A participation in the monetary union would imply – different from the stage in the ERM-2 – threatening by the sanctions in the case of the country non-compliance with the requirements of public finance position. Fiscal policy rules of the member countries of the euro area have been established by the regulations of the Maaastricht Treaty and the Stability and Growth Pact. According to the Article 104 of the Treaty (and to the Protocol No. 5 attached to it – on the excessive deficit procedure), the countries are to avoid the excessive public sector deficits beyond 3 percent of the GDP and gross public debt above 60 percent of the GDP.

The first criterion might be treated in a less rigorous way in case of a considerable, permanent reduction in the public sector deficit to the level close to 3 percent or minor, exceptional or temporary deviation from 3 percent level; the public debt indicator might be above the limit of 60 percent of the GDP only when it approaches this reference value at a satisfactory rate.

According to the Stability and Growth Pact, the member countries of the monetary union are expected to present to the Council and European Commission at regular intervals stabilization programs aiming, *inter alia*, at the attainment of the public sector position close to its equilibrium or surplus in the medium run, together with the path of adjustment and with the expected path of the public debt to the GDP ratio. In the case of the results actually achieved worse than those determined in the program, the Council would recommend the country to undertake the necessary remedial measures (Article 6). The Council might also apply sanctions, as a rule, in the form of a non-bearing interest deposit (Article 11) (Gloekner, 2001).

History of the European Monetary Union has still been too short to conclude on the implemented procedures as adequate for successful economic performance of the euro area. There is also a disagreement on the scale of coordinating the country's and Community's fiscal and monetary policies. Fahrholz and Mohl (2003) point to the lack of major fiscal consolidation, and in particular of the reductions in the public sector deficits in the member countries since the introduction of the euro. They see a reason of it mainly in structural character of the fiscal deficits, but also in political voting cycles.

The impact of these cycles can be analyzed with the index of discretionary fiscal policy created by Buti and von den Nord (2002). They distinguish two components in the primary balance of the public sector. The first one is assigned to neutral fiscal policy and the second one is responsible for changes in this policy, its "easing" or tightening. This index has been used by these authors to point out a trend towards easing fiscal policy in the monetary union since its establishment.

According to Fahrholz and Mohl (2003) in several member countries a lack of synchronization of the business cycles and inflation rates may be observed. In their opinion, it would confirm doubts raised by some economists about the European Monetary Union as the optimum currency area. Structural differentiation of this Union member countries would imply the transmission of external shocks into asymmetric effects in the individual economies, impeding policy of stable, well-balanced economic growth in the euro area.

Bofinger (2003) raises the question of coordinating the national fiscal policies and the common monetary policy – an important aspect of the European Monetary Union performance. He points to the lack of positive correlation between the fiscal deficits and inflation rates in the individual member countries. The countries with the higher fiscal deficits have also been the ones with the low relative rates of economic growth. Moreover, in 1999-2002 in the member countries of the EMU there was observed, different from the earlier period, the relationship described by Philips's curve - the countries with the higher rates of economic growth were the ones with also higher inflation.

Policy of the unified nominal interest rates in the Union with the different rate of economic growth in the member countries leads to the different real interest rates. In countries with the higher rates of growth, there are also higher relative wage increases. This leads to inflation rates above the Union average and a reduction in the real interest rates, generating the additional impulse for growth and, by the same, also an improvement of the public sector position. In countries with the lower rates of growth, nominal wage increases and inflation rates are below the averages for the monetary union. As a consequence, the relative real interest rates are higher, additionallly hampering economic growth and contributing to the worse results in the public sector. Thus, Bofinger postulates to formulate an adequate *policy mix* in the individual countries with more flexible fiscal policy, i.e. the acceptance of the higher temporarily fiscal deficits in the countries with low economic growth provided macroeconomic policy as a whole is not pro-inflationary[7].

Kopits and Szekely (2002) raise doubts about the one formula – exactly the same rules for all member countries of the European Union in the context of potential adjustment of transition economies. In their view, negotiations would be required, firstly, to likely prolong a transition period and to make available financial means to reduce fiscal costs of the economies acceding to the EU and, secondly, a change of the regulations for temporary non-fulfilment of fiscal criteria as determined in the Stability and Growth Pact (p.17).

The above touched only discussion on the experience of the EU in fiscal policies and, at large, macroeconomic policies would point to the complex challenges facing these policies in the transition country. These challenges would even be more complex as they also cover some uncertainty about potential effects of the implementation of the Union fiscal rules which have appeared to be not easy for the uncomparably more mature and wealthy economies.

3. Fiscal Policy Risks in Poland

Fiscal policy in Poland at the beginning of 2004 may be assessed, firstly, from the angle of its aims and tasks – as a part of national macroeconomic policies and, secondly, in the context of integration with the EU. The second approach implies, in a sense, "imposing" the additional requirements on the national policies in their adaptation to the Union rules. The answer to the question how far these rules, different at the successive stages of the country participation in the institutional framework of the Union would tighten the field of manoeuver in fiscal policy and to what extent this policy would be able to meet the Union requirements without exposing the Polish economy to major risks of its destabilization (which should also

[7] As one of several counterarguments (mentioned in part 1) for such more flexible fiscal policy in the European Union is presented, *inter alia*, relatively low value of fiscal multipliers in the European countries brought about by the „leakage" of financial means for import and savings.

be conceived as hampering the economic growth), should determine the strategy of Poland's incorporating into this institutional framework.

By invoking the classical premises of the public sector formation, one would say that public revenue and expenditure are to be "cut out" according to the possibilities of the country determined by the GDP per capita. In the Polish economy since the beginning of transition, the major dilemma has been the excessive size of the public sector meeting the relative large part of social needs in the view of population's incomes artificially low by the market economy standards. Thus, a task in this respect would be a gradual reduction in public expenditure compensated by the population's income increase. However, in the view of processes of stabilization and transformation of the economy mainly at the first stages but also in the recent years of alarmingly increased unemployment, public finance has been assigned a role to absorb non-active professionally social groups – the receivers of earlier pensions, disability pensions, benefits and other forms of compensations though modest in their average level, nevertheless, very significant in terms of their quantities.

Aiming at the gradual decrease in public expenditure and revenue in the successive years, the reduced budget has been undergoing ever more intensive tightening leading to the fulfilment of social tasks at the verge of the necessary minimum – with the waste of public financial means and considerable shortage of the funds to promote economic growth, infrastructure, education, research and development.

Thus, the allocative function of fiscal policy would leave much to be desired. The above mentioned social tasks might be treated as a form of income redistribution towards weaker social groups in terms of their age and professional status. However, this has been counterbalanced, to some extent, by the changes in the tax system. Since a longer time, a drastic increase of the share of the indirect taxes in total tax revenue and in the relation to the GDP, generally recognized as a regressive burden on incomes, affects to the disadvantage of the poorest social layers. Frequency of the changes in the Polish tax system has made it an almost text-book example of the lack of stability detrimental to economic growth.

As for smoothing the rate of economic growth by fiscal policy, the Polish experience seems to be rather difficult for a credible assessment. This has been the result of the significant amplitude of fluctuations in the rate of economic growth and of the activities on the side of public finance aiming at its consolidation parallely to the unexpected changes in growth dynamics and inflation. For example, the decrease in the rate of economic growth in 2001-2002 was responsible to a large degree for the rapid increase in the public sector deficit in this period (from 3,1 percent of the GDP in 2000 to 6,7 percent of the GDP in 2002). The increment of the structural defict in 2001 is estimated at about 0,75 percent of the GDP. There were attempts to eliminate this increase, regardless of the virtual standstill of the economy in 2002; it has not been eventually managed, mainly due to inflation lower than excpected (Republic of Poland, 2003).

In Poland the conventional constraint on public debt has been additionally strengthened by the legal regulations. They are endowed in the Constitution in the form of the limitation of the public debt ratio to the GDP at 60 percent and in the Public Finance Law of 1999 in the form of prudence and sanitation procedures, making fiscal policy ever more rigorous if the public debt ratio to the GDP exceeds 50 percent, 55 percent and 60 percent. These procedures mean shortening of the horizon in the fiscal policy adjustment compared to the conventional constraint. They would make this policy extremely difficult during the temporarily low rate of economic growth and the higher real interest rates.

In Poland imposing of this additional constraint has coincided with the implemenation of the reforms in the pension system, health care system, education and public administration. In particular, the pension system reform has led to a significant increase in the burden on the state budget – with the aim of intergenerational equalization of the burden. Transformation of the system implies a necessary extra financing of the second pillar, the Open Pension Funds. This affects a potential increase in public debt and so does drying out of privatization revenue since 2001.

The above-mentioned reforms and ownership changes on the supply side compose to the list of the structural barriers in public finance in Poland. This list has been supplemented with institutional weaknesses, *inter alia*, of the tax administration still gradually gaining on professional qualifications and experience and with international barriers created by globalization conducive to the “harding up” of a portion of tax revenue in the Polish state budget from international business. In such circumstances, the scale of the changes introduced to the public finance system, increased the exposure of public revenue and expenditure to internal and external shocks.

The clear evidence of it were the results in the public sector in 2001-2002. According to the estimates of the IMF, a negative shock in terms of the reduction of the rate of economic growth in 2005-2007, similar in its scale to the one from 2001-2002, would lead to the increase of the public sector deficit to the level of above 10 percent of the GDP in 2007 and of public debt to the level above 100 percent of the GDP in 2012 (Republic of Poland, 2003: 7-8).

The less transparency in the rules of fiscal policy has also been a result of the methodological barriers - the methods of recording of public revenue and expenditure and public debt according to the present Polish and the EU methodology. According to ESA' 95, the indices of the public sector deficit and public debt to the GDP ratios would be significantly lower, and this especially with the inclusion of the Open Pension Funds to that sector[8]. Disparities between these indices and unclearness about the treatment of the procedures contained in the Public Finance Law of 1999 make more difficult a credible assessment of the situation of the public finance sector in the not too distant future. Similarly, it would be difficult today to assess the eventual results of the reduction in expenditure on public administration and social expenditure planned mainly for 2005-2007.

The fulfilment of the fiscal convergence criteria would open for the Polish zloty the opportunity to join the ERM-2. However, functioning in it, before joining the euro area, would require the Polish economy to be also prepared in terms of its real components to meet the challenges of the test in the trial period and after it in the long run. These challenges face both fiscal policy and macroeconomic policies as the whole.

The major risks, endangering the targets of fiscal policy in the shorter and longer run, include a macroeconomic risk implied by the changes in the rate of economic growth, exchange rate and interest rates. One of the fundamental conditions of successful public finance consolidation as designed would be the fast economic growth in 2004-2007. Maintaining of it also in the later period would be not less important for good performance of the Polish economy in the ERM-2 and in the monetary union. However, the amplitude of the changes in the rate of growth of the Polish economy since 1992 appeared to be relative high and especially if compared with the euro area. The higher average rate of growth in Poland of the order of about 2,3 percentage points in the whole period was accompanied with the standard deviation from the average of 1,9 percentage points, while in the euro area it amounted to only 1,1 percentage points. Thus, the risk of the change in the rate of growth of the Polish economy would be much higher than for the majority of the member countries of the monetary union even taking into account a potential reduction of that risk in the future

[8] Treatment of the Open Pension Funds in the ESA 95 is not yet finally decided. In case of inclusion of the OPF to the public sector, estimates presented by the Ministry of Finance – prior to taking into account the reduction in public expenditure for administration and social expenditure – point to the ratio of the public sector deficit to the GDP according to the ESA' 95 in 2002-2006 at the level of 3,8%, 4,2%, 5,7%, 3,9%, 2,8%, whereas using the Polish methodology: 6,3%, 6,3%, 6,3% 4,7%, and 3,7% respectively. Ratio of public debt to the GDP according to the ESA' 95 would be not more than 42% in 2002 to slightly more than 51% in 2005-2006 (about 45% in 2003 and 47,6% in 2004), whereas based on the Polish methodology – this ratio would be in successive years 47,2%, 51,5%, 54,8%, 59,3% and 59,5 respectively.

along with the further advancement of structural transformation in Poland (Republic of Poland, 2003: 7-8).

Changes in economic growth have been, first of all, induced by macroeconomic policies, with monetary policy being included. A significant weakening of the Polish zloty against the euro in the last year was conducive to the higher dynamics in the Polish exports as the leverage for economic growth. A consolidation of the trend to depreciate the Polish zloty or a trend towards its appreciation in the years preceding joining the ERM-2 would mainly depend on perception by foreign investors of the quality of the Polish economy and also on the position of the central bank on the likely intervention in the exchange market, maybe temporarily reasonable.

Joining the ERM-2 would require to fix the central rate of the zloty to the euro. Of fundamental importance would be to fix the parity at the level of the real equilibrium exchange rate and to accomplish up to that moment structural changes in the Polish economy sufficient for the relative stability of this exchange rate or its gradual strengthening mainly due to the positive processes on the supply side. Joining the ERM-2 would mean in practice stabilizing the exchange rate of the zloty against the euro within the fluctuation margins +15/-2,5 percent. Such an exchange rate regime does additionally expose the economy to a risk in the cases of the all-type potential “slippages” in fiscal policies, as it increases foreign investors’ sensitivity to the fiscal results and the balance of payments development (Sławiński, 2004).

The likely worse results in the public sector would have to be then transmitted more clearly, firstly, into the higher risk premium and the higher returns on the Polish public securities and, as a consequence, the higher costs of public debt service and, secondly, into the higher risk of refinancing of this debt by foreign investors. The relative risk of public debt refinancing in Poland is also significant today. The still low domestic capital stock and the increasing share of foreign investors in the purchases of the Polish public securities has also led to the higher exposure of the zloty to speculative attacks as self-fulfilling expectation.

The next major risk might be a lack of coordination of fiscal and monetary policies at the particular stages of integration with the EU. The situation in public finance today does not allow for likely “easing” fiscal policy; rather natural and expected would be a trend towards its tightening. Monetary policy focused on direct inflation targeting would neither leave a broader field of manoeuvre in response to domestic and external shocks.

Such shocks, both asymmetric covering also the domestic ones and apparently symmetric but bringing eventually asymmetric effects for Poland and for the rest of the euro area, may not be excluded and especially in the view of the still lasting transformation of the Polish economy and the low relative income per capita in Poland. The accomplishment of the structural reforms also at the micro-level and partial, at least, making-up of arrears in the development of economic infrastructure would have increased the adaptative ability of the Polish economy to functioninig within the Union (Małecki, 2004).

The dimension of the above-mentioned risks in fiscal policy as put against the background of the Polish economy performance today and in the not-too-distant future of at least several years, would point to a need of careful formulating the strategy over the time for the stages of Poland's formal participation in the EU.

4. Conclusions

At the time of Poland's accession to the UE the Polish economy is in the modest shape of the GDP per capita slightly above 40 percent of the Union average, after two years of the virtual standstill before 2003. Thus, it would be difficult to overappreciate the significance of consolidation of economic growth in the near and more distant perspective. An assessment of the chances in this respect must go beyond the fulfilment of the nominal convergence criteria. True value of these indices would have been determined by the cohesion of the Polish economy with the Union member countries in the real terms. Thus, the tasks of macroeconomic policy and fiscal policy for today and tomorrow should mainly be assessed from the angle of their impact on real processes. In this respect, fiscal policy, macroeconomic and refinancing risks as well as the lack of coordination with monetary policy would increase potential threats along with closer integrating with the UE.

The changes in the Polish public finance as desinged and partially already accomplished, mainly positive such as reducing costs of public administration and social expenditure reform as well as increase in growth promoting expenditure, inter alia, for economic infrastructure forced by the Union regulations have unfortunately been consolidating inequalities in income distribution. Such is the direction of the major changes in the tax system.

Instability of the budget position and uncertainty about the effects of the systemic changes create a potential barrier in economic growth. The one-sided changes in the future – public finance consolidation and hardly attainable the national and the Union fiscal limits do not leave a field to stablize economic growth in the case of negative domestic and external shocks. This would be even less optimistic forecast of adaptative ability of fiscal policy at the stage of participating in the ERM-2, if joining it were to depend only on the fulfilment of the „border" criteria.

Thus, artificial shortening (at any price) of a distance of the Polish economy from undertaking the formally sanctioned test in the ERM-2 does not seem to be the optimal choice. The most even perfect institutional framework, though the Union arrangements are hardly the case, judging on the until now experience, would not offset essential deficiencies. It means that these arrangements would not be a substitute for the real readiness of the economy to function as a part of the integrated whole. This institutional framework may, on the contrary, contribute to disclosing and intensifying weaknesses of the national economy, making the unavoidable adjustment process more costly. Too early, on the country's authorities own record, resigining of the national monetary policy and shifting the responsibility for stable economic growth to actually difficult fiscal policy would not be very promising for Poland's future in the unified Europe.

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