Public Expenditures in Poland: Major Trends, Challenges and Policy Concerns

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PUBLIC EXPENDITURES IN POLAND: MAJOR TRENDS, CHALLENGES
AND POLICY CONCERNS

I Introductory remarks

In most general terms, public expenditures can be seen as one of the key means used by
the government in an endeavor to achieve its policy objectives. Before embarking on a more
detailed discussion, it seems advisable to first outline a more general analytical framework or
broader context of the behavior of public expenditure. The level, dynamic and allocation of
the latter are best understood if looked upon from the angle of the role and goals pursued by
the government in a market economy.

According to one of the most influential views, prevailing in the 1960s and 1970s, the
government was perceived as having three economic roles or functions [Musgrave and
Peacock, 1958]. The first was the stabilization function; its responsibility was to ensure that
the economy remained at full employment with stable prices. The second function was allocation. Here the government intervened with a view to influence the allocation of resources in the economy. It could do it either directly (government procurement of goods and services) or indirectly, through taxes and subsidies. The third function was distribution; while focusing on a more equitable distribution of goods produced among the society’s members it entailed the equity-efficiency trade-off. In the real world these three areas of government activities are intertwined and cannot be that easily categorized. Still, the foregoing typology provides a convenient analytical tool that enables a better understanding of government policies.

Another line of argument, aimed to highlight the role and objectives of the
contemporary government hinges on possible rationales of government involvement in a
market economy. In the view of Joseph Stiglitz, the 2001 Nobel Prize laureate, there are three
such rationales of fundamental nature: (1) market failures, (2) redistribution, and (3) merit
goods [Stiglitz, 2000].

A market failure is present when the economy (a market) is unable to achieve Pareto
efficiency. The sources of market failure comprise the following [Stiglitz, 2000; Gwartney,
Stroup and Sobel, 2000].¹

- Imperfect competition
- Public goods
- Externalities (negative and positive)
- Incomplete or missing markets; they are due, inter alia, to information asymmetry and
  may give rise to adverse selection (e.g. insurance, loans and risk)
- Imperfect information

¹ They are not mutually exclusive. For example, externalities are frequently thought to arise from missing
markets, and public goods are sometimes viewed as an extreme case of externalities.
• Unemployment, inflation and disequilibrium.

The common thread in all of these sources of market failure is that - in the absence of government intervention - they result in economic inefficiency. However, even if the economy were Pareto efficient there are two other arguments for government intervention; both are put forward on the equity or/and normative economics grounds.

The first is *income redistribution* geared to achieve a more equitable allocation of goods and services produced among the members of a society in the pursuit of broader-than-economic goals (such as e.g. fairness). The second non-economic rationale for government intervention in a Pareto efficient economy arises from concern that individuals may not act in their own best interest (*merit goods* or *merit bads*).

The government intervention, however, is not necessarily the best solution to market failures. Government action may in turn be conducive to even greater inefficiencies, if compared to private markets. There are four main reasons for the systematic failures of the government to achieve its stated objectives [Stiglitz, 2000]:

1. **Limited information.** The consequences of any government actions are complicated and difficult to foresee.
2. **Limited control over private market response.** The government can only partly control these consequences.
3. **Limited control over bureaucracy.** Those who design legislation have only limited control over the implementation of government programs. This is of particular importance in view of the weak incentives for operational efficiency embedded in government bureaucracies.
4. **Limitations imposed by political process.** Due to the very nature of the latter (e.g. the ‘rational ignorance’ effect) politicians tend to be subject to a ‘short-sightedness’ syndrome and biased to further special interests rather than the public interest. As a result, their decisions need not yield efficient outcomes [Buchanan and Tullock, 1962; Buchanan, 1987].

In ascertaining the appropriate role of government, an understanding of the limitations of both government and markets is essential. The recognition of government failures implies that government ought to take actions only in those areas in which market failures are most significant and/or where government intervention can make a real difference (e.g. alleviation of poverty). In particular, the government should not intervene if the relevant welfare loss, due to market failure, is small and the costs of intervention may exceed gains.

The present paper aims to survey – against this background – the behavior of government (or public) expenditures in Poland, one of the top-reformer transition economies in East-central Europe. The ensuing discussion has been organized as follows. Section two provides an overview of major trends in public expenditures during systemic transformation, i.e. the period of 1990-2000. It also highlights the process of reprioritization of government objectives in channelling budgetary funds. Section three gives account of the most salient effects of the changing pattern of public expenditure (and more broadly – of the fiscal stance of the government) and discusses main policy concerns involved. In the last section the most significant challenges ahead are outlined, with special emphasis on the implications of the public finance crunch in Poland that emerged in mid-2001. It is also argued that two “external” factors, i.e. the process of globalization and the forthcoming EU accession will be gaining importance in the future in shaping public expenditure in Poland.
2. Major trends in public expenditures in Poland

One of the key dimensions of institutional reforms Poland embarked on in its road from plan to market was the replacement of its fiscal system, inherited from the centrally-planned economy, with one designed for a market economy. Prior to 1990, fiscal policies were dominated by excessive enterprise taxation on the one hand, and by lack of discipline in government spending, on the other. Firms not only were supposed to pay profits tax of 45% to 60% but also a large part of the depreciation fund was to be surrendered to the central budget. At the same time a substantial redistribution of income through the tax system was taking place in the form of tax reliefs and direct subsidies. These implied the transfer of funds from efficient entities (mostly medium and small size manufacturers) to inefficient ones (large heavy industry enterprises). Subsidies constituted the most important single item in the government budget and their share grew from some 25% in 1983-84 to 36% in 1988 [Rosati, 1991]. Another salient feature of the fiscal system was that government expenditures were not directly dependent on budget revenues – they could always be financed through non-interest bearing credit from the National Bank of Poland (printing money). This mechanism of money creation was conducive to very low financial (and monetary) discipline. As a result Poland entered its road from plan to market burdened with deep macroeconomic imbalances – to give but one example, the budget deficit in 1989 amounted to 10% of country’s GDP [Blazyca and Rapacki, 1991].

The early years of systemic transformation in Poland saw a comprehensive fiscal reform and overhaul of the entire financial system. They were implemented under adverse macroeconomic conditions: the Polish economy initially responded to the Balcerowicz ‘shock therapy’ with a transformation recession, i.e. the burst of corrective inflation, deep fall of real incomes and output contraction by a cumulative 18%. The fiscal reform comprised both the revenue and expenditure side; in the first place direct subsidies were dramatically cut or eliminated and the tax system inherited from the command economy radically overhauled. As a result, by 1998 the central government budget was financed by taxes that, for the most part, did not exist during the era of central planning [Kemme and Rapacki, 2000].

Below we embark on a more detailed analysis of major trends in public expenditures in Poland in the 1990s. The data presented in Tables 1-4 allow a number of observations.

First, as the most general remark, it should be noted that – in a sharp contrast to an orthodox liberal phraseology of the first ‘Solidarity’-backed governments (1989-1993) – the 1990s did not witness an unequivocal trend towards downsizing the general government sector. The share of total public expenditures in Poland’s GDP amounted in 1999 to 44.0%, compared to 45.1% in 1990, 50.5% in 1994 and 43.1% in 1998 [OECD, 1997 and Table 4]. This ratio was above the average for OECD countries and below the mean for the EU (46.4% in 2000) [Wernik, 2001]. Simultaneously, the share of government spending on goods and services in aggregate demand increased slightly between 1996 and 1999 – from 15.6% to 17.0% (Table 4). By the same token, its contribution to overall economic growth – seen from the demand-side perspective – rose accordingly.

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2 According to most recent estimates, the actual contraction was shallower than implied by official statistics. If ‘shadow economy’ or unreported activities are accounted for the cumulative fall (1990-91) of Poland’s GDP would total some 11%. For details, see RCESS [1999].

3 Excluding transfers between the central budget, local budgets, extra-budgetary funds and extra-budgetary units.
<table>
<thead>
<tr>
<th>Year</th>
<th>Total Expenditures</th>
<th>Subsidies for Economic Entities</th>
<th>Housing and Community Services</th>
<th>Social Security Contributions*</th>
<th>Current Expenditures of Budgetary Units</th>
<th>Domestic Debt Service</th>
<th>Foreign Debt Service</th>
<th>Subsidies for Local Government</th>
<th>Investment Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value (in million zloty)</td>
<td>% GDP (Share)</td>
<td>Value (in million zloty)</td>
<td>Share</td>
<td>Value (in million zloty)</td>
<td>Share</td>
<td>Value (in million zloty)</td>
<td>Share</td>
<td>Value (in million zloty)</td>
</tr>
<tr>
<td>1991</td>
<td>24 185,8</td>
<td>29,9</td>
<td>934,6</td>
<td>3,9</td>
<td>729,8</td>
<td>3,0</td>
<td>3 639,4</td>
<td>15,0</td>
<td>14 134,7</td>
</tr>
<tr>
<td>1992</td>
<td>38 189,0</td>
<td>33,2</td>
<td>529,4</td>
<td>1,4</td>
<td>921,1</td>
<td>2,4</td>
<td>7 345,3</td>
<td>19,2</td>
<td>20 758,6</td>
</tr>
<tr>
<td>1993</td>
<td>50 242,8</td>
<td>32,2</td>
<td>702,5</td>
<td>1,4</td>
<td>596,4</td>
<td>1,2</td>
<td>10 420,7</td>
<td>20,7</td>
<td>26 911,7</td>
</tr>
<tr>
<td>1994</td>
<td>68 865,0</td>
<td>37,1</td>
<td>1 747,3</td>
<td>3,2</td>
<td>14 270,0</td>
<td>36,9</td>
<td>7 345,3</td>
<td>15,0</td>
<td>26 911,7</td>
</tr>
<tr>
<td>1995</td>
<td>91 169,7</td>
<td>29,6</td>
<td>2 583,1</td>
<td>3,2</td>
<td>15 280,8</td>
<td>36,9</td>
<td>7 345,3</td>
<td>15,0</td>
<td>26 911,7</td>
</tr>
<tr>
<td>1996</td>
<td>108 841,7</td>
<td>28,1</td>
<td>2 420,2</td>
<td>2,2</td>
<td>1 739,0</td>
<td>13,8</td>
<td>36 767,7</td>
<td>18,1</td>
<td>3 749,9</td>
</tr>
<tr>
<td>1997</td>
<td>125 674,9</td>
<td>26,6</td>
<td>2 669,9</td>
<td>2,1</td>
<td>21 075,0</td>
<td>16,7</td>
<td>41 608,0</td>
<td>13,2</td>
<td>12 610,3</td>
</tr>
<tr>
<td>1998</td>
<td>139 755,8</td>
<td>25,2</td>
<td>2 394,6</td>
<td>1,7</td>
<td>25 218,7</td>
<td>18,0</td>
<td>46 214,3</td>
<td>33,1</td>
<td>14 141,2</td>
</tr>
<tr>
<td>1999</td>
<td>138 401,2</td>
<td>22,5</td>
<td>2 573,0</td>
<td>1,9</td>
<td>29 436,4</td>
<td>21,3</td>
<td>25 809,5</td>
<td>18,6</td>
<td>14 893,8</td>
</tr>
<tr>
<td>2000</td>
<td>151 054,9</td>
<td>22,0</td>
<td>2 382,2</td>
<td>1,9</td>
<td>36 908,6</td>
<td>24,3</td>
<td>26 928,5</td>
<td>17,8</td>
<td>3 727,9</td>
</tr>
</tbody>
</table>

Notes: Data for 1994 and later for expenditures of budgetary units are not exactly comparable to earlier periods due to changes in classification of units. Expenditures are on an accrual basis.
* Social security contributions are for both unemployed and pension fund subsidies.

Source: *Rocznik Statystyczny*, GUS, various issues
The size of the government can be also indirectly measured by means of such yardsticks as e.g. the share of budget spending on public administration in total expenditure and the level of employment in public administration. As can be seen from Table 2, the former ratio grew from 2.9% in 1991 to 4.4% in 2000. Simultaneously, overall employment in public administration rose from 380 thousand in 1997 to 480 thousand in end-2000 and 485.9 thousand in the first quarter of 2001, i.e. by 28% [Kieżun, 2001].

Second, it was expenditure of the state budget (central government) that underwent actual downsizing. This process was particularly pronounced in the second half of the 1990s – while the share of state budget expenditures4 in GDP remained fairly stable in 1990-95 (34.6% in 1990, 29.9% in 1991, 33.2% in 1992 and 29.9% in 1995 [Table 1 and OECD, 1997], this ratio fell to 25.2% in 1998 and 22.0% in 2000. This downward trend reflects in most part decentralization of the public finance after 1995. In particular, local governments have gradually taken over the responsibility for primary and secondary education, and – since 1999 – for health care (regional health care funds or kasy chorych, see Table 3). As a result, the share of local government expenditure in GDP increased from 4.3% in 1991 to 5.4% in 1995 and 10.7% in 1999 [OECD, 1997; Rocznik Statystyczny, 2000]. Simultaneously, the share of funds transferred from the state budget to local governments (both general subsidies and appropriated allocations) in total expenditures of the former augmented from 5.0% in 1991 to 24.3% in 1999 and 25.9% in 2000 [Mały Rocznik Statystyczny, 2001].

Third, Table 1 shows the changing pattern of expenditures of the central government. During the 1990s the two largest expenditures were current expenditures of budgetary units and social insurance contributions. Current expenditures of budgetary units reflect the operations of government agencies and consist predominantly of wages and salaries. While this was – until 1998 - the largest single expenditure its share of total government expenditures has fallen from 58.4% in 1991 to 33.1% in 1998 and 17.8% in 2000, an indication of the shrinking central government.

Table 1 also indicates that social security contributions grew dramatically in the early transition period. Social contributions exploded due to the very low retirement age,5 incentives for early retirement, branch and occupational privileges, liberal definitions of entitlements, liberal rules for granting disabilities and preferences for setting pension terms in agriculture [Kemme and Rapacki, 2000]. Then, during 1995-98, social security spending declined in relative terms, as a function of shrinking unemployment. Since 1999 this budgetary item has accelerated again. By 2000 social insurance contributions (including Farmers’ Social Security Fund, KRUS) had reached 24.3% of budget expenditures. Apart of the rising burden of unemployment benefits, the major underlying cause of the skyrocketing growth of social security expenditure should be seen in the generosity of the pension system in force. In Poland, pensions as a percentage of GDP amount to 15%, the highest of all of the Central European countries6 and above the average for both OECD (10%) and EU (12%). One of the possible explanations of the high share of pensions in Poland’s GDP are lax eligibility rules for disability and family pensions and the resulting excessive proportion of this category of beneficiaries in the total number of pensioners. For example, of the total number of 7,524 thousand persons outside agriculture eligible for pensions in 1999 only 3,532

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4 Including transfers between the central budget, local budgets, extra-budgetary funds and extra-budgetary units.
5 As stipulated by law it is 60 years for women and 65 for men. However, the effective retirement age amounts to 55 and 59, respectively.
6 In Slovenia pensions amount to nearly 13% of GDP, but in the Czech Republic, Slovakia, Hungary and Romania this proportion is substantially less than 10% of GDP [Kemme and Rapacki, 2000].
thousand were receiving employee retirement pay (or old-age pensions) while the number of those entitled to disability and family pensions amounted to 3,992 thousand. It is also worth stressing that the replacement ratio was quite high for a transition economy as well: for all pensions it amounted in 1999 to 57.4% and for old-age pensions alone – to 65.7%. It displayed, however a downward trend, declining from 63.5% and 73.6% in 1995, respectively [Rocznik Statystyczny, 2000].

**Subsidies** from the central government budget were a major portion of government expenditures during the era of central planning and were channeled directly to enterprises, for particular industrial activities or for specific products (food, children's clothing). For example, in 1988 food subsidies accounted for 17.1% of budget expenditures. By 1990 food subsidies were completely eliminated. As indicated in Table 1 total explicit subsidies to enterprises in 1991 represented 3.9% of budget expenditures, and by 2000 their share had fallen to 1.9%. The remaining large budget categories, debt service and investment, grew in absolute amounts, but their shares remained approximately the same.

Table 2. Government expenditures by sectors, 1991-99 (%)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>1.5</td>
<td>1.6</td>
<td>1.7</td>
<td>1.7</td>
<td>..</td>
</tr>
<tr>
<td>Transport</td>
<td>2.2</td>
<td>1.4</td>
<td>2.2</td>
<td>1.9</td>
<td>..</td>
</tr>
<tr>
<td>Municipal economy</td>
<td>1.9</td>
<td>1.0</td>
<td>1.3</td>
<td>0.6</td>
<td>..</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>2.5</td>
<td>1.6</td>
<td>1.7</td>
<td>2.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Education</td>
<td>11.6</td>
<td>11.3</td>
<td>5.0</td>
<td>2.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Higher education</td>
<td>2.7</td>
<td>2.4</td>
<td>3.0</td>
<td>3.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Culture and art</td>
<td>1.0</td>
<td>0.7</td>
<td>0.8</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Health care</td>
<td>16.1</td>
<td>14.4</td>
<td>15.0</td>
<td>4.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Social welfare</td>
<td>5.5</td>
<td>9.3</td>
<td>6.6</td>
<td>7.3</td>
<td>7.9</td>
</tr>
<tr>
<td>Public administration</td>
<td>2.9</td>
<td>3.4</td>
<td>4.2</td>
<td>4.3</td>
<td>4.4</td>
</tr>
<tr>
<td>Administration of justice</td>
<td>1.4</td>
<td>1.9</td>
<td>2.2</td>
<td>2.8</td>
<td>2.7</td>
</tr>
<tr>
<td>Public safety</td>
<td>3.5</td>
<td>3.7</td>
<td>4.0</td>
<td>4.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Finance</td>
<td>8.4</td>
<td>18.5</td>
<td>15.3</td>
<td>15.2</td>
<td>13.6</td>
</tr>
<tr>
<td>Social security</td>
<td>15.0</td>
<td>16.8</td>
<td>18.0</td>
<td>21.3</td>
<td>24.3</td>
</tr>
<tr>
<td>National defence</td>
<td>7.5</td>
<td>5.6</td>
<td>6.0</td>
<td>6.8</td>
<td>6.6</td>
</tr>
</tbody>
</table>


In order to properly address the problem of subsidies, a distinction should be made between explicit and implicit budget subsidies. While explicit subsidies consistently tended to shrink the implicit subsidies increased. Implicit subsidies took the form of growing tax payment arrears of state-owned enterprises (SOEs) in declining or inefficient sectors such as coal mining, metallurgy, rail transport, as well as public institutions – e.g. schools, hospitals, etc. The scale of uncollected taxes and social security contributions (including pension system contributions) from these debtors tended to sharply rise. For example, in 1999 tax arrears increased by 41.9%, to 7,502 million zloty by the end of the year. Simultaneously, cumulative payment arrears of the coal-mining sector alone (including uncollected direct and indirect taxes, and social security contributions) amounted to 20,489 million zloty, i.e. some 16.3% of total budget revenues in 1999. These trends adversely affected the level of potential budget...
revenues and led to budget expenditures in excess of target levels. As a result, the fiscal stance of the government proved much less restrictive than intended.

Fourth, the changing pattern of public expenditures can be also analyzed from the angle of government functions or objectives outlined earlier in the text, i.e. stabilization, allocation and redistribution.

The stabilization function of the government has been performed mostly via macroeconomic policy, i.e. the mix of fiscal and monetary policies. Nevertheless, some features of public expenditures alone may have contributed to dampen the adverse effects of external and domestic shocks on the macroeconomy and to diminish the volatility of aggregate demand in the 1990s. First, government expenditure – as the most autonomous component of aggregate demand – tended to display certain rigidity even in the most turbulent times. For instance, in 1991, when industrial output contracted by 17.1% and GDP shrank by 7.0%, state budget expenditure rose by 10.2% [Blazyca and Rapacki, 2001] thus providing a cushion against an even deeper transformation recession. Second, government spending has had some automatic stabilizers built-in, one example being unemployment benefits. As unemployment started to rise fast after 1998 (from 10.4% to 15.0% in 2000 and 16.5% in 2001), so did budget disbursements for the jobless. This, again, may be seen as a factor providing for a stabilization of consumer demand and thus – aggregate demand.8

Table 3. Consolidated public expenditures, 1995-99 by sectors (%)

<table>
<thead>
<tr>
<th>Item</th>
<th>1995</th>
<th>1998</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
<td>B</td>
<td>C</td>
</tr>
<tr>
<td>General public services</td>
<td>5,3</td>
<td>66,4</td>
<td>33,6</td>
</tr>
<tr>
<td>National defence</td>
<td>3,9</td>
<td>100,0</td>
<td>-</td>
</tr>
<tr>
<td>Public safety</td>
<td>3,8</td>
<td>97,2</td>
<td>2,8</td>
</tr>
<tr>
<td>Education</td>
<td>11,5</td>
<td>65,5</td>
<td>34,5</td>
</tr>
<tr>
<td>Health care</td>
<td>10,1</td>
<td>89,8</td>
<td>10,2</td>
</tr>
<tr>
<td>Social security and welfare</td>
<td>46,1</td>
<td>96,1</td>
<td>3,9</td>
</tr>
<tr>
<td>Housing and community services</td>
<td>8,5</td>
<td>25,7</td>
<td>74,3</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>100,0</td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

A – total, B – central government (% share in total expenditure for respective items), C – local governments (% share in total expenditure for respective items).

Source: As in table 2.

As can be seen from Tables 2 and 3, public expenditures have also served as a device for resource allocation. This was done, on the one hand, through the public provision of

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7 For example, as a result of arrears in social security contributions in 1999 the government had to increase the budget subsidy to ZUS (Social Insurance Institution) by some 6 billion zloty above the planned level. Moreover, to fully cover its deficit ZUS also had to resort to commercial borrowing (2.8 billion zloty), which is also a part of the broad government sector deficit or public sector borrowing requirements (PSBR). The growing burden of the social safety net on the state budget was among the major underlying reasons for the reform of the old-age pension system implemented in 1999.

8 The significance of this factor, however, is smaller than the data on incremental unemployment rate would suggest. This is due to the fact that over 60% of registered unemployed in Poland nowadays are not eligible for transfer payments, as they have remained jobless for more than one year.
public goods, such as national defence or public safety, or merit goods, such as primary and secondary education, which was predominantly funded from the state budget or local governments. On the other hand, via explicit budget subsidies or public procurement of goods and services on private markets, the government provided incentives affecting the behavior of private suppliers and influenced the level and composition of output in the economy. This category of public expenditure represented 21.0%\(^9\) of GDP and 47.7% of the total public spending in 1999 and remained pretty stable in the second half of the 1990s.

An equally important proportion – in quantitative terms – of public expenditure (and GDP) in Poland was allocated to meet the redistribution objective of the government. In the second half of the last decade some 20% of GDP or 45% to 50% of total government spending was disbursed for transfer payments (Tables 3 and 4). The overwhelming majority of transfers were channeled towards the social safety net, i.e. social security and welfare programs. In 1999 they made up 44.3% of the consolidated public expenditure, compared to 46.1% in 1996. Bearing in mind the fact that in the early 1990s the weight of the state budget in Poland’s public finance had been much greater than today and that a full-fledged decentralization of public expenditures began in 1998, it may be argued that the scale of redistribution significantly increased in Poland throughout the 1990s, both with regard to GDP and central government expenditure. While in 1991 transfer payments represented 20.5% of the latter in 1995 this proportion augmented to 26.1% and in 2000 – to 32.2% (Table 2). Simultaneously, the share of transfer payments from the central budget in GDP amounted in 1991 to 6.1% and in 1995 it grew to 7.7% (own calculations based on Tables 1 and 2, and OECD, 1997).

Table 4. Composition of consolidated public expenditure, 1996-99 by type (billion zloty and % of GDP)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Public revenues</td>
<td>163.8</td>
<td>42.2</td>
<td>197.4</td>
<td>41.8</td>
<td>225.2</td>
<td>40.7</td>
<td>251.7</td>
<td>40.9</td>
</tr>
<tr>
<td>Public expenditures</td>
<td>175.8</td>
<td>45.3</td>
<td>210.7</td>
<td>44.6</td>
<td>238.8</td>
<td>43.1</td>
<td>271.0</td>
<td>44.0</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>161.0</td>
<td>41.5</td>
<td>192.4</td>
<td>40.7</td>
<td>216.3</td>
<td>39.1</td>
<td>249.2</td>
<td>40.5</td>
</tr>
<tr>
<td>Goods and services</td>
<td>60.6</td>
<td>15.6</td>
<td>71.9</td>
<td>15.2</td>
<td>82.3</td>
<td>14.9</td>
<td>104.3</td>
<td>17.0</td>
</tr>
<tr>
<td>Transfers and subsidies</td>
<td>86.1</td>
<td>22.2</td>
<td>104.4</td>
<td>22.1</td>
<td>115.9</td>
<td>20.9</td>
<td>125.9</td>
<td>20.4</td>
</tr>
<tr>
<td>Interest on public debt</td>
<td>14.3</td>
<td>3.7</td>
<td>16.2</td>
<td>3.4</td>
<td>18.0</td>
<td>3.3</td>
<td>19.0</td>
<td>3.1</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>11.9</td>
<td>3.1</td>
<td>16.7</td>
<td>3.5</td>
<td>20.4</td>
<td>3.7</td>
<td>19.4</td>
<td>3.2</td>
</tr>
<tr>
<td>Balance</td>
<td>-12.1</td>
<td>-3.1</td>
<td>-13.3</td>
<td>-2.8</td>
<td>-13.6</td>
<td>-2.5</td>
<td>-19.2</td>
<td>-3.1</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance; OECD [2001], p. 219.

The actual scale of income redistribution in Poland (other than through the tax system) tended to be larger than suggested by data on transfer payments. One of the underlying reasons for that was embedded in the provision of both public goods and merit goods, such as e.g. education and health care. As the share of certain social groups or regions in the consumption of such goods exceeded their tax contribution to finance those activities (e.g. children of poorer families and poor regions in case of education, and the elderly in case of

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\(^9\) This ratio is the sum of three expenditure items: (i) spending on goods and services (17.0%), (ii) capital expenditure (3.2), and (iii) subsidies to economic entities (0.8%). The latter figure was derived indirectly from Tables 1 and 4, the former are explicitly shown in Table 4.
health care) this entailed the transfer of wealth from the well-off to the poorer and from the young to the old generation, respectively.

Fifth, in the second half of the 1990s some new unfavorable trends unfolded that increased the rigidity of public expenditure, restricted the scope of control of the central government over fiscal policy while simultaneously adversely affecting the transparency of all public finance and accountability of fiscal authorities. As a consequence of institutional arrangements embedded in the central budget and aimed to ensure fulfillment of the redistribution priority (e.g. indexation mechanisms built-in in the transfer payments) the share of rigid items in total state budget expenditures has steadily grown to reach 63.2% in 2001, compared to 57.7% in 1999 [Ministry of Finance]. This tendency left little room for maneuver in allocating public funds for ‘pro-growth’ purposes. Secondly, the late 1990s witnessed a sharp increase in the number of various extra-budgetary entities and in the associated volume of off-budget financial flows. This included in particular ‘inflation’ of different government agencies, auxiliary units of budgetary entities and their special funds. Such a policy facilitated, on the one hand, concealing the actual fiscal stance of the government (e.g. via moving some state budget expenditures to extra-budgetary funds) but on the other – it was conducive to declining transparency of fiscal policy and its lower effectiveness.

3. Most salient effects and policy concerns

While assessing the effects of public expenditure in Poland and the resulting policy concerns we will occasionally refer back to the theoretical framework outlined in the first section. The following issues seem worth highlighting from this perspective.

1. As the foregoing discussion demonstrated, the 1990s witnessed – in the broadest terms – a clear reprioritization of public expenditure towards redistributive objectives. Although this trend was less unambiguous in the second half of the last decade the share of spending on social safety net (and in particular – on pensions) seems to be excessive and ranks among the highest in all Central European countries. The gains from this pattern of reprioritization accrued predominantly to the beneficiaries of the pension system, and in particular – those receiving disability pensions. Another category of gainers encompasses a substantial part of coal-mining employees, laid off within the restructuring program of this sector being implemented since 1998, who received generous compensation from the budget. The costs that had to borne by the Polish society at large boil down to constrained supply of most of the public (and merit) goods and their declining quality as well as to creating perverse incentives discouraging a self-sustained, long-run economic growth. These problems are discussed in more detail later in the text.

2. Based on available statistics, it may be claimed, however that the ‘redistributive bias’ in Poland’s public expenditure policy may have produced one more general positive effect. Namely, the growing share of public funds devoted to strengthen the social safety net may be seen as an important explanatory variable for the relatively slow pace of growth of the ‘poverty zone’ and income disparities in Poland, compared to other transition economies. It should not be overlooked that Poland entered its road from plan to market as a country with one of the most inequitable patterns of income distribution in East-Central Europe. In 1988 the Gini coefficient amounted to 26 whereas in the Czech Republic and Slovakia it was 19, in Hungary – 21, in Estonia – 23 and in Russia – 24. At the same time the percentage of population living below the poverty line totaled 6 in Poland, 1 in Estonia and Hungary, and 2 in Russia. By 1995 the Gini coefficient rose in Poland to 28; in Slovakia it remained unchanged, in the Czech Republic it stood at the level of 27, in Hungary – 23, in Estonia – 35
and in Russia – 48. In the same year the proportion of the population living in poverty increased in Poland to 10% while in Hungary – to 7%, in Estonia – to 34% and in Russia – to 39% [Milanovic, 1998].

3. In designing and implementing the public expenditure policy (and more broadly – fiscal policy) Polish policy-makers had to face two important dilemma: the equity-efficiency trade off and the choice between short- and long-term objectives. If we assume that public goods are the extreme case of externalities (see footnote 1) then the provision of the former (in adequate quantity and quality) may be regarded as a means to enhance positive external effects for the private sector and by the same token – an efficiency driver. Seen from this perspective, the equity or redistribution ‘bias’, documented earlier in the text, tended to adversely affect both the available aggregate supply and quality of public and merit goods in Poland. This general conclusion is not inconsistent with diverging trends that can be traced in public expenditures with regard to particular categories of those goods. For example, as both Table 2 and Table 3 demonstrate, the 1990s saw a decline in relative spending on national defence and on research and development. At the same time, the proportion of public money allocated to such areas as public safety, education, health care, justice and public administration increased. However, the growth in financing the provision of public goods does not automatically safeguard their greater availability and adequate quality (the problem of weak incentives for operational efficiency in the public sector). Indeed, according to anecdotal evidence the late 1990s saw deterioration in the availability and quality of a number of public goods. These comprised declining yardsticks measuring the level of public safety, poor standard of health care services10, rising ineffectiveness of the judiciary power, low enforcement of the law and incompatibility of educational curricula at primary and secondary levels with the needs of a market economy [Blazyca and Rapacki, 2001].

4. It is fair to say that successive Polish governments, while deciding on the priorities in public expenditures and faced with the trade off between short- and long-term goals, tended to be biased towards the former. In particular, they appear to have neglected the importance of policies aimed at actively creating or enhancing positive externalities for the private sector, as key preconditions for a long-term, sustainable (steady-state) economic growth. As a matter of example, it suffices to mention unsatisfactory government support for the domestic R&D effort and low investment in physical infrastructure (especially roads). Although the government funding of R&D has steadily increased in the 1990s in nominal terms its share in both state budget expenditures (Table 2) and in Poland’s GDP has consistently fallen. Its ratio to GDP reached in 1999 its lowest level after the war (0.4%).11 If the private sector R&D outlays were included this ratio would increase to 0.7%, which is still well below the OECD (2.15%) and EU averages (1.85%) and also lower than the respective indices in the Czech Republic or Hungary [Blazyca and Rapacki, 2001]. As a result, the 1990s brought a marked deterioration of key indicators illustrating the innovative capability of the Polish economy. They include data on inventive and patent activities, trade of licences and the share of new and improved products in industrial output [Blazyca and Rapacki, 2001]. The government failure in encouraging the indigenous R&D effort, developing domestic science and technology base and in generating new knowledge and technological innovations may impede the further growth of productive and allocative efficiency and by the same token adversely affect the competitive position of Polish firms in the global environment.

10 The health care system reform implemented in 1999, due to serious shortcomings in its very design, has not solved this problem.
11 A similar trend was recorded in Polish industry: the share of R&D expenditure in the value of output decreased from 0.43% in 1991 to 0.42% in 1999 [Rot, 2001].
5. The unequivocal assessment of public expenditures as a vehicle for enhancing the development of human capital in Poland is difficult. On the one hand, the share of government funding of higher education in state budget expenditures tended to grow in the 1990s (exception being year 2000 – see Table 2). On the other hand, the upward trend in government financing did not match an even faster increase in demand for college and university education – between 1990 and 2000 the number of students enrolled almost quadrupled. Some 50% of this increase was absorbed by mushrooming private colleges and graduate schools. However, this quantitative expansion has not always come in par with appropriate content of curricula and quality of delivery. Simultaneously, the ambiguity of government policy about the status of higher education (merit good or private investment) and the perverse system of incentives prevailing in public universities adversely affected both instruction and research. Nonetheless, all in all the new developments in the field of higher education have no doubt contributed to a considerable increase of the stock of human capital in Poland. Similarly, the rising inflow of public funds to the health care sphere has not helped much in solving its structural problems. It remained mostly inefficient and ‘patient-unfriendly’ even after the reform of 1999. On the other hand, however, most indicators of the health status of Polish population did improve during the 1990s, which apparently reflects positive changes in human capital as well.

6. Public expenditure can also give rise to some important macroeconomic effects indirectly – through the balance of the state budget (and more broadly – the general government sector or PSBR). Polish fiscal authorities have run deficits in every year of the last decade, exception being only 1990. These have not been excessively expansionary, however, as both the state budget deficit and that of the general government sector as a percentage of GDP have been falling. Moreover, until 1999 both measures of fiscal imbalance were kept below the ‘Maastricht ceiling’ (3% GDP). This trend was reverted in 1999. Although the central budget deficit alone was still under control (2.3%) the overall deficit of the government sector augmented to 3.2% and in 2000 it grew further to 3.8% of GDP [Rocznik Statystyczny, 2000; OECD, 2001]. The major shock came from extra-budgetary funds – their expenditures in 1999-2000 increased much faster than revenues and the resulting deficit rose to 1% of GDP. The single most important source of these developments lied in the endangered liquidity of the Social Insurance Fund (FUS) – its surplus from earlier years turned to deficit amounting to 0.8% of Poland’s GDP. The fiscal stance of the government dramatically deteriorated in 2001. The unanticipated loosening of fiscal policy led to two unfavorable macroeconomic effects. First, it diminished the stock of domestic savings available for investment. One of the peculiarities of Poland’s economic growth path in the 1990s, compared to other Central European countries, was the combination of fastest GDP growth and the lowest savings rate (some 20% of GDP in average) [Rapacki, 2001]. Depressed domestic savings should be seen as a potential supply-side barrier to long-run economic growth. Second, growing fiscal deficit was eventually conducive to crowding out of private investment. Statistics seem to support this assertion. In 1999 the growth rate of gross fixed investment halved, compared to 1998 (6.9% and 14.1%, respectively). In 2000 it grew only by 3.1% and in 2001 is expected to fall in absolute terms.

7. A more expansionary fiscal policy has also put in motion a chain reaction in terms of adjustments in monetary policy that in turn gave birth to induced macroeconomic effects. Since 1999 the monetary policy has undergone a sharp tightening; as a result real interest rates have been running at double-digit levels (14%-15% for business loans and 10% for bank deposits). Although excessively restrictive monetary policy was very effective in disinflating
the Polish economy (CPI is expected to be 4.5% in 2001, down from 8.5% in 2000) it is simultaneously to be blamed (at least partly) for a dramatic slow down of economic growth in Poland (from 4.0% in 2000 to a likely 1.5% in 2001). Seen from a long-run economic growth perspective the combination of the expansionary fiscal and restrictive monetary policies is the worse policy-mix possible. If continued it would entail: /1/ fall in the average efficiency of resource allocation, /2/ discouragement of private investment and /3/ slower growth of potential output [Rapacki, 2001].

As a concluding remark in this section we will attempt to briefly hypothesize on possible determinants of the major trends and effects of public expenditure, outlined earlier, applying the public choice framework. First, it should be noted that two previous Polish governments (1993-97 and 1997-2001) – due, inter alia, to their coalition nature – were particularly susceptible to the pressure of special interests. This holds true especially in the case of trade unions whose political influence by much exceeded their real significance at factory level (a sort of a ‘trade unionist capture’). One of the most detrimental effects of their political power, the outbreak of unemployment in end-1990s, stemmed in large part from their resistance to reform the labor code with a view to make the labor market more flexible. Similar pressures were coming from other powerful special interest groups – regional, sectoral, professional, etc. Second, the past ruling coalitions appear to have embarked on a policy aimed at maximizing the volume of ‘political goods’ and at redistribution of the ‘economic pie’ rather than increasing the size of the latter. This gave birth to political favoritism and the development of ‘crony capitalism’ – Polish politicians tended to trade off efficiency goals for political perks. The widespread rent-seeking, as a symptom of government failure, was the obvious outcome. Third, the above developments entailed strengthening of the ‘short-sightedness’ effect. This would explain the strong bias of public expenditures towards short-term goals and negligence of positive externalities that might enhance the long-run growth potential of the Polish economy and its international competitiveness in the global marketplace.

4. Challenges ahead

As Poland’s accession to the European Union proceeds, the role of monetary (and exchange rate) policy will diminish and the role of fiscal policy by necessity will increase. This, combined with global developments and several vulnerabilities of the Polish economy, creates serious challenges for fiscal policy in general and public expenditure in particular. The following major challenges deserve highlighting here.

The first is connected with unanticipated liquidity problems that emerged in the state budget in mid-2001 and endangered stability of the entire general government sector. They were a derivative of three factors: (i) economic slow down, (ii) cumulative effects of past government failures in fiscal policy and (iii) imprudent decisions to excessively increase public expenditures taken by the outgoing parliament during 2001. As a result, the state budget deficit in 2001 is likely to overshoot the target figure by some two-percentage points (4.7% of GDP compared to 2.7%). Moreover, if no countervailing action were undertaken the pertinent deficit would rise in 2002 to 11% of GDP. The new government, in the office since mid-October, pledged to keep the deficit within the 5%-5.5% band. It will have, however, to resort to unpopular measures including spending cuts and higher or new taxes. Some of these measures (e.g. new tax on deposit interests and capital gains) may prove detrimental to domestic savings and future growth prospects.
The second challenge is closely related to the first one. Ad hoc measures proposed by the new ruling coalition are insufficient to solve structural problems and restore sustainable, long run fiscal stability. What is really needed is an in-depth, comprehensive reform and overhaul of Poland’s public finance system aimed to make it simpler, more transparent, effective and ‘development-friendly’. A key precondition of such a reform is the redefinition of the new role and functions of the government in a maturing market economy. As far as fiscal reform is concerned, the following changes seem the most desirable:

- Consolidation of extra-budgetary agencies, special funds and entities into the state budget or local governments budgets, which would allow a stronger control of fiscal authorities over public expenditures.
- Simplification of the tax code and the subsequent reduction of tax rates (stronger supply-side incentives for private entrepreneurship).
- Fine-tuning of the social safety net (means-tested approach) to reduce the burden of transfer payments on public expenditures.
- Reprioritization of public expenditure towards provision of public goods at the cost of redistributive objective.
- While ranking public (merit) goods top priority should be given to those expenditure items that create or enhance positive externalities for private markets, such as e.g. spending on R&D, human capital, new opportunities increasing access to information-communication technology, and investment in physical infrastructure.

Third, delayed restructuring and privatization in a number of key sectors of the Polish economy and the political power of the labor force in those sectors (e.g., mining, railways, metallurgy, power generation and agriculture) may lead to excessive fiscal expenditures to appease these social groups. Bearing in mind the electoral program of the present government coalition and the expectations of their constituency one may wonder what is the political feasibility of a comprehensive fiscal reform outlined above. Additional political pressures may arise from skyrocketing unemployment and growing income and regional disparities.

Fourth, a special challenge of strategic significance stems from Poland’s accession to the European Union. EU assistance funds to promote integration must be effectively absorbed, minimizing the potential of a real appreciation of the zloty and reduction in international competitiveness (the Dutch ‘disease’). In this regard Spain and Portugal may serve as examples of effective utilization of EU assistance funds to meet development goals as opposed to Greece where problems have been more prevalent.

Finally, Poland, as a small open economy, will be increasingly exposed to global interdependencies and external shocks. The real challenge here boils down to the question: how to best appropriate potential benefits of globalization while minimizing the costs to be borne? In the case of public expenditures Poland’s growing global exposure may bring about both gains and losses. The former may consist in ‘institutional convergence’, that is in sticking to global trends in public governance, which entail downsizing the government in general and contracting out some of its traditional functions to private agents. Simultaneously, this may call for a new ranking of public goods or government functions. The demand is likely to increase for those government actions in particular that are to alleviate such market failures as information imperfections, incomplete or missing markets and global pollution.

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12 More details can be found e.g. in [Rapacki, 2001a].
13 A potentially promising device for fostering infrastructure investment is the Public-Private Partnership (PPP).
14 For an interesting discussion of the relevance of those countries’ experience for Poland, see Orlowski [1996].
The gains may also materialize in an improved access to newest information technology, financial management techniques, proven fiscal procedures and best international practices that enhance effectiveness and transparency of public finance. On the other hand, globalization is likely to result in higher volatility of economic conditions (due, for instance, to rising divergence between the ‘real’ economy and financial markets) and more uncertainty in designing and executing fiscal plans. Simultaneously, it may entail swapping the domestic rigidity in public expenditure for external constraints. These may stem, for example, from EU-imposed norms and standards that would call for increased spending or excessive government regulation. Another possible source of rigidity may originate from Poland’s new commitments as a NATO member after 11 September (e.g. higher spending on national defence or concerted anti-terrorist actions). As a concluding remark, it is worth noting that Poland’s growing global exposure may be also seen as a factor that in some respects constrains the autonomy of national fiscal authorities and adds a new dimension to the problem of their accountability.
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