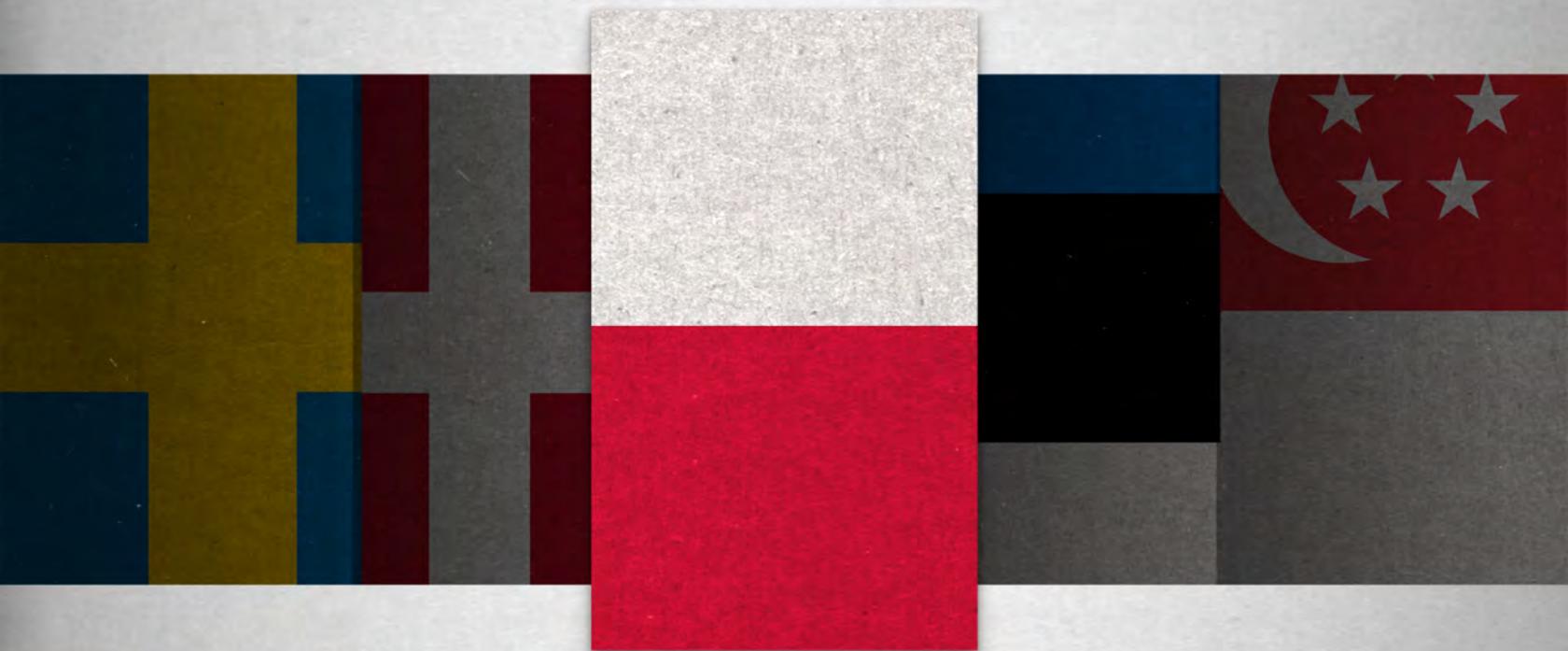


# THE ROAD TO SOCIALISM AND BACK

An Economic History of Poland, 1939–2019

Peter J. Boettke, Konstantin Zhukov, Matthew Mitchell



REALITIES OF  
**SOCIALISM**



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### **Dedications**

The authors jointly dedicate this book to Anna Walentynowicz, whose sense of justice helped spark a revolution that toppled an empire, and whose death made her one of the last victims of the Katyn massacre.

Peter J. Boettke dedicates this book to Matthew, Stephen and Liz and the hope that their generation and beyond will escape the errors of the socialist past and instead enjoy the peace and prosperity produced by the creative power of a free civilization.

Konstantin Zhukov dedicates this book to Anna and Richard, for inspiring his intellectual curiosity and pursuit of knowledge.

Matthew Mitchell dedicates this book to Megan for her constant love and support.

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## THE POLISH EXPERIMENT

For four decades during the latter half of the 20<sup>th</sup> century, Poland and its people were the subjects of a grand socio-economic experiment. Under the watchful eye of its Soviet masters, the Polish United Workers' Party transformed the mixed economy of this nation of 35 million into a centrally planned, socialist state (albeit one with an irrepressible black market). Then, in the closing decade of the 20<sup>th</sup> century, under the leadership of Polish minister of finance Leszek Balcerowicz, the nation was transformed back into a mixed economy.

In this book, we document the results of this experiment. We show that there was a wide chasm between the lofty goals of socialist ideology and the realities of socialism as the Polish people experienced them. We also show that while the transition back from a socialist to a mixed economy was not without its own pain, it did unleash the extraordinary productive power of the Polish people, allowing their standard of living to rise at more than twice the rate of growth that prevailed during the socialist era. The experiences of the Poles, like those of so many behind the Iron Curtain, demonstrate the value of economic freedom, the immiserating consequences of its denial, and the often painful process of regaining lost freedoms.

The road to socialism and back also teaches us something about the intellectual development of economic thinking. As we will see, the debate surrounding economic calculation in a socialist economy highlighted not only a fundamental flaw in socialist planning, but also a critical feature that allows markets to work. Markets work because they permit economic decision-makers to engage in rational economic calculation. This calculation depends on the constellation of relative prices and the accounting of profits and losses that emerge from the free choices of individuals trading property rights. It allows us to sort out the economically viable projects from the technologically feasible ones. Without such a price system, these calculations are impossible, and this sorting does not occur. Resources are systematically wasted and inefficiencies in production and exchange abound.

In the middle of the 20<sup>th</sup> century, many economic theorists were blind to the basic but crucial point that the price system depends on the property rights arrangements within which it operates. The appreciation of this fact led to the emergence of property rights economics, the fields of law and economics, public choice economics, and the entrepreneurial theory of the competitive market process. It is those theories that were able to shed light on the failing socialist economies of the 1980s and their collapse between 1989

and 1992. Moreover, these ideas formed the theoretical underpinning of the transition from socialism to an economy grounded in private property and freedom of contract protected by the rule of law.

But it is one thing to state this basic formula and quite another to implement it and sustain it against the political pressures of a new class of interest groups. As memories fade and as the number of living witnesses to the socialist experiment dwindle, the temptation to jump back on the road to socialism grows stronger.

Here is the plan for the book. In chapter 1 we discuss the political economy of socialism. We focus on the three great challenges of socialist planning—the control problem, the knowledge problem, and the incentive problem—and describe how these challenges give rise to what we call the pathologies of privilege. In chapter 2 we discuss the socialist era in Poland, describing how the communist government took control and attempted to centrally plan the Polish economy. We describe the features of the socialist economy—from the elimination of private property and central planning to soft budget constraints, rampant shortages, favouritism, and black markets. We also discuss the different approaches taken by successive socialist administrations (though our discussion is only loosely chronological). The chapter ends with the economic and political crisis that emerged in the early 1980s. In chapter 3 we discuss the transition from socialism to a mixed economy. We address the so-called Washington Consensus and shock-therapy as well as the main components of Leszek Balcerowicz's transition plan. In chapter 4 we assess the transition. We discuss both the good—hyperinflation was tamed, shortages disappeared, growth resumed, and living standards rose—and the bad—unemployment soared and remained high for decades. In chapter 5 we discuss the changed landscape of the new, mixed, Polish economy. In chapter 6 we describe contemporary economic and regulatory policy in Poland. And in chapter 7 we discuss three services that are typically provided in both socialist and mixed regimes—social safety nets, health care, and education—contrasting their provision under the socialist and mixed-economy regimes. In chapter 8 we offer concluding remarks.

## THE POLITICAL ECONOMY OF SOCIALISM

In a socialist regime, the state owns and operates the means of production. The main goals of socialism are the ultimate eradication of want from human experience, and material and social equality between individuals.<sup>1</sup> In Marx's view, this new order is supposed to come about through natural historical processes, whereby the capitalistic stage of society is replaced by the socialistic stage and, eventually, the communist stage in which the state withers away.<sup>2</sup> Lenin, however, believed that capitalist forces would suppress revolutionary notions and that a revolutionary vanguard needed to seize power by force and establish a dictatorship of the proletariat.

Private property would eventually become a relic of the past and all individuals would be able to obtain desired goods and services at will. Central planners, who would be capable of correctly estimating the needs of the population and effectively providing for these needs through the appropriate mechanisms, would provide these goods and services (Conway, 1987).

This, at least, was the goal. In this chapter, we briefly sketch the challenges that socialist planners face in attempting to realize this goal. These are the control problem, the knowledge problem, and the incentive problem. Together, these challenges give rise to what we call the pathologies of privilege.

The sad irony is that the society of a socialist state bears a striking resemblance to Marx's indictment of capitalism. Though he thought it was capable of "massive" and "colossal productive forces" Marx believed that capitalism would ultimately lead to stagnation, inequity, materialist obsession, worker alienation, environmental degradation, political suppression, crisis, and revolt.<sup>3</sup> As we will show, this is exactly what materialized in socialist Poland (Clark and Wildavsky, 1991).

### The control problem

First consider the control problem. Above all, central planning requires control. To state the obvious, every human is different. We each have our own interests, abilities, and plans. In a market economy, people are free to make their own plans, fitting them in with the plans of others through a process of mutual adjustment. But in a centrally planned economy, the planner who wishes to reallocate capital or labour must override the individual plans of the people. In Adam Smith's famous metaphor, the central planner

seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might chuse to impress upon it. (Smith, 1759: VI.II.42)

In impressing their own plans upon individuals, planners must exercise a great deal of control. They must override what Smith identified as the natural, human “propensity to truck, barter, and exchange” (Smith, 1776: I.II). They must override individuals’ plans to work, shop, invest, and exchange with whomever they want on whatever terms they want. And to do this, they must apply force or the threat of force.

Once leaders obtain this power, moreover, they are liable to abuse it. The Russian revolutionary Mikhail Bakunin warned in 1873 that

from whatever point of view we look at this question, it always comes down to the same dismal result: government of the vast majority of the people by a privileged minority. But this minority, the Marxists say, will consist of workers. Yes, perhaps of *former* workers, who, as soon as they become rulers or representatives of the people will cease to be workers and will begin to look upon the whole workers’ world from the heights of the state. They will no longer represent the people but themselves and their own pretensions to govern the people. Anyone who doubts this is not at all familiar with human nature. (Bakunin, 1873/1990: 178)

Socialist thinkers were unphased by these concerns because they believed that socialism would remake human nature. The New Socialist Man (sometimes called the New Soviet Man) was to be intelligent, healthy, muscular, selfless, and supremely dedicated to the cause. The New Socialist Woman was to be an upright communist citizen, loyal to the state, her job, and her family (Clements, 1994).

The advocates for economic freedom, by contrast, were much less utopian. For them, the system of free enterprise serves human wants and desires, even if humans are deeply flawed. As Friedrich Hayek put it, Smith and his contemporaries had advocated for a

system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid. (Hayek, 1948: 11-12)

Because free enterprise operates without any central command structure, it need not have perfect men and women at the helm. And because the system is an open-access order, as

North, Wallis, and Weingast (2009) have put it, free enterprise is not as susceptible to sincere errors or human imperfections as is the command economy. If a private entrepreneur fails to see an opportunity or misjudges consumers' wants, another rival can jump into the market and profit by correcting this oversight. But if a central planner errs, there is no check or balance to his mistakes.

And if power corrupts, as Lord Acton warned, then he may be liable to make quite a few mistakes (Acton, 1887). Worse still, the apparatus of control may tend to *attract* the worst elements of society. Here, again, Adam Smith was prescient, warning that the statesman who attempted to plan peoples' lives would "assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it" (Smith, 1776: IV.II).

Hayek would also pick up on this point, arguing that in a centrally planned state, the worst would tend to rise to the top of the hierarchy. One reason, he suggested, was that "It seems to be almost a law of human nature that it is easier for people to agree on a negative program—on the hatred of an enemy, on the envy of those better off—than on any positive task" (Hayek, 1944: 153). As we will see, Smith, Bakunin, and Hayek's concerns were all realized in socialist Poland.

In summary, the control problem suggests that socialism and totalitarianism go hand-in-hand. To exercise this much control over the behaviour of humans, the state must erect a vast apparatus of coercion. Once it has done so, the apparatus will attract the worst elements of society, especially those who are willing to seek and maintain power through demagoguery. Thus, it is no accident that socialist states routinely employ secret police, a network of informants, forced labour camps, the threat of extradition, and mass murder (Paczkowski, 1999). These measures did not go so far in Poland as they did in other socialist countries. But as we will see, even the comparatively "mild" variety of totalitarian socialism was terrifying.

### The knowledge problem

If the control problem requires planners to rearrange the members of society like so many chess pieces, the knowledge problem suggests that planners will not know where to put the pieces. Though Donald Lavoie coined the term in 1985, the knowledge problem was first raised by the Austrian economist Ludwig von Mises in 1920 and elaborated on by fellow Austrian Friedrich Hayek in 1945 (Mises 1920/2015; Hayek 1945; Lavoie 1985).<sup>4</sup> As Mises and Hayek explained, useful economic knowledge often concerns what might seem to be trivial or mundane, such as consumers' subjective preferences or workers' alternative job opportunities. This knowledge is highly dispersed; it is found in the subjective, often contradictory beliefs of countless market participants.

This is not just a matter of communicating *existing* information up and down the chain of command—though that, too, can be a problem in a bureaucracy.<sup>5</sup> For example, if the

task were simply to communicate that “a mining truck has broken down in Silesia” this could be done. The Polish socialist economist Oskar Lange (mis)interpreted the problem this way and thought it could be solved by computers (Lange, 1967).

But the type of knowledge involved in the knowledge problem is often tacit and contingent and cannot be communicated, even if one were instructed to do so. Think, for example, of the tacit knowledge involved in negotiating with a particular vendor, or the impossible-to-recount strategies one has adopted to manage a complex workflow. This sort of knowledge is only gained through trial and error.

Importantly, *some economic knowledge can only be known when a decision-maker is faced with a decision*. For example, it is impossible to know whether customers will prefer a more durable but more expensive fabric to a flimsier and cheaper alternative until they are given the opportunity to choose. Even the apparently simple example of the broken-down truck is not so simple. Only when an actual customer is faced with the actual choice of paying for repairs will we know whether, in the customer’s mind, the repairs are worth the expense.

In a market economy, Mises and Hayek argued, prices elicit this dispersed knowledge, turning it into signals to which others may react. To take Hayek’s example, if consumers come to place more value on tin, or if producers find it more difficult to make tin, then the price of the metal will rise. This signals to consumers that they should economize on its use and encourages entrepreneurs to explore alternative ways to satisfy consumer desires. In Hayek’s words, this allows people to “fit their plans in with those of others” without any central coordination or coercion (Hayek, 1945: 521).

But for this process to work, prices must emerge from the free choices of individuals exchanging rights over private property. Moreover, entrepreneurs must be allowed to try out new ideas, to experiment with novel products, production techniques, prices, and management strategies. As Hayek would later put it, competition serves as a “discovery procedure” (Hayek, 2002).

In this way, exchange helps sort between the merely technologically feasible and the economically valuable. For example, it may be technologically feasible to build houses with platinum instead of brick. But the only way to know whether it is economically valuable to do so is if a customer out-bids others for the scarce raw material (Boettke and Storr, 1985/2015). In this sense, competition is not an end-state in which price equals marginal cost, as the textbook competitive model tells us, but a *process* of entrepreneurial discovery (Mitchell and Boettke, 2017: 36).

Because central planners set prices by diktat and because their plans do not countenance the “chaos” of market experimentation, they are unable to make use of this knowledge. They are blind, guessing at the marginal value that consumers place on goods as well as the marginal opportunity cost of producers. This is the essence of the knowledge problem. And according to Mises and Hayek, it makes central planning extremely difficult, perhaps even impossible.

The knowledge problem tends to grow more severe over time. At first, planners can copy the prices that emerged under the free choices of individuals before the imposition of central planning. But as preferences, technologies, and opportunities evolve, these prices will diverge more and more from the current subjective realities of market participants. The knowledge problem is especially acute when it comes to brand new knowledge produced by entrepreneurial discovery, for in this case, there was no previous price.

The knowledge problem also becomes more severe as the *type* of growth changes. After the conflagration of World War II and the Soviet looting of productive property, the capital stock of Eastern Europe was decimated, so the main task for many countries in the communist bloc was to rebuild their capital stock. As Nobel Laureate Robert Solow explained, this type of growth—which has since come to be known as “catch-up growth”—can be quite rapid (Solow, 1956). Note that since the previous capital stock was known, planners did not face a significant knowledge problem during the catch-up phase of growth. Once these nations had rebuilt, however, new growth was not simply a matter of adding more machines.<sup>6</sup> At this point, new growth had to be driven by new ideas—or at least by copying new ideas from other countries. This type of “cutting-edge growth” is not so easy to achieve. And since it requires brand new arrangements of capital, it presents a significant knowledge problem.

### The incentive problem

The control problem and the knowledge problems are compounded by the incentive problem. Simply put, most decision-makers in a socialist system are not given an incentive to serve the general interest. In fact, many decision-makers can improve their positions by *undermining* the general interest.

First, consider the interests of the leader. The late public choice economist Mancur Olson provocatively suggested that when powerful and secure dictators first come to power, they have an incentive to maximize society’s wealth. This is because dictators have what he termed an “encompassing” interest in the productivity of the societies they oversee (Olson 1982; 1993). Writing in 1991 as the socialist systems in Eastern Europe were falling apart, Olson and Peter Murrell described the encompassing interest of the socialist dictator:

Consider Stalin. At least to an approximation, he controlled the Soviet Union just as the owner of a firm in a market economy controls his firm. He had, as it were, a property right in his society that democratic politicians did not have in any of the societies of the West. Just as the owner of a firm has an incentive to make the firm as valuable and productive as possible, so Stalin had an incentive to make the domain he owned as productive and wealthy as he could. (Murrell and Olson, 1991: 253)

Even if an autocrat’s “sumptuary styles should be exceptionally grand,” they continue, “the resources needed to provide for their personal consumption are bound to be small in relation to the output of a nation; it is the leaders’ interest in power, prestige, and

international influence that is important” (Murrell and Olson, 1991: 254). This doesn’t necessarily mean that the leader has an incentive to maximize the *welfare* of the average worker, only the *growth rate* of society at large, since it is upon the latter that his own welfare depends: “The consumption of ordinary citizens need be no higher than the leader determines is necessary to ensure a healthy and productive workforce” (Murrell and Olson, 1991: 255).

In related work, Olson (1993) likened a secure and powerful dictator to a “stationary bandit” that predares on his society. Because a secure leader plans on sticking around for a while, he has an incentive to maximize the wealth of the society upon which he feeds. The story is quite different, however, for an insecure leader whose tenure is less assured. An insecure dictator, he reasoned, is like a “roving bandit.” He too predares on society but because he doesn’t know how long his own tenure will last, he is less concerned with the long-run health and stability of the society on which he feeds. “Whenever an autocrat expects a brief tenure,” Olson explains, “it pays him to confiscate those assets whose tax yield over his tenure is less than their total value. This incentive plus the inherent uncertainty of succession in dictatorships imply that autocracies will rarely have good economic performance for more than a generation” (Olson, 1993: 567).

Next, consider the incentives of subordinates. Socialist societies, of course, are supposed to ensure equality. But central planning tends to create stratification. One reason is that central planning requires bureaucracy and bureaucracies everywhere tend to become hierarchical over time. To ease the managerial and informational demands of supervision, bureau chiefs delegate authority to other managers and they, in turn, further delegate, creating a pyramid-shaped organizational structure (Mises, 1944/2007; Tullock, 1965). Managers soon learn that they can increase the perquisites of their positions if they can contrive to increase the size of the operations they oversee (Niskanen, 1971; 1975).

As corporate workers in market economies can attest, private firms are susceptible to bureaucratization too. But in a competitive market, entrepreneurs can challenge firms that have become overly bureaucratic. Even the threat of such a challenge can discipline firms to keep costs low, customers happy, and internal bureaucracies in check (Baumol, 1982). And if it doesn’t, then old behemoths will be replaced by newcomers. This sort of churn, when it is permitted, tends to check monopoly power and enhance productivity.<sup>7</sup> There is no such check in a socialist planned economy.

Entrepreneurship is one casualty. Though central planners in socialist societies may want to encourage their managers to be entrepreneurial, the system’s incentives stand in the way. As Schumpeter explained, the role of the entrepreneur is to “reform or revolutionize the pattern of production” (Schumpeter, 1912: 132). So almost by definition, innovation is a departure from the norm, a challenge to the “plan.”<sup>8</sup> The socialist manager who departs from the plan, however, risks missing his planning targets and therefore his bonus. Even if he were willing to take this risk, he would gain no personal share in the reward if his innovation worked. As a result, there is very little innovation in planned economies (Smith, 1983: 57).

There is also very little creative destruction, and this means that these economies tend to be dominated by inefficient, hulking, bureaucratic state-owned firms. And even if a secure dictator's incentives are encompassing, the incentives of those who lead these behemoths are certainly not. Their incentive to accurately transmit information up the chain of command is especially perverse:

Each subordinate's chances of promotion or bonuses are lowered if a superior learns of his mistakes, his shirking, and his other forms of on-the-job consumption. There is accordingly an incentive not to transmit, or even actively to conceal, information about any shortcomings that can be successfully hidden. There is also an incentive to overstate the difficulties faced and to understate potential production. The incentives to distort information operate and cumulate at every level of a hierarchy, so they increase nonlinearly with the size of the bureaucracy and are bound to be exceptionally serious in a centrally planned economy. (Murrell and Olson, 1991: 255-56)

By forcing bureaus to compete with one another, the central authority may be able to overcome some of these problems, especially when the regime is new, or "after a purge, cultural revolution, or other total shake-up of society" (Murrell and Olson, 1991: 257). But over time, groups of individuals up and down the chain of command overcome the collective action problems that stand in the way of working together and find it easier to collude with one another.<sup>9</sup> This can happen at the upper level of the bureaucracy, where managers withhold or distort information to press for more power and resources for themselves. And it can happen at the individual work-group level where workers collectively shirk (Murrell and Olson, 1991: 260).

According to this theory, the process eventually undermines the chief ideological aims of socialism—social and economic equality and the elimination of want. In the end, an entrenched aristocracy of bureaucrats extract society's wealth and misallocate resources, leading to stagnation and collapse.

Eventually, the devolutionary process that our theory predicts reaches the point where the dictatorship of the General Secretary and even of the Politburo largely disappears. The higher ranking subordinates gain so much power that they become the constituents of the General Secretary and the Politburo and, ultimately, the people who determine who becomes General Secretary and who enters the Politburo. The last stage of communism is not the stateless and classless society that Marx forecast, but rule by a rather large aristocracy of upper level bureaucrats. When this stage is reached, the encompassing interest of the dictatorial leader that has been the motivating force for growth and productivity in the traditional Soviet-type society disappears. The class of officials to whom power has devolved is then too large to engage in productive collective action. When this stage is reached, no one owns the society, and no one has an incentive to make it work. So economic performance

deteriorates even further. In time, the system must collapse or be fundamentally transformed. (Murrell and Olson, 1991: 260)

### The pathologies of privilege

As upper level bureaucrats gain power, a whole new set of problems known as the “pathologies of privilege,” arise (Mitchell, 2012). These pathologies are a set of social and economic problems that occur when some members of society are privileged over others. Of course, socialism is supposed to eliminate privilege and the official wages for the various jobs reflected this goal. Managers earned higher wages than the workers they oversaw, but the differences were not as great as in the West.<sup>10</sup> As one study found, “inequality of official money incomes does not itself constitute a primary dimension of social inequality” (Asselain, 1987: 21). Instead, the main source of inequality arose from unequal access to scarce goods. As Clark and Wildavsky put it, “The locus of privilege [in a socialist political economy] is scarcity” (Clark and Wildavsky, 1991: 163).

Theoretically, by making it difficult for socialist managers to set prices correctly, the knowledge problem could have made surpluses just as common as shortages, irrespective of the good in question. Instead, there was a consistent pattern: socialist systems tended to experience surpluses of raw materials and shortages of consumer products. As the Hungarian economist János Kornai put it, “shortage and slack appear simultaneously in the same workshop” (Kornai, 1980: 35).

Political economy explains why. Concentrated interests find it easier to organize for political action than do diffuse interests (Olson, 1965; Lowi, 1969). And compared with the makers of consumer goods, the producers of raw materials were more concentrated and therefore better at lobbying the central authorities to ensure that the overarching plan demanded their materials.<sup>11</sup> Meanwhile, central planners and the managers that lobbied them engineered shortages of consumer goods (Levy, 1990; Shleifer and Vishny, 1992). Shleifer and Vishny explain why:

These bureaucrats intentionally plan shortages in order to invite bribes from rationed consumers. If markets cleared, firms in an industry could earn profits, but most of these profits would accrue to the state treasury, not to the managers or the ministries. The key feature of socialism is that the decision makers who determine the prices and output of firms do not, to a first approximation, keep any of the profits. In contrast, when there is a shortage of a good, potential customers try to obtain it by offering bribes and favors to the bureaucrats in the ministry (and to the managers of firms). (Shleifer and Vishny, 1992: 238)

In an important contribution to economic theory, Gordon Tullock argued that when individuals can use the political process to obtain privileges such as transfers or above-normal profits, they have an incentive to expend scarce resources *seeking* these privileges (Tullock, 1967). In many cases, these efforts are themselves wasteful. Individuals, firms, and

“ministerial lobbies” (as they were known in socialist Poland) will waste time, money, and effort ingratiating themselves to higher authorities. For example, they may hire these authorities’ friends or family members, or alter their business models to curry favour with decision-makers, even if these alterations create no value for consumers (Mitchell, 2019). Because the above-normal profits of privileged monopolists are called “rent,” these wasteful efforts have become known as “rent seeking.”<sup>12</sup>

Tullock showed that this waste grows as the privilege-seeking “market” grows more competitive and as favoured interests get better at seeking favour (Tullock, 1980). Ultimately, this leads to a perverse allocation of talent as society’s best minds dream up new ways to obtain privilege rather than new ways to create value for consumers (Baumol, 1990; Murphy, Shleifer, and Vishny, 1991). Moreover, the wasteful competition for privilege can take place at multiple levels. Firms and ministerial lobbies will waste resources competing over perquisites and above-normal profits, while party officials and bureaucrats will waste resources competing over the right to *dispense* these privileges (Buchanan, 1980).

In an important extension of Tullock’s concept, Fred McChesney developed the notion of “rent extraction” (McChesney, 1987; 1997). In this case, the problem is not favour but disfavour. If those in power are able to selectively punish certain members of society—say, by threatening their livelihoods—then the threatened interests will waste time, money, and effort trying to avoid being subject to predation. Given the control problem and the large apparatus of coercion in socialist societies, rent extraction could be rife.

Ironically, it is sometimes possible to avoid the waste associated with rent seeking and rent extraction when it is impossible to contest favour or disfavour (Mitchell, 2019). For example, Polish First Secretary Edward Gierek was infamous for favouring his home-region of Silesia with investments (Clark and Wildavsky, 1991: 120), but this probably didn’t generate much rent-seeking waste if officials from other regions assumed that their entreaties were unlikely to win his favour. In this sense, government-granted privilege traps citizens between the Scylla of contestable favour, which maximizes rent-seeking waste, and the Charybdis of uncontestable favour, which maximizes inequity.<sup>13</sup>

In another irony, Tullock (1975) showed that favoured interests typically don’t earn above-normal profits (rent) over the long run. As he put it, “there are only transitional gains to be made when the government establishes special privileges for a group of people” (Tullock, 1975: 671). Those who were initially privileged may benefit handsomely. But after that, newcomers must often pay a price to access some sort of asset or station that entitles them to the privilege. For example, if one needs to be a member of the party in order to obtain certain privileges, then eventually aspirants will bid up the price of joining the party or rising in its ranks. Of course, this “price” may not be a monetary price. And it may not be legal. It may be paid in favours or gifts or special attention given to party leaders. Net of this price, the privilege may not be especially valuable (and its value is further reduced by the fact that rent-seeking societies are poor societies (Murphy, Shleifer, and Vishny, 1993).) Whatever price is paid, however, it is often a sunk cost and cannot be recovered. This means that if a privilege is then taken away—say because of a transition

to free enterprise—then those who “paid their dues” to rise to the top of the party will have no way to recover their sunk costs. As we will see, this was an especially important factor during Poland’s transition away from socialism.

Now that we have sketched the contours of socialist political economy, we are ready to see how socialism actually played out in Poland.

## Notes

- 1 The terms “communism” and “socialism” have a complicated and technical history. Many of the regimes of the 20th century that described themselves as communist countries were still in their socialist stage. That is, they were thought to be transitioning from the previous capitalist economy to the full communist system. However, by the traditional definitions, none ever achieved the final stage of full communism in which the state withered away. So, we will refer throughout to these regimes as socialist economies, reserving the words “communist” and “communism” for the parties or for the international alliances (such as the communist bloc).
- 2 It was Karl Marx who developed this notion of the stages of history. In his view, societies naturally progress through six stages: primitive communism, slave society, feudalism, capitalism, socialism, and global stateless communism.
- 3 Marx and Engels waxed poetic about the productive power of capitalism, writing: “The bourgeoisie, during its rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding generations together. Subjection of Nature’s forces to man, machinery, application of chemistry to industry and agriculture, steam-navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalisation of rivers, whole populations conjured out of the ground – what earlier century had even a presentiment that such productive forces slumbered in the lap of social labour?” (Marx and Engels, 1848).
- 4 For a comprehensive review of this debate, see Lavoie (2015) and Boettke (2000).
- 5 Gordon Tullock called this phenomenon “whispering down the lane” asserting that “the amount of error (“noise” in communications-theory terminology) would increase exponentially with the increase in the number of persons in the transmission chain and with the complexity of the message transmitted” (Tullock, 1965: 148)
- 6 Once it has rebuilt, a nation’s capital stock is close to its “steady state” level. At the steady state, old capital depreciates at the same rate that new capital is formed.
- 7 Though economically freer societies permit significantly more churn than did planned economies, they often privilege certain producers. Researchers find that societies that permit more churn among their top firms tend to grow faster (Fogel, Morck, and Yeung, 2008; Mitchell, 2012).
- 8 Clark and Wildavsky call this “the autonomy-command contradiction.” As they put it, “The command, ‘Be innovative!’ is like the commands ‘Be autonomous,’ ‘Think for yourself,’ or ‘Question commands.’ Part of being innovative is thinking differently, going outside or beyond what is ordered. In demanding that an individual follow the command to innovate, one is in essence commanding that he question commands. Not an easy task” (Clark and Wildavsky, 1991: 284).
- 9 One collective action problem is the temptation to free ride. It stands in the way of collusion. But over time, individuals with the same interests find ways to overcome the temptation to free ride and this can lead to the proliferation of special-interest pleading. This problem is not unique to centrally planned societies. In fact, Olson first developed his theory to explain sclerotic growth in advanced Western societies, attributing it to the rise of distributional coalitions that, over time, find it easier to collude with one another to obtain government protection from competition and other privileges (Olson, 1982). As his later work demonstrates, however, Olson came to believe that these problems were more serious in centrally planned socialist societies.

- 10 “The earned income of a factory director is barely three times that of a female dairy worker, a miner is better paid than a chief medical officer and a lawyer is well below a train driver” (Asselain, 1987: 33)
- 11 As we will see, without the signals of market-determined prices, profit, and loss, planners fell back on naïve targets such as weight counts.
- 12 The term “rent seeking” was coined by Anne Krueger who, unaware of Tullock’s original work, independently developed the concept. The economists’ peculiar use of the term “rent” as the above-normal profit of an exclusive producer dates back to Ricardo (Krueger, 1974; Ricardo, 1817: 33-44)
- 13 In 1972, the Polish Council of State created a new set of privileges with both uncontestable and contestable features. Among the uncontestable favours, the grandchildren of party leaders were awarded special rights to inherit property and have access to certain positions. This was grossly unfair but unlikely to generate wasteful rent-seeking since those who didn’t meet the criteria could do little about it. At the same time, the premier was given the power to extend these privileges to any individual of his choice. If we assume that he was open to the entreaties (and bribes) of any and all, then this form of privilege was an expensive open invitation to seek rent.



## SOCIALISM IN POLAND

### Poland succumbs to Soviet control

In September 1939, in accordance with the Molotov-Ribbentrop Pact, Germany invaded Poland from the West while the Soviets invaded Poland from the East (see figure 2.1). Within a month, the occupiers were in control, dividing the nation down the middle and annexing the occupied territories to their respective empires. Both occupations were brutal. In the West, the Germans summarily executed tens of thousands of Poles in Hitler's first attempt at ethnic cleansing (Rossino, 2003). In the East, in what became known as the Katyn Massacre, the Soviets killed 14,587 prisoners of war, burying them in mass graves in the Katyn forest (Paczkowski, 1999: 369). In total, about 30,000 Poles were shot by the Soviets during the occupation; between 330,000 and 340,000 were deported, sent to work in Soviet factories or mines; 90,000 to 100,000 died in deportation camps (Paczkowski, 1999: 372). Unfortunately, the Poles were no strangers to foreign occupation, having previously been invaded and partitioned by tsarist Russia, Austria, and Prussia. As Staniszkis (1979: 185) put it, "In the Polish tradition, the state was always an 'enemy' state."

In 1941, the Germans double-crossed their erstwhile allies, invading the Soviet Union and ending the non-aggression pact between the two nations. For the next three years, the Germans controlled the entirety of Poland, prosecuting a reign of terror against the local population, targeting Polish Jews, Romani, and other ethnic groups for mass murder and subjugation.

Figure 2.1: A Timeline of the Communist Takeover



Poland was devastated by World War II. Over 6 million Poles lost their lives. Thirty-eight percent of Poland's pre-war assets were destroyed. Sixty percent of all establishments, 38 percent of all rail lines, 20 percent of all arms, 43 percent of all cultural assets, and 55 percent of all medical facilities were lost (Brzeziński, 1967: 9). In the summer of 1944, as the Soviets prepared to reinvade, the Polish resistance Home Army organized the Warsaw Uprising. It was the largest counteroffensive of any European resistance movement during the war. The Soviets refused to grant RAF planes permission to use Russian airfields, leaving the Polish freedom fighters to fend for themselves against the Germans. More than 200,000 Poles lost their lives in this one episode. As British historian F.B. Singleton put it, the catastrophe “removed from the scene the only important non-Communist resistance movement in Eastern Europe and ensured that the future government of Poland would be made in the image of its Soviet patron” (Singleton, 1965: 96).

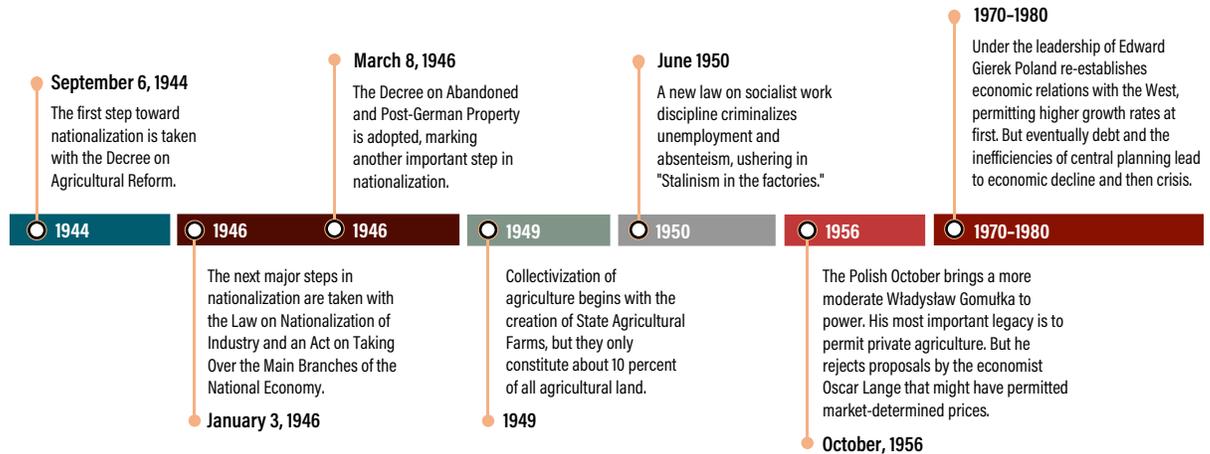
When the Soviets finally reinvaded in the summer of 1944, they established control through the communist Polish Committee of National Liberation. Stalin assured his Western allies that a post-war Poland would retain its sovereignty and that the nation's fate would be decided by free and fair elections. Nevertheless, once they established control over the country, the Soviets held fraudulent elections and established a one-party socialist regime run by the Polish United Workers' Party, merging the party with the formerly independent Socialist Party in 1948 (Hunter, 1986: 302). Bolesław Bierut, who considered himself a student of Stalinism, became the leader of Poland for the first decade of communist rule (Jerzy, 2014). To ensure control over the country, Constantine Rokossovsky, a Polish-born Soviet marshal, was appointed commander-in-chief of the Polish army and minister of defense in 1949. All high military positions in Poland were awarded to Russian officers, ensuring near-complete dominance by the Soviets.

Under this arrangement, Polish interests—like those of other communist bloc nations—were often sacrificed for the greater international communist cause. So when the United States offered aid to help rebuild Poland, Stalin insisted that Poland reject the offer, fearing it would lead to greater Western influence (Clark and Wildavsky, 1991: 51). In fact, the Soviets established something like the Marshall Plan in reverse. Marer estimates “the value of the unrequited flow of resources from Eastern Europe to the Soviet Union during the first postwar decade to be roughly \$14 billion, or of the same order of magnitude as the aid the United States gave to Western Europe under the Marshall Plan” (Marer, 1974; 1984: 156). Polish factories were dismantled and shipped to the USSR under the theory that the Soviets were entitled to them since the Germans had used them during the war. In total, the Soviets estimated that they took about \$500 million worth of industrial equipment from the Poles, which is less than they took from East Germany, Hungary, or Romania (Clark and Wildavsky, 1991: 91).

## The elimination of private property

“The theory of the communists may be summed up in a single sentence,” declared Marx and Engels in the *Communist Manifesto*: “Abolition of private property” (1848/1969: 22). Even before the establishment of the Polish People’s Republic in 1952, the Soviets began to expropriate productive private property (Kozminski, 1997). The process took several years and included both direct and indirect nationalization (see Figure 2.2).

Figure 2.2: A Timeline of Nationalization and Central Planning



Indirect nationalization generally took the form of confiscatory taxes on property reaching as high as 85 percent of income. Over time this forced property owners to renounce their property for the benefit of the state (Stec, 2001). Direct nationalization began in 1944 with a series of laws passed under the auspices of the Soviet-backed Polish Committee of National Liberation, stipulating confiscation of German property on Polish territory. In time, additional laws nationalized most economic activity in Poland. The most important acts enabling nationalization were the Decree on Agricultural Reform of September 6, 1944; the Law on Nationalization of Industry and an Act on Taking Over the Main Branches of the National Economy, both passed on January 3, 1946; and the Decree on Abandoned and Post-German Property of March 8, 1946 (Stec, 2001; Bazylar and Gostynski, 2018; Hunter, 1986).

Some acts only confiscated property of the former Third Reich and German citizens on newly acquired territories and Polish land. Confiscated property included factories, mines, banks, pharmacies, and other commercial enterprises. But by the authority of the Decree on Abandoned and Post-German Property it included both moveable and immovable property of Germans. Expropriated owners were not compensated (Stec, 2001).

Other acts targeted the Polish citizens themselves, confiscating their property regardless of religion or ethnicity. By order of the Law on Nationalization of Industry of January 1946, private firms employing more than 50 people in one shift were nationalized, as were firms of any size in strategic industries like telecommunications, transport, energy,

and mining. Other legislation expropriated the property of private enterprises like banks, pharmacies, ships, and even went so far as to nationalize the property of all religious and charitable establishments (Stec, 2001). And though expropriated asset owners were supposed to receive compensation, in reality owners received none (Bazyler and Gostynski, 2018; Stec, 2001: 293).

The nationalization of property in Warsaw in 1945 is illustrative. There, according to the Decree on Use and Ownership of Immovable Property in Warsaw of October 26, 1945, all immovable property within the city was expropriated. And although a former property owner could attempt to acquire a perpetual lease in formerly owned buildings, this was essentially impossible to attain (Bazyler and Gostynski, 2018; Stec, 2001).

Nationalization of private property was also extended to the agricultural sector, although over time, the regime eased restrictions on ownership of private agricultural plots. The agricultural industry was governed according to the Decree on Agricultural Reform of 1944 and accompanying decrees like the nationalization of forests (Stec, 2001). Per regulations, large farms over 100 hectares, and in some instances even smaller agricultural plots were to be nationalized, along with adjacent farm buildings, tools, machinery, and cattle. Once nationalized, the plots were redistributed to smaller farms at a nominal fee, while expropriated farmers received no compensation (Bazyler and Gostynski, 2018; Stec, 2001).

The process of nationalization in the late 1940s thus set the framework of property relationships in Poland until the collapse of the regime. For the next four and a half decades, Poles could not exchange fixed productive property such as factories or shops. Nor could they enter into contracts concerning their use or exclude others from using these assets. Private property rights over movable assets such as cars or mechanical tools were also limited by regulations that hampered a person's ability to profit from or exchange these resources. These non-fixed assets were allocated by the central bureaucracy. In short, they had none of the standard rights of private ownership to productive property.

Indeed, ownership over commercial assets gradually withered away as additional laws passed in the late 1940s further constrained private businesses by constructing a maze of bureaucratic rules, such as license requirements and arbitrary fines and taxes (Montias, 1974). Thus, the property rights regime left few options, outside of illicit markets, for potential entrepreneurs to employ capital in productive ways. As we will discuss below, state monopolization of trade and production of goods and services further weakened entrepreneurial incentives.

There were exceptions, however. Small private enterprises were tolerated in crafts, retailing, and small industry (Kozminski, 1997). And the government eventually abandoned its plans to collectivize agriculture. But as we illustrate later, private employment in non-agricultural sectors was quite low.

Because of these changes, the most common types of firms during the socialist regime were state-owned firms, firms owned by regional authorities, and cooperatives (Kornai, 1992). State-owned firms were fully controlled by the bureaucracy. Bureaucrats set the

prices of goods, hired managers, determined the supply chain, and exercised other control rights over these firms. And since state-owned firms are, by definition, owned by the state, they could not be sold or leased out. Because profits and losses in these firms accrued to central authorities there was little incentive to either maximize value creation or minimize resource consumption. Firms owned by regional authorities differed from state-owned firms only in their responsibility to regional bureaucracies, although in the end, the ultimate arbiter of decision-making was still the central government bureaucratic apparatus.

Cooperatives, the third type of firm, were mostly found in agriculture in the form of state-owned farms. Members of cooperatives generally could not decide to leave the cooperative, employ permanent labour outside the cooperative, or join a different cooperative on a voluntary basis (Kornai, 1992). Moreover, cooperative leadership could not independently decide how to use revenue in excess of expenses (if there was any), how to employ the cooperative's means of production, or even whether to purchase new agricultural tools.

Importantly, however, cooperatives operated alongside private agriculture. The Polish Workers' Party attempted to collectivize agriculture in 1949, creating State Agricultural Farms as part of the Three Year Plan of National Reconstruction. But these collective farms only constituted about 10 percent of all agricultural land, and Polish farmers were fiercely resistant to further nationalization (Zawadzki, 1956). This resistance grew in the mid-1950s just as a post-Stalinist Soviet Union was relinquishing some control over Poland. As we will see below, important changes in 1956 ensured that agriculture would remain mostly private.

Though they tolerated small private enterprises (employing 50 or fewer persons), the socialists were largely successful in eliminating private ventures outside of agriculture (Kozminski, 1997). For instance, Montias (1974: 54) cites data by Berman and Minc which shows that private retail shops decreased from 78 percent of all shops in 1946 to just 15 percent in 1950, while private wholesale trade was essentially eliminated. A similar scenario played out in industry and handicrafts, where private output decreased from 21 percent in 1946 to just 6 percent in 1950. Clark and Wildavsky report that, in total, the state sector produced 91.2 percent of all goods and services by 1946 (1991: 97).

Kornai (1992: 84) shows that the trend continued for the next several decades. He reports that private nonagricultural employment was 11.6 percent of total nonagricultural employment in 1949, and between 1950 and 1980, this share more than halved and hovered at around 4 percent. Finally, according to Fallenbuchl (1982: 32) total private employment in the national economy steadily decreased from 53 percent in 1950 to around 29 percent in 1983.

### **The push for breakneck industrialization**

Though Marx worried that capitalism led to commodification, he was no anti-materialist.<sup>1</sup> His famous promise to supply “each according to his needs” (1875/1970) presupposed that the socialist economy would be *able to meet* these needs. Indeed, Marx and Engels

were confident that socialism would offer “such an abundance of goods” that it would be “able to satisfy the needs of all its members” (1848/1969: 51). And quite a few socialists (and some non-socialists) believed this. Khrushchev’s assertion that “we will bury you,” for example, was not a militaristic threat; it was an (ultimately incorrect) empirical claim that socialism would out-produce capitalism.<sup>2</sup>

This is one reason why Marx held that socialism needed to follow capitalism. The socialist society, Marx thought, could build on the impressive record of productivity that capitalism had unleashed. As Clark and Wildavsky put it, “Marx’s thought is not about efficiency, for that was supposed to have been taken care of by capitalism” (Clark and Wildavsky, 1991: 335). For the socialist planners tasked with realizing Marx’s promise, outproducing the capitalists was a tall order. It was especially difficult given that socialism did not arise in advanced capitalist societies as Marx had predicted, but had instead been instituted in relatively unindustrialized nations like the USSR and Poland. Planners devised several strategies to out-produce the capitalists.

One key, they thought, was to encourage what the Polish-born London School of Economics professor Stanislaw Gomulka called a “culture of growth” in which “strong material incentives dominate; relatively large income inequalities are maintained, ideals of competition, promotion, success, power and economic efficiency are cultivated” (Gomulka, 1986: 16-17). Clark and Wildavsky argue that, in practice, this meant “officials in the central apparatus of communist regimes do not behave like real capitalists, but rather like the capitalists portrayed by Marx and neo-Marxists” (Wildavsky, 1991: 10-11).

Especially in the first years of power, this culture of growth stressed breakneck industrialization and investment. Planners believed that, left to their own devices, workers would consume too much of their incomes. By restraining consumption, they believed a planned economy could encourage the appropriate level of savings and investment. Today’s sacrifices would yield tomorrow’s plenty. And, indeed, socialist states saved and invested about 30 percent of national output compared with just 10 percent in the United States (Clark and Wildavsky, 1991: 104, 274).<sup>3</sup>

As Kornai explains, socialist political economy reinforced the ideological imperative to invest: “In a socialist economy there is no firm or nonprofit institution that does not want to invest. There is no saturation. *Investment hunger* is permanent” (Kornai, 1980: 191-92). This hunger arose for several reasons. First, as mentioned above, input industries tended to possess outsized political power which meant that their products were well-represented in the plan. Second, managers found it handy to have an excess of inputs in case a shortage might arise. Third, managers were able to obtain higher salaries, more perquisites, and bigger bribes if they had more resources at their disposal. And finally, managers could always sell excess raw materials on the black market. As we discuss below, the state accommodated investment hunger, leading to what Kornai called soft budget constraints. Moreover, investment hunger was self-perpetuating since planners tended to give more resources to larger enterprises and were more likely to funnel resources to projects that were already underway (Clark and Wildavsky, 1991: 272-76).

Not only did socialist planners believe that workers in a market economy would not save and invest enough on their own, but they also believed that enterprises in a market economy would not invest in the right ways. These enterprises, planners thought, would direct too much capital to frivolous consumption goods and not enough to heavy industry.

As a result, socialist planners in Poland and elsewhere prioritized heavy industry, channeling society's resources to coal, iron, utilities, and other producer's goods. Without market-determined signals of prices, profit, and loss, planners often focused on what Poles called "the producer's economy" or "production for production sake" (Clark and Wildavsky, 1991: 190, 260). And lacking any better metric, planners rewarded managers for sheer weight. As Clark and Wildavsky put it:

Polish planning can be summarized in two words: Weight counts. During the heyday of Stalinism in the first half of the 1950s, this was often quite true: The production target of an enterprise would be assigned in terms of tonnage of output, and firms would produce X thousand kilotons of nails. (Clark and Wildavsky, 1991: 8)

Over time, planners added other metrics.<sup>4</sup> But weight remained an important gauge of production. By 1985, the emphasis on weight was so evident that even Soviet leaders like Mikhail Gorbachev were complaining that their economies used twice as much metal, 23 percent more fuel, and 30 percent more raw materials for each unit of output (Dobbs, 1989).

As we will see below, in the producer's economy the consumer's desires were ignored. As Kornai explains, in socialist economies "in many cases the producer does not manufacture what he *should*, but what he *can*, that is, what he is able to produce from the combination of available inputs" (quoted in Clark and Wildavsky, 1991: 159).

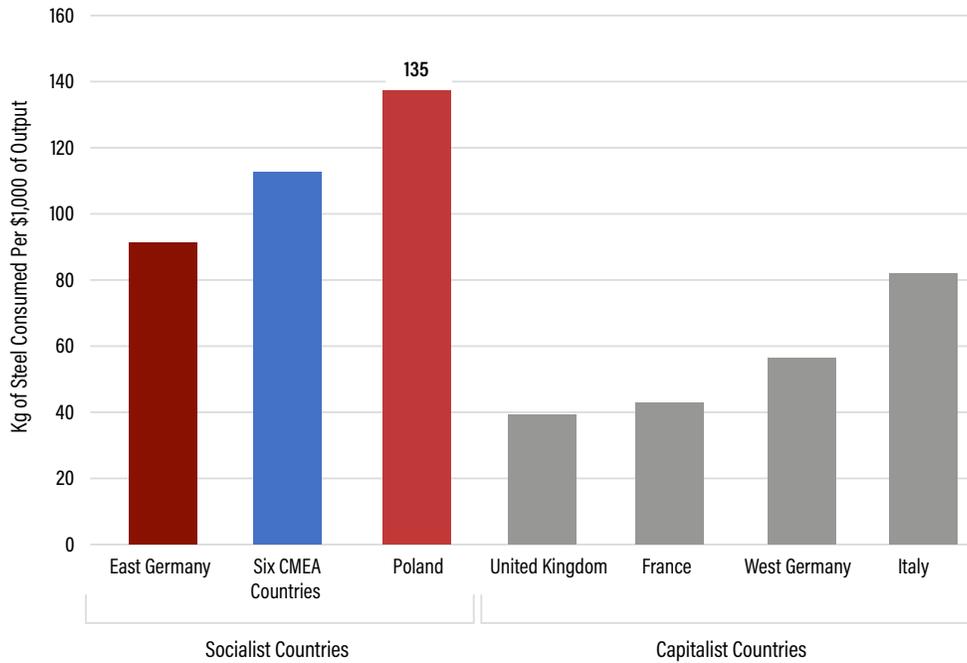
### Exploitation of natural resources

Given the emphasis on production for production's sake, planners paid little attention to natural resource stewardship. Stanisław Gomulka explains that in socialist economies the push to industrialize:

relied on a merciless exploitation (some would say short-sighted plundering) of the countries' natural resources of land, water, and minerals, and processing these resources in a rather wasteful way to produce poor quality products using methods of production which appeared to be what had been significantly more capital- and labour-intensive than need be. (Gomulka, 1986: 103)

Figure 2.3 illustrates the result. It shows steel consumption per \$1,000 of output in socialist and capitalist countries in 1980. While the typical capitalist country used a little over 50 kg of steel to produce \$1,000 in output, Poland used 135 kg.

Figure 2.3: Steel Consumption Per Output, 1980

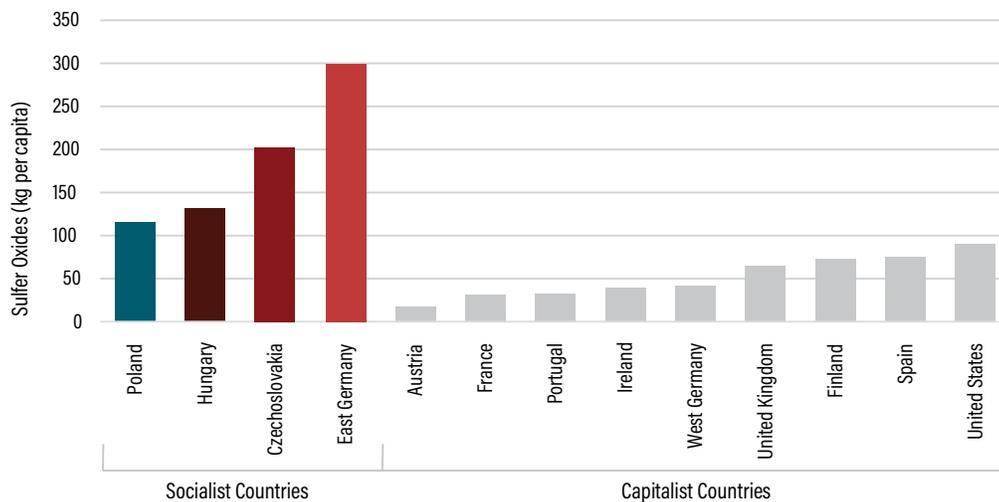


Note: The six Council for Mutual Economic Assistance (CMEA) countries are Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and the Soviet Union.

Source: Kornai, 1992: 294, table 12.4.

The socialist record of pollution was notorious and industrial pollution in Poland was especially bad. A 1991 article in the *Washington Post* described Warsaw’s tap water this way: “It spurts yellowish-brown from the tap, laced with heavy metals, coalmine salts and organic carcinogens. It stains the sink, tastes soapy and smells like a wet sock that has been fished out of a heavily chlorinated swimming pool” (Harden, 1991). The same article reported that Warsaw tap water had double the World Health Organization’s

Figure 2.4: Air Pollution in Selected Countries, 1985



Source: Kornai, 1992: 179, table 9.4.

limits on chloroform concentration; a quarter of Poland's big industrial plants had either no waste-water treatment or used treatment devices with insufficient capacity; 57 percent of the Vistula river was classified as unfit for any purpose and the average concentration of mercury was nine times greater than the Polish norm for safe drinking water (Harden, 1991).

Figure 2.4 shows the degree of air pollution, as measured by sulfur oxides per capita in socialist and capitalist countries in 1985. As we will see below, socialist countries had relatively few cars per capita, so these numbers indicate an especially high level of pollution per unit of output.

### Exploitation of human resources

Ironically, the push to industrialize also meant that the Polish United Workers' Party ignored worker welfare. Marx had famously pilloried the capitalist's "soul," writing that:

As capitalist, he is only capital personified. His soul is the soul of capital. But capital has one single life impulse, the tendency to create value and surplus-value, to make its constant factor, the means of production, absorb the greatest possible amount of surplus-labour. Capital is dead labour, that, vampire-like, only lives by sucking living labour, and lives the more, the more labour it sucks. (Marx, 1867/1976: 342)

The administration of Bolesław Bierut—who controlled Poland as president and later as president *and* party leader from 1947 until his death in 1956—made its own attempts to absorb surplus labour.<sup>5</sup> Thus:

One of the first acts of the communist government was to increase the work week from forty to forty-six hours. New directives gave management sweeping powers in the workplace—in particular, harsh punitive measures aimed at those who shirked work. The Labor Discipline Act of 1950 codified the imposition of disciplinary action, a wage cut, and/or transfer to a lower-paid job for an unjustified one-day absence. State-defined "social parasites" were subject to administrative assignment to two years' compulsory labor anywhere the state thought necessary. Management was freed of interference not just from unions but from labor courts, which were abolished in 1950 and replaced by management-controlled review boards. (Ost, 1996: 33)

As the historian Padraic Kenney put it, the 1950 law on work discipline "marks the official beginning of the open battle with worker crime and the dawn of Stalinism in the factories" (Kenney, 2012: 206). Though drunkenness and leaving the workplace during the day were also addressed, the focus of the law was absenteeism.

Just as production targets focused on weight, employment targets focused on hours. In other words, planners attempted to maximize labour inputs, not labour outputs. The law "virtually ignored workers' behavior during work" (Kenney, 2012: 206). This meant that

many were employed without doing much work. A worker who missed four days of work in a year could be subject to criminal prosecution. The standard punishment was 10 to 15 percent of pay for one or two months. “In just seven months in 1950, 42,443 workers were convicted under the law; this represented 21 percent of *all* convictions in Poland that year” (Kenney, 2012: 206). Though the socialists could boast that there was very little unemployment in socialist Poland, this is mostly because unemployment was illegal.

### Urbanization

The push to industrialize altered the Polish landscape. Poland experienced a massive wave of urbanization as Poles increasingly moved away from their rural homelands to cities. By the end of the 1960s, for the first time in the history of Poland, more than one-half of the population was living in urban areas, illustrating the new significance of urban workers in the economy. During the next decade the trend only strengthened, with the industrial sector employing 40 percent of the workforce and the agricultural sector employing 30 percent of the workers (Koryś, 2018: 288).

Urbanization was partly encouraged by the agricultural reforms. In an effort to win the sympathies of the peasants and small landowners, the regime collectivized all estates over 100 hectares and parceled them out to farmers with either smaller plots or to those without land altogether. No compensation was given to those farmers whose land was seized. Authorities faced severe backlash from agricultural groups and the rural population. This backlash was strengthened by the support of the Catholic Church. Collectivization helped accelerate the decline in agricultural production, and this, in turn, put at risk the state’s ability to maintain enough industrial production in the cities. As a result, the government eased the pressure on the rural population and allowed both collective and private farms to co-exist. This made agriculture one of the few bastions in which private enterprise was permitted, although, as noted below, private farms remained at a disadvantage due to the lack of access to capital markets and due to the allocation of state funds to collectives.

### The Polish October

The Man of Steel, Joseph Stalin, suffered a stroke on March 1, 1953, and died four days later. Once he had eliminated and sidelined his rivals, Nikita Khrushchev became the new leader of the Soviet Union and began to pursue a softer approach to governing.<sup>6</sup> This new approach was famously signaled by Khrushchev’s “Secret Speech” of February 25, 1956, in which he exhaustively recounted and denounced Stalin’s crimes.<sup>7</sup> The speech had an immediate impact in Poland where the Stalinist leader, Bolesław Bierut, read it on March 12 and died of a heart attack (Gaddis, 2006: 131).

At the same time, public anger with socialist leadership was beginning to boil over. Shortages were endemic to the Polish socialist economy.<sup>8</sup> And these shortages often lead to violent protests and regime change. Angry over stagnant living standards, continued Soviet dominance, and persistent shortages of food and other necessities, rioters took to the streets of Poland in the spring and summer of 1956. These protests would prove to

be the most important resistance to the communist regime up until the Solidarity protests of 1981 (Machcewicz, 1999).

Initially, the Polish government responded with violence. Several dozen protesters and innocent bystanders—including at least one child—were massacred by government authorities when 100,000 protesters gathered in June in Poznań. But as one historian put it, the communist government’s violent reaction soon “turned to nervous sensitivity about the real state of public opinion, which the censored media so strenuously concealed” (Machcewicz, 1999).

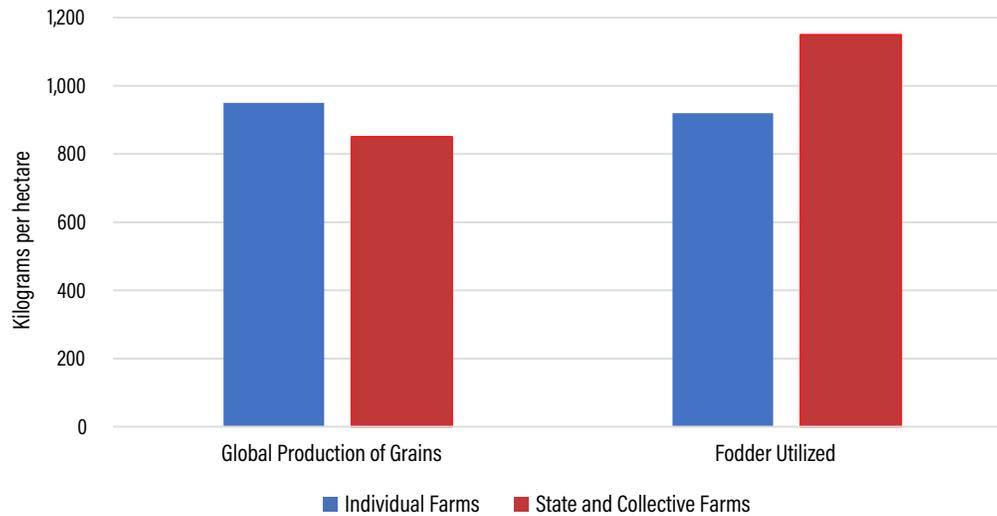
Bierut’s death had weakened the hardline communist faction in Poland and in what came to be known as the Polish October or Polish Thaw, the Soviets permitted Władysław Gomułka, a once-jailed leader of the moderate faction of the Party, to take control of the country in October of 1956. Though a committed communist and central planner, Gomułka permitted some liberalization. For example, he repealed the draconian labour discipline laws that Bierut had adopted, though employment remained mandatory for all able-bodied persons 18 years or older (Ost, 1996: 33; Inglot, 2008: 153).

And importantly, he allowed private agriculture a place in the socialist order (Kemp-Welch, 2006). Kozminski (1997: 95) estimates that near the end of the socialist regime, over 85 percent of agricultural land was private. In 1980 16.6 percent of GNP was produced by the private sector, and 11.1 percent of it by private agriculture. On the eve of Poland’s transition in the late 1980s, private activity produced about 19 percent of GNP, with agriculture accounting for half of it (Kozminski, 1997: 95). Thanks to Gomułka and the Polish October, private agriculture would play a much more significant role in Poland than in any other nation in the communist bloc.

The decision to allow private farms did not signal the abandonment of the idea of nationalized agriculture. It was a pragmatic response to low agricultural outputs at the time. And it allowed the country to avoid the devastating famines that seem to be so common in socialist regimes (Zycher, 2016). Even in this case of relative liberalization in which markets for agricultural produce were permitted, private farms were constrained along multiple dimensions. Prices were set administratively, and the state was the main buyer of produce. Furthermore, farmers had to meet mandatory sales quotas, while the bureaucracy rationed inputs used in the production of agricultural produce (Kochanowicz, 2015).

All firms require access to credit markets in order to hedge against risks and to bridge the gap between the time when an investment is made and profits are earned. This is especially true in the seasonal and risky enterprise of farming. In Poland, however, private farmers’ access to credit was limited due to prohibitions on private financial institutions and due to the fact that state credit was channeled to favoured collective farms.

Other policies explicitly aimed to stymie the growth of private farming. As one scholar put it, “the Polish bureaucracy tried to limit the expansion of small-scale [private] farming as much as possible. Land turnover was very restricted right up to the early 1980s, and so were purchases of means of production and sale of produce. Consequently the ‘private’

**Figure 2.5: Individual vs. State and Collective Farm Productivity in Poland in 1980**

Source: Hirszowicz, 1986: 78.

Polish farms remained backward and poor” (Mizsei, 1992: 286). So private farms generally conducted their work on small and scattered fields, resulting in mostly subsistence farming with outdated technologies.

Still, as Figure 2.5 shows, despite their disadvantages, private farms managed to obtain higher yields with fewer inputs than their state and collective counterparts

As we will soon see, however, Gomulka was less interested in reforming the process of central planning.

### The central planning process

The Polish economic system revolved around the communist Polish United Workers’ Party which set policies and goals for the entire country (Pajestka, 1964). The Planning Commission formulated the plans, although other bureaucratic agencies such as the Council of Ministers, the Economic Committee, and the Economic Council also took part in the process (Montias, 1974).

Plans were developed in several major steps. First, the Planning Commission issued directives for plan articulation. These entailed the formation of a preliminary yet comprehensive plan for the economy, including decisions on the allocation of the most important resources (Montias, 1974; Pajestka, 1964). During the plan articulation phase, the Planning Commission estimated the desired output in terms of the aggregate volume of goods to be manufactured throughout the plan’s timeline by the main sectors of the economy (heavy industry, agriculture, chemicals, automotive, etc.). The plan also included an outline of how the goods were to be used and the appropriate distribution of raw inputs and semi-finished materials across industries. The plan incorporated assessments of the necessary labour hours and wages to be paid for different kinds of work. Aiming to imitate

the market process, the agency added investment targets, and goals for innovations, new technologies, and the use of the new inventions (Kornai, 1992).

It was an immensely complex task to determine the production patterns and strategies for millions of items by thousands of different firms throughout the economy. At the second stage, the Planning Commission had to disaggregate the production plans to direct the entities below in the hierarchical top-down bureaucratic structure. Thus, there was a breakdown of the production quotas to the responsible ministries, with each ministry further delegating the assigned figures to the agencies, factories, and farms they oversaw. Ultimately the production quotas reached the firms' superiors, who then sent their feedback and suggestions back to the upper agencies (Kornai, 1992). Based on this feedback on the original plan, the commission then amended the National Economic Plan, which upon approval by the Council of Ministers was promulgated and used to draw the final details for the associated agencies and ministries (Montias, 1974; Pajestka, 1964).

Consistent with the economic theories discussed in the previous chapter, the state had to erect a vast apparatus of suppression to deal with the control problem inherent to central planning. The nation's top economic central planner, Hilary Minc, waged a war against private economic activity that became known as the "battle for trade." They created a secret service, the "Bezpieka," that employed 34,000 people by 1952 (Paczkowski, 1999: 381). The Bezpieka, in turn, relied on a network of 26,000 informants, turning Pole against Pole (Paczkowski, 1999: 381). In 1945, the government established the Special Commission for the Fight against Economic Abuses and Sabotage (Paczkowski, 1999: 381-82). It had a wide remit, enforcing production quotas and policing "hooliganism." But it also prosecuted Poles for speculation and black marketing. Between 1945 and 1952, 84,200 Poles were sent to forced-labour camps for these "crimes" (Paczkowski, 1999: 382). By 1952, the country had 49,500 political prisoners (Paczkowski, 1999: 382).

While the control problem loomed large in the early years of Polish central planning, neither the incentive problem nor the knowledge problem was especially noticeable at first. Following the devastation of World War II, early central planners focused on rebuilding the nation's capital stock. And as the Solow growth model predicted, this catch-up growth was quite rapid. Though the Polish economists have been criticized for their statistical methods and though official growth figures were likely exaggerated, historians generally believe that the Polish economy grew rapidly at the end of the 1940s and early 1950s (Hunter, 1986: 301; Erlich, 1959: 95).

However, in time, both the knowledge and incentive problems began to undermine the system's productivity and stability. Because prices, profit, and loss did not emerge from the free choices of market participants, central planners had no way of knowing what workers thought about different employment options or how consumers thought about different purchasing options. Without this information, the central plan was nothing more than guesswork.

These knowledge problems were made worse by the fact that information generally moved in a top-down direction. While subordinate entities could send amendments and suggestions to their superiors and could also coordinate with other agencies through horizontal interaction, the disaggregation of the economic plan was in essence a command rather than a request for suggestions. This was, in many ways, inevitable because superiors had the authority to make life-altering decisions for their inferiors and so inferiors were understandably reluctant to question decisions that came from the top (Mises, 1944/2007; Tullock, 1965).

It is also important to note the kind of information that planners used in the process of creating and disseminating production plans. In the absence of a market-based price system that distributes knowledge to market participants and hence allows them to coordinate their actions, central planners had to rely on the accumulation of massive and unmanageable amounts of data that agencies and firms had collected. The planners' data included targets for long-term plans, current performance statistics, and summary balances of the national economy. It also included preliminary forecasts of growth in national income, consumption, investments in fixed capital, and inventories for the future year (Montias, 1974; Pajestka, 1964). They had to pay particular attention to the structure of investments and labour supply in order to attempt to make plans consistent over time.

In the wake of the Polish October, there may have been an opportunity to mitigate some of the knowledge problem, but it was squandered. The official notes of the 7th Plenary Session of the Polish United Workers' Party in July of 1956 included the following admission:

In the course of the implementation of the Six Year Plan, an excessive centralization of the planning and administration has taken place, as well as an excessive growth of the state apparatus... and the bureaucratization of the methods of leadership. These phenomena have hampered the initiative of the masses... have caused waste and have retarded technical progress and economic expansion in general. (Hunter, 1986: 303)

One might have expected the moderate Władysław Gomułka to address some of the problems when he came to power that October. And the prospects for change were especially bright after the Polish economist Oscar Lange became the head of the newly created State Economic Council. Lange was a thoroughgoing socialist. But he had read Mises and took his critiques seriously. Lange believed that the knowledge problem could be overcome by incorporating market pricing tools within the socialist framework. He even went so far as to proclaim that Professor von Mises deserved a marble statute in the halls of the future Central Planning Board (Hayek, 1945: 529).

The State Economic Council, under Lange's leadership, recommended that the economic structure be decentralized, permitting factories and enterprises to make decisions regarding investment and new production. They also recommended that private enterprise be permitted in retail trade, handicrafts, services, and small-scale production. Though Lange's

ideas were adopted in Hungary (where they permitted higher levels of economic growth), they were thoroughly rejected by the Gomułka regime in Lange's native Poland.<sup>10</sup>

Hence, at the height of the socialist regime in the 1950s, '60s, and '70s, the main instruments for the coordination of economic activity in Poland were government plans informed by statistics that did not necessarily reflect the subjective preferences of the Polish people. Prices for producer and consumer goods produced by state firms (that is, a vast majority of goods) were set centrally by the planning authorities.

### **Biased prices and the shortage economy**

In setting prices for producer goods the planning authorities relied on three main principles (Kornai, 1992: 149-55). First, prices were supposed to reflect socially necessary costs of production. In practice, this meant that the firm was supposed to earn a normal profit after it made other payments to the budget.<sup>11</sup> For ideological reasons, firms were not allowed to count the cost of using land or capital and they were required to rely on average instead of marginal costs. This often meant that prices were not high enough to cover actual marginal costs and firms often lost money and needed to rely on the state for assistance (see the section below on soft budget constraints).

The second principle called for using prices to encourage specific production processes. For example, if planners wanted firms to use a certain agricultural input, its prices would be set artificially low. But since the public firms could almost always receive more funds from the state, they were not responsive to these signals.

Finally, the third principle of price-setting called for stable prices. The requirement of stable prices had nothing to do with economics and was desirable purely for political reasons. The planners were afraid that inflation would erode consumers' purchasing power and lead to political demonstrations and demands for change (Montias, 1974: 151). As a result, the planners strived to leave prices unchanged for long periods of time. The final principle clearly contradicted the first two because it prevented prices from adjusting to changed costs and technologies.

These mutually contradictory goals ensured that prices failed to convey useful knowledge. As Kornai explained:

One function of price in market coordination is to convey information in a concise form on the relative scarcity of resources and products. No such information is conveyed by the prices here described. In fact, they impart almost no useful information at all, as it is almost all lost in the conflict between the disparate pricing principles. In other words, the relative prices emerging under the classical [socialist] system are arbitrary and irrational. (Kornai, 1992: 151-52)

Though unstated, an important function of centrally-determined producer prices in Poland was to "create the weighting system needed for arriving at the aggregate volume

indicators” (Kornai, 1992: 152). Hence prices became accounting tools for the generation and maintenance of the centrally-developed plan. They were not, as in a market economy, genuine signals of how consumers and producers hoped to realize their *own* plans based on their own preferences. Nor did prices create the sorts of incentives that they do in a market economy. They did not encourage workers or firms to direct their efforts in ways that create value for consumers or to economize the use of resources, including human resources (Piatkowski, 2018).

The Planning Commission fixed prices for most raw materials, investment goods, semi-fabricated goods, export articles, industries’ by-products, transportation, water, gas, and other services. In those instances where the Planning Commission did not set producer prices, this price-setting authority was delegated to regional ministries and organizations. The guiding principles for consumer goods pricing included all of the above principles, but also incorporated two additional principles. First, the planners set consumer prices to direct consumer preferences in accordance with what planners thought was best for the people. This manifested the regime’s paternalistic nature and disregard for the subjective wishes of the people. Second, prices were set to encourage income redistribution. Thus, officials set higher prices and/or imposed higher taxes on luxury goods.

The Planning Commission’s counterpart in the consumer market was the State Planning Commission. It set all retail prices for consumer goods, including procurement prices for compulsory deliveries of food, medication, and other goods (Montias, 1974). Piatkowski captured the result of such a system well:

Prices largely lost their relation to the inherent value or costs of production. Distorted prices led to [a] large misallocation of resources into low-return heavy industry rather than high-return consumption-oriented industry. They also blunted incentives for technological progress by keeping the potential rents from innovation low. Centrally set prices also removed information inherent in market-based prices about the changing patterns of demand and ensured that the structure of production was increasingly removed from demand. (Piatkowski, 2018: 87-88)

As we discussed in the previous chapter, the knowledge problem predicts that planners will not be able to set prices correctly. And as we have just seen, this challenge was compounded by price-setting principles that often conflicted with one another. By themselves, these problems suggest that prices might be too high or too low and that there might be surpluses or shortages. The incentive problem predicts, however, that consumer prices are more likely to be set too low than too high. This is because if prices are below the market-clearing equilibrium, shortages will emerge and these shortages allow local bureaucrats to obtain bribes from rationed customers (Levy, 1990; Shleifer and Vishny, 1991). Central authorities were happy to accommodate these local bureaucrats because they perceived high prices to be politically unpopular and because they were happy to purchase the cooperation of local authorities. As a result, socialist economies were shortage economies (Kornai, 1980). This meant that the typical Pole (though, as we will see,

not the elite) often went without basic consumer goods, had to wait weeks and even years to obtain certain items, and grew accustomed to paying bribes or pilfering from their apartments or places of employment.<sup>12</sup>

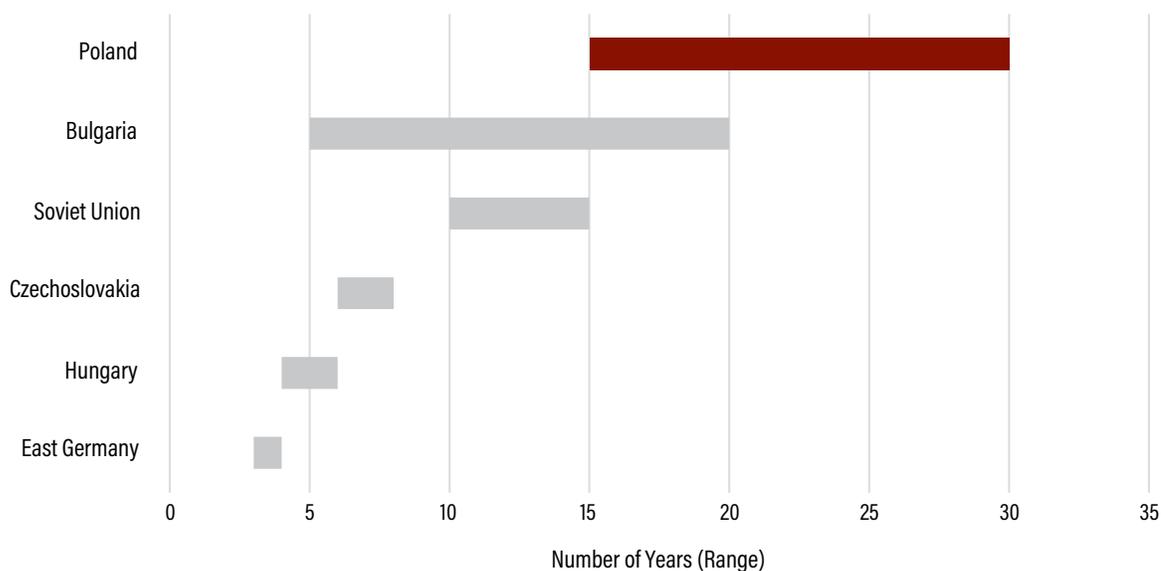
Figure 2.6 shows the range of wait times for housing in socialist countries in the 1980s. Poles waited between 15 and 30 years to obtain housing. And when they finally did, it was often poor quality. Clark and Wildavsky describe a large housing complex outside of Gdańsk in the late 1970s:

All of the several hundred units in the complex were occupied by one family or more, even though more than half of the flats did not have hot water, and many did not have running water or electricity. None of the flats had telephones. In fact, the only phone within a half mile was a pay phone outside the complex that had not worked for years. (Clark and Wildavsky, 1991: 144-45)

Figure 2.7 shows the number of people waiting for telephone service for every 100 subscribers. Not only were there more people on waiting lists in socialist countries than in capitalist countries (in most capitalist countries there was no wait at all), but the trends were moving in opposite directions. In the early 1970s, for every 100 telephone subscribers in Poland, there were another 34 people waiting for service. By the 1980s, there were 57 Poles waiting for service for every 100 subscribers.

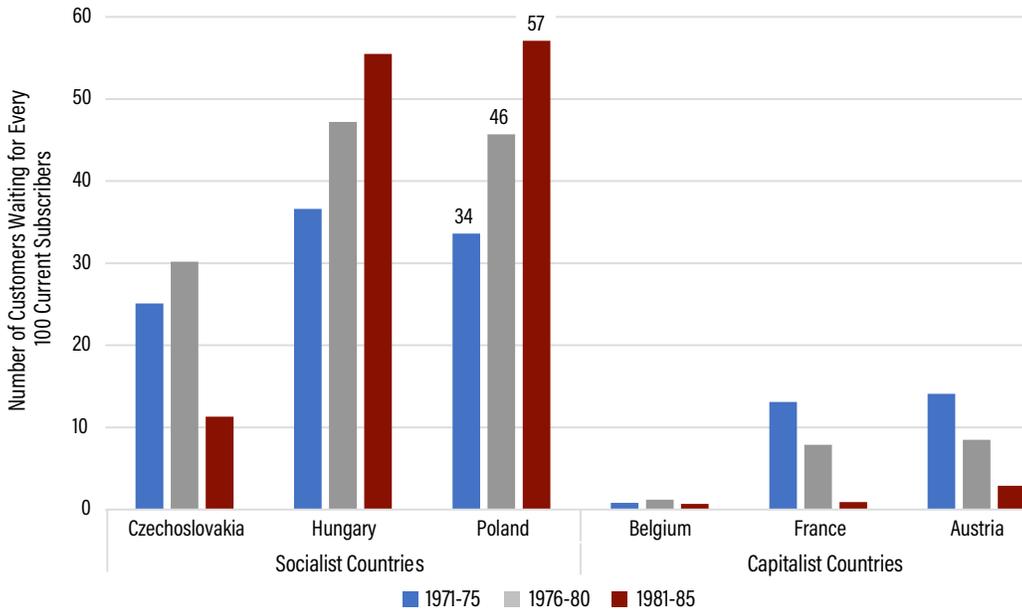
Figure 2.8 shows the number of main telephone lines per 100 people in socialist and capitalist countries in 1986. Poland had only 7 main lines per 100 inhabitants while capitalist countries averaged about 24 lines per 100 inhabitants.

**Figure 2.6: Waiting for Housing in the 1980s**



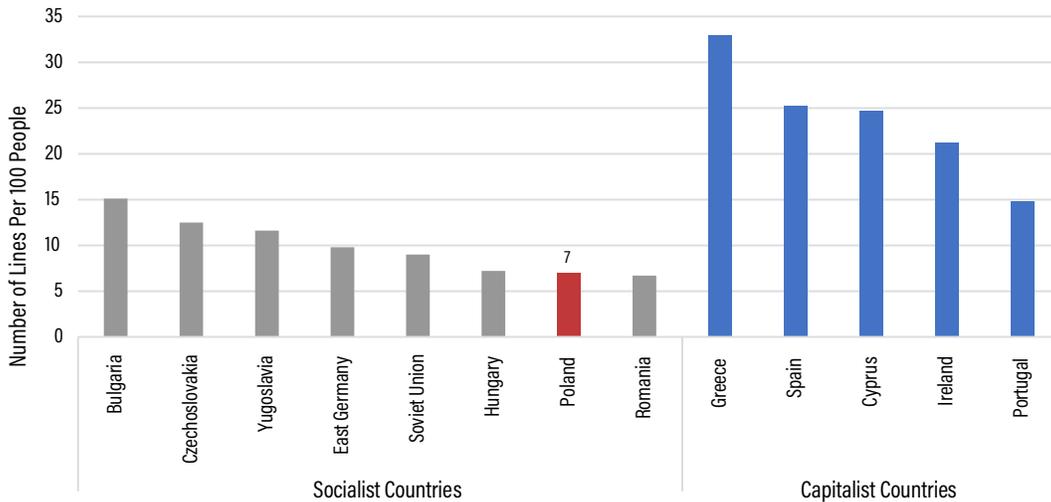
Source: Kornai, 1992: 234, table 11.2.

Figure 2.7: Number of Customers Waiting for Telephone Service



Source: Kornai, 1992: 235, table 11.3.

Figure 2.8: Main Telephone Lines Per 100 Inhabitants, 1986

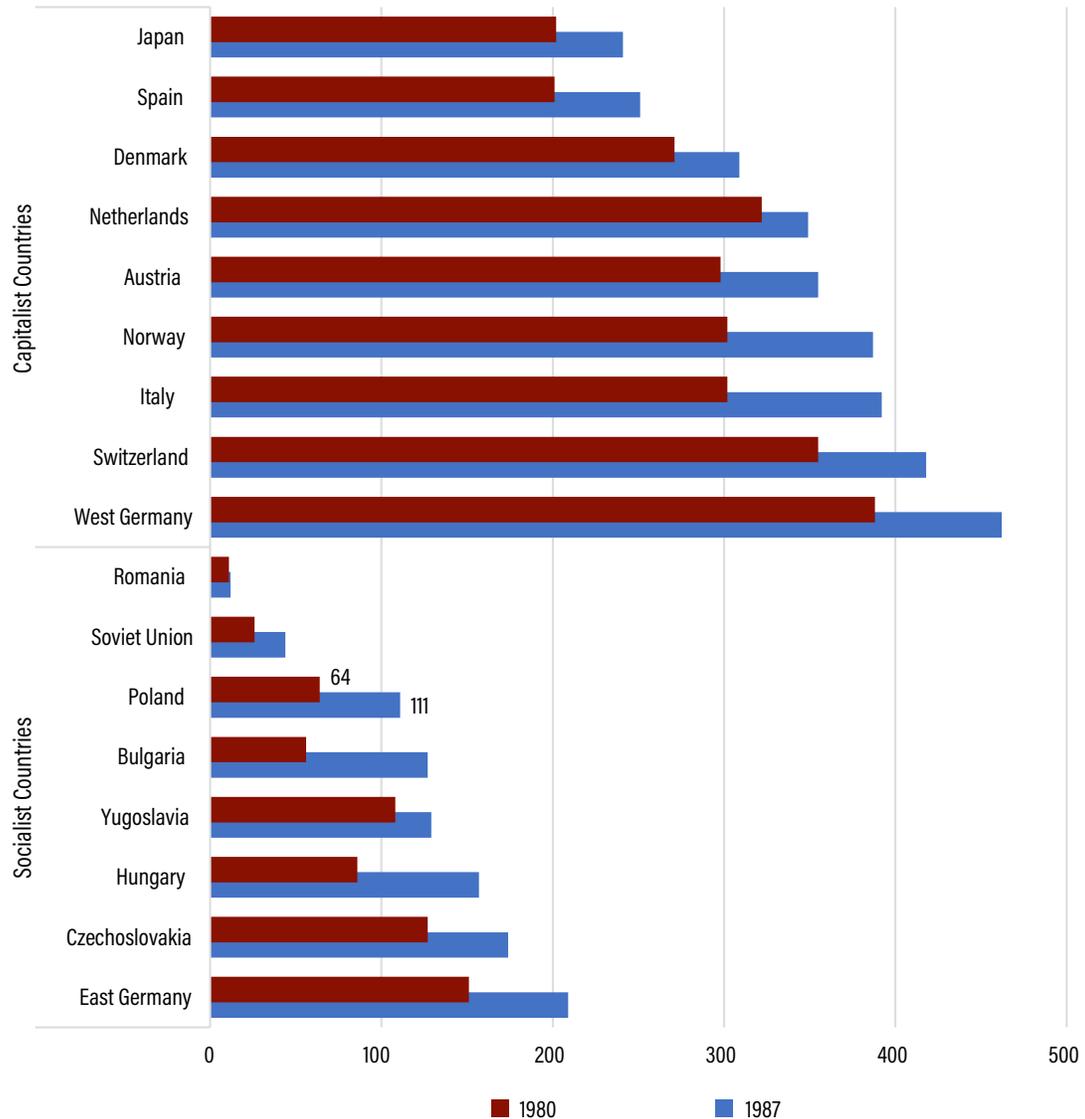


Source: Kornai, 1992: 304, table 13.2

Figure 2.9 shows a similar pattern with cars. In 1980 there were just 64 cars for every 1,000 Poles while in the typical capitalist country there were nearly 300 cars for every 1,000 people. By 1987 there were 111 cars for every 1,000 Poles, while in the typical capitalist country there were more than 350 cars per 1,000 people.

Unsurprisingly, certain cultural norms emerged to deal with the shortage economy. Pregnant women, for example, were often given priority in food queues. Clark and Wildavsky recount the emergent phenomenon of queuing committees. Rather than wait in line for

Figure 2.9: Number of Cars Per 1,000 People, 1980 and 1987



Source: Kornai, 1992: 305, table 13.3.

weeks on end for a refrigerator, customers would spontaneously organize committees and take turns waiting in line for one another. Twice a day (at, say, 10 a.m. and 9 p.m.) anyone who wanted a refrigerator had to show up. If a person wasn't there when his or her name was called out, the name would be struck from the list. In between these times, a smaller set of customers would stand guard, waiting in line for 3 hours a night, every third night. This smaller contingent needed to have at least 18 men or so to prevent thugs from jumping the queue. Occasionally, such a coup would occur, however. "Those who have not spent three hours every third night on refrigerator duty may have trouble empathizing" (Clark and Wildavsky, 1991: 142-43). This sort of waste is precisely what Tullock had in mind when he described the social cost of rent seeking.

Ironically, the shortage economy encouraged the commodification that Marx and his followers decried. For example, consumers hoarded items that were in short supply and speculated in items that might be. When the zloty lost value, items that were in short supply such as vodka, chocolate, or ham, were used as currency. As one Pole sardonically put it in the 1980s:

I'm into toothpaste futures. I take the view that in the whole history of the world there has never been a recorded case of a nation rioting over a lack of toothpaste. Accordingly, toothpaste must have a low priority in the office of the planning ministry. So I tell everyone that comes to see me from the West "bring me nothing else but toothpaste." With toothpaste I live like a king. It has proved to be a much more solid and reliable currency than the Polish zloty! (Clark and Wildavsky, 1991: 135)

### **Incomplete capital markets**

Ideally, economies develop through capital markets that turn savings into useful investment, labour markets that encourage the productive division of labour and the acquisition of useful skills, management systems that efficiently organize economic activity, and entrepreneurship that drives change. But under central planning, without the signals and incentives of a market-generated price system each of these engines of economic development is significantly handicapped.

Consider private capital markets, which were essentially non-existent in Poland, as the planning authority was responsible for directing investments into specific projects and industries with the aid of nationalized banks that facilitated the dispersal of financial resources (Montias, 1974). The investments in a specific year were determined by the long-term plan and current projections of growth. These investments were generally directed at the capital goods industry and heavy industries, especially steel, chemistry, and coal, at the expense of the consumers' desires (Piatkowski, 2013). The few, predominantly agricultural, private firms that did exist were deprived of financial resources available to state firms, thereby constraining private firms' abilities to compete with state companies. As the reform-era minister of finance, Leszek Balcerowicz, put it decades later, "the range of financial assets available to enterprises and individuals was extremely limited, as a market-type financial system could not have coexisted with central planning" (Balcerowicz, 2002: 29).

### **Incomplete division of labour**

In a similar vein, central planning did a poor job of orchestrating the efficient division of labour. The authorities could not exert direct control over the allocation of labour in specific industries, except in cases where technically trained specialists were assigned to particular projects. But the state used indirect means such as wages, regulation of purchasing power, and other material benefits that gave workers the incentive to take on certain jobs (Montias, 1974). For instance, it was widely known that cities with strategic

(often military) facilities received a wider variety of better-quality consumer goods, hence creating competition among workers for jobs in these locations.

For ideological reasons, pay gaps were not allowed to be significant. For instance, according to one report, “the earned income of a factory director is barely three times that of a female dairy worker, a miner is better paid than a chief medical officer and a lawyer is well below a train driver” (Asselain, 1987: 33). While these relatively narrow ranges scratched the ideological itch for equality, they offered workers little incentive to acquire expensive training or skills.

And since factories so often found that they couldn’t obtain the right parts, or parts that were in working order, they often had to resort to making these themselves. As Clark and Wildavsky explain, “A basic reason behind the inefficiencies of command economies is that so many factories are forced into making things that are supposed to be supplied to them. The advantages of specialization are lost along with many other things” (Clark and Wildavsky, 1991: 157).

### **Negotiating with ministerial lobbies**

Since the planning authorities determined firms’ production processes, the incentive structure encouraged intensive bargaining between the bureaucratic entities, further undermining the efficient use of productive resources and making it difficult to satisfy consumer demands. Given the allotted inputs, firms were expected to produce their assigned output targets, and faced the possibility of punishment if they failed.

The socialist system encouraged managers to report lower than actual output capacity. This allowed them to receive a lower production target and to request higher-than-necessary quantities of inputs which they could then sell on the black market. This strategy reduced the risk that managers would fall short of the plan, allowing them to avoid punishment and increasing their chances of receiving a bonus (Kornai, 1992). It was a common tactic. As one scholar has put it, the one rule that operates no matter what is: “the lower the targets of the plan... the more means for its realization are available” (Hunter, 1986: 301).

As the knowledge problem became more pronounced over time, so too did the incentive problem. And these problems, in turn, exacerbated the pathologies of privilege. Consider Brada and Montias’s 1984 study of the Polish leadership’s attempt to encourage specialization in the late 1960s. In March of 1968, Gomułka delivered the keynote address at the Central Committee’s meeting, telling the attendees that “smaller countries, even the more developed among them, must specialize their production” (Brada and Montias, 1984: 386). Planners were ordered to draw up a list of export industries in which Poland should specialize. This kicked off an intense scramble among privileged industries, bargaining with one another and with the planners to make the list. When the final list of “specialized” exporters was published, it included 17 industries, together representing 60 percent of all output in the Ministry of Heavy Industry and 65 percent of all output

of the Ministry of Machine Building (Brada and Montias, 1984: 388-89). Consistent with Olson's thesis, as time went on, ministerial lobbies found it easier to overcome their collective action problems and grew better at seeking privileges.

Władysław Gomułka, like Bierut before him, was forced from power when economic unrest turned to protest, and protest turned to deadly confrontation with the Polish army.<sup>13</sup> (A young electrician named Lech Wałęsa witnessed the army fire on striking workers at the Gdańsk shipyard in 1970 and it no doubt left an impression (Gaddis, 2006: 255)). Gomułka left office in December 1970, replaced by Edward Gierek.

Gierek also had to bargain with the ministerial lobbies. He was especially solicitous toward the military industrial complex with its well-known links to Moscow (Brada and Montias, 1984: 391-92). As Brada and Montias summarize their research:

Even a casual analysis of this experience should put to rest the notion that, in such planned economies, "whatever the center wants it gets." What actually happens is the outcome of a complex bureaucratic process in which lower organs exert nonnegligible counterpower. (Brada and Montias, 1984: 417)

The leaders, meanwhile, grew less secure as one regime after another was toppled by protest and civil unrest. Thus, the leaders increasingly behaved as roving bandits instead of stationary bandits. That is, their incentive to maximize society's long-term growth rate grew weaker as their grip on power grew less secure (Olson, 1993). In order to maintain power, leaders offered more and more privileges to party and managerial elite, cultivating what Ginny Choi and Virgil Storr (2019) have called a "culture of rent seeking," which we will discuss at length below. As one scholar has put it, "it is well known that the market does not yield to the pressures of group interests like central command planning did" (Kolodko, 1989: 65).

As Murrell and Olson's theory predicted, these concessions to special interests carried an economic cost. In their own empirical analysis, Murrell and Olson point to the fact that centrally planned economies achieved high levels of catch-up growth in the early postwar period but that their performance deteriorated over time compared to that of market economies (Murrell and Olson 1991, 239). In a more precise test of the hypothesis, Roger Faith and Nancy Short find that increasing bureaucratic tenure in Czechoslovakia and Hungary had an adverse effect on technical efficiency (Faith and Short, 1995). And in his study of Poland's unfolding economic crisis in the late 1970s and early 1980s, Montias places the blame squarely on special interest lobbies.

The "ministerial lobbies," as they are now called, successfully pressed for more investments and more imports for the enterprises under their direction long after it had become obvious that increases in either would have nefarious consequences for the economy. (Montias, 1982: 12-14)

## Soft budget constraints

Another source of inefficiency was soft budget constraints (Kornai, 1986; Boettke and Candela, 2021; Vahabi, 2021). Under a hard budget constraint, a firm must cover its costs using revenue or capital raised through markets. If it fails to do so, it will go bankrupt. Under a soft budget constraint, however, the firm need not raise revenue or capital to cover its costs because it expects the government to cover its losses. In socialist systems, nearly every firm faced a soft budget constraint.

To better understand the consequences of soft budget constraints, we need to briefly discuss the fundamental idea of resource scarcity. Despite boundless human desires, life on Earth is characterized by limited resources. This means that we are forced to carefully select among alternative ways to use our resources (including our human resources) so that we can gain the most at the least sacrifice.

Over the long run, organizations and projects that fail to use their resources wisely will fail to thrive and may even fail to survive. When an organization faces a hard budget constraint, it confronts this reality. In a market order, firms that employ their resources wisely are rewarded through higher profits, while those that fail to use their resources wisely will incur losses, and in the worst case, will have to liquidate their assets. The assets, of course, do not disappear. Instead, they can then be reallocated to better uses.

Though scarcity and failure are facts of life, socialist planners effectively ignored them. As Kornai put it, “Failure, in the true sense of the word, is impossible” (1980: 194). As a result, firms in socialist Poland did not expect to go bankrupt when their costs exceeded their profits. Instead, their survival depended on the favour of the bureaucratic authorities, who had a different criterion for the entities’ survival: the fulfillment of predetermined output targets (Kornai, 1992). And since the fulfillment of the plan was an essential goal, the state allowed sustained losses on the part of some firms and consistently granted subsidies to keep them afloat. As Clark and Wildavsky put it, “a command economy generates so powerful a nexus of interests around its industrial programs that it is not possible to allow factory complexes to decline, only to feed them with ever greater doses of resources” (Clark and Wildavsky, 1991: 112).

Kornai eloquently captured the phenomenon:

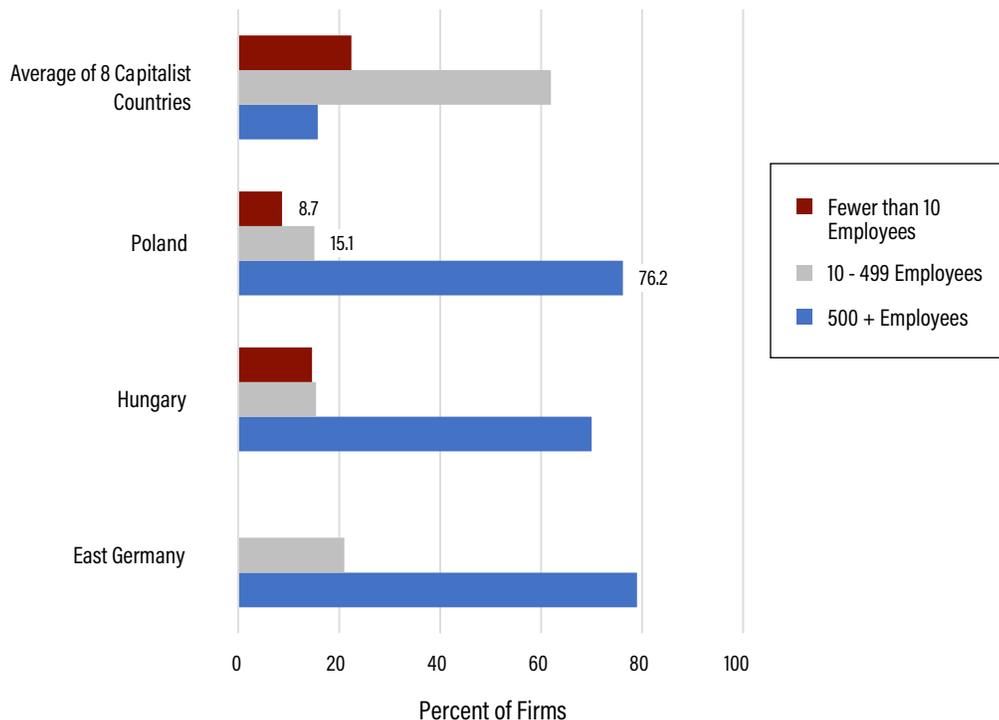
Whether profitable or loss-making, this did not affect an enterprise’s subsequent operation or development. Losses were either covered automatically, or its administratively controlled prices would be adjusted from time to time to its costs. What was demanded above all from existing SOEs [state-owned enterprises] was fulfillment of its production plan. Investment decisions prescribed firstly what capacity was to be created and when production was to begin; expected profitability did not play any essential role. There was of course a cost target, but exceeding it was ignored. What was punished was late completion of the new facility (Kornai, 1986: 35).

When the government extended credit to firms, the Polish Bank typically accommodated it, increasing the money supply and causing inflationary pressure (Crane, 1988: 9). Thus, while official prices tended to be kept below the market-clearing rate, real prices on the black market were pushed higher, giving rise to a phenomenon that some have called “shortageflation” (Kolodko and McMahon, 1987).

The effects of the state-sponsored soft budget constraint on the allocation of resources were predictable. On the one hand, inspired by the output targets and dictates of the bureaucratic apparatus, input demands from firms soared, often beyond the quantities necessary for the actual production. Yet these inputs could have been used more productively in some other ventures, leaving activities that the central planners undervalued starved of capital. On the other hand, because unprofitable firms never had to reckon with their unprofitability, they had little incentive to improve their manufacturing processes. This adversely affected both the quantity and quality of output.

The problem got worse over time as the least profitable industries in Poland received the most financial support and attracted the most workers, siphoning resources away from more profitable enterprises (Feiwel, 1971: 279-81; Crane, 1988). And if the experience of Hungary is any guide, firms with the most political clout (as measured by the size of fixed assets and employee involvement in the party) received the most aid (Winięcki, 1989). Figure 2.10 illustrates one consequence: Large firms dominated socialist economies. While construction firms with 500 or more employees were only about 16 percent

Figure 2.10: Distribution of Construction Firm Sizes in about 1980



Source: Kornai, 1992: 400, table 173.

of the industry in capitalist economies, they represented over 70 percent of the industry in Poland and other socialist countries.

As we will see, the results of the soft budget constraint were well illustrated during the period of the transition from a socialist to a market-based economy, when many firms with negative value-added production went bankrupt in the absence of state-supplied loans and subsidies. That is, the value of the inputs that these firms used was higher than the value of their outputs, indicating inefficient production. As we will discuss in chapter 5, when they finally faced competitive pressures after reforms in the 1990s, many of these firms went bankrupt.

### Foreign trade and foreign debt

As discussed above, Edward Gierek succeeded Władysław Gomułka in late 1970 following the violent suppression of protests over economic conditions. Gierek believed that Gomułka's regime had been too inward-looking and "self contained" (Hunter, 1986: 305). He and his team wanted to increase both investment and consumption, and they believed the way to do so was to open the economy to foreign trade and to reestablish economic relations with the West (Hunter, 1986; Brada and Montias, 1984). Leveraging his personal relationship with Soviet leader Leonid Brezhnev, Gierek was permitted to reach out to the West, establishing good relations with the leaders of France and Germany and opening trade between Poland and Western countries (Jerzy, 2014: 255-85).

Gierek promised to build a "second Poland," that is, to double the size of the economy. In the early 1970s, Polish exports increased at an average of 10.7 percent per year while imports increased at an average of 15.4 percent per year; most of the increase came from the West (Hunter, 1986: 305). Meanwhile, the Gierek regime built new factories that turned raw imports from the West into finished goods. At first, the strategy seemed to pay off. Real growth exceeded 6 percent per year in the early-to-mid 1970s (Hunter, 1986: 299). The growth fed the ever-present investment hunger, allowing the state to build more factories in Gierek's home region of Silesia. The regime constructed the nation's first modern highway and embarked on an ambitious plan to address the nation's housing shortage by building millions of new apartments (Browns, 1974).

But the growth was not sustainable. Unfortunately, most of the trade deficit was financed through the accumulation of foreign debt which rose from almost nothing in 1970 to \$29.3 billion by the end of the 1970s (Hunter, 1986: 299). The cost of servicing that debt rose from 27 percent of export income in 1974, to 43 percent in 1975, and to 70 percent in 1980 (Clark and Wildavsky, 1991: 117). This unsustainable debt-servicing burden began to crowd out imports of consumer goods as well as imports of semi-finished goods and raw materials. Those factories that had been built to finish imported raw materials found it difficult to stay open (Slay, 1994: 43).

By the late 1970s, the economy was collapsing under the weight of this foreign debt. Economic conditions worsened, food shortages once again reemerged, and the ambitious

housing plan proved a failure (Hunter, 1986: 299). By the end of the decade, the number of housing units per household was lower than it had been at the beginning (Mayo and Stein, 1995). At the same time, the pathologies of privilege grew more evident. As Clark and Wildavsky put it: “A ‘Second Poland’ was built with the money borrowed, it is true, but it was a Second Poland of lavish estates and Swiss bank accounts for the party elite” (1991: 312).

In a familiar cycle, the once-popular Gierek was removed by the Central Committee in September 1980.

### **Black markets**

There is yet one more sense in which the term “Second Poland” could be employed. In light of their inability to deliver “to each according to his needs,” socialist systems inevitably give rise to “parallel” or “second” economies (Katsenelinboigen, 1977; Grossman, 1983; Treml and Alexeev, 1997; Murphy, Shleifer, and Vishny, 1991).

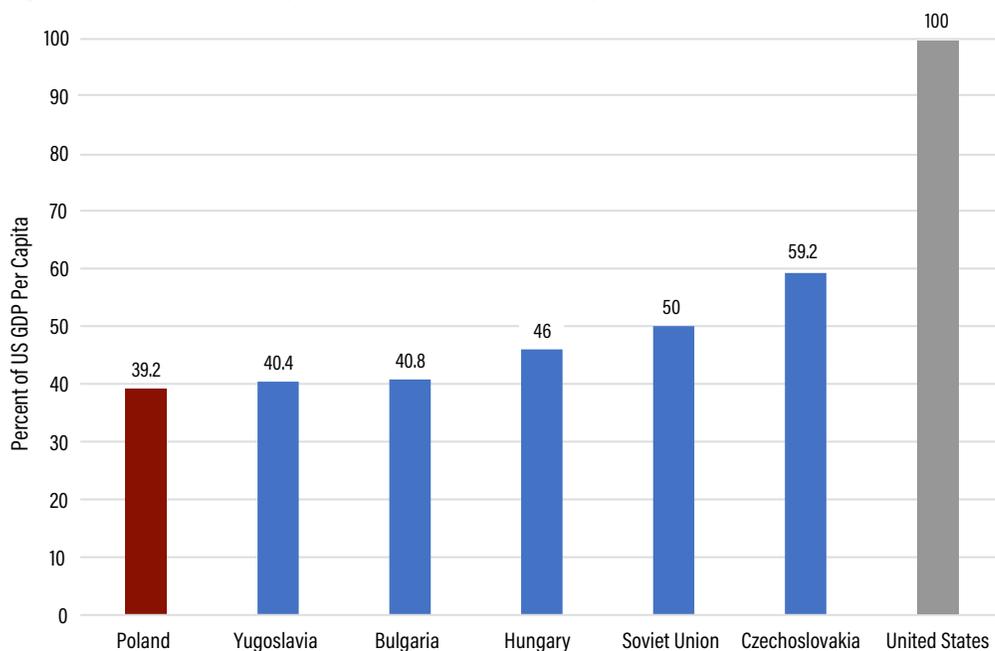
The state adopted an ambivalent, and at times contradictory, approach to the second economy. On the one hand, it attempted to suppress it. As discussed above, the Special Commission for the Fight against Economic Abuses and Sabotage fought back, arresting black marketers (Paczkowski, 1999: 382). On the other hand, it tolerated some degree of “benign plan violation” since it would be impossible to fulfill the plan without going outside of it (Wiles, 1982). The irony, as we have described, is that black markets held the socialist system together since the only way for managers to internalize profit was to sell rationed goods on the black market (Levy, 1990; Shleifer and Vishny, 1991). Though this helped address the control problem by securing the loyalty (or at least quiescence) of local managers, it encouraged a culture of corruption and contributed to disillusionment.

The black market in currency also contributed to this disillusionment. Since the Polish National Bank was willing to monetize the debt, the zloty was seen as worthless. As a result, “Nothing worthwhile, from apartments to cars to travel, [could] be bought without foreign currency. The zloty is devalued not only nominally but as a sign of national autonomy” (Clark and Wildavsky, 1991: 14). As a sign of their contempt for their own currency, Poles came to refer to foreign currency—which kept its value—as “hard currency.”

### **Stagnant living standards**

As the years of socialist rule wore on, the immiserating effects of socialism exposed the glaring inability of the system to achieve its promise of banishing want from the human experience. Simply put, central planning failed to deliver an adequate quality of life. Consider Figure 2.11. It shows per capita production in six socialist countries as a share of US per capita production in 1985. Only in Czechoslovakia was per capita production more than 50 percent of US per capita production. In Poland, per capita production was less than 40 percent of US per capita production.

Figure 2.11: GDP or GNP Per Capita As a Share of US GDP Per Capita, 1985



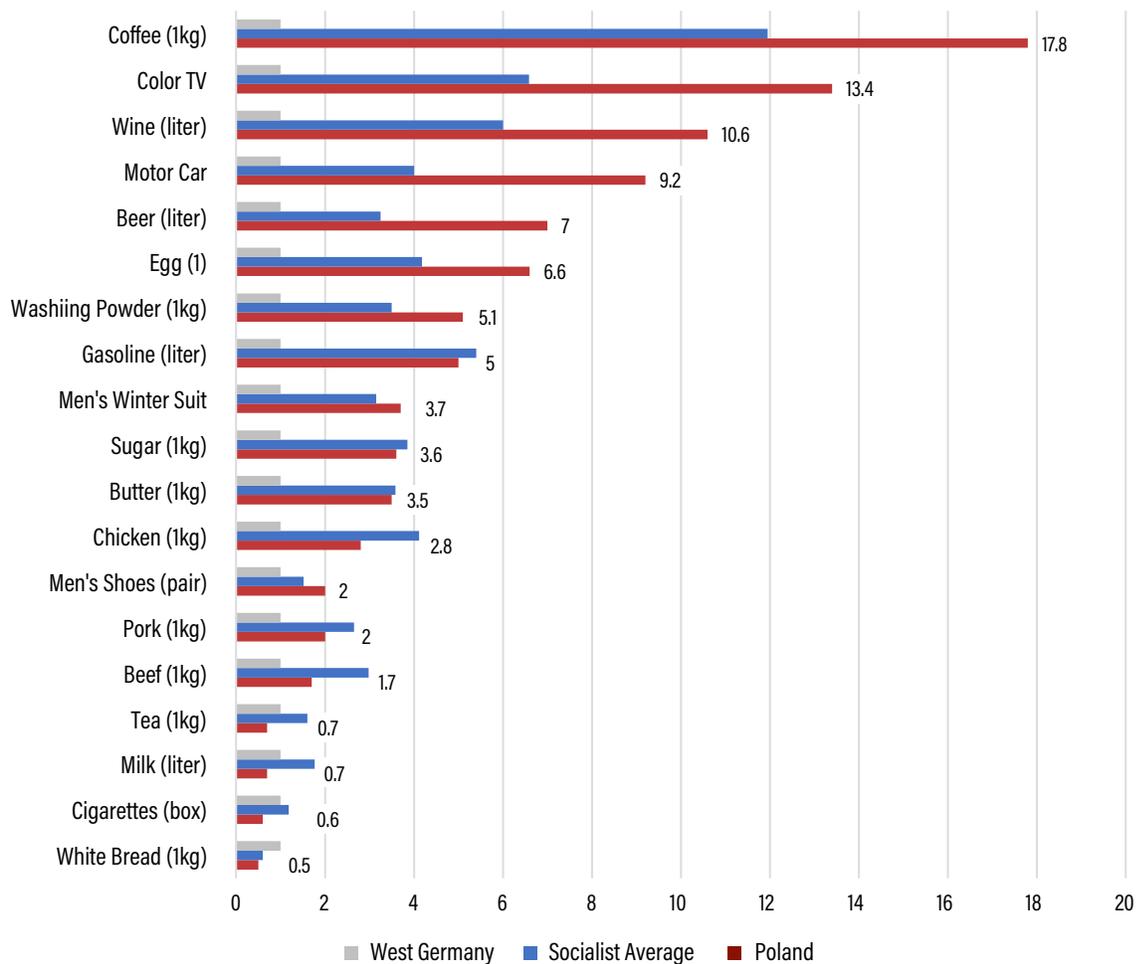
Source: Kornai, 1992: 6, table 1.1.

Life in Poland also reflected the planners' belief that certain consumer items were frivolous and unnecessary. Croatian journalist Slavenka Drakulić poignantly captured this reality when she was asked to give an academic presentation on women in Eastern Europe:

But before I started my speech, I took out one sanitary napkin and one Tampax and, holding them high in the air, I showed them to the audience. "I have just come from Bulgaria," I said, "and believe me, women there don't have either napkins or Tampaxes—they never had them, in fact. Nor do women in Poland, or Czechoslovakia, much less in the Soviet Union or Romania. This I hold as one of the proofs of why communism failed, because in the seventy years of its existence it couldn't fulfil the basic needs of half of the population." (Drakulić, 2016: 120)

Given differences in incomes and prices across countries, one of the best ways to make an apples-to-apples cross-country comparison is to see how long an average worker must work in order to afford certain items. Figure 2.12 shows how long people had to work in Poland and in an average of six socialist countries to afford 19 basic items in 1988. It presents this data relative to West Germany. It shows, for example, that the average Pole had to work nearly 18 times as long as the average West German to make enough money to buy a comparable amount of coffee. Poles had to work 13 times as long as West Germans for TVs, 10 times as long for wine, and 9 times as long for cars. They had to work about twice as long for beef and pork and nearly three times as long for chicken. For the most expensive items, Poles typically had to work longer hours than their socialist comrades in other countries. When it came to four cheaper items, tea, milk, cigarettes, and white bread, however, Poles fared better than their comrades—and

Figure 2.12: Hours of Work Required to Buy 1 Unit of Consumer Goods Relative to West Germany, 1988

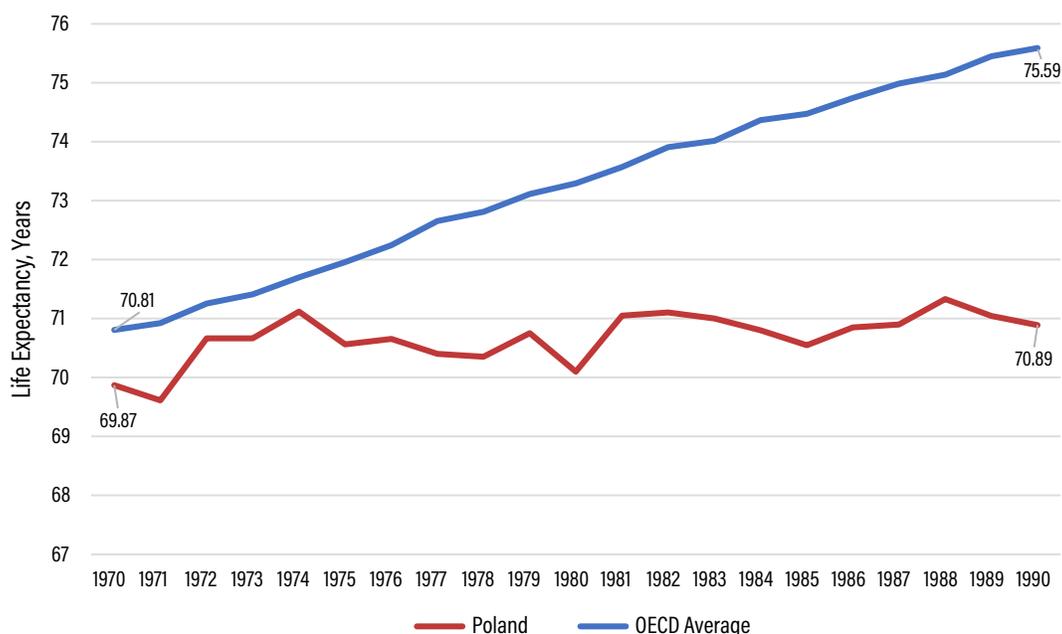


Source: Kornai, 1992: 308-9, table 13.5.

even better than West Germans. Note that compared with West Germany the only item that could be bought for fewer hours of work in the average socialist country was white bread. Even this, however, reflected the strange reality of socialist planning. Bread was cheap because its production was highly subsidized. It was so highly subsidized, in fact, that it was cheaper for farmers to feed their animals bread than it was for them to feed them unprocessed grains (Reaves, 1981).

Perhaps the most striking indication of socialist malaise was stagnant life expectancy. Figure 2.13 shows life expectancy at birth from 1970 through 1990 for Poland and the original OECD nations. Over this time, the average life expectancy of a child born in an OECD nation grew by nearly 5 years while it grew by just 1 year in Poland. In fact, Polish life expectancy declined from 1974 to 1980, and between 1981 and 1989 reached a ceiling of just 71.3 years.

Figure 2.13: Life Expectancy at Birth, Poland vs. OECD Average, 1970-1990



Source: World Bank, 2021.

### The pathology of privilege in Poland

The term “nomenklatura” first originated in Soviet Russia, but it came to be used in all socialist economies. It referred, at first, to a list of positions throughout society that were so important that the party alone retained the right to fill them. In time, it also came to refer to the occupants of these positions. Hence the nomenklatura comprised party and government officials at the helm of the party, the bureaucratic and planning agencies, and the heads of state-controlled enterprises. These were the party’s trusted elite who were entitled to the top positions. In Poland, a nation of 30 million, there were about 70,000 members of the nomenklatura in the 1950s and 130,000 in the 1970s (Clark and Wildavsky, 1991: 214). They were the top one-half of one percent.

And having access to key positions in economic and bureaucratic agencies endowed the group with influence and personal benefits such as access to consumer goods and other services that ordinary workers could not obtain (Tarkowski, 1994). They also had access to luxurious summer resorts, spas, hunting grounds, special medical care, and their own retirement benefits (Bloom, 2013: 20). The elite did not pay taxes; and the party made sure that this fact was classified (Clark and Wildavsky, 1991: 168). These privileges were a way around the officially “flat” pay structure and they helped the regime address the control problem inherent to central planning.

Some of these privileges were extraordinary. Consider Maciej Szczepanski, who oversaw national broadcasting under Gierek. He had 10 luxury residences, a 32-acre sheep farm, a hunting lodge appointed with more than a million dollars’ worth of antiques, a 40-room

mansion in Warsaw, a yacht, a villa in Kenya, and an office with a swimming pool and sauna. Somehow he managed to afford gifts for Gierek that were more than four times his official salary (Clark and Wildavsky, 1991: 168).

The privileged position of the *nomenklatura* contrasted sharply with the socialist aspiration of material and social equality between individuals, sapping the regime of its moral authority. Making matters worse, because the elites were spared from the worst consequences of the system, they became oblivious to these problems and uninterested in addressing them.<sup>14</sup> Author Stewart Steven recounts the story of a mid-level party member who had read a story in *Newsweek* about a food shortage:

Thinking the Western media was slandering Poland again, the official mentioned this incident to a colleague who, surprisingly, remained silent. The next week the colleague took the official aside, saying, “We live like foreigners in our own country. We know less about what’s really going on than a foreigner who flies in, talks to ordinary people, and leaves again.” Shocked at this revelation, the official decided to check up on his own. He invited to dinner a cousin he hadn’t seen for a long time, inquired about the food shortage, and heard the truth. He then recalled that it had been years since he had a conversation of more than a minute or two with a Pole who was not a member of the *nomenklatura*. (Steven, 1982: 94)

### **Alienation, and monstrous moral hybrids**

At the same time, the shortage economy forced non-elites to sacrifice their morals and commodify their relationships. As one observer put it: “one can make a generalization that everybody in Poland who has the chance engages in a good deal of stealing, cheating, and supplementing his or her income by illegal means” (Korbonski, 1978: 102-3). Cheating could take many forms: “goods snatched from workplaces, private services rendered during work hours; private utilization of state machines, tools, or transport, procuring goods ‘under the counter’” (Los, 1987: 34).

One Pole complained: “Why must I so often do things to get a promotion or improve my family’s living standard that run against my conscience? Why and how has it become true that I am a swine? When did I realize it, and when did I stop caring?” (Vale, 1981: 86). Planners, too, worried about the corrosive effects: “What is going to happen to the character of the young generation,” a state planner asked, “if from the very beginning of their working career in the enterprise, they are being taught and morally forced to cheat at the expense of the whole society?” (Zielinski, 1973: 106).

These sentiments are consistent with what Ginny Choi and Virgil Storr call “a culture of rent seeking” (Choi and Storr, 2019). It is a culture that arises when members of a society come to view it as acceptable and necessary to seek privileges and to subvert the rules in their favour. In such cultures, people often feel a sense of guilty pleasure in cheating. The anthropologist Janine Wedel describes a Polish woman who manipulated her connections

to obtain curtains: “[She] feels a kind of revengeful pride—she is happy to manipulate a system that has humiliated her all her life” (Wedel, 1986: 150).

Unfortunately, as Clark and Wildavsky have argued, this sort of manipulation tends to corrupt relationships:

When the need for social or political contacts to accomplish anything—from getting enough steel in order to meet one’s factory’s plan quota to finding chocolate for a child’s birthday party—become indispensable, as in [communist political economies] human relations suffer. People expect both too much and too little from friends, family, and acquaintances: too much, since almost every aspect of your life depends on what others can do for you; too little, since the instrumentalization of these relations means that they are sucked dry of any inherent pleasure. (Clark and Wildavsky, 1991: 332-33)

Not long after they wrote this, Jane Jacobs coined the memorable phrase “monstrous moral hybrid” to describe this sort of moral perversion. She argued that it arises when an ethical system which has evolved for one sphere of human life is (mis)applied to another (Jacobs, 1992). Like so much of the socialist experience, the monstrous moral hybrid that characterized life in Poland bore a striking resemblance to the Marxian indictment of capitalism.<sup>15</sup> Under capitalism, 20th century Marxists claimed, the workers would find themselves spiritually impoverished even if they were surrounded by material prosperity (Marcuse, 1964). In socialist Poland, workers seemed to be both materially and spiritually impoverished.

And this impoverishment created alienation:

To have been among the Poles before the collapse of communism in 1989 was to understand the meaning of alienation, to have witnessed a visceral rejection of existing political and economic institutions. It is a wholesale and unrelenting rejection of what the party-state does—imprison, beat, lie, and destroy—and what it had made most Poles become—criminals, manipulators, cynics, dissemblers. (Clark and Wildavsky, 1991: 222)

### **Socialist cycles of crisis**

Recurring crises were another source of alienation. As we have seen, Poland slipped into economic and then political crisis on a regular basis. As Koryś (2018) points out, “the scale and scope of the protests were larger in each successive wave: in 1956, the protests took place in Poznań and then Warszawa, in 1970, in all the main cities on the coast (Gdańsk, Gdynia, Szczecin, Elbląg) and a few cities in other regions, in 1980—all over Poland” (Koryś, 2018: 291).

Marx had criticized capitalism for its “regularly recurring catastrophes,” which “lead to their repetition on a higher scale,” and would eventually culminate in “its violent overthrow”

(Marx, 1861/1993: 750).<sup>16</sup> Unfortunately, socialist regimes proved to be more susceptible than their capitalist counterparts to regularly recurring economic (and political) crises. Zielenski reports that “European socialist countries during the period 1958–1968 show even *higher* fluctuations than capitalist countries over the same period” (Zielinski, 1973: 7).

With no separation between state and economy, economic crises were often intertwined with political crises. And when the public protested or went on strike, the regime reacted with a mix of repression and conciliation. For example, the government would often respond to protests with violence but then alter whatever policy was being protested.

The regime’s response to protests also confirmed Hayek’s hypothesis that collectivist governments find it easier to rally the public around “hatred of an enemy” than on “any positive task” (Hayek, 1944/2007: 153). In 1968, students took to the streets to protest the suppression of free speech. The Six Day War (in which the Soviets supported the Arabs) was raging in the Middle East, and Gomułka decided to respond to the protests by blaming the Jews. In what became known as the “Zionist speech” Gomułka told Polish Jews to leave Poland, declaring “We do not want a Fifth Column in our country” (Judt, 2006: 434-35). Since the Nazis had murdered about 90 percent of Jews in Poland, the population was not large. But following Gomułka’s speech, some 13,000 Polish Jews were given one-way tickets and special documents that allowed them to leave, but not return (Bash and Sharpe, 2022).

Scholars have offered several explanations for socialist business and political cycles. One theory, offered by economics professor (and Polish resistance fighter) Bogdan Mieczkowski, is that the regime’s relentless focus on investment and consequent neglect of consumption occasionally boiled over into public rage to which the regime then reacted. The regime responded by permitting increased consumption but eventually returned to its old policy (Mieczkowski, 1978; 1979).<sup>17</sup> Political scientist Valerie Bunce contends that when new leaders took control they permitted more consumption as a way to consolidate power. They were able to do this because, as new leaders, they were less beholden to the previous leader’s commitments to input industries’ ministerial lobbies (Bunce, 1980). Once they were established, however, leaders would once again begin to ignore consumption and favour input industries.

To these theories, we can suggest others. The control problem contributed to cycles of political repression as people chafed under the constraints of a command economy and as the government oscillated between violently suppressing dissent and accommodating it. The knowledge problem and the incentive problems ensured that resources were regularly misallocated, necessitating painful reallocations when shortages grew too large or painful to ignore. Soft budget constraints meant that firms’ mistakes were covered up, never addressed, and allowed to accumulate. Thus, by guaranteeing stability for individual firms, the regime sowed instability for the entire system.<sup>18</sup> And finally, the bias toward below-equilibrium prices caused the regime to adopt an all-or-nothing approach to price adjustments. Reluctant to anger consumers or the ministerial lobbies that benefited from shortages, the regime would freeze prices for long periods of time only to raise them

precipitously when the consequences of disequilibrium could no longer be ignored (Clark and Wildavsky, 1991: 134).

### Solidarity and the crisis of the 1980s

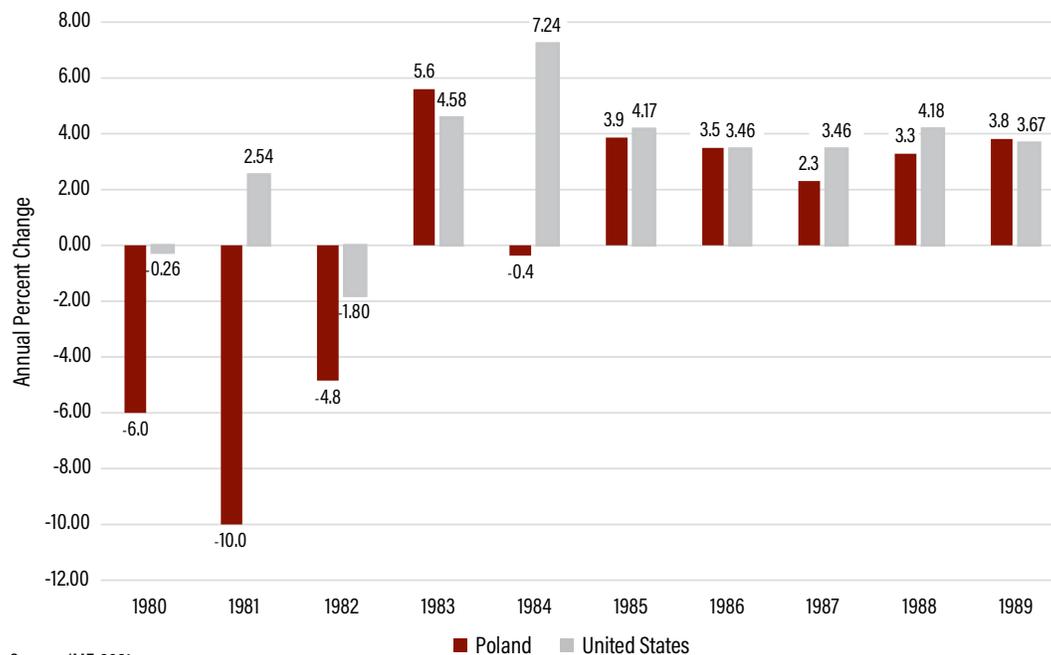
Socialist Poland's worst economic and political crisis began in the early 1980s. The economy contracted sharply and the country was gripped by dangerous shortages and civil unrest. As figure 2.14 shows, real gross domestic product contracted for three straight years beginning in 1980, including by 10 percent in 1981. For comparison, the figure also shows the annual change in US real GDP over this time. Americans of a certain age will recall the recession of 1982 as especially painful and yet it pales in comparison to what the Poles experienced.

As figure 2.15 illustrates, real GDP per capita fell by 18 percent from 1980 to 1982. Investment fell by 50 percent and consumption by 15 percent (World Bank, 1987: xi). The collapse was so steep that per capita GDP did not get back to 1979 levels until 1985.

As production collapsed, Poles encountered shortages of nearly all products, but especially of soap, coffee, sugar, laundry detergent, cigarettes, rubber, transportation, and—above all—meat. The already meager meat allotments were reduced by 20 percent in the summer of 1981 to just 3 kg per person per month and citizens stood in line for days and even weeks for basic necessities (Ash, 2002: 192).

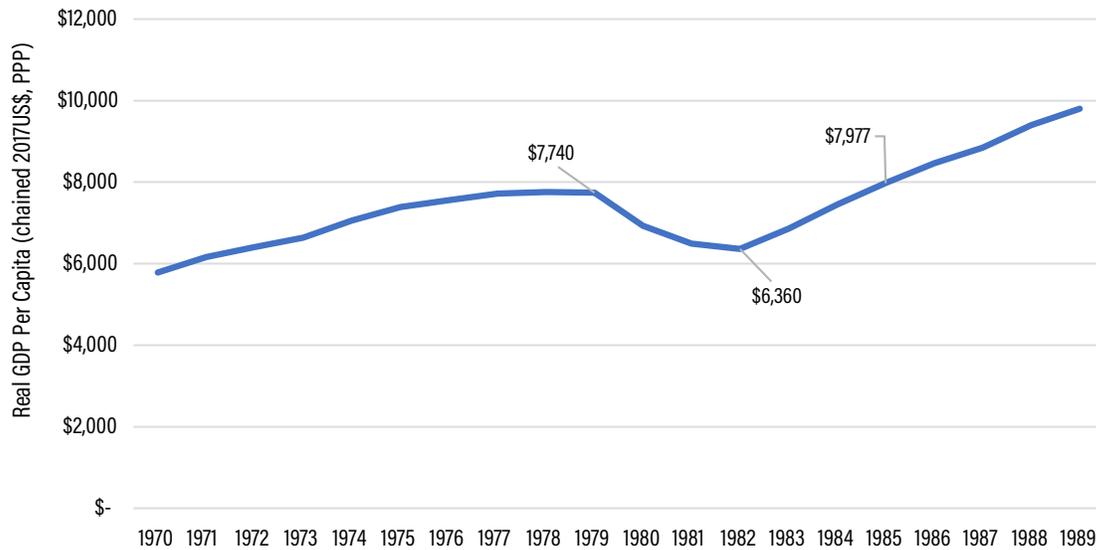
As had happened before, the economic pain turned to political unrest. But several factors bolstered the protests of the early 1980s. Ironically, one factor was exposure to markets.

Figure 2.14: Annual Percent Change in Real Gross Domestic Product, 1980-1989



Source: IMF, 2021.

Figure 2.15: Real Gross Domestic Product per Capita, 1970-1989



Source: Feenstra, Inklaar, and Timmer, 2001.

By permitting trade with the West in the 1970s, Gierek unintentionally exposed Poles to a better way of life. He also gave them a glimpse of capitalism closer to home: In 1976, the regime had raised the price of meat, sparking protests and prompting the government to backtrack. But to appease protesters, Gierek allowed commercial shops to open in 1977 (Clark and Wildavsky, 1991: 134). This accommodation, however, exposed the absurdity of the shortageflation economy. Here is how one Pole described it:

We are always being told that in the West there is rationing by price—though a lot of products are on the market, the ordinary person cannot possibly afford them. This rings very hollow in Poland, for not only do we have genuine rationing, we have rationing by price and then rationing by dollars as well. If anyone had told me in the forties that, after forty years of Socialism, the only store in Poland with a decent selection of goods would be stores that refuse our own currency and accept only the American dollar, I would not have believed them. (Steven, 1982: 84)

The Catholic Church was another factor bolstering the protests. Early in his term Gierek had abandoned the government's longstanding antagonism toward the Church, allowing it to grow in prominence throughout the 1970s. This *détente* proved especially significant when, in 1978, Polish Bishop Karol Wojtyła was unexpectedly elected to the papacy, taking the name Pope John Paul II. The next year, the anti-communist pope visited his native country where he was greeted by throngs of admirers, telling them, "be not afraid." Angelo Codevilla described the impact of the Pontiff's visit:

Visiting his native Poland in 1979, Pope John Paul II struck what turned out to be a mortal blow to its Communist regime, to the Soviet Empire,

[and] ultimately to Communism.... Had the Pope chosen to turn his soft power into the hard variety, the regime might have been drowned in blood. Instead, the Pope simply led the Polish people to desert their rulers by affirming solidarity with one another. The Communists managed to hold on as despots a decade longer. But as political leaders, they were finished. (Codevilla, 2009: 207-8)

The next important step toward reform occurred in August of 1980 when the authorities at the Lenin Shipyard in Gdańsk made the fateful decision to fire a 51-year-old worker named Anna Walentynowicz. Once celebrated by party leadership as a model worker, she had a strong sense of social justice and spoke out when she saw a supervisor steal money from the worker's bonus fund. She was fired for impugning her superior. Outraged at her treatment, workers at the shipyard went on strike while Walentynowicz worked with the charismatic electrician, Lech Wałęsa, to form a union that would eventually become known as Solidarity (Liulevicius 2015).

Within a year, 10 million Poles were members of Solidarity, representing one-third of the working-age population. The movement gained steam just as economic conditions worsened; Solidarity's publications fueled further outrage. The historian Timothy Ash captured the effects:

No, it was not just the fact of queuing. It was that while they stood in those queues they could read in the local paper, or, even more, in the uncensored Solidarity news bulletins, the latest scandal of corruption or maladministration. Here, 3,000 lb. of butter had gone rancid due to official neglect; there, lard had been used to feed animals; while people could obtain neither in the shops. Truckloads of cigarettes were found on a rubbish-dump, while people queued for two hours to buy one packet at the tobacconist. In Silesia whole consignments of letters from Britain, France and Sweden (centres of Polish emigration) were found at the bottom of a lake. On one page the housewife would read about a hospital in Lower Silesia where fourteen babies died from a serious infection caused, incredibly, by a shortage of water—the local authorities having failed to invest adequately in the municipal water system. On the next, she could read about the pasha-like lifestyle of the men responsible for this mess. (Ash, 2002: 193)

In mid-1981 Solidarity organized widespread hunger demonstrations. Most of the participants in these peaceful protests were women and their children. Their banners read “We want to eat,” “How do you eat ration coupons,” and, in an obvious reference to the closing lines of the Communist Manifesto, “The hungry of all countries—unite” (Markham, 1981). A common saying began to appear in graffiti: “Workers of the world... I apologize. – Karl Marx” (Clark and Wildavsky, 1991: 15).

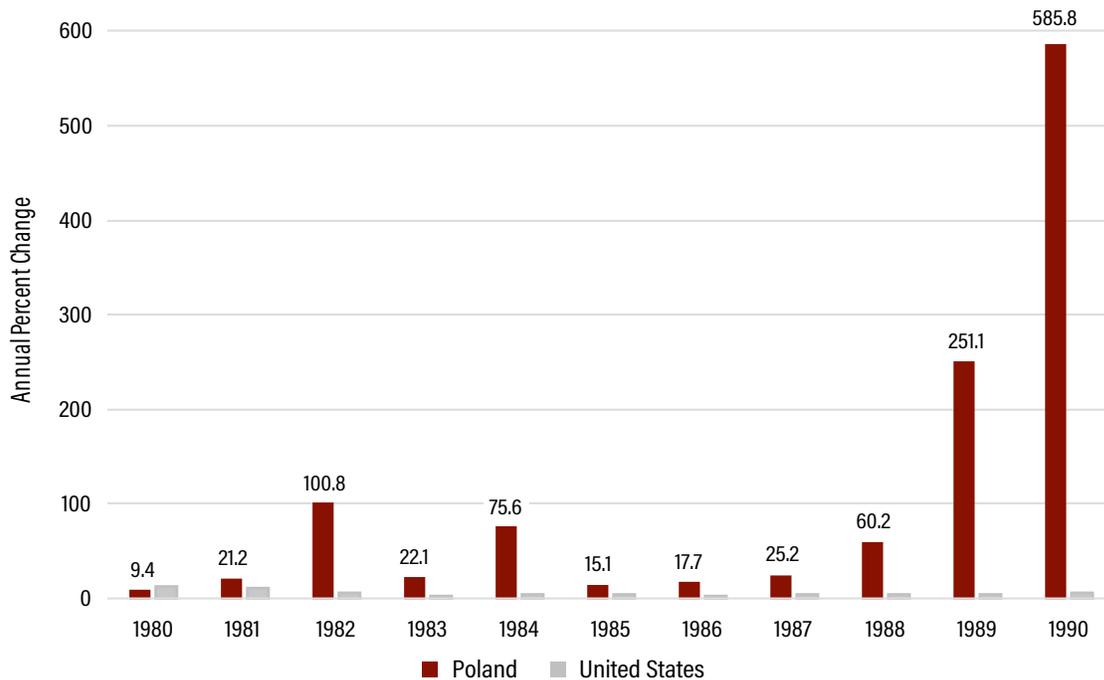
The regime's response was swift and merciless. On December 13, 1981, General Wojciech Jaruzelski, the First Secretary of the Polish United Workers' Party and the de facto head

of the government, declared martial law (Mastny, 2006: 30). During the night he sent 80,000 soldiers and 60,000 militiamen and secret police to round up the troublemakers (Kozłowski, 2022). In all, some 200,000 Poles were fined, 10,000 were arrested, and 3,500 were ultimately sent to prison. Kozłowski reports that “there is a story of an engine driver who started a train whistle for 60 seconds as a symbol of opposition to martial law, and was sentenced to two years’ imprisonment” (Kozłowski, 2022). When they came for Walesa he was defiant, telling his captors: “This is the moment of your defeat. These are the last nails in the coffin of communism” (Gaddis, 2006: 259).

All public meetings, demonstrations, and strikes were banned and the government imposed a news blackout. Solidarity was eventually outlawed (Perdue, 1995: 9, 65). To justify these heavy handed tactics, Jaruzelski repeatedly warned that if order was not restored then the Soviets might invade at any moment as they had done in East Germany in 1953, Hungary in 1956, and in Czechoslovakia in 1968 (Clark and Wildavsky, 1991: 323). Under the so-called Brezhnev Doctrine, announced in the last of these interventions, the Soviets had asserted the right to intervene militarily if any socialist state wavered in its commitment to the cause. While no one knew it at the time, the Politburo had already decided to abandon this doctrine (Gaddis, 2006: 258).

The economy began to grow again in the second half of the 1980s, but shortages persisted. And inflation, already a problem, spiraled out of control. Figure 2.16 shows the annual inflation rate from 1980 to 1990. For comparison, it also shows the inflation rate in the

Figure 2.16: Annual Inflation Rate, 1980-1990



Source: International Monetary Fund, 2021.

United States, which had reached the scandalous height of 13.5 percent in 1980. From 1981 onward, the Polish annual inflation rate never dipped below 15 percent. And as the decade ended, inflation spiked to more than 250 percent and then to nearly 600 percent. This was a problem that was unique to Poland. As one economist has put it, comparing Poland with other socialist countries, “Only in Poland inflation approached the hyperinflation level” (Gomulka, 2016: 19).

As so often happens, policy makers attempted to tame inflation through price controls rather than by addressing its root causes in monetary policy. In 1982, the government introduced the “tax on excessive payroll payments” which came to be known by the acronym *popiwek* (Dabrowski et al., 1997:10).<sup>19</sup> Under *popiwek*, firms were levied heavy taxes if they raised wages significantly more than the price level. As we will see below, *popiwek* was briefly employed during the transition period as well.

Fiscal conditions were no less concerning: the budget deficit reached 10 percent of GDP by September 1989 (Slay, 1994: 86). And in that year foreign debt stood at \$40 billion, becoming increasingly hard to manage (Slay, 1994: 87).

But for the socialist leaders, the tasks of managing fiscal and monetary policy were not nearly as difficult as the task of managing the control problem. Over four decades, the regime had employed various strategies to rearrange the pieces of the Polish chess board, some heavy-handed, others conciliatory. The pieces, of course, always had their own principles of motion. And as the Soviet Union lost its ability to control its satellite states, Poland’s leaders had little choice but to give up controlling their subjects. We turn, now, to this part of the story.

## Notes

- 1 We will have more to say on his views of commodification below.
- 2 Francis Spufford captures the promise and the hope of socialist abundance in *Red Plenty* (Spufford, 2012).
- 3 The investment gap may be one reason why Western observers such as Paul Samuelson repeatedly predicted that the Soviets would over-take the Americans (Levy and Peart, 2009). The Soviet-turned-American economist Igor Birman was one observer who got it right (Shapiro, 2011).
- 4 The number of planning targets tended to rise over time. As one manager put it: “I have to produce not only machine tools but also indicators... to arrange my product mix so that it fits all the directives imposed on me: directives concerning the total sale value and the value of per capita terms of the work force, the ratio between the average rise in wages and the gains in productivity, the share in export production, the cost factor, the size of accumulation, and so on. Compared to all this activity, the development of a new generation of tools seems child’s play” (Vale, 1981: 48).
- 5 Joseph Stalin orchestrated Bierut’s rise to power and trusted Bierut.
- 6 Three men—Lavrentiy Beria, Georgy Malenkov, and Vyacheslav Molotov—initially shared power following Stalin’s death. Working with Malenkov, Khrushchev accused Beria, the longtime chief of the Soviet secret police, of treason. Beria was tried and executed in December of 1953. Malenkov was then demoted, having been accused of, among other things, facilitating Beria’s rise to power. Molotov was allowed to keep his position, if not his power, until he too was removed from the Party and power in 1961.
- 7 Despite its name, the speech was no secret. While only party members were allowed to read it, its contents were soon widely known.

- 8 As the economist Władysław Balicki has observed, “Wherever a centrally planned economy exists, there exists the inevitable shortages or queues in shops” (quoted in Hunter, 1986: 306).
- 9 The Polish Thaw was part of a broader thaw throughout the Soviet sphere following the death of Stalin (Alexeyeva and Goldberg, 1993).
- 10 Gomułka backtracked on many of his earlier, more liberal, policies. He reintroduced censorship of the press and reinstated commissions to control science, culture, and education (Hunter, 1986: 304).
- 11 Montias points out that in the immediate post-war period prices were artificially determined based on multipliers of prewar cartel prices (1974: 218). But we do not know what multipliers Polish planners used in a later period. Montias notes the arbitrariness of prices by citing a journalist who referred to the price system as “abracadabra” (1974: 209).
- 12 The socialist mindset encouraged this pilfering. “Poles, of course, condemn theft: but they define ‘theft’ as theft from other individuals, not from the state” (Clark and Wildavsky, 1991: 330).
- 13 We discuss the reasons for these cycles below.
- 14 That dominion and discrimination go hand-in-hand is a theme of Nobel Laureate James Buchanan’s work. See, for example, Buchanan and Congleton (1998).
- 15 This is a theme to which Clark and Wildavsky (1991) return again and again.
- 16 Though it is beyond the scope of the current analysis, macroeconomists debate the degree to which recessions are a natural feature of capitalism or of government interference with the market process. For an overview of this debate, see Snowdon and Vane (2005) and White (2012).
- 17 Though it is not his focus, Mieczkowski also finds evidence that the party’s focus on investment is misplaced: “Periods of weakened CP [Communist Party] rule which lead to improvement in consumption performance also produce an acceleration in economic growth—and ironically—faster growth of investment, thus proving the incorrectness of the traditional policy of CP leadership” (Mieczkowski, 1978: 262).
- 18 Anticipating Taleb’s (2014) arguments in *Antifragile*, Clark and Wildavsky write: “In the hope that they can avoid the fluctuations and instability of capitalism, command economies do not allow bankruptcy. The result may seem surprising. Because the stability of its parts is low, the stability of capitalism as a system is high. The opposite, we have seen is true in [communist political economies], where the stability of the parts leads to the instability of the system” (Clark and Wildavsky, 1991: 341-42).
- 19 Popiwek stood for *podatek od ponadnormatywnych wypłat wynagrodzeń*.

## POLAND'S TRANSITION FROM SOCIALISM TO THE MARKET SYSTEM

The Solidarity movement had given voice to what many had long felt: Socialism had failed in its promise to deliver prosperity and equality. Instead, socialist Poland had come to resemble Marx's worst characterizations of capitalism. It was not just a poor society, but a profoundly unequal one, with great luxuries for some and shortages for the rest. Instead of serving the needs of the humble worker, it catered to the desires of its largest enterprises, indulging their insatiable hunger for investment at the expense of the environment and the consumer. The new socialist man was not the selfless creature of Marxist writing. He was a grifter who had no choice but to make his way by cheating the rest of society, just as the rest of society cheated him. In the face of pervasive shortages, he was forced to commodify his friendships and familial relations, using them as instruments to supply him with what the command economy could not. "Even the privileged were victimized," as Clark and Wildavsky put it, "by living in a country that was far poorer than it had any right to be" (Clark and Wildavsky, 1991: 163). Though the elite were spared many of socialism's greatest hardships, by the end of the 1970s even members of the party seemed to be overcome by "pervasive cynicism" (Smolar, 1983: 48).

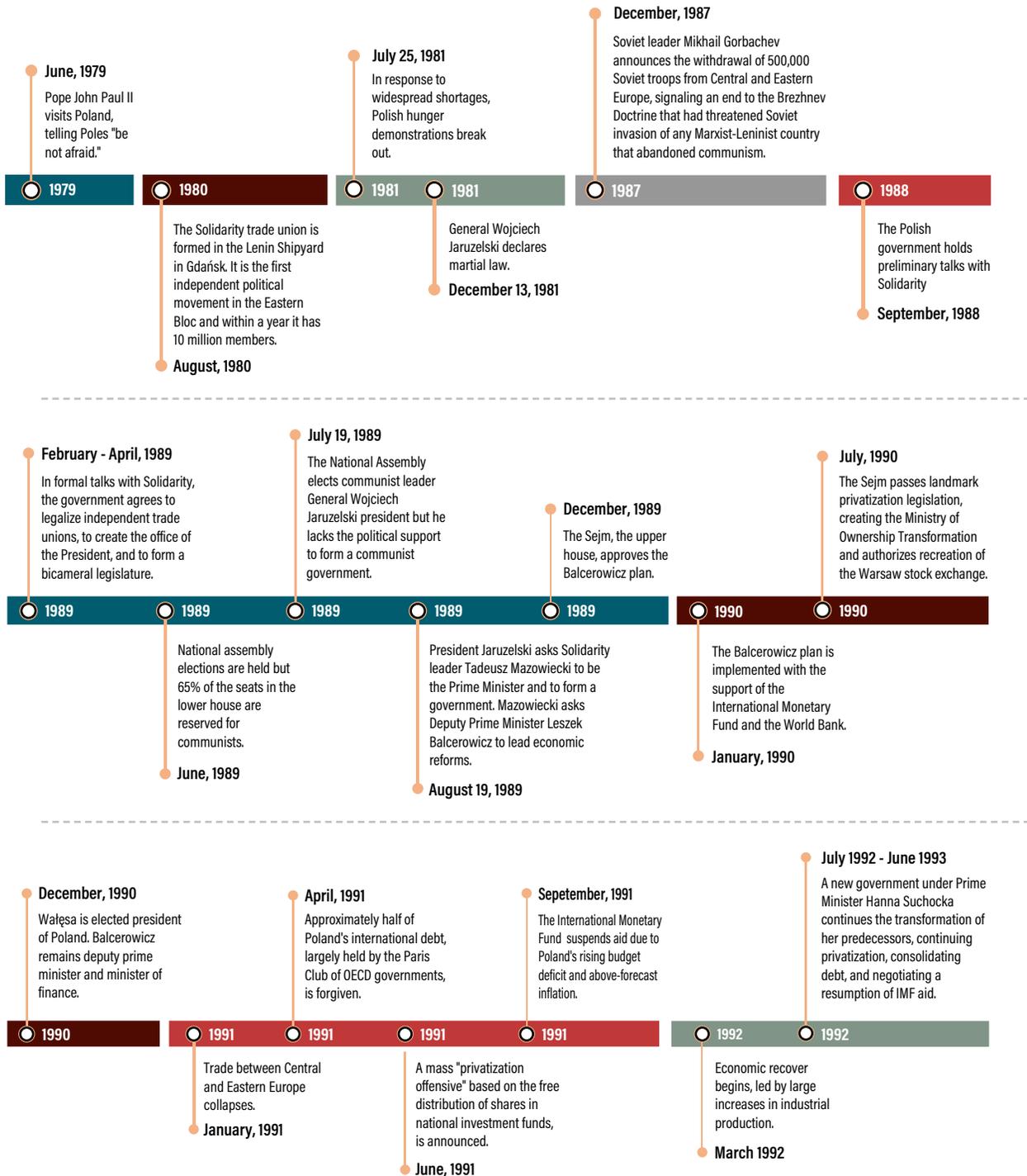
So at least in retrospect, it seems obvious that by the 1980s Poland was ready for change. In this chapter we will document the institutional and policy changes that swept over the country in that decade and the next. In the following chapter we will assess the effects of these changes.

### The end of the socialist era

Though the major changes began in 1989, Poland made several important steps toward liberalization throughout the 1980s (see figure 3.1 for a timeline of events). The regime had hoped that these measures would quench the desire for more sweeping change. Instead, they only seemed to emphasize the necessity and inevitability of radical change in both the political and economic organization of Polish society (Koryś, 2018).

Although reforms throughout the 1980s did make the soon-to-be-followed transition easier by removing regulations limiting new firms and further liberalizing foreign trade, the reforms failed to substantially alter and revitalize the economic system. For instance, at the time of the collapse of socialism in 1989, state and cooperative sectors still accounted

Figure 3.1: Timeline of Crisis and Reform



for nearly 80 percent of Polish national income (Slay, 1994: 87). And Polish planners continued to focus on heavy industrial production, neglecting the consumer sector.

Despite attempts to introduce market prices earlier in the decade, most prices continued to be fixed by the state or regulated by it. Subsidies to inefficient state firms continued to crowd out private production and discourage more efficient management. The

private financial mechanisms capable of supporting entrepreneurs—like banks and a stock exchange—were in embryonic stages. And Poland was highly depended on its fellow Com-econ (Council for Mutual Economic Assistance) countries, relying on the Soviet Union to buy its exports of machinery, coal, electronics, and pharmaceuticals, and depending on its fellow members for cheap imports like oil and gas that were sold at below market prices (Koryś, 2018: 307).<sup>1</sup>

One possible exception to this trend is the Economic Activity Act of 1988, which would prove to be successful. It began the process of deregulating firms across all industries, helping to create an environment for market entrepreneurs to take advantage of the new conditions (Slay, 1994: 92).

The ascendance of Mikhail Gorbachev as the General Secretary of the Communist Party of the Soviet Union was a catalyst for Polish reform. Gorbachev's *perestroika* (reconstruction) and *glasnost* (openness) signaled newfound Soviet tolerance for change. At the same time, the general secretary renounced the Brezhnev Doctrine, which had threatened Soviet force against any communist bloc nation that abandoned communism (Davies, 2005: 501).

The turning point in the liberation of the country came after the Polish Round Table negotiations in the spring of 1989 between the ruling elite and the opposition. The agreement that the parties struck at the Round Table talks re-established Parliament and the Office of the President (Dudek 2003). Shortly thereafter, on June 4th, 1989, general parliamentary elections were held symbolically marking the end of socialist rule in the country and the beginning of the Third Polish Republic. These elections were only partially free since 65 percent of the seats in the lower chamber were reserved for the communist party and its coalition parties. Nevertheless, this was significant progress. The National Assembly selected the communist leader General Wojciech Jaruzelski as president, but given the weak performance of the communists in the contested parliamentary elections that summer, he lacked the political capital to form a communist government. Instead, he asked Solidarity leader Tadeusz Mazowiecki to be prime minister and to form a government.

It may be tempting, in retrospect, to think of the reforms as an experiment. But after the four-decade experiment with socialism, the Poles didn't see it that way. In his parliamentary address shortly before he was elected the first non-Communist prime minister in the Eastern bloc, Mazowiecki put it this way:

I am fully aware of the great effort that repairing the economy will require of the new government and everybody. The long-term, strategic goal of government's activities will be restoring to Poland economic institutions long known and tested. I understand by this a return to a market-oriented economy and a role for the state similar to that in economically developed countries. Poland cannot afford ideological experiments any longer. (Mazowiecki, 1989)

Crucially, Mazowiecki selected Leszek Balcerowicz as deputy prime minister and minister of finance. A western-educated economist, Balcerowicz led Poland's transition to a market-oriented economy, pushing for as quick a change as possible. In 1990, the country held direct presidential elections, and Solidarity's Lech Wałęsa was chosen to be Poland's president. The first free parliamentary elections were held a year later in 1991.

### The Washington Consensus

The new government set the country on a new path. Their guide was the Washington Consensus, a set of widely accepted reforms to help nations transition from a socialist to a market economy. Broadly, the Washington Consensus called for:

1. Fiscal discipline,
2. Substitution of broad-based spending (such as spending on public goods) for narrow spending on subsidies,
3. A broadened tax base with lower marginal rates,
4. Market-determined interest rates,
5. Competitive exchange rates,
6. Liberalized trade,
7. Liberalized foreign direct investment,
8. Privatization of state enterprises,
9. The elimination of anticompetitive regulations, and
10. Legal security of property rights. (Global Trade Negotiations, 2003)

The Consensus was based on a market-oriented restructuring of the economy that gave priority to macro-economic stability (Gomulka, 2016). Advocates hoped that these measures would unleash market forces and spur economic growth, increasing Poles' standard of living. While some left-leaning groups such as social democrats and post-communists raised some concerns regarding welfare-related considerations and the transparency of the privatization process, according to the Polish economic historian Piotr Koryś, "the transformation model was not criticized by any of the mainstream political groups" (2018: 341).

With the general support of the major political groups, Leszek Balcerowicz, the Polish minister of finance between 1989-1991 and 1997-2001, spearheaded reforms. The economic strategy Balcerowicz adopted addressed two primary problems in the Polish economy at the time: macroeconomic fiscal imbalance and a large foreign debt. A package of measures that could be broadly divided into macro-economic stabilization (hereafter, stabilization policy), microeconomic liberalization (liberalization policy), and institutional restructuring (institutional policy) dealt with these problems (Balcerowicz, 1994).

Stabilization policies aimed to combat unsustainable macroeconomic fiscal and monetary policies by reducing the budget deficit, seeking foreign debt relief, cutting subsidies,

stabilizing the growth of the money supply via the Central Bank of Poland, and moving towards a positive real interest rate.

Since inflation was still raging and since previous concessions to labour had put upward pressure on prices, wages, and the budget deficit, the government introduced temporary wage controls. The main instrument was the *popiwek*, the tax on excessive payroll payments that had been introduced by the communist government in the early 1980s. It imposed steep penalties on firms that raised wages significantly faster than inflation. Private firms were exempted from the tax in 1991, it was relaxed in 1992, and finally abandoned in 1994 (Dabrowski et al., 1997: 10).

Liberalization policy also aimed to alleviate macroeconomic imbalance and product shortages by limiting state intervention into the economy, permitting increased flexibility of the supply of goods, and by permitting market-determined pricing. The hope was that this would stabilize the economy and infuse the market with desired goods and services.

Institutional reforms removed economic regulations and restrictions on private activity, eliminated the central allocation of resources, permitted price liberalization, and opened foreign trade, moving Poland closer to a market economy. Institutional policy also sought to privatize the state sector by breaking up domestic monopolies, establishing an independent central bank, and commercializing the financial and insurance sectors (Balcerowicz, 1994).

These policies were implemented jointly, since all three policies complemented one another. Macroeconomic stabilization and the capacity to service foreign debt depended on economic growth and the development of private enterprises, while firms relied on this stability and an absence of distorting factors like inflation.

### Shock therapy

Poland attempted a radical pace of reform that came to be known as “shock therapy.” With shock therapy, reforms are implemented quickly and immediately, as opposed to gradually over time. Economists are divided between the shock therapy approach and a more gradual process of transformation, where reforms are spread out over a longer period of time (Wolf, 1999). On the one hand, supporters of shock therapy view gradualism as limited in its potential gains. They worry that if change is too gradual, there will not be the political will to see it through. Moreover, as time passes, special interests will have an easier time hijacking or derailing reforms in order to preserve their privileges (Sachs, 2012; Olson, 1965). On the other hand, gradualists note that attempted reforms do not unequivocally bring about actual reforms and could in fact worsen economic conditions, especially if all the pieces for reform are not in place. For example, the imposition of a hard budget constraint on firms could lead to a wave of bankruptcies if the existing banking system and stock exchange are at a rudimentary stage of development.

In Poland's case, several factors proved to be decisive in attempting to adopt a relatively fast pace of reform. First, there was an urgent need to arrest runaway inflation. Second, incomplete and sluggish reforms throughout the 1980s had led to the belief that policies must be implemented as a package and within a short timeframe so that changes in the whims of policy-makers or the public could not throw them off track.

Policy-makers also hoped that shock therapy would improve the synergy between stabilization, liberalization, and institutional change. For instance, price liberalization would encourage firms to use resources effectively, while eliminating subsidies and increasing competition from foreign trade would further discipline firms, leading to the elimination of inefficient enterprises and freeing up resources to be used by other, more efficient, firms. Concurrently, disciplined macroeconomic policy would avoid the pitfall of rapid price increases amidst price liberalization across the country. Perhaps the most important factor was the reformers' political capital. The general public expressed strong support for economic and political transition after the collapse of the regime and waiting for another several years would have run the risk of eroding this support (Balcerowicz, 1994).

So the reform process went full steam ahead beginning in January 1990. The Polish currency, the zloty, was devalued and pegged to a basket of currencies instead of its previous peg to the dollar (Balcerowicz, 1994: 80). Poland's central bank increased the real interest rate to the market-clearing level, creating an incentive for private savings, eliminating credit shortages, and encouraging borrowers to account for the marginal opportunity cost of loanable funds. Over time, the central bank attempted to distance itself from direct influence over the economy by letting newly established private banks supply credit to firms and households. The Warsaw securities market was reestablished in 1991 and policies to marketize state insurance funds were developed between 1990 and 1992, all with the aim of providing private financial mechanisms operated by new market participants.

Poland significantly opened up to foreign trade by eliminating quantitative import restrictions in manufacturing, reducing tariffs, and creating a favourable environment for foreign direct investment. In addition to these measures, close to 90 percent of prices were liberalized (Slay, 1994: 92).

Additional reform measures liberalized the labour market, allowing private enterprises to set their own wages, ending inflationary wage indexation and the *popiwiek* tax on excessive payroll payments (Slay, 1994). Additional labour legislation sought to establish a consensus-based system of collective bargaining, in which workers' rights to strike were guaranteed in instances when all other methods of collective bargaining were exhausted.

### Privatization

Privatization was a crucial step in institutional restructuring. In 1985 the state sector produced close to 82 percent of total output in Poland, and 71 percent of all employment was in state-owned enterprises (Sachs and Lipton, 1990: 300). If reformers sought to

transform the structure of their economy in accordance with the Washington Consensus model, it was essential for Poland to privatize state enterprises. It took close to 10 months to select the appropriate framework.

In the end, the privatization law adopted in July of 1990 authorized several privatization strategies (Blanchard, 1994). It is beyond the scope of this volume to offer an extensive discussion of the privatization tools used in the process of transition. Nevertheless, we offer a general overview of the major developments to present a more complete picture of the new economic environment and transformation.<sup>2</sup>

The Ministry of Ownership Transformation facilitated the transfer of state property into private hands. One of the first goals was the privatization of capital, as authorities were eager to rid the industrial sector of central oversight. Capital privatization occurred via public offerings, trade sales, management or employee buy-outs, or a combination of each (Frydman, Rapaczynski, and Earle, 1993). Capital privatization was only partially successful. By 1992 only 32 companies were privatized by more than 51 percent ((Frydman, Rapaczynski, and Earle, 1993: 181). The slow pace of capital privatization can be partly attributed to the inchoate private capital market. Poland had no domestic investment banks, a low household savings rate, and a rudimentary stock exchange, all of which made public capital offerings difficult to successfully implement (Sachs, 1991).

By contrast, privatization through liquidation was considerably more successful and became the most common method of privatization in Poland, accounting for nearly 90 percent of privatization in the country between 1990 and 1992 (Slay, 1994: 107). The strategy consisted of selling or leasing a state firm's assets. The new owners could then use the assets in private firms. Despite the widespread use of this method, it is difficult to evaluate its effectiveness due to a lack of data. Moreover, since many assets were only temporarily leased, some worried that this approach would forestall permanent private ownership (Slay, 1994). Other scholars have noted that privatization by liquidation was potentially advantageous to insiders—employees and managers—who could gain from their knowledge and positions (Frydman and Rapaczynski 1993). At any rate, as of March 1992, 1,055 enterprises were liquidated and were replaced by 545 new private economic units (Frydman and Rapaczynski 1993, 192).

To further bolster privatization, the Ministry of Privatization initiated additional reforms known as sectoral privatization,<sup>3</sup> small privatization,<sup>4</sup> quick privatization,<sup>5</sup> and mass privatization.<sup>6</sup> As of March 1992, 46 firms were privatized via quick privatization (Frydman, Rapaczynski, and Earle, 1993: 193). Moreover, the Ministry of Privatization claimed that in 1990 close to 80 percent of 100,000 small firms were privatized through small privatization. Others figured that 300,000 small stores were privatized in 1990 alone, while sources outside the ministry claimed privatization numbers for small firms varied between 30,444 as of mid-1992 and up to 35,000 in 1990 alone (Frydman, Rapaczynski, and Earle, 1993: 202).

There were also efforts to privatize financial markets. Reformers sought to grant the National Bank of Poland more independence from the government and to establish a robust financial private sector. To the latter end, market-based policies facilitated the formation of over 80 private banks by 1992. Here too the process was not without problems as inexperience and high levels of economic uncertainty caused banks to accumulate non-performing loans, which made up 20 to 30 percent of all bank loans by the end of 1992 (Balcerowicz, 1994: 88). The fairly high percentage of non-performing loans could also be considered hidden subsidies that were provided to state firms within the first few years of the transition and that were meant to cover firms' losses (Blanchard, 1994: 1170). Privatization of state property sought to eliminate privileges as state firms that were incapable of repaying their debts were ordered to either shut down or to restructure.

The privatization process proceeded slower than expected for large firms, and this became one of the major criticisms of the transition (Sachs, 1991; Balcerowicz, 1994). There were many reasons for the sluggish pace of privatization. Given the complexity of the task at hand and the sheer magnitude of the required changes, problems were to be expected. A host of macroeconomic, political, bureaucratic, and structural problems decelerated privatization (Rondinelli and Yurkiewicz, 1996). The transition also presented a major shock to the economy, with people uncertain as to what activities to pursue and where to apply their talents. This uncertainty was magnified by the public's inexperience in operating within a different institutional environment and by the initial incoherence of the economic structure. There was a great deal of regulatory uncertainty and enforcement mechanisms for private agreements were at embryonic stages of development, leaving many opportunities for exploitation (Balcerowicz, 1994). Finally, privatization was slowed by lengthy deliberations and conflicts between political parties (Sachs, 1991; Slay, 1994).

Nevertheless, despite its imperfections, the privatization program produced tangible results within several years of its inception. Balcerowicz reports that the private workforce was just 13 percent of the total workforce in 1989, but increased to 34 percent in 1992 (Balcerowicz, 1994: 87). One estimate suggests that the private sector created one million new jobs between January 1990 and July 1991, with private employment reaching 50 percent of total employment by 1993 (Slay, 1994: 102). Similarly, Rapacki reports that private employment reached 61 percent of the total labour force by 1994 (Rapacki, 1995: 59).

Private entities saw a similar boom in numbers, though privatization of industrial and large firms was not as successful as reforms in the retail and service sectors. For instance, according to Slay (1994), 1.631 million private businesses had been established by late 1992, including 59,000 wholly private domestically owned joint-stock firms, and 10,800 joint ventures (Slay, 1994: 102). The number increased to 1.95 million private enterprises by 1996 (Blaszczyk et al., 1999: 14).

Private output increased from 19 percent of total output in 1989 to 60 percent of total output by 1995 (Blaszczyk et al., 1999: 16). Between 1989 and 1996 the share of private firms in industry grew from 16 to 52 percent, the share of private firms in construction

grew from 26 to 88 percent, the share in transportation rose from 12 to 40 percent, and the share in retail rose from 60 to 93 percent (Błaszczuk et al., 1999: 16).

### Macroeconomic reform

Poland experienced macroeconomic instability at the beginning of the transition. Prices and wages were liberalized while monetary policy remained accommodative. Since planned prices were systematically biased downward and since the central bank had been willing to monetize the debts of state-owned firms, the liberalization of 90 percent of all prices between 1989 and 1991 unleashed extraordinary inflationary pressures (Frydman, Rapaczynski, and Earle, 1993; Balcerowicz, 1994). The annual inflation rate rose to 251 percent in 1989 and 586 percent in 1990, but then gradually declined to 70 percent in 1991 and 28 percent in 1995 (IMF, 2021). The decline in inflation was a monetary phenomenon. The rate of growth of the broad money supply declined from 509 percent in 1989 to 36 percent in 1995 (World Bank, 2021). While the zloty had a fixed exchange rate to the dollar until May 1991, thereafter it was devalued and pegged to a basket of foreign currencies. Together, these policies helped to break hyperinflationary pressures. A reduction in subsidies to state firms, open international trade, and privatization further decreased inflationary pressures and eliminated shortages. These changes also significantly increased the supply of goods and services to the market.

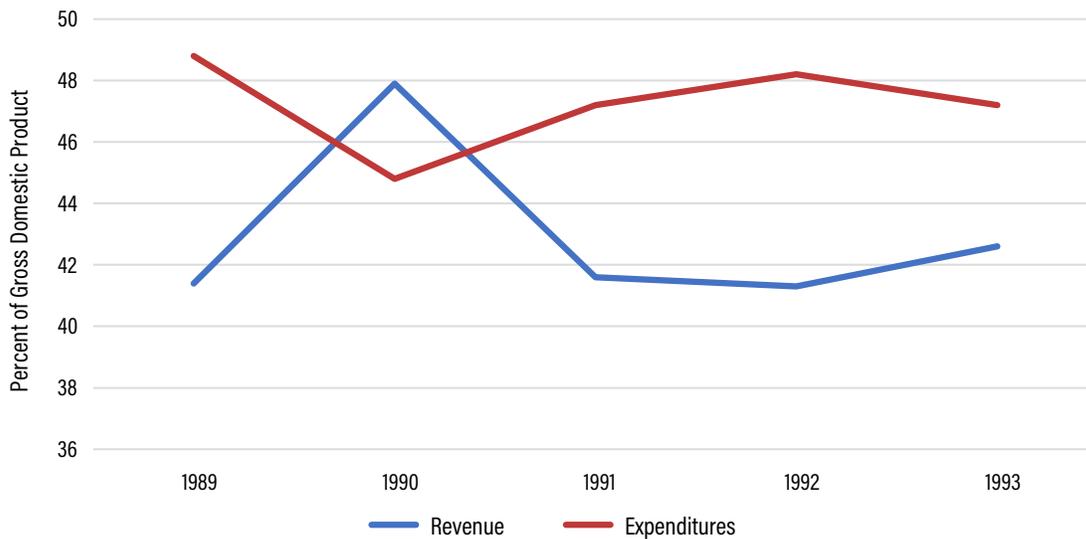
### Foreign debt

At the time of its transition, Poland faced significant foreign debts; they amounted to \$48.4 billion of gross hard currency at the end of 1991 (Frydman, Rapaczynski, and Earle, 1993: 156). Paying off the debt would have been essentially impossible for a transition economy that was undergoing dramatic changes. Thus, while reformers encouraged Poland to pursue market-based reforms, they also encouraged Western governments to forgive Poland's debts (Sachs, 2012). Debt relief came from the capitalization of unpaid interest and, most importantly, from partial debt write-offs provided by the Paris Club of Western governments and the London Club of private Western banks. These groups reduced debt contingent on Poland's ability to implement reforms and set economic targets, like decreasing its budget deficit. This process was by no means smooth; Poland frequently failed to reach its required targets, which delayed the partial forgiveness of its debt.

### Budget deficits

The Third Polish Republic inherited a clumsy and complex fiscal system from its predecessors. The country ran a \$3 billion deficit in 1991 alone (Frydman, Rapaczynski, and Earle, 1993: 155). Poland needed to find ways to restrain its ballooning budget deficit. Its failure to meet its fiscal targets in 1991 cost Poland temporary support from the IMF, which suspended disbursements of its conditional adjustment loan. Figure 3.2 shows expenditures and revenue as a share of GDP during the transition. Initially, revenue declined while

Figure 3.2: Polish Revenue and Expenditures as a Share of GDP During the Transition



Source: Gomulka, 1994.

spending rose, widening the budget deficit as a share of GDP. In time, however, revenues rebounded, shrinking the deficit, and permitting the resumption of IMF aid.

The main sources of government revenue during the socialist period had been profit taxes on enterprises, sales taxes, and social security contributions. Most profit taxes were derived from state-owned firms. Several factors initially depressed revenue during the transition. First, there were fewer government firms to tax as state firms were liquidated (Green, Holmes, and Kowalski, 2001). Second, the profits of government firms that continued to operate declined as they faced new competition from both domestic and foreign competitors, as they had to restructure their supply chains, and as their management struggled to adapt to the new market environment. Third, it was necessary to build a new administrative system capable of maintaining and enforcing the new tax structure and its associated regulations. This inevitably took some time to develop and while this capacity was being built, some revenue went uncollected.

Just as revenue was falling, expenditures increased, driven largely by increased spending on extrabudgetary funds. Like Social Security or Medicare in the United States, these are funds with their own sources of revenue that are outside of the general budget. Also like Social Security and Medicare, these funds could and often did receive infusions of money from the general budget. In 1990, there were several dozen extrabudgetary funds, but the most important of these were the Social Security Fund (general workers' pensions), the Farmers' Social Security Fund (farmers' pensions), and the Labour Fund (unemployment). Total expenditures on these funds increased from 11 percent of GDP in 1987, to 18 percent of GDP in 1991, and to 21.6 percent of GDP in 1992 (Gomulka, 1994: 48). Most of the increase was in pensions. As Stanislaw Gomulka put it: "As subsidies to the

household sector were reduced, the authorities apparently felt compelled to increase the average pension to about two-thirds of the average wage rate in 1992, up from about 50% [of] the average wage rate before the reform” (Gomulka, 1994: 48).

The fiscal conditions necessitated adjustments on both the revenue and cost side of the ledger. On the cost side, reformers eliminated a significant portion of extrabudgetary funds in 1990 and clarified budgetary procedures in 1991, making finances more integrated and transparent.

Subsidies and financial support to state firms were cut, especially in the food, raw materials, production inputs, and energy sectors (Balcerowicz, 1994; Gomulka, 1994). According to Gomulka, government subsidies declined from 16 percent of GDP in 1987-1988 to 4.8 percent in 1991 (1994: 47). Those subsidies that remained were of a different nature, as pre-reform subsidies were allocated according to produced items (food, coal, etc.), and post-reform subsidies were allocated to specific entities (Dabrowski et al., 1997). The government also reduced national defense expenditures due to changes in the geopolitical climate and the end of the Cold War. Meanwhile, local authorities took over some costs related to government services and local police.

Some of the obstacles to a balanced budget were left unresolved, however, as hidden subsidies were continued through bank loans and tax exemptions. Moreover, the aging population and inefficiencies in the pension system made the social security system increasingly costly, with pension expenditures reaching up to 15 percent of GDP by 1993 (Balcerowicz, 1994: 89).

On the revenue side of the ledger, reforms simplified the fragmented and complex tax system by implementing a flat corporate tax rate of 40 percent and closing loopholes. In addition, a personal income tax as well as a goods and service tax were introduced in 1992, along with a value-added tax in 1993. Other relevant revenue sources included a 30 percent tax on dividends paid to foreign investors, employer contributions of 43 percent of total employee wages to social security, and an additional 2 percent to an unemployment fund. These measures took time to implement, however, and there was a high degree of tax evasion as the new fiscal administration was inexperienced at enforcing collection from private firms (Frydman, Rapaczynski, and Earle, 1993: 155).

In September 1989 Poland's budget deficit stood at 10 percent of GDP. By November 1991 the deficit was still 4 percent of GDP and 15 percent of budgetary expenditures (Slay, 1994: 86, 99). The unexpectedly protracted privatization process failed to bring in forecasted revenues from private firms adding to the difficulty of restraining budget deficits (Green, Holmes, and Kowalski, 2001).

Ultimately, Poland was able to avert a fiscal crisis. The new income tax and VAT increased revenues, and the administrative system became more effective in collecting taxes. At the same time the growth rate of budgetary expenditures decreased as the growth in expenditures on wages and pension benefits eased and as the growth in the proportion

of pensioners decreased.<sup>7</sup> (Dabrowski et al., 1997: 28). Bond restructuring and debt forgiveness by the London and Paris Clubs were instrumental in alleviating the debt burden and reducing the cost of interest payments. With these changes, the deficit was eliminated by 1994 (Slay, 1994: 114).

### **Institutional liberalization**

As the reformers worked to stabilize the economy they also liberalized and adjusted the institutional structure.<sup>8</sup> As noted above, privatization played a significant role in restructuring the economy in accordance with the Washington Consensus. But freeing private activity from bureaucratic restrictions was no less important. Take, for instance, the elimination of shortages and queues. As we have emphasized, shortages were an endemic feature of socialist Poland. Some inefficiencies were eliminated in the post-socialist period through privatization, as private profit-seeking firms took the place of public firms. The new private entities had an incentive to produce goods to satisfy consumer demands rather than to satisfy the demands of the state leaders and the ministerial lobbies. Privatization alone, however, would have been insufficient to eliminate shortages as administrative restrictions and price controls hampered free exchange.

Additional institutional reforms were necessary and price liberalization was one of the most important of those reforms. By the end of 1991 close to 90 percent of prices were free from central authority control, with the important exception of prices in utility services (Balcerowicz, 1994). The government also increasingly eliminated restrictions on the entry of new firms to markets. Coupled with the development of financial institutions, entrepreneurs finally had the resources and the ability to start new ventures. As we will show below in our assessment of the transition, there was an explosion in private economic activity. These policies had an impact on all sectors of the economy, but the most dramatic and exciting changes took place in the wholesale and retail trade and banking services that the state had hitherto monopolized. Deregulation and price liberalization opened the gates for productive entrepreneurial activity, as now individuals could legally benefit by creating value for others. “Thus,” Balcerowicz writes, “the fastest growing sectors have been the ones which were the most neglected under socialism” (Balcerowicz, 1994: 90).

### **Trade liberalization**

In 1995, economists Andrew Warner and Jeffrey Sachs argued that trade liberalization was especially important for transition economies. Not only did open trade establish “powerful direct linkages between the economy and the world system,” they argued, “but [it] also effectively forces the government to take actions on the other parts of the reform program and the pressures of international competition” (Warner and Sachs, 1995: 2).

In Poland, increased foreign trade was marked by a reorientation of exports and imports to the West, as former trade arrangements and routes with Comecon countries were

altered due to new economic and political realities. As Blanchard put it: “In thinking about transition in Poland, two dates are important. The first is January 1990, when economic transition started in earnest, with price liberalization and stabilization; the second is January 1991, which saw the collapse of trade between Central and Eastern European countries” (Blanchard, 1994: 1169).

With these changes, domestic firms faced not only competition from local rivals, but also from foreign firms that were more experienced in operating a private enterprise. Exports reached \$12 billion in 1990 and increased by another 25 percent in 1991. Similarly, convertible currency imports increased from \$8.3 billion in 1990 to \$15.5 billion in 1991 (Frydman, Rapaczynski, and Earle, 1993: 157).

Exports to the West increased by 61 percent between 1990 and 1991, and by another 13 percent between 1992 and 1993 (Balcerowicz, 1994: 92), while exports to Comecon nations dropped by 65 percent in 1991 (Frydman, Rapaczynski, and Earle, 1993: 157). A similar situation took place on the imports side, as imports from Western countries increased by 53 percent from 1990 to 1991 and by 40 percent from 1992 to 1993 (Balcerowicz, 1994: 92). Finally, openness to trade can also be illustrated by foreign direct investments, which increased from \$60 million in 1989 to \$1.5 billion in 1993 (Balcerowicz, 1994: 92).

As foreign investments poured in, they brought fresh capital, technology, and expertise to newly established enterprises in the service, trading, and financial sectors. The percentage of Poles employed in the trade and service sectors increased from 36 percent of total employment in 1989 to 54 percent in 2004 (Koryś, 2018: 339). As we will see in the next section, Warner and Sachs were right to argue that trade liberalization would make it easier to commit to further reforms.

## Notes

- 1 According to Koryś (2018: 307-8), imports of fuel and energy increased from 7.5 percent of total imports in 1960 to 18 percent of all imports in 1980, while exports of coal constituted 20 percent of all export value in 1975. Moreover, trade with Western capitalist countries increased over time, from 10 percent of all exports in 1956 to 44 percent in 1980, while trade with Comecon countries decreased from 60 percent of all exports in 1956 to 54 percent in 1980. A similar situation occurred with imports.
- 2 For more details, see *The Privatization Process in Central Europe* by Frydman, Rapaczynski, and Earle (1993) and *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, the Caucasus, and Central Asia* by Anders Åslund (2012).
- 3 Sectoral privatization was not, strictly speaking, privatization, but was rather a preparatory step in launching the privatization of firms in related sectors.
- 4 Small privatization targeted small firms that were owned by local authorities, and the strategies differed by locale.
- 5 Quick privatization transferred ownership of small and medium size firms. By this method, firms would be bundled up in groups of approximately six units and offered for sale to potential investors.
- 6 The mass privatization plan announced in June 1991 aimed to commercialize more than 400 of the largest industrial firms in the country. The firms were to be transformed into joint-stock companies, and 60 percent of their shares were to be distributed to financial

intermediaries called National Investment Funds. The investment funds would then monitor the firms' performance, selling or restructuring firms accordingly, and over time distributing shares among Poland's adult population free of charge. Thirty percent of the remaining stock would remain state property, and 10 percent would be distributed between workers of the respective enterprises (Slay, 1994: 105). The program underwent several modifications after 1991 and was approved by Parliament in April 1993.

- 7 Expenditures related to unemployment benefits, however, were increasing (Dabrowski et al., 1997: 28).
- 8 During the transition process, the intellectual focus of attention moved from macroeconomic stabilization to microeconomic reforms and within microeconomic reforms from "getting the prices right" to "getting the institutions right." As a result, the contributions of New Institutional Economics became more and more part of the mainstream of economic science and political economy through the 1990s and into the first decade of the 2000s. A key figure in this literature was Andrei Shleifer and his work not only on privatization in Russia, but also the difference between the invisible hand of the market and the grabbing hand of the state.

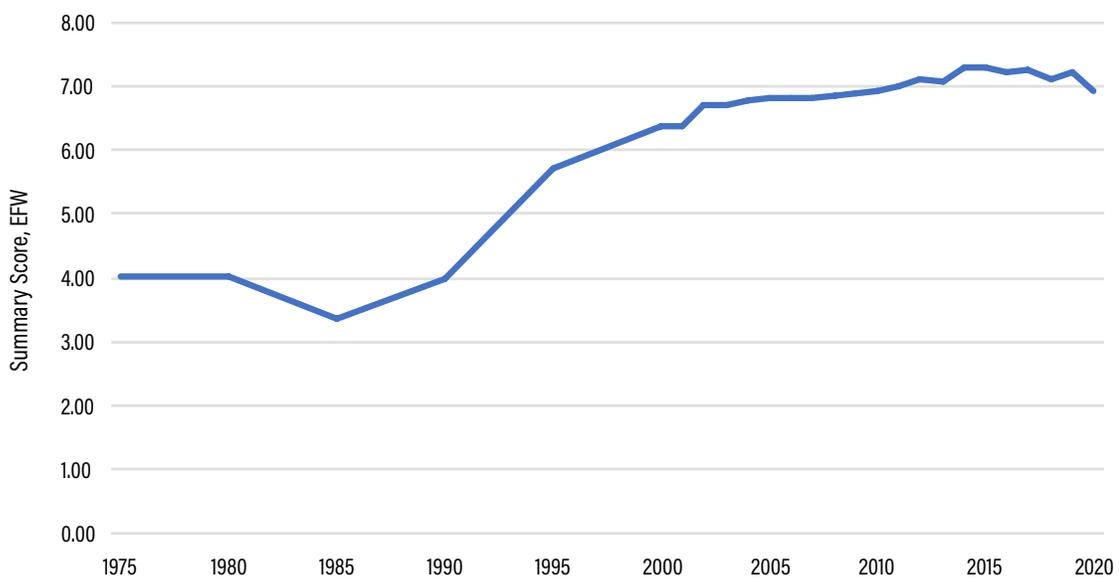
## ASSESSING THE TRANSITION

Did it work? Almost as soon as it began, critics complained that Poland’s transition was too quick and too comprehensive (Kabaj and Kowalik, 1995). In this chapter we evaluate the transition and its effects. We begin by asking whether Poland managed to increase economic freedom and whether this change was as quick or as comprehensive as is widely thought. Then we assess the effects of the transition on various measures of wellbeing.

### An increase in economic freedom

In *Economic Freedom of the World* (EFW), a publication released annually by the Fraser Institute, economists James Gwartney, Robert Lawson, Joshua Hall, and Ryan Murphy measure economic freedom in each of 165 jurisdictions around the world. Conceptually, citizens are said to have greater economic freedom when they have more freedom for personal choice, greater freedom to engage in voluntary exchange, more open markets, and more clearly defined and enforced property rights (Gwartney et al., 2022). There are

Figure 4.1: Polish Measured Economic Freedom Over Time



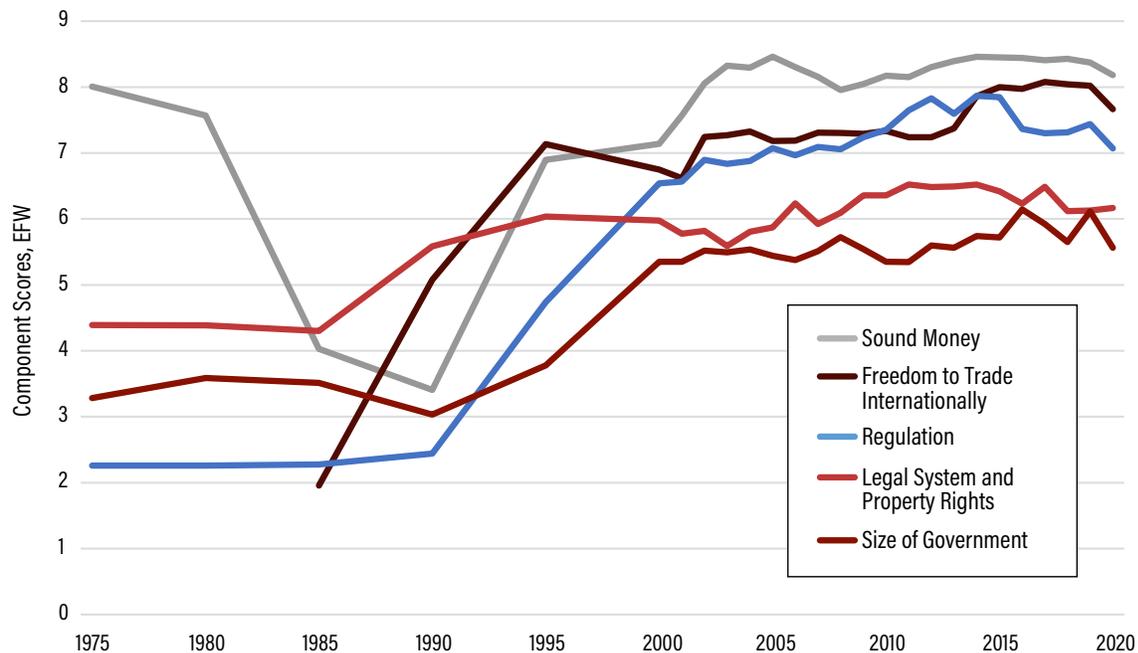
Source: Gwartney, Lawson, Hall, and Murphy, 2022.

strong theoretical reasons to believe that people will prosper when they are permitted greater economic freedom (Mitchell and Boettke, 2017: 57-58). And EFW has offered economists a surfeit of data with which to test this proposition. There have now been over 1,300 peer-reviewed journal articles citing the index. In a recent review of this literature, Robert Lawson reports that “Two thirds of the relevant studies found that economic freedom was positively related to economic growth, 72.5% to increased incomes and productivity, and 62.9% to increased entrepreneurship” (Lawson, 2022).

*Economic Freedom of the World* measures economic freedom with 42 distinct variables that together comprise five main areas of measured economic freedom: 1) size of government,<sup>1</sup> 2) legal system and property rights,<sup>2</sup> 3) sound money,<sup>3</sup> 4) freedom to trade internationally,<sup>4</sup> and 5) regulation of credit, labour, and business.<sup>5</sup> From these components the authors create a summary score that theoretically ranges from 0 to 10, though in practice, the highest score is usually about 8.6 and the lowest score is usually around 3.3. Figure 4.1 charts Poland’s measured economic freedom from 1975 through 2020.<sup>6</sup> Measured economic freedom grew significantly between 1990 and 2000 and then leveled off.

Figure 4.2 shows each of the five major components of economic freedom separately so that we can see what changes drove the overall pattern shown in figure 4.1. First, note that Poland’s sound money score collapsed over the course of the 1980s as hyperinflation set in. The fall in this component of economic freedom, however, was offset by relatively modest gains in the legal system and property rights, and the freedom to trade internationally components. Second, note that from 1990 onward each of the measured economic

Figure 4.2: Polish Components of Measured Economic Freedom Over Time



Source: Gwartney, Lawson, Hall, and Murphy, 2022.

freedom components rose, while some components saw some improvements before that as the communist leadership attempted to liberalize during the 1980s. Finally, note that the most significant gains were in sound money, freedom to trade internationally, and regulation, while there were more modest gains in the legal system and property rights, and the size of government components.

The picture that emerges from figures 4.1 and 4.2 is consistent with the history of reform reviewed in the previous chapter. More specifically, it confirms that the reforms that were undertaken in 1990 were, indeed, significant. Recent analysis, however, suggests that Poland's reforms may not have been implemented as swiftly as those of other nations. Kerianne Lawson and Robert Lawson recently studied 77 nations that undertook significant liberalizations over the past five decades (Lawson and Lawson, 2020). These 77 nations have improved their EFW score by 2 points or more since 1970.

It took the average country 14.94 years to rise 2 points in measured economic freedom, while Poland did it in 10. This suggests that Poland was a *relatively* fast reformer, especially compared with slow reformers like China, Botswana, and Ireland, all of which took 20 years or more to rise 2 points in measured economic freedom. On the other hand, 13 nations improved their scores in under 10 years, including fellow communist bloc nations Latvia, Ukraine, Romania, Bulgaria, and the Slovak Republic.

To better understand how Poland's reforms compare with those of other communist bloc nations, consider table 4.1. It shows the length of reform (how long it took to

**Table 4.1: Comparing Liberalizing Nations**

Country and Year Reform Began	Reform Length	Pre-Reform EFW	Post-Reform EFW	Change in EFW	Standard Deviation of Reform (Higher Scores Indicate More Narrow Reforms)
<b>Poland (1990)</b>	<b>10</b>	<b>3.47</b>	<b>6.54</b>	<b>3.07</b>	<b>1.86</b>
Latvia (1995)	6	5.38	7.51	2.13	2.54
Ukraine (1995)	7	3.34	5.42	2.08	2.31
Romania (1995)	7	3.85	6.31	2.46	2.17
Bulgaria (1995)	8	4.72	6.78	2.06	2.92
Slovak Republic (1995)	9	5.41	7.52	2.11	1.71
Hungary (1990)	10	4.99	7.00	2.01	1.54
Albania (1995)	11	5.04	7.14	2.10	2.49
Russia (1995)	15	4.54	6.54	2.00	3.16
<b>Average of Fellow Communist Bloc Reformers</b>	<b>9.13</b>	<b>4.66</b>	<b>6.78</b>	<b>2.12</b>	<b>2.36</b>
<b>Average of all 77 Reformers</b>	<b>14.94</b>	<b>4.5</b>	<b>6.69</b>	<b>2.19</b>	<b>1.83</b>

Source: Lawson and Lawson, 2020.

rise 2 points in EFW), pre- and post-reform EFW scores, the difference between these scores, and the standard deviation of reform across sub-components of EFW. For the last of these measures, a higher standard deviation indicates that the reform was narrower, whereas a lower standard deviation indicates that it touched on more aspects of economic freedom.

There are several important distinctions with Poland's reforms. Note, first, that Poland was an early reformer, beginning in 1990, whereas most other communist bloc nations liberalized later.<sup>7</sup> Second, Poland began with a comparatively low level of measured economic freedom. Only Ukraine had a lower level when it began to reform. Third, no other communist-bloc reformer saw as large a change in measured economic freedom over its reform period than did Poland. Fourth, several reformers did eventually achieve higher levels of economic freedom than did Poland. Finally, Poland's reforms were relatively broad; only the Slovak Republic and Hungary saw a lower standard deviation of reform.

In summary, Poland was neither the fastest reformer nor did it achieve the highest levels of economic freedom. But it started earlier with a lower level of economic freedom, and it liberalized more than others. These achievements are even more impressive when we consider the fact that Poland was one of the largest nations in the communist bloc with a population nearly 5 times the size of Bulgaria and nearly 15 times the size of Latvia.

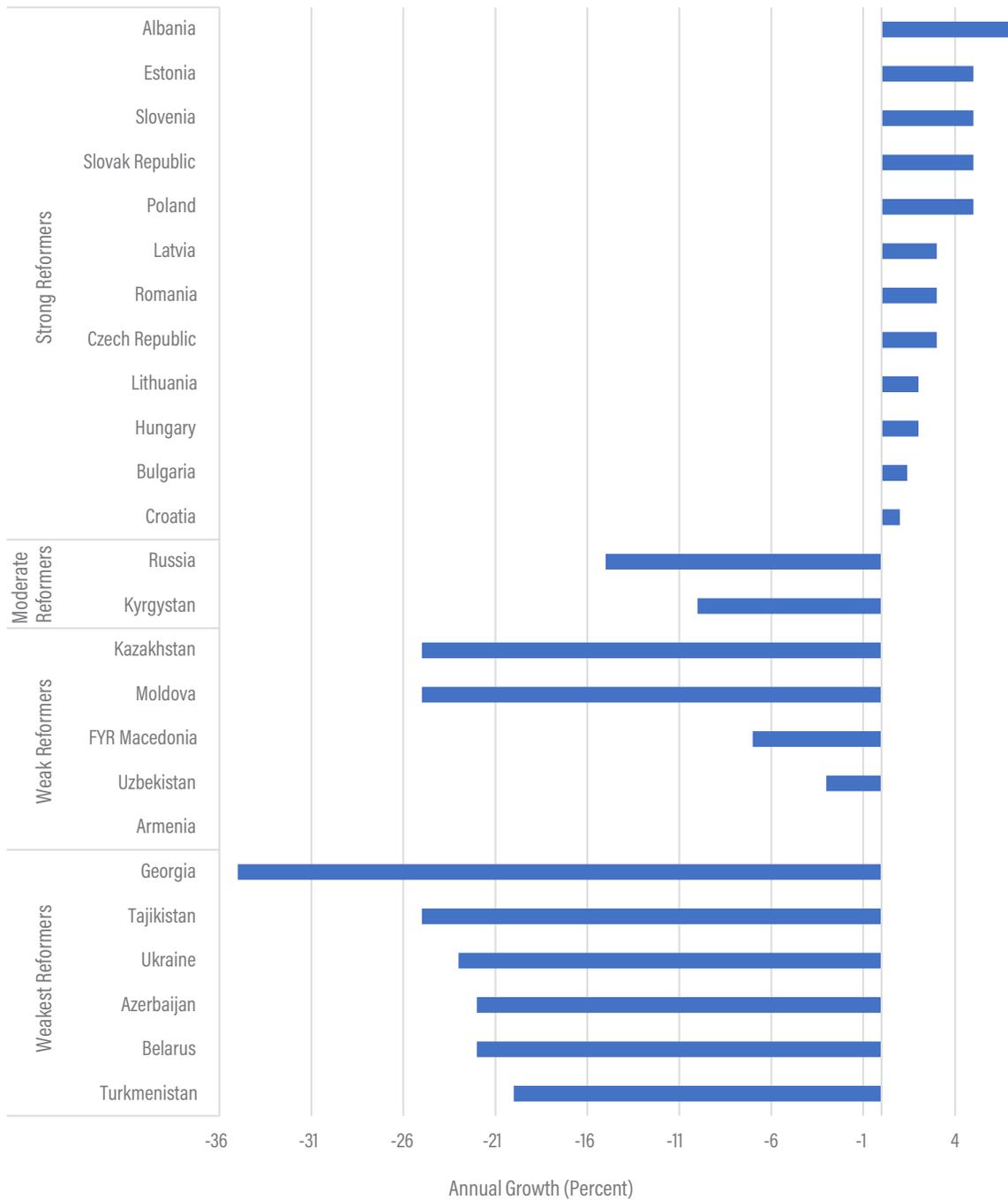
### **Strong reformers fared better**

Warner and Sachs's 1995 study, mentioned above, was one of the first to assess the effects of strong and weak reforms. The European Bank for Reconstruction and Development had ranked the reforms of each post-communist country based on the extent of trade liberalization, privatization, regulatory reform, and fiscal reform. Using these data, Warner and Sachs found that all of the strong reformers had achieved positive growth by 1994 and that none of the comparatively weaker reformers had done so. Figure 4.3 summarizes their results. It shows that all of the strong reformers achieved growth while none of the others did. Warner and Sachs's findings were necessarily preliminary, but they were corroborated by subsequent, more sophisticated analysis.

Interestingly, this subsequent analysis suggests that Poland would have benefited from faster reform. In a series of regressions, Lawson and Lawson find that faster reforming nations outperformed slower reformers economically. In particular, they find that "a seven-year longer reform period, which is about one standard deviation, corresponds to about 0.8 percent lower annualized growth" (Lawson and Lawson, 2020: 679).

Another study, this one by Kevin Grier and Robin Grier (2021), looked at 141 countries from 1970 through 2015, identifying 49 cases of generalized reform. Like Lawson and Lawson, they used positive changes in EFW scores to identify nations that had adopted reforms consistent with the Washington Consensus. Carefully controlling for possibly confounding effects, they find that those nations that pursued sustained economic reforms

Figure 4.3: Post-Reform Growth Among Strong, Moderate, Weak, and Weakest Reformers, 1994



Source: Warner and Sachs, 1995: table 16.

were 16 percent richer than non-reformers 10 years later as measured by per capita GDP. As their journal title aptly puts it, “The Washington Consensus Works.”

In summary, there is abundant evidence that those nations that managed the quickest and most comprehensive transition to free enterprise fared the best. We now assess the impact of reform on several measures of wellbeing in both the short and long run.

### Unemployment during the “transformational recession”

None of this is to suggest that reform was easy. Immediately following the implementation of the Balcerowicz Plan in January 1990, Poland entered what János Kornai has termed a “transformational recession” (Kornai, 1994). Unfortunately, this type of downturn occurred in all post-socialist nations. In the case of Poland, GDP declined by 7.2 percent in 1990, and by another 7.0 percent in 1991 (IMF, 2021). Some have called these figures into question, arguing that official reports during the transition period over-measured declining sectors and under-measured rising sectors such as services, meaning that the actual decline was likely more modest (Sachs, 2012: 3). In any case, with the exception of Slovenia, Poland’s officially-measured recession was smaller than that of other communist bloc countries dealing with their own transformational recessions and it recovered sooner than others (Gomulka, 2016: 20).

Unemployment also spiked, rising from 6.3 percent in 1990 to 11.8 percent in 1991 and to 16.4 percent in 1993 (IMF, 2021). The recession and the concomitant rise in unemployment are not surprising. First, as we explain below, the central bank succeeded in reining in rampant inflation. But resetting inflationary expectations is almost always a painful process. As we have noted, the annual inflation rate had been at least 15 percent since 1981 and had spiked to 250 percent and then to 600 percent in 1989. As disinflation kicked in and the actual inflation rate fell below the expected inflation rate, borrowers had to pay back money that was worth more than they expected it to be worth. As with any monetary squeeze, this re-setting of expectations created a painful redistribution from borrowers to creditors and the disruption in plans entailed real losses.<sup>8</sup>

Second, as prices adjusted to reflect genuine consumer wants and the actual opportunity cost of various activities, significant malinvestments were revealed. While the socialist government had directed labour and capital to heavy industry, the Polish consumer had wanted more services. Once consumers regained their sovereignty, a significant amount of labour and capital had to be reallocated to activities that would create more value for them. And this, too, was quite painful—especially for workers who had little practical knowledge of the products and services that consumers wanted.

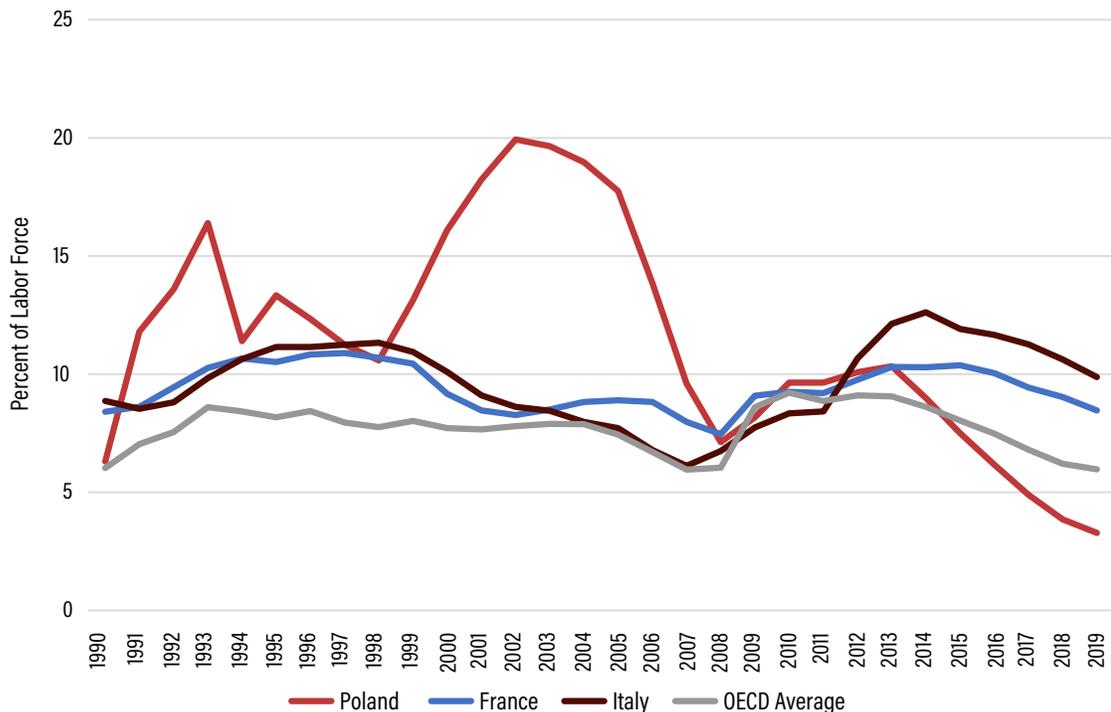
Finally, as soft budget constraints became hard budget constraints, firms and their workers suddenly had to create value for consumers or find something else to do. In this new environment, many firms found themselves highly indebted with outstanding bank loans and credits that at one point reached 145 trillion zloty, or approximately \$13 billion (Slay, 1994: 152). While there is no good employment data from the socialist era, historical accounts suggest that employment rates were quite high, even though many workers sat around all day without creating any value for customers.<sup>9</sup> It is no wonder, then, that many of these employed-but-idle workers were thrown out of work once they had to respond to genuine market signals.

Tullock’s (1975) insights in the “Transitional Gains Trap,” described above, were especially relevant during the transition from socialism to free enterprise. To obtain their

positions of privilege under socialism, many party members often had to “pay their dues.” They had to offer gifts, favours, or bribes to those above them. Net of these costs, the privileges of party membership were not extraordinary—especially since socialist society was so poor. But, crucially, the costs of these dues were sunk and unrecoverable. So when the transition came, party members lost their privileges without recovering the dues they had paid to obtain them. Ironically, the very poverty of socialist Poland may have made this transition possible. In the presence of “very large dead-weight loss,” Tullock noted, “it is conceivable that simultaneously abolishing all [privileges] would lead to a net gain for almost everyone. The individual would lose his particular privilege, but would gain from the loss of privileges of other people” (Tullock, 1975: 678). We suspect that more than a few party leaders didn’t oppose the fall of socialism because they figured that their own fortunes would be better in a free economy.

But not everyone gained. While GDP would soon recover (as we discuss below), unemployment remained relatively high for the next two decades. Figure 4.4 shows the Polish unemployment rate alongside that of France, Italy, and the OECD average. Compared with the US, European nations are known for having relatively high structural unemployment rates.<sup>10</sup> While the Polish unemployment rate generally declined throughout the 1990s, it began to rise again in 1998, peaking at 20 percent in 2002. Thereafter it fell, settling near the rates of France, Italy, and other OECD nations for several years and then finally drifting down from 2013 onward to levels comparable to the United States.

Figure 4.4: Unemployment in Poland and Other Nations, 1990-2019



Source: International Monetary Fund, 2021.

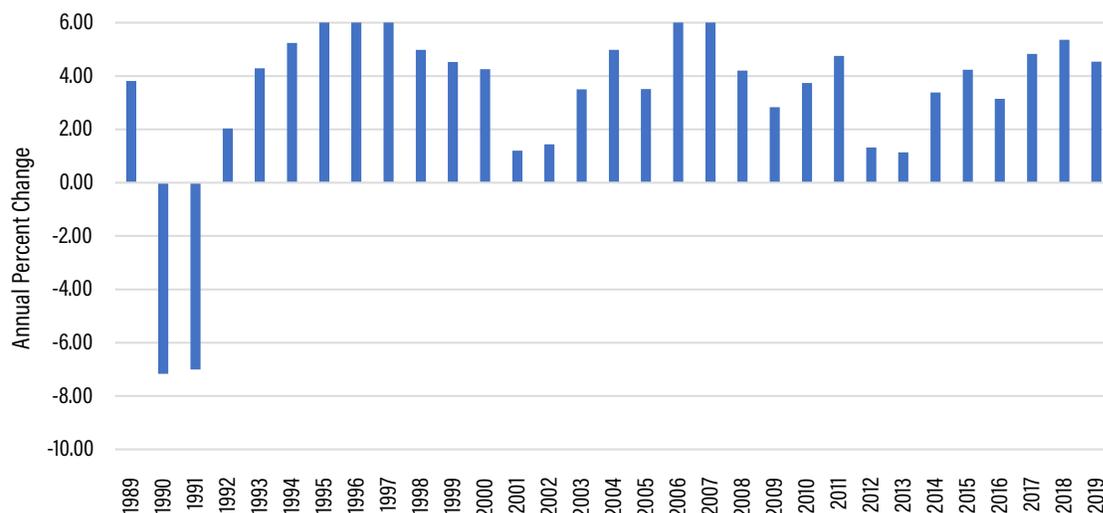
### Post-reform economic growth and rising living standards

Figure 4.5 shows annual growth rates in real Polish GDP from 1989 through 2019. Following the transformational recession, real GDP grew in each of the next 28 years. Only two OECD nations—Poland and Australia—went without a single year of economic decline over that time.

Poland’s real GDP grew from \$181 billion in 1991 to \$570 billion in 2019 (World Bank, constant 2015 US\$). More significantly, real GDP per capita grew from \$8,493 in 1991 to \$31,985 in 2019 (Feenstra, Inklaar and Timmer, 2021, in 2017 US\$). Figure 4.6 shows real GDP per capita from 1970 through 2019. It also shows the pre-reform trend line. From 1970 through 1991, real GDP per capita grew at about 1.8 percent per year. At this rate, it would take 38 years to double. However, from 1991 onward, real GDP per capita grew more than twice as fast, at an average annual rate of 4.7 percent per year. At this rate, GDP per capita doubles every 14.8 years. To help illustrate the dramatic change in pre- and post-reform growth rates, the figure also traces the pre-1991 trend line beyond 1991. If growth had continued at the pre-1991 rate, then in 2019 real GDP per capita would have been just \$14,177. Instead, the actual GDP per capita that year was, as noted, nearly \$32,000—more than 2.3 times higher than it would have been had growth continued at its sluggish, pre-reform pace.

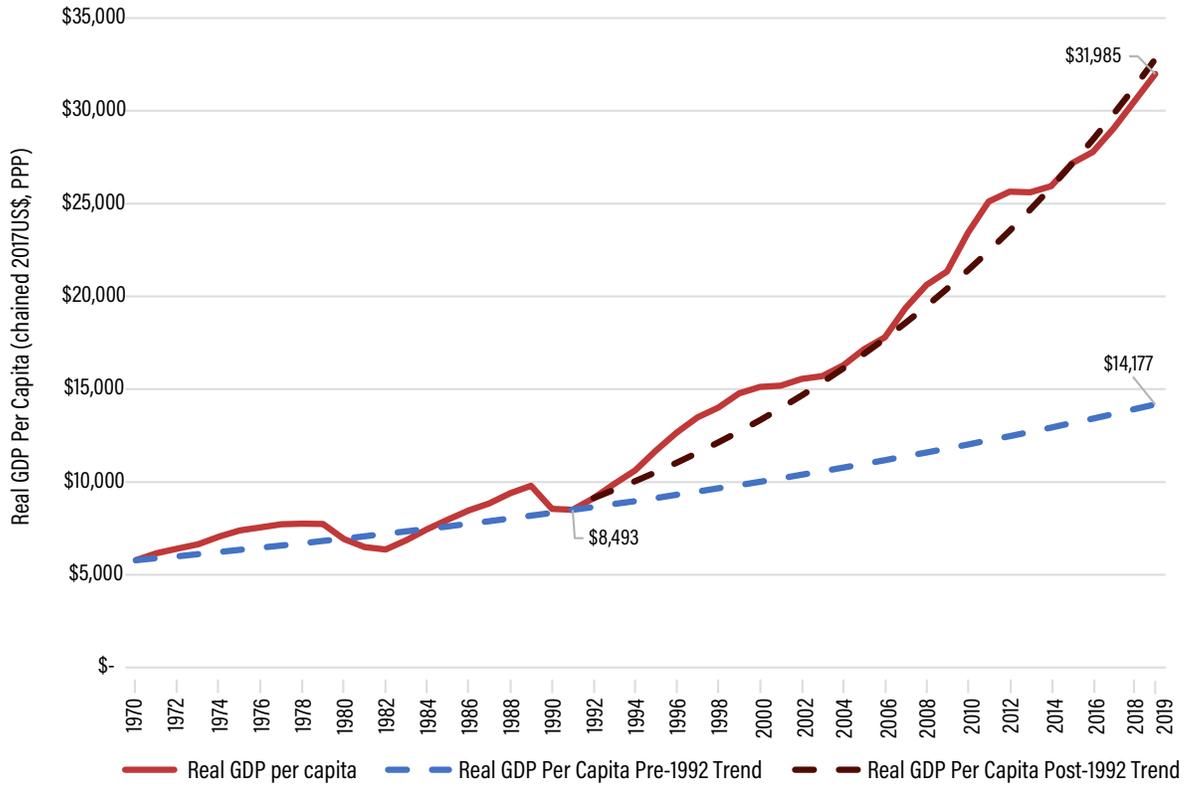
As incomes rose and opportunities for trade expanded, living standards improved. Decades of endemic shortages ended within weeks (Sachs, 2012: 3). As one economist put it, “The most spectacular success was connected with the immediate elimination of market shortages” (Dabrowski et al., 1997: 11). Sachs reports that “Ownership of VCRs, stereo tape recorders, color televisions, cameras, automobiles, washing machines, freezers,

Figure 4.5: Annual Percent Change in Real Gross Domestic Product, 1989-2019



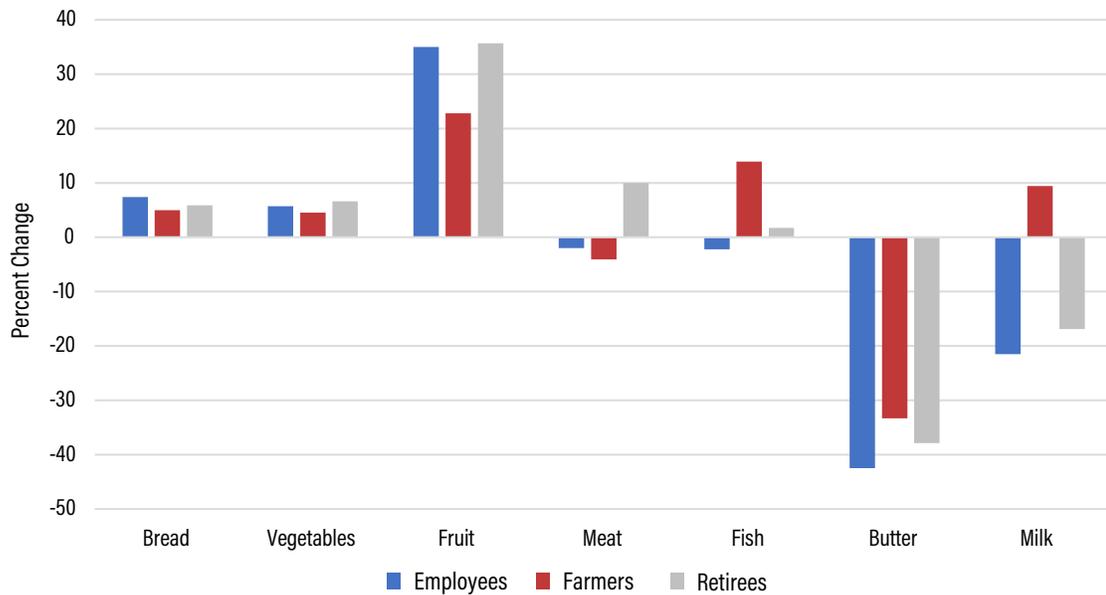
Source: International Monetary Fund, 2021.

Figure 4.6: Poland's Real GDP Per Capita, 1970-2019



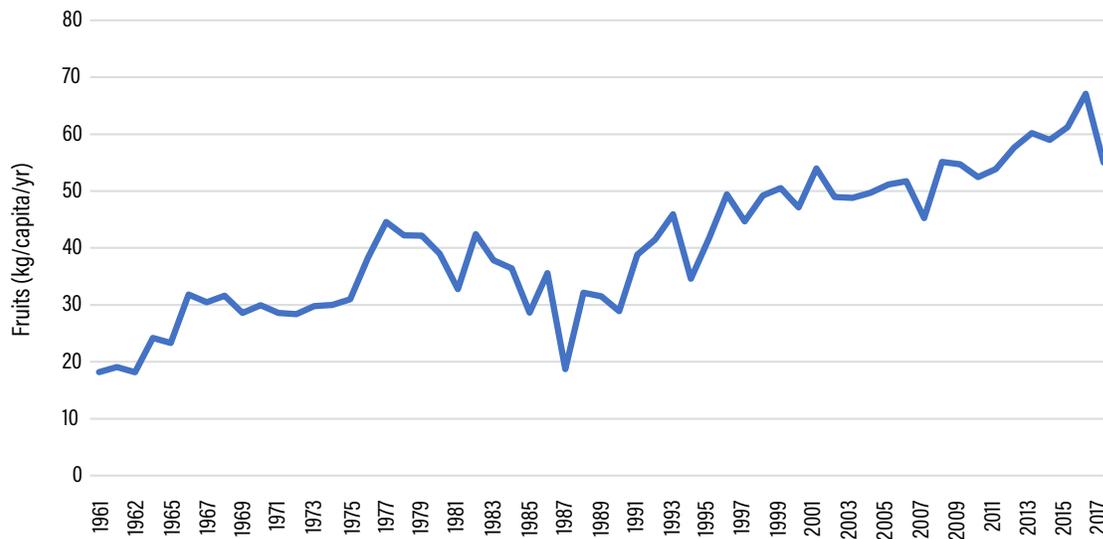
Source: Feenstra, Inklaar and Timmer, 2021; trend lines calculated by authors.

Figure 4.7: Change in Per Capita Food Consumption, 1989-1993



Sources: Polish Statistical Yearbook, 1990, and Polish Statistical Bulletin, May 1994. Adapted from Sachs, 1995.

Figure 4.8: Fruit Consumption per Capita, 1961-2017



Source: United Nations, Food and Agricultural Organization, 2022.

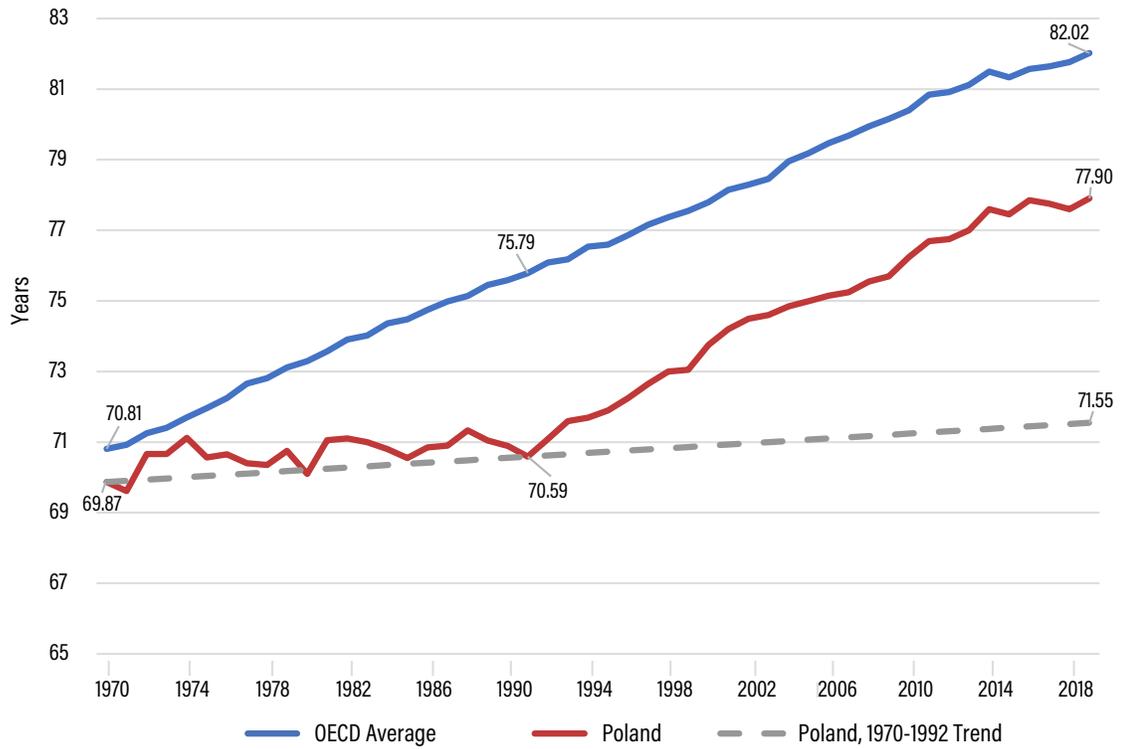
and many other big-ticket items soared between 1989 and 1993” (Sachs, 1995). As figure 4.7 shows, diets improved as consumption of low-fat fruits and vegetables rose while that of high-fat butter fell. Figure 4.8 displays the long-term trend in fruit consumption, which clearly shows continual improvement thanks to higher living standards and increased trade with the West.

As living standards improved, Polish life expectancy at birth began to grow. Figure 4.9 continues the series shown in figure 2.13 above, comparing life expectancy at birth from 1970 through 2019 for Poland and the OECD nations. It also shows the pre-reform Polish trend line. From 1991 onward, Polish life expectancy grew at a slightly faster pace than that of the OECD. Between 1991 and 2019, 6.23 years were added to OECD life expectancy, while 7.32 years were added to Polish life expectancy. If life expectancy had continued to grow at the same pace it did from 1970 through 1992, the average Pole today could expect to live to 71.55 years of age instead of 77.90 years.

### Taming inflation

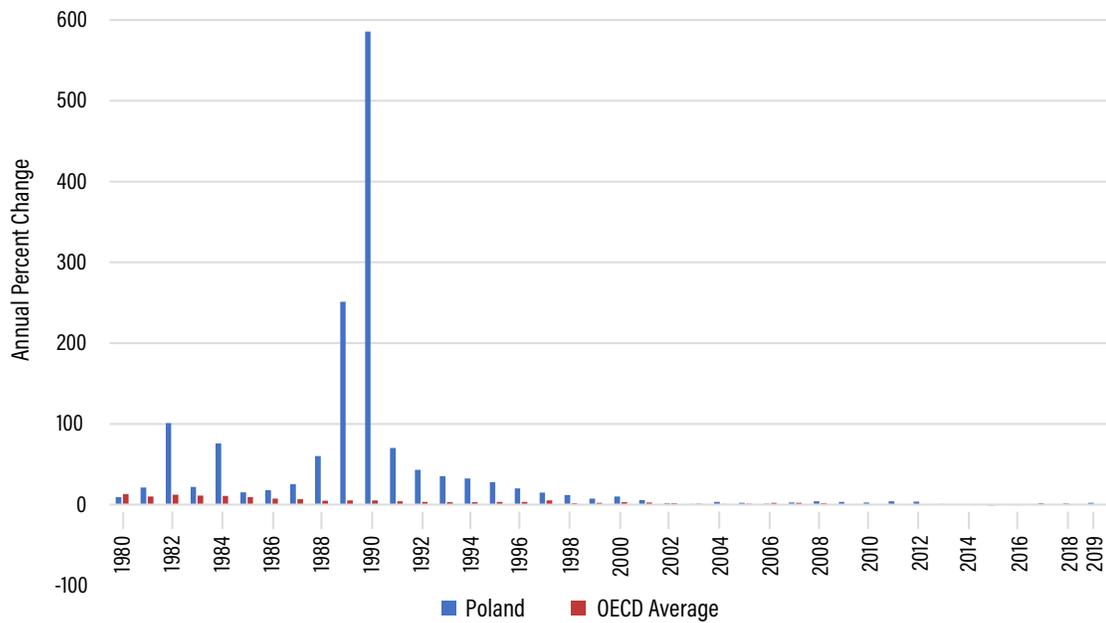
Inflation also moderated. Figures 4.10 and 4.11 show the annual inflation rate in Poland as well as the average annual inflation rate of the 38 nations currently comprising the OECD. Figure 4.10 shows this data from 1980 through 2019 while figure 4.11 shows it from 1992 through 2019. From 1980 through 1990, Poland averaged an annual inflation rate of over 107 percent, more than 80 percentage points greater than the OECD average during that period (IMF, 2021). The Polish hyperinflation of the late 1980s disappeared within the first year of reforms as inflation went from 585 percent in 1990 to 70 percent

Figure 4.9: Life Expectancy at Birth, Poland versus OECD Average, 1970-2019



Source: World Bank, 2021.

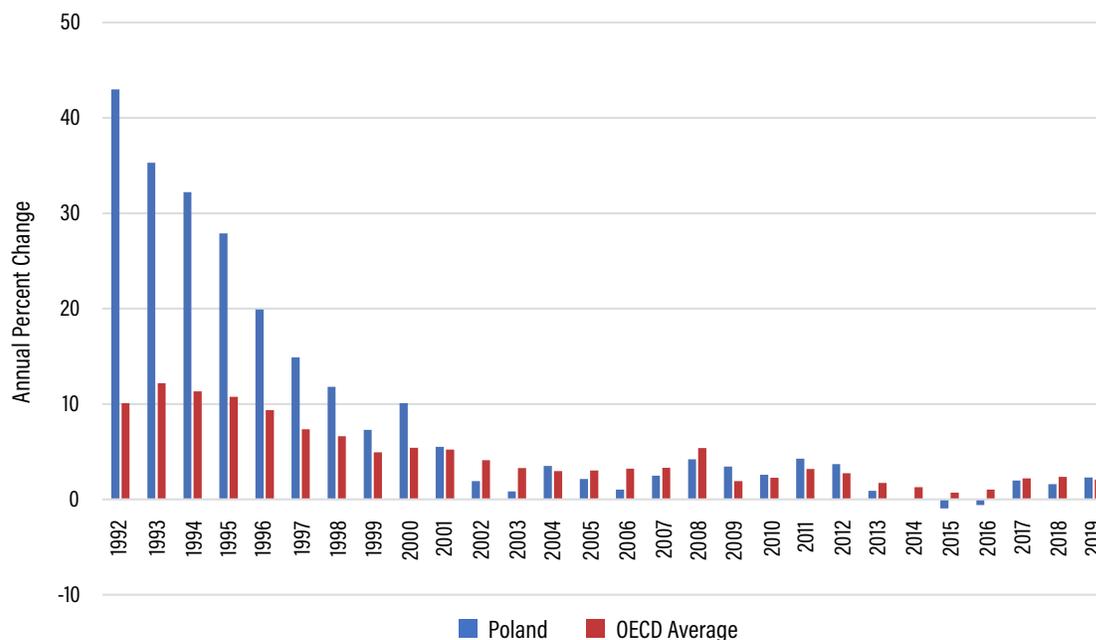
Figure 4.10: Annual Inflation Rate, 1980-2019



Source: International Monetary Fund, 2021.

in 1991. Polish inflation then drifted downwards throughout the rest of the 1990s. From 1998 onward, the average annual inflation rate in Poland was just 3.18 percent, comparable to the OECD average of 3.13 percent during that time.

**Figure 4.11: Annual Inflation Rate, 1992-2019**



Source: International Monetary Fund, 2021.

## Notes

- 1 The size of government area is constructed with measures of government consumption, transfers and subsidies, government investment, top marginal tax rates, and state ownership of assets.
- 2 This area includes measures of judicial independence, impartial courts, protection of property rights, military interference in the rule of law and politics, integrity of the legal system, legal enforcement of contracts, the regulatory costs of the sale of real property, and the reliability of police.
- 3 This is measured by money growth, the standard deviation of inflation, inflation in the most recent year, and freedom to own foreign currency bank accounts.
- 4 This component includes measures of tariffs, regulatory trade barriers, black market exchange rates, and control of the movement of capital and people.
- 5 This area includes measures of credit market regulations, labour market regulations, and business regulations.
- 6 From 1975 through 2000, EFW only measures economic freedom in 5-year intervals. From 2000 onward, EFW measures freedom on an annual basis.
- 7 1995 is the earliest year of the EFW for many communist bloc nations, so some of these nations may have begun reforms earlier. Still, contemporaneous accounts are clear that Poland was one of the first reformers.
- 8 The opposite had been true in the late 1980s. Then, as inflation unexpectedly spiked, borrowers were able to repay loans with money that had lost quite a bit of purchasing

- power. In that part of the cycle, unexpected inflation had redistributed money from creditors to borrowers.
- 9 Consider this anecdote: Danuta Nowak was a lathe operator at the Żerań factory. She reports: “I worked on the morning shift. I would come to work at 6AM, punch in, get a coffee, chat with people for hours and have nothing to do until 1PM or so... People were so bored that they often did terribly stupid pranks that not once or twice had serious consequences” (Oleksiak, 2015).
  - 10 Structural unemployment is persistent, long-term unemployment due to semi-permanent features of an economy. While a full discussion is beyond the scope of this current project, structural unemployment has been linked to labour regulations that raise the cost of hiring and firing workers, to relatively generous unemployment benefits, to high minimum wages, to employment protection laws, and to relatively high union participation. For further details, see Martin (2000) and Cowen and Tabarrok (2020: 238-44).



## THE NEW POLISH ECONOMY

In this chapter, we briefly review the ways in which the transition has reoriented the Polish economy.

### Changes in industrial composition

Heavy industry—so favoured by the socialist regime—was most adversely affected by the transition. As subsidies were cut, prices were liberalized and barriers to trade were removed, resources were reallocated toward wholesale and retail trade, the service sector, and the telecommunications sector and away from heavy industry. Indeed, during the first years of the restructuring many of the industrial state enterprises collapsed due to their inability to adjust to the changing environment.

As we've noted, many of these firms were incapable of producing the goods that were in demand by the Polish people. At the same time, the transition inadvertently created disruptions for firms' operations, as the privatization process was slow and the banking sector was undercapitalized in the initial stages of the transition.

Some changes were immediate. Overall industrial production fell by 24.2 percent in 1990, with production of fuels, metallurgy, engineering, chemicals, and minerals falling by more than 20 percent (Slay, 1994: 139). Industrial production further decreased by 12 percent in 1991 and experienced only a modest increase of 4 percent in 1992 (Slay, 1994: 139). Other changes played out over a longer time. Industrial employment as a share of total employment decreased from 36 percent in 1989 to 29 percent in 2004 (Koryś, 2018: 337).

The changing composition of industrial production indicated a move towards a consumer-oriented economy. Food processing comprised about 21 percent of all industrial output in 1989, and the engineering sector claimed the highest share of industrial output at 25 percent. The composition had changed by 1992 when 21.5 percent of industrial output was produced by the fuels and power sector, engineering had slipped to 20 percent, and the food processing sector had risen to 23 percent of total industrial production (Slay, 1994: 140).

Changes in the industrial sector have continued, but over time it has stabilized. As increasing private investments into equipment and machinery led to the emergence of a new automobile industry, household appliances, and high tech, these industries began to gain market share against the behemoths of heavy industry and mining. These changes were no doubt painful for the workers involved and likely explain much of the unemployment

discussed above. But they also mean that the new Polish economy is built on a more solid foundation as it better reflects the genuine desires of consumers and the opportunity cost of resources.

### Changes in agriculture

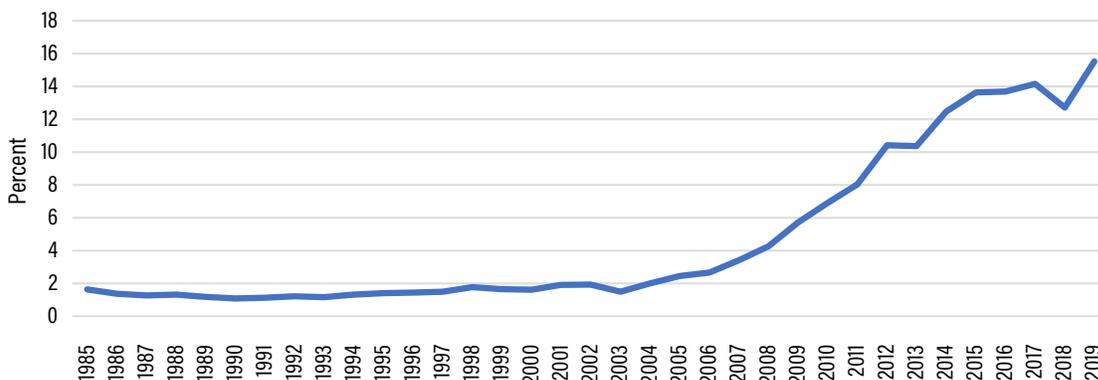
The agricultural sector was also affected by deregulation and the gradual liquidation of state-owned farms—though to a lesser extent than the industrial sector since the bulk of agriculture was already in private hands before the transition. State-owned agricultural holdings were replaced with privately owned estates. The average area owned by any estate grew from year to year (Koryś, 2018). The shift indicated a more productive and market-oriented approach, in which an emphasis on profit resulted in the introduction of new technologies and a reduction in overall agricultural employment, which declined from 29 percent in 1989 to 17 percent in 2004 (Koryś, 2018: 339).

Under the socialist regime, private farmers generally worked small plots of land and were essentially cut off from supporting financial and trade institutions. But the post-reform economic environment permitted farmers to achieve economies of scale through larger operations and to have access to higher quality capital equipment, permitting more efficient agricultural production. At the same time, trade liberalization allowed Poles to import more agricultural products. As a result of these changes, agricultural output fell in real terms from \$36.6 billion in 1990 (2015 US\$) to \$31.5 billion in 2019 (2015 US\$), while the value-added per agricultural worker increased by about 66 percent from 1995 to 2019 (Our World in Data, 2022).

### Technological change

In more recent decades, the technological and power infrastructure began to modernize and develop. Wind and other renewable sources of power production advanced so that,

Figure 5.1: Share of Electricity Production from Renewables, 1985-2019



Note: Renewables include electricity production from hydropower, solar, wind, biomass & waste, geothermal, wave, and tidal sources.

Source: Our World in Data, 2023.

by 2019, renewable sources produced nearly 16 percent of all energy in Poland (figure 5.1). Cellular tower technologies replaced obsolete telephone lines and by 2007 there were more mobile phone subscriptions than people in Poland (Our World in Data, Undated.)

### Changes in social, political, and economic equality

In the previous chapter that assessed the transition, we discussed the rise and fall of unemployment. We now address economic inequality and poverty. Under socialism, the government had maintained relatively low official income inequality through centrally planned wages (Asselain, 1987: 21). As chapter 3 discussed, the main sources of inequality arose from unequal access to scarce goods and from the extraordinary privileges afforded to the elite.

Still, there was *some* official wage inequality under socialism. Some workers, for example, received higher incomes if they possessed skills and education in fields deemed a priority by the state (e.g., the military industrial complex). These differences, combined with differential investments in sectors deemed “productive,” such as heavy industry, also contributed to geographic inequality in socialist Poland (Fuchs and Demko, 1979). Fuchs and Demko cite studies finding incomes in highly urbanized *voivodships* (regions) such as Krakow, Lodz, Poznan, Wroclaw, and Warsaw, exceeded the national average by 80 percent or more (Fuchs and Demko, 1979: 307).<sup>1</sup> By contrast, nearly half of *voivodships* had per capita incomes that were only three-fourths of the national average. As a result, “measures of income, industrialization, services, and facilities per capita reveal a strong decline from west to east” (Fuchs and Demko, 1979: 307).

In 1989, at the beginning of the transition, income and consumption inequality initially increased, and then decreased to below pre-transition levels from 1990 to 1992 (Keane and Prasad, 2002: 324). The most common measure of income inequality, the Gini coefficient, decreased from 0.256 in 1988 to 0.230 in 1992.<sup>2</sup> In other words, official income inequality was lower in 1992 than in the last years of socialism in Poland. When one considers the extraordinary unofficial privileges afforded the elite during the socialist era, it is obvious that in the immediate aftermath of the transition to capitalism material inequality fell.

Thereafter, income and consumption inequality gradually increased and moderately surpassed pre-transition levels, with the Gini coefficient reaching 0.276 by 1997. “To put an increase of 0.020 in the income Gini coefficient in perspective,” Keane and Prasad write, “it is only two-thirds as much as the increase reported for the United States in the 1980s.... Viewed another way, it still leaves Poland with a Gini value closer to those of Scandinavian countries (around 0.25) than that of the United States (0.41)” (Keane and Prasad, 2002: 324).

At the same time, Poland’s relatively generous social transfers mitigated the transition costs in the early years of the transition (Keane and Prasad, 2002).<sup>3</sup> The process of capital

formation also increased the returns to education. As Keane and Prasad put it, “the earnings premium for a college degree relative to a primary school degree increased from 47% in 1988 to 98% in 1996. The high school premium increased from 23% to 41% over the same period” (Keane and Prasad, 2002: 334).

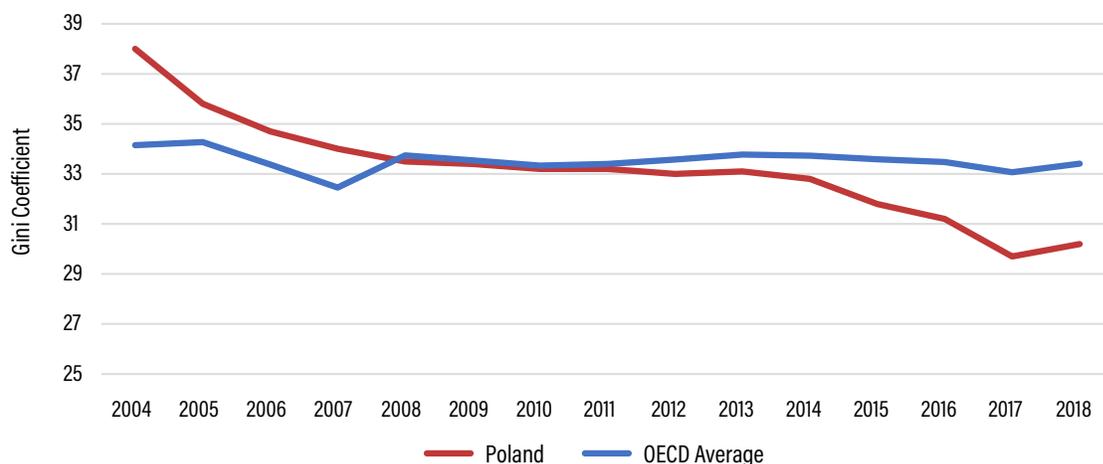
Figure 5.2 shows income inequality in Poland and the OECD nations from 2004 through 2018 (the years for which we have comparable data). In 2004, income inequality—as measured by the Gini coefficient—was higher in Poland than in the average OECD nation. But by 2008, the two figures were comparable, and in more recent years Polish income inequality has been lower than in the average OECD nation.

Much of this change seems to have been driven by the post-transition rise, and subsequent fall, in poverty. As figure 5.3 shows, the share of the population living on less than \$6.85 per day (in 2017 international dollars), rose precipitously after the transition, but quickly fell and has since tapered off. Note, further, that while the poverty rate in Poland in 2019 (2.63 percent) was slightly higher than the poverty rate just before the transition (1.88 percent), it is well below the 10 percent peak in the mid-1980s.

Economic inequality also has a geographic dimension. Unlike the agricultural and industrial regions, large, urbanized centers (Warsaw, for instance), clearly benefited from the reforms as liberalization of trade and financial services brought about new ranks of modern entrepreneurs, creating new opportunities for both blue- and white-collar professionals (Koryś, 2018: 332-33).

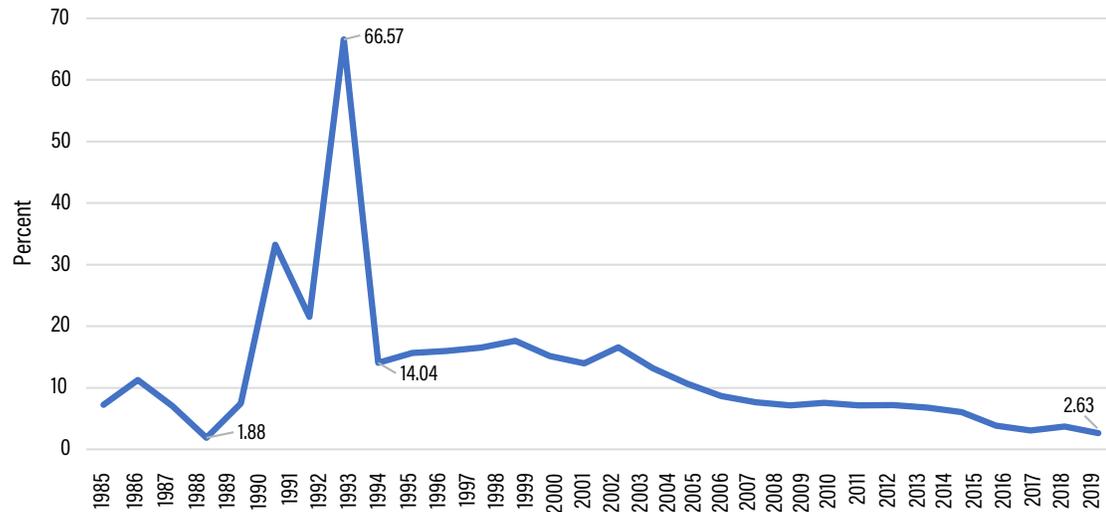
The entrepreneurs finally had the prerequisites for successful ventures thanks to their newfound access to capital, a workable price system, and protection of property rights. Middle-class workers were in high demand due to the emergence of these new ventures and foreign investments into Poland’s business sector. The transition created circumstances

**Figure 5.2: Income Inequality in Poland versus OECD Average, 2004-2018**



Source: World Bank, 2023

Figure 5.3: Share of the Population Living on Less than \$6.85 per Day, 1985-2019



Note: This data is measured in international \$ at 2017 prices.

Source: Our World in Data, 2022b.

that were not as favourable for lower income populations, however. The process of privatization and the elimination of state-owned firms in different industries instigated a wave of unemployment, as discussed above, and this lasted until roughly the beginning of the new century. Many of the firms in the heavy and supporting industries did not survive the economic transition due to obsolete technologies, fierce competition, and inefficient production processes. Naturally, the adjustment process dramatically reduced the demand for low-skilled workers (a situation not unique to Poland).

A similar scenario played out in the agricultural sphere. As state-owned farms were gradually eliminated and new production technology was increasingly used, many farmers found themselves seeking new jobs. Thus, a significant migration of Poles took place during the first post-socialist decade, both externally and internally. Many took the opportunity to leave Poland for the West. It is estimated that close to 2 million Polish citizens were living abroad by 2016 (Gomulka, 2016).

## Notes

- 1 As a rule, urbanized areas harboured industry and could provide factories with an ample supply of workers.
- 2 The Gini coefficient ranges from 0, if income is completely equal for the whole population, to near 1, if a few individuals earn almost all income. Hence the higher the value of Gini coefficient, the more unequal the statistical distribution of income.
- 3 Transfers reduced inequality but also reduced political resistance to reforms.



## CONTEMPORARY ECONOMIC AND REGULATORY POLICY IN POLAND

Having discussed the initial development of Poland's transition from socialism to a more market-oriented economic system, we now aim to dive deeper into current economic conditions and explore the extent to which Poland has continued to advance market reforms, to deregulate the economy, and to move away from the command-and-control institutions of the socialist period. The analysis, we hope, will let us pinpoint the specific reforms and processes responsible for post-transition growth, and identify areas for possible improvement.

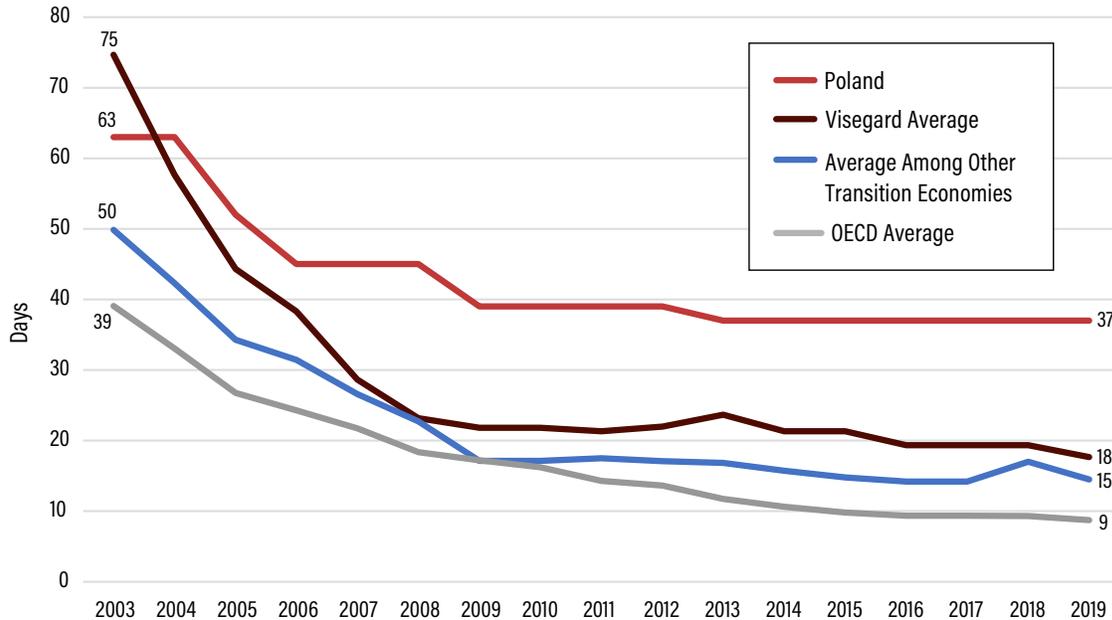
### Doing business in Poland today

Consider, first, the World Bank's *Doing Business Index* (World Bank, 2020). The project provides objective measures of business regulations and their enforcement across 190 economies and select cities at the subnational and regional level. It ranks each country's regulatory and business environment across several dimensions, including the ease of opening a business, establishing a location, accessing finance, dealing with day-to-day operations, and operating in a secure business environment.

Overall, in terms of ease of doing business, Poland ranked 40<sup>th</sup> out of 190 countries in the latest *Doing Business* report (World Bank, 2020). It scored well in resolving insolvency (25<sup>th</sup>), getting credit (37<sup>th</sup>), dealing with construction permits (39<sup>th</sup>), and trading across borders (where it tied for 1<sup>st</sup> place with 15 other nations). But it ranked lower in terms of enforcement of contracts (55<sup>th</sup>), protection of minority investors (51<sup>st</sup>), getting electricity (61<sup>st</sup>), paying taxes (77<sup>th</sup>), and registration of property (92<sup>nd</sup>). Its poor ranking in registration of property was driven by the long wait time for registration (135 days, whereas the OECD average is just 23 days). Poland scored especially poorly in the category of starting a business, ranking 128<sup>th</sup> out of 190 countries. This was driven by the relatively high cost of starting a business in Poland (11.6 percent of annual income per capita, whereas the OECD average is just 3.9 percent), and the relatively long wait time to begin operating a business (37 days, whereas the OECD average is 9 days) (World Bank, 2020).

Figure 6.1 shows the number of days required to legally begin operating a business in Poland and in the average of three comparison groups. The first comparison group includes the other Visegrád countries, the Czech Republic, the Slovak Republic, and Hungary (we do not include Poland in the calculation of this average). The second comparison

Figure 6.1: Days Required to Start a Business in Poland vs. Other Liberalizing Nations, 2003-2019



Source: World Bank, 2020.

group includes the eight transition nations included in table 4.1 above.<sup>1</sup> And the final comparison includes all the OECD nations (again, excluding Poland). The figure suggests that while Poland continued to make it easier to do business in the first part of this century, its reform efforts may have lost some steam, especially when compared to other nations. In 2003, it took 63 days to begin operating a business in Poland and now it takes 37. In each of the comparison groups, however, it took significantly less time to begin operating a business in 2003.

In the early 2010s, the government of Poland estimated that the administrative burden on businesses was more than 5 percent of GDP per year, and took steps to reduce this burden (OECD, 2012). To that end, the government decreased the number of registration documents required for new businesses and replaced some professional certificates with self-certification procedures. The information requirements for running a business were also reduced and the government is slowly introducing e-filing and online documentation processing. More recently, Poland has introduced “100 changes for business” and “business constitution” programs aimed at simplifying regulatory and tax compliance.

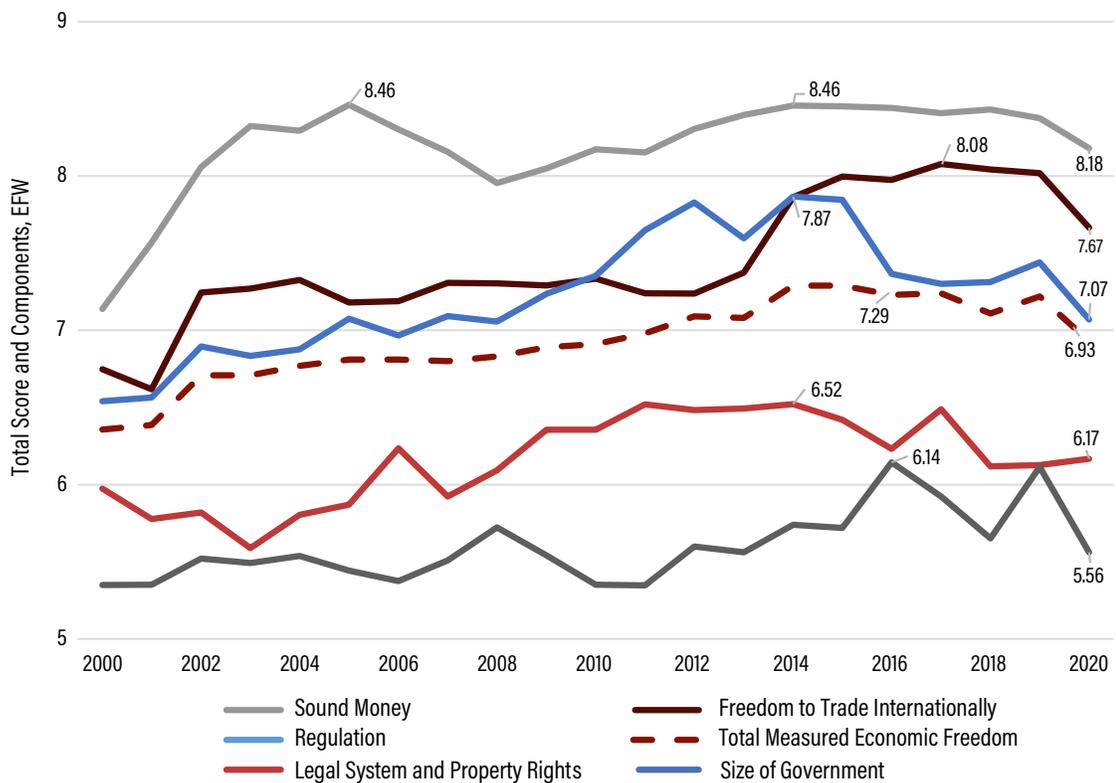
In 2016, corporate insolvency reform streamlined bankruptcy proceedings in an attempt to speed up the process, reduce its costs, and make it easier for creditors (Dec, 2016). The reforms incorporated procedures that are common in the West, such as pre-packaged liquidation, whereby a restructuring plan is agreed to in advance of a company declaring insolvency. The government also established a tribunal dedicated to firm restructuring and the registration of bankruptcies in an attempt to streamline insolvency proceedings

(OECD, 2018a). As a result, resolving insolvency has become one of Poland’s strengths in terms of its business climate, contributing to its 25<sup>th</sup> place ranking in the resolving insolvency category of the 2020 issue of the *Doing Business* report (World Bank, 2020).

### Economic freedom in modern Poland

Figure 6.2 shows total measured economic freedom as well as the components of economic freedom from 2000 onward (these are the same data shown in figures 4.1 and 4.2, above, but we have restricted the sample to 2000 and the years afterward). Note, first, that total measured economic freedom and its components have continued to grow in this century, but the pace of growth has slowed. Between 1990 and 2000, Poland’s measured economic freedom rose 2.38 points on the EFW scale, whereas from 2000 to 2010, it rose only 0.55 points on the scale. Furthermore, note that both the total score and most of the component scores peaked around 2014 or 2015 and have since declined. The most precipitous declines were in the regulation component (which fell 0.8 points from its peak in 2014) and the legal system and property rights component (which fell 0.58 points from its peak, also in 2014). Finally, note that size of government, and legal system and property rights are consistently Poland’s lowest-scoring components of economic freedom. We now examine several policy trends in closer detail to help explain these trends and the stalled pace of reform over the last several years.

Figure 6.2: Total Economic Freedom and Components of Economic Freedom, 2000-2020



Source: Gwartney, Lawson, Hall, and Murphy, 2022.

## Foreign direct investment

Poland's economy has benefited from a systematic opening to foreign direct investment (FDI), as regulations pertaining to FDI, foreign trade, and currency convertibility have been continuously liberalized. Prior to the transition, FDI was subject to the so-called "enclave model," in which foreign investments were only permitted in specific sectors of the economy and in small foreign business operations with a minor share of foreign capital. Moreover, foreign investors had to obtain special permits through burdensome procedures, and there were restrictions on the transfer of profits abroad.

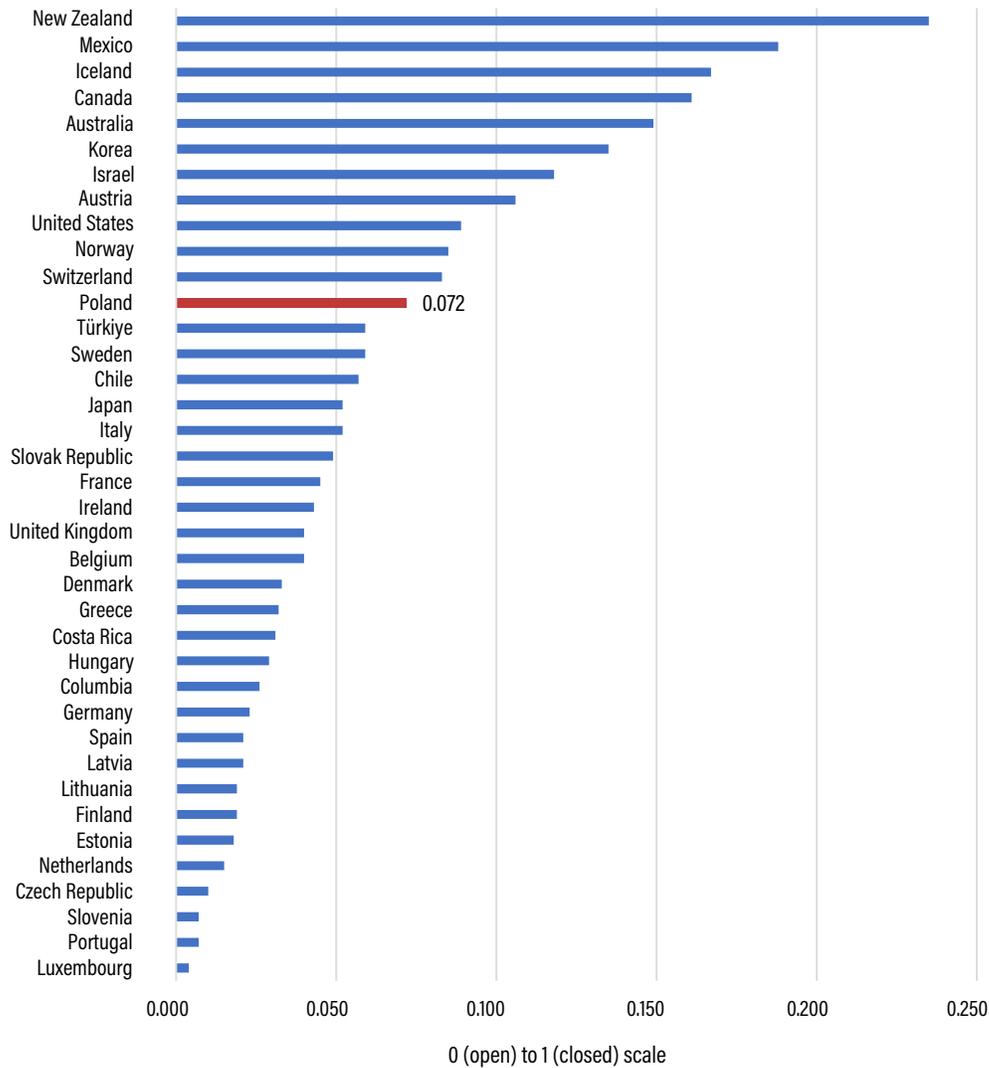
Since the initial reforms of the early 1990s, Poland has made considerable progress in treating foreign investors on equal terms and conditions with domestic entities. Foreign investors receive guarantees of full compensation in the unlikely case of expropriation by government, and permits are required only when foreign investors buy equity, lease, or purchase the assets of state-owned firms (Gorynia, Nowak, and Wolniak, 2007).

Over time, foreign companies have gained significantly greater access to the Polish market, including the ability to establish and own businesses (OECD, 2018c; United States, Department of State, 2020). Consider the OECD's FDI Regulatory Restrictiveness Index (OECD, 2023), which measures statutory restrictions on foreign direct investment across 22 economic sectors.<sup>2</sup> Countries are scored along a 0 to 1 scale with 0 indicating that the country is open to FDI and 1 indicating it is closed. In 1997, Poland earned a score of 0.17, making it the 9<sup>th</sup> most restrictive nation in the OECD. As barriers were reduced in the 2000s, however, Poland's score improved. Since 2010, Poland has scored 0.07 on the index. Figure 6.3 shows OECD member nations' scores on the index in 2020. Poland is still slightly more restrictive than the average (0.063) and is now the 12<sup>th</sup> most restrictive nation in the OECD. This reflects the fact that while Poland has eased restrictions on FDI, so have other OECD member nations.

Poland's score also reflects the fact that, despite progress, several constraints on foreign direct investment remain. For instance, existing laws impose limitations on the purchases of land and real estate and limit foreign ownership of firms by non-EU citizens to 49 percent in certain industries designated as strategic. The restricted industries include air transport, radio, television broadcasting, and airport and seaport operations. In the insurance sector, at least two management board members, including the chair, must speak Polish. Additionally, the government has advanced the idea of protecting incumbent domestic firms by requiring a larger share of domestic private ownership of firms in banking and retail industries and has also implemented sectoral taxes (United States, Department of State, 2020).

Figure 6.4 shows foreign direct investment (FDI) as a share of GDP from 1990 through 2019. For comparison, it also shows FDI as a share of GDP in the average OECD nation. Net inflows of foreign direct investment increased from about 0.1 percent of GDP in 1990 to 5.42 percent of GDP in 2000. Though FDI collapsed in the years after the Great Recession, reaching just 0.15 percent of GDP in 2013, they have since risen and have

Figure 6.3: Restrictions on Foreign Direct Investment, 2020



Note: The FDI Regulatory Restrictiveness Index (FDI Index) measures statutory restrictions on foreign direct investment across 22 economic sectors. It gauges the restrictiveness of a country's FDI rules by looking at the four main types of restrictions on FDI: 1) Foreign equity limitations; 2) Discriminatory screening or approval mechanisms; 3) Restrictions on the employment of foreigners as key personnel and 4) Other operational restrictions, e.g. restrictions on branching and on capital repatriation or on land ownership by foreign-owned enterprises. Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is the average of sectoral scores. The discriminatory nature of measures, i.e. when they apply to foreign investors only, is the central criterion for scoring a measure. State ownership and state monopolies, to the extent they are not discriminatory towards foreigners, are not scored.

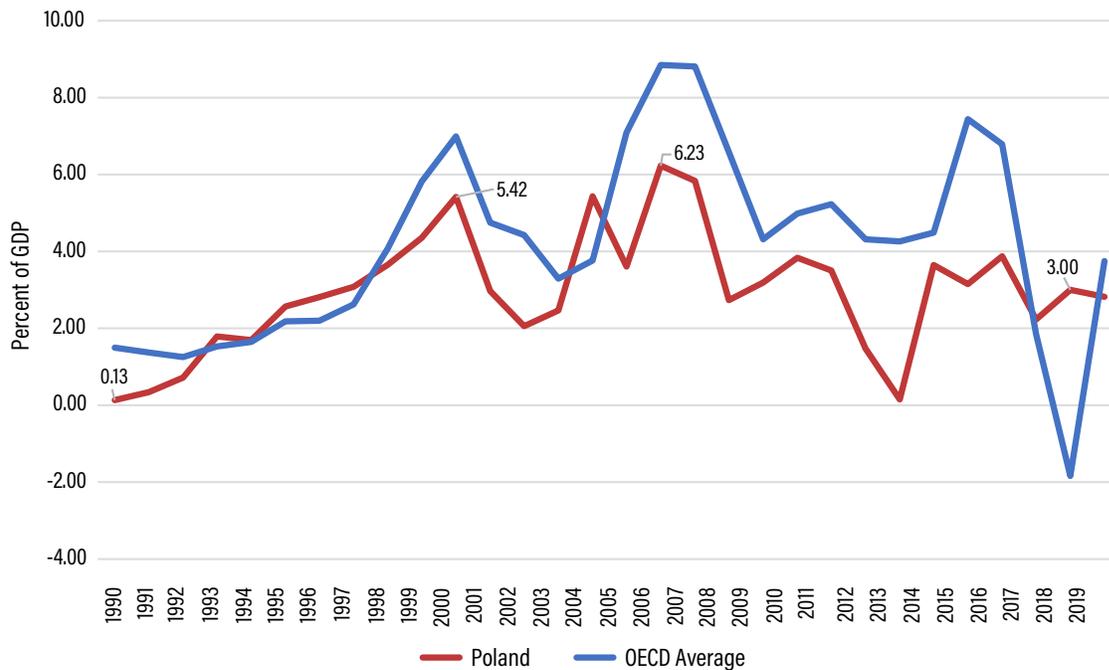
Source: OECD, 2023

been about 3 percent of GDP in recent years. For most of this period, FDI in Poland was less than that of the average OECD nation, perhaps reflecting its slightly more restrictive stance toward FDI.<sup>3</sup>

### Foreign trade

Now consider trade in goods and services. Since the early periods of transition in the 1990s, trade liberalization has been considered a good proxy for the overall opening

Figure 6.4: Foreign Direct Investment as a Share of GDP in Poland vs. the OECD Average, 1990-2019



Source: World Bank, Undated.

of an economy for commerce. Trade liberalization has also been interpreted as a way to signal to market participants that policy makers are committed to market reforms (Warner and Sachs, 1995: 2). Thus, increases in imports and exports are illustrative of transition success.

The transition from socialism to a more market-oriented economy has not only supplied citizens with access to financial markets and foreign investments but also to international goods and services. The process was jump-started in January 1990 with the easing of nontariff barriers to trade and with the implementation of a new customs code in line with the General Agreement on Tariffs and Trade (GATT). The average level of tariffs was set at approximately 8.9 percent (Hagemejer and Michalek, 2008).

Average customs rates increased in 1991 due to protectionist calls and a widening fiscal deficit during the transformational recession. But since then, motivated by aspirations to join the European Union, Poland has continuously reduced its barriers to trade. Protectionist measures on industrial, automotive, and other non-agricultural imports have either been eliminated or significantly reduced. While Poland was preparing to join the EU, it entered into international trade agreements like the European Free Trade Association and the Central European Free Trade Area. There was little space left for protectionist policies and by the end of the 1990s Poland boasted free trade with most of the European countries in nonagricultural products. Reductions in tariffs and other non-tariff barriers to trade with non-European countries furthered the process of trade liberalization. The trend continued into the new century and upon Poland's acceptance into the EU in 2004, it implemented

common customs duties on imports outside the EU and common rules of origin for products outside the EU. It also eliminated custom duties for other members of the EU.

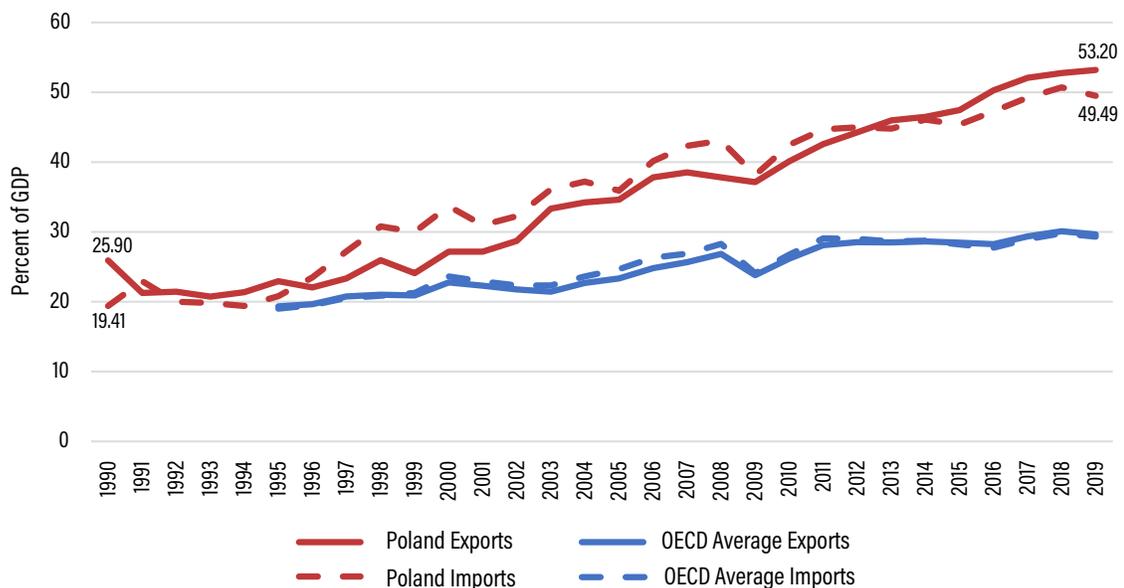
Together, these measures earned Poland 1<sup>st</sup> position in the trading across borders category of the *Doing Business* index in 2020, tied with 15 other nations, including the Czech Republic and Hungary (World Bank, 2020). Notably, Poland was ranked higher than Germany and the regional average score, primarily due to the minimal time and costs associated with imports and exports.

Figure 6.5 shows imports and exports as a share of GDP for Poland (1990-2019) and for the average OECD nation (1995-2019).<sup>4</sup> Poland’s imports grew from 19 percent of GDP in 1990 to 49 percent in 2019, while its exports grew from 26 percent in 1990 to 53 percent in 2019. Both imports and exports relative to GDP have grown faster in Poland than in the average OECD nation. This cannot be attributed to Poland’s relatively small economy (that is, to the denominator) because Poland’s economy grew relative to the average OECD nation over this time. In 1990, Poland’s economy was about half the size of the average OECD nation but by 2019, it was slightly larger than the average OECD nation. Thus, Figure 6.5 suggests that Poles are significantly more involved in foreign trade than are other OECD members. This makes sense given the data presented above in figure 6.2 showing that Poles are relatively free to trade internationally.

### State-owned enterprises

In 1990, before the country initiated its reforms, there were approximately 8,500 state-owned enterprises (SOEs) in Poland. More than two decades later, by 2012, 2,300 SOEs

Figure 6.5: Exports and Imports as a Share of GDP in Poland (1990-2019) vs. OECD Average (1995-2019)



Source: OECD, 2022a.

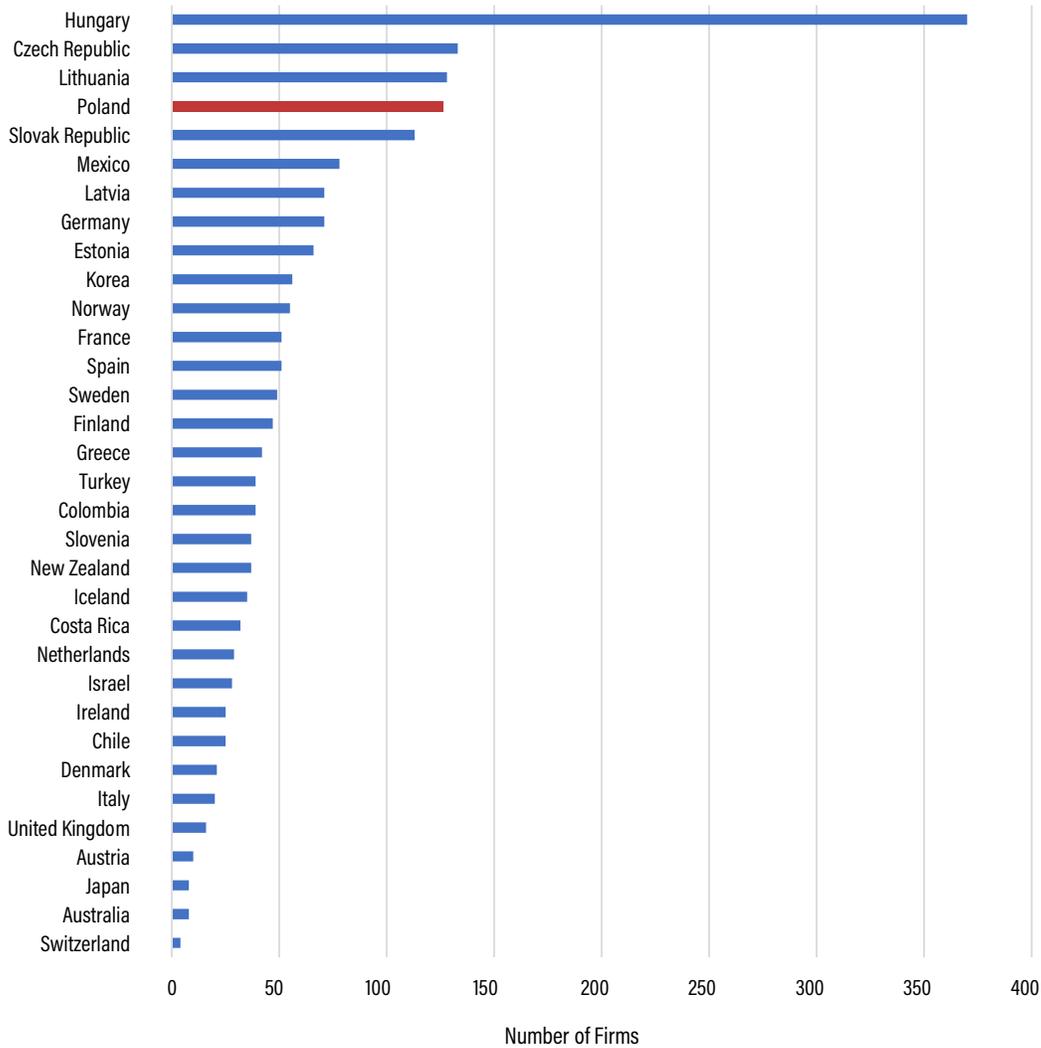
had been privatized, 900 had been liquidated, close to 1,800 had been corporatized and commercialized, while fewer than 400 of the remaining SOEs remained under state control (Égert and Goujard, 2014: 10). The outcome of privatization was less successful than expected. As late as 2009, Poland still had 590 state-owned enterprises that collectively employed over 700,000 employees, making it the OECD nation with the 6<sup>th</sup> highest percentage of SOE employment as a share of total employment (Christiansen, 2011). Unfortunately, the privatization process has also been dogged by accusations of corruption as those with insider knowledge seemed to have an upper hand in acquiring shares and assets (Rider and Zajicek, 1995).

In the late 2000s, a new round of privatization was launched; close to 800 firms in the energy, financial, and mining sectors were privatized between 2008 and 2011. Still, the government classified close to 50 firms as “strategic” with the intention of retaining a majority state ownership in them (Égert and Goujard, 2014: 12). By 2015 (the latest year for which we have data), Poland had further reduced the number of state-owned enterprises to 126. As figure 6.6 demonstrates, this was still a large number by international comparisons; only three other OECD nations had more state-owned enterprises that year. But because it does not account for population this figure overstates the importance of SOEs in Poland’s economy. Figure 6.7 shows SOE employment as a share of all non-agricultural employment in Poland and other OECD nations in 2015. Less than one percent of the non-agricultural Polish workforce worked for an SOE that year. This was half the OECD average and significantly less than others such as Norway (8.9 percent), Latvia (6.1 percent), Slovenia (5.5 percent), and Estonia (4.3 percent).

The nation’s continued reliance on state-owned enterprises is predicated on the supposedly strategic nature of certain industries (energy companies are especially likely to be considered strategically important). This, according to the proponents of state ownership, necessitates extensive government involvement and support. The so-called “golden veto” legislation, introduced in 2005, is one example of this thinking. The legislation allowed Poland’s treasury to maintain a privileged position in strategic state-controlled enterprises for public-interest reasons. And though the legislation was revoked by the European Commission as incompatible with EU law in 2010, the state continued to maintain either majority ownership or a large minority stake in many firms.

Overall, state ownership of firms in Poland is concerning for the reasons outlined in the earlier chapter on the socialist economy. State firms tend to operate under soft budget constraints. With distorted profit and loss signals, they lack both the knowledge and the incentive to use their resources efficiently to maximize consumer welfare. At the same time, state-ownership encourages rent-seeking and other associated pathologies of privilege (Mitchell, 2012). Unlike private firms that must create value for paying customers, SOEs must create value for their political patrons and this further distorts their allocation of resources.

Figure 6.6: Number of State-Owned Enterprises in Poland vs. Other OECD Nations, 2015

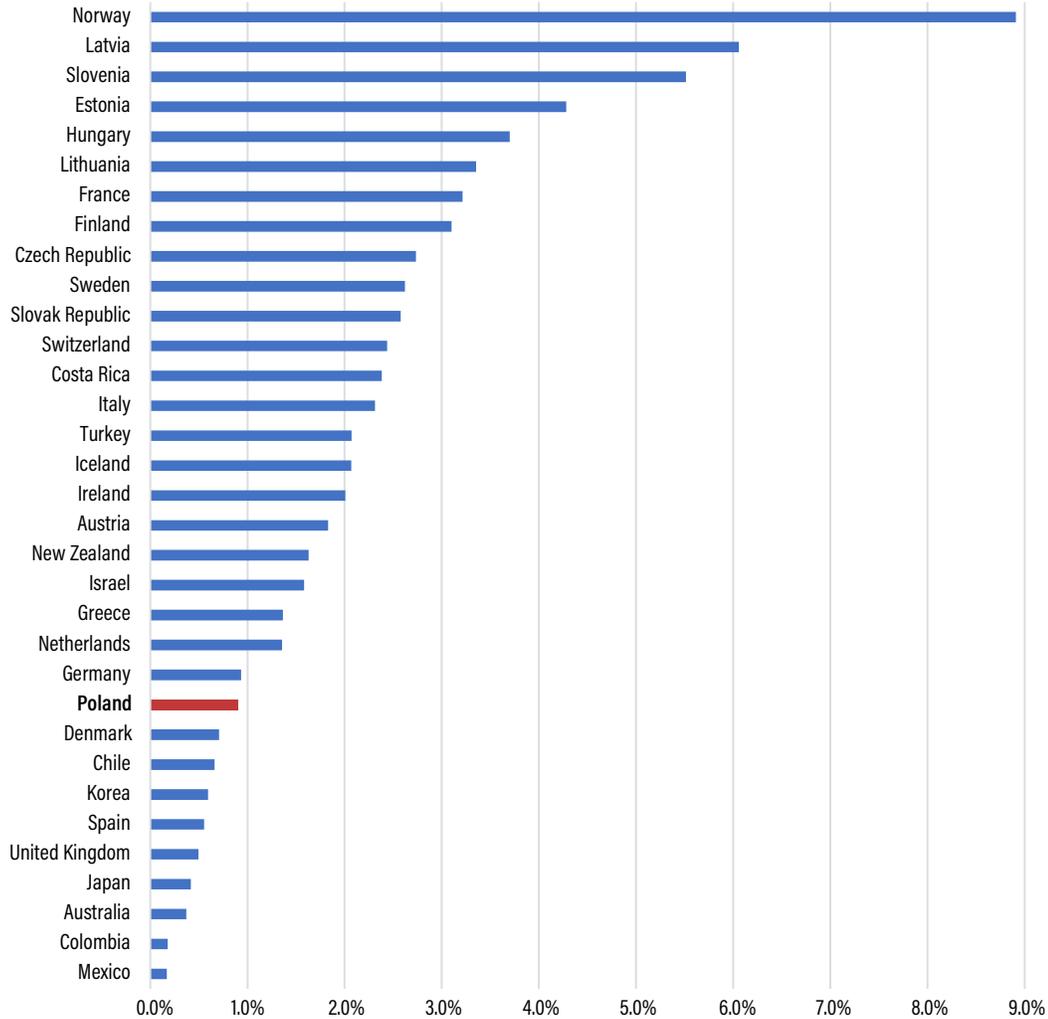


Source: OECD, 2017.

### Protection of property

When it comes to the protection of property rights, Poland’s recent record is mediocre. Figure 6.8 shows Poland’s record on the protection of property rights from 1985 through 2018. It is a sub-component of the *Economic Freedom of the World* index and is derived from survey data collected by the World Economic Forum’s *Global Competitiveness Report* and from the World Bank’s *Country Policy and Institutional Assessment*. Note that in contrast to other institutional and policy measures, there was no noticeable change in property rights protection around the adoption of the Balcerowicz Plan in 1991. While there were modest improvements in the late 1990s, Poland’s score declined in the first years of the 21<sup>st</sup> century, more than erasing these gains. While Poland’s record on property rights improved from 2003 to 2009, it has since declined again. Figure 6.9 shows this same data for all OECD nations in 2018. Only Colombia, Greece, and Hungary have worse records.

**Figure 6.7: State-Owned Enterprise Employees as a Share of Non-Agricultural Employees in Poland vs. Other OECD Nations, 2015**



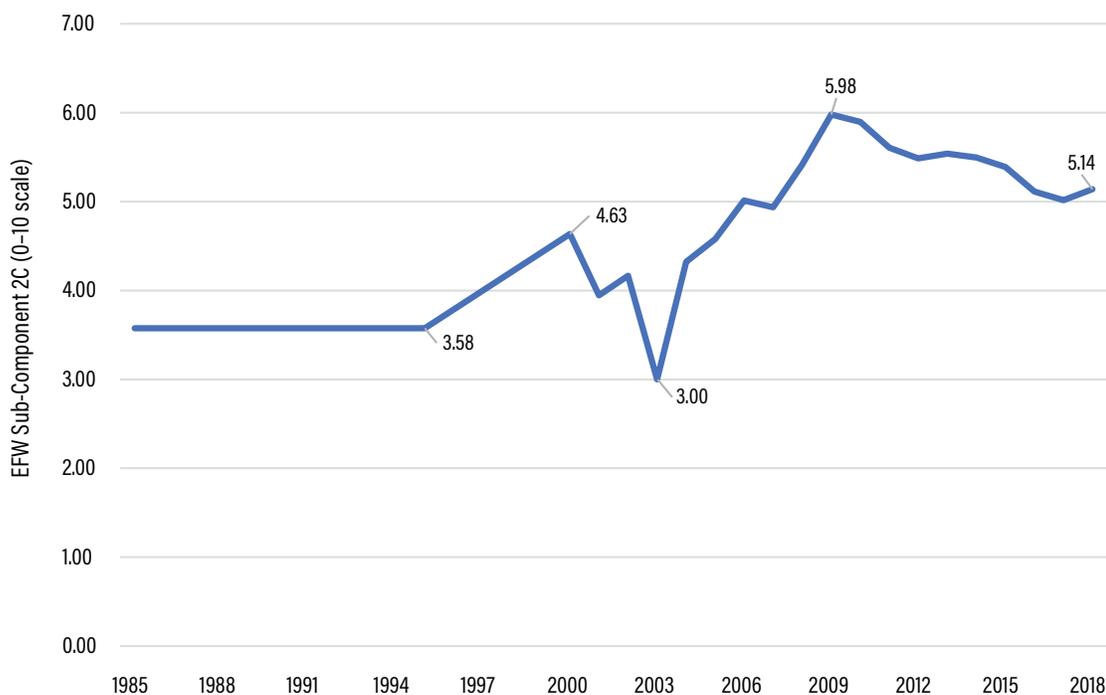
Sources: Total Employment data from OECD.Stat, ISIC (Rev. 4); SOE employment from OECD, 2017; and authors' calculations.

One explanation for Poland's poor record in this area appears to be bureaucratic sclerosis. The US State Department notes that while Poland does recognize and enforce property rights, and the judicial system does uphold the sanctity of contracts, foreign firms are "wary of the slow and over-burdened Polish court system" (United States, Department of State, 2020). More recently, the European Union has criticized Poland for its lack of judicial independence. As Carlo Bastasin explains, "Although Article 45 of the Polish constitution acknowledges the same principles defended by Brussels, the Polish government has taken control of the judiciary, manipulating its powers for political purposes" (Bastasin, 2021).

### **Competition policy**

Competition policy is hotly debated among economists. On the one hand, some believe that an active antitrust authority may be able to serve the general interest by breaking

Figure 6.8: Protection of Property Rights in Poland, 1985-2018



Source: Gwartney, Lawson, Hall, and Murphy, 2022. Derived from surveys conducted by World Economic Forum, Global Competitiveness Report; World Bank, Country Policy and Institutional Assessment.

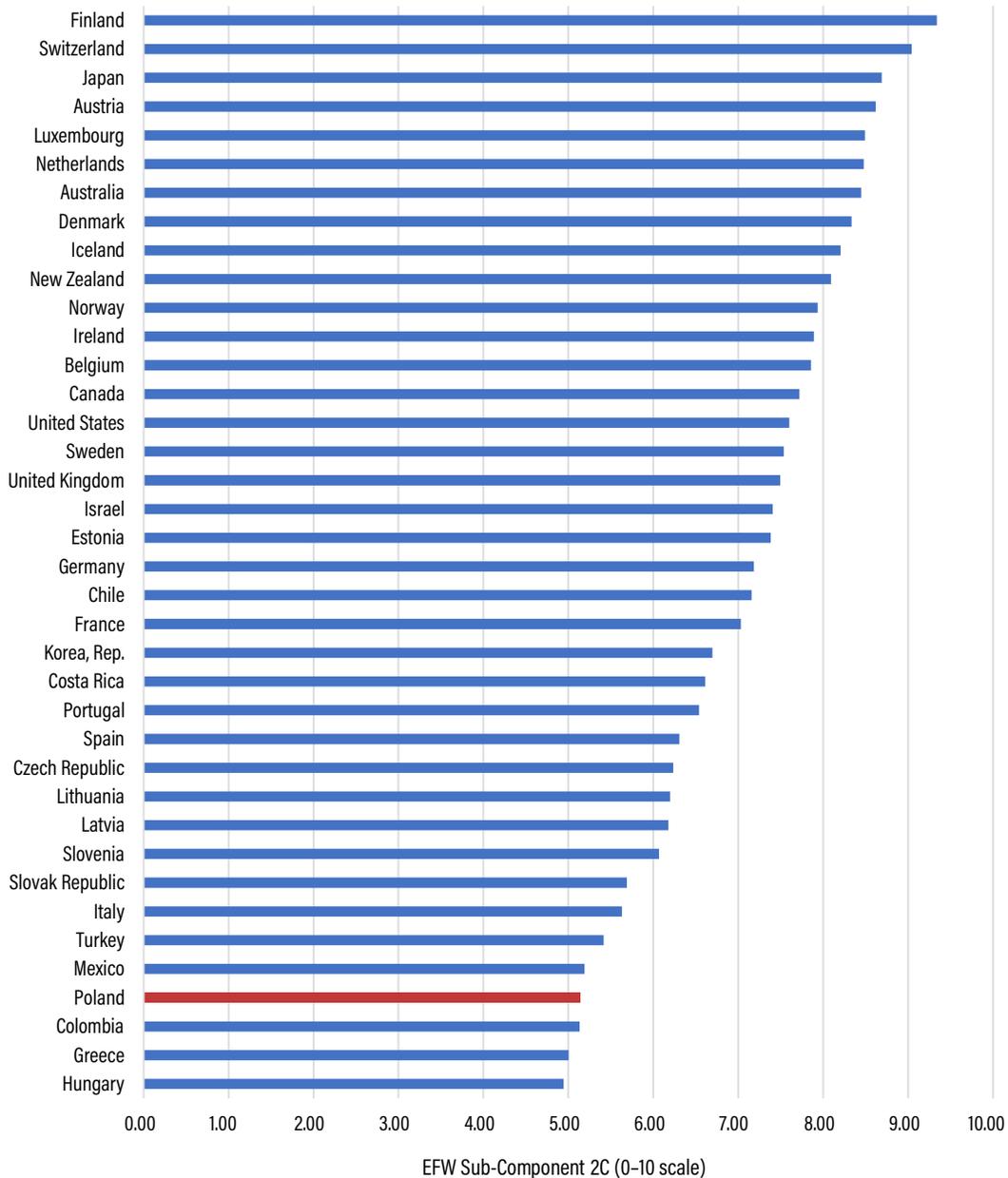
up monopolies, stopping mergers, and thwarting anticompetitive practices such as price collusion, tying, or restrictive contracts (Yoo, 2020). On the other hand, some economists worry that competition policy may undermine the general interest. It is not always easy to identify truly anticompetitive behaviour. Firms may obtain market share because they are especially attentive to customer desires or because they have achieved economies of scale. Worse still, antitrust policies can be hijacked by those who wish to *limit* competition (Baumol and Ordober, 1985; Abbott 2021). In general, European nations have taken a more active approach to competition policy than has the US (Manne, Auer, and Bowman, 2021). And Poland is no exception.

At least in theory, most economists agree that government spending, taxing, and regulating powers should not create monopoly power by favouring some firms over others (Stigler, 1971; Mitchell, 2012).<sup>5</sup> And this is especially important in a post-socialist country, where the temptation to favour formerly state-owned firms or politically powerful insiders may be especially strong.

OECD economists Égert and Goujard argue that Poland's competition policy framework has improved in recent decades:

Poland's competition policy framework (legal barriers, antitrust exemptions, barriers to competition in network sectors and services) was the second least conducive to competition in 2003 but ranked better than

Figure 6.9: Protection of Property Rights, OECD Nations, 2018



Source: Gwartney, Lawson, Hall, and Murphy, 2022. Derived from surveys conducted by World Economic Forum, Global Competitiveness Report; World Bank, Country Policy and Institutional Assessment.

the OECD average in 2013. Similarly, government involvement in business operations, such as through command and control regulations, decreased significantly between 2003 and 2013. Reductions in explicit and implicit barriers to trade and investment have also been impressive, but they remained among the largest in the OECD in 2013. By contrast, progress has been moderate for barriers to entrepreneurship, and Poland still ranks among the worst OECD countries as regards red tape, as measured by the administrative burden on start-ups and

regulatory and administrative opacity. Moreover, the government's grip on the economy remains one of the tightest in the OECD. (Égert and Goujard, 2014: 7)

That is, while Poland has improved its competition policy, decreasing both barriers to trade and government's intervention in the economy, there remain many obstacles to the free exchange of goods and services. This is consistent with the data we presented earlier on regulatory barriers to entry and suggests that there may be considerable public choice problems in freeing this aspect of Poland's economy. These barriers to entry almost certainly shield incumbent firms from competition and benefit the bureaucracies that enforce them. And because incumbent firms and bureaus are concentrated and well-organized interests, they tend to find it easier to influence policy than do the comparatively diffuse customers and would-be competitors who bear the costs of barriers to entry. This is no less a problem for advanced mixed economies than for transitioning ones (Olson, 1965; Lowi, 1969; Wilson, 1991; Lindsey and Teles, 2017; McLaughlin, Mitchell, and Thierer, 2020).

Poland's initial efforts to permit greater competition began as early as 1988, with a law that marginally freed part of the private sector by eliminating some permits and licenses (Brzezinski, 1994; Wise, 2003).<sup>6</sup> Subsequent measures included efforts to deregulate the economy more broadly and to prevent the emergence of monopolies and anti-competitive behaviour. Though a broad system of permits and licenses remained until 2000, various controls on economic activity—like controls on entry via licensing requirements—were eliminated across economic sectors, including sectors related to public safety, resource extraction, and infrastructure.<sup>7</sup>

As Michael Wise of the OECD's Competition Division puts it, Poland's competitive reforms throughout the 1990s included

abolition of the state monopoly on domestic trade in products such as alcohol, fuel, coal, steel, and pharmaceuticals; elimination of state commercial monopolies; abolition of state monopolies in banking, insurance, radio, and television; abolition of the state monopoly in foreign trade, leading to development of distribution networks for foreign firms and stronger intra- and inter-brand competition. (Wise, 2003: 92)

The process of deregulation continued in the 2000s with the elimination of legal barriers to entry and barriers to competition—especially in telecommunications network and service industries. Moreover, government intervention in business operations through command-and-control regulations as well as barriers to investments decreased between the early 2000s through 2013 (Égert and Goujard, 2014).

Due to the fear that former state monopolists might acquire large market power during the post-transition period, Poland introduced the competition law of 1990 to curb anti-competitive behaviour.<sup>8</sup> It was the first competition law to be enacted in Central Europe and it generally followed the more active approach to competition policy that characterizes

the European view (Wise, 2003: 89) The law prohibited onerous contract terms, whether or not the firm was dominant, and presumed a firm's dominance if it had market share of at least 30 percent, authorizing the enforcement agency to control prices of monopolistic firms (Brzezinski, 1994; Wise, 2003). Monitoring anti-competitive state aid also became a priority (Wise, 2003).

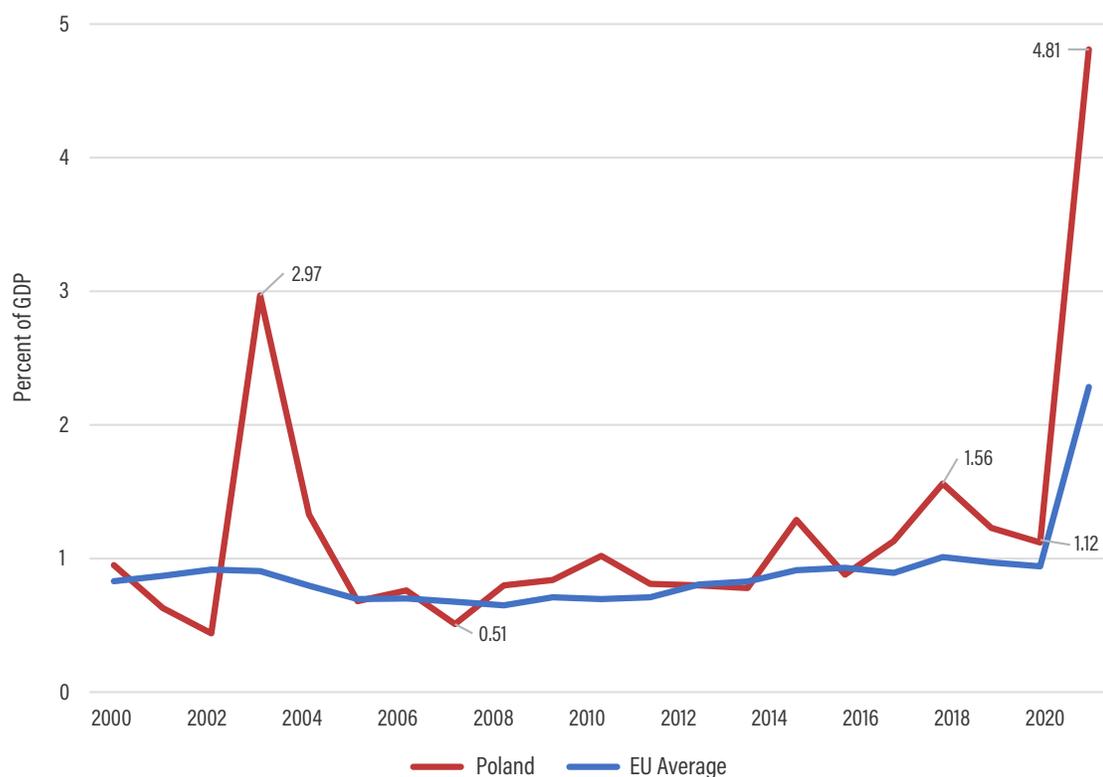
Competition policy was subsequently amended by the Competition and Consumer Protection Law of 2007, which unified competition rules on antitrust and mergers regulated by the competition authority. As a result, Poland's competition authority has been perceived as a fairly active enforcer of competition policy (Égert and Goujard, 2014). But despite the relative vigour of the agency, some continue to see problems with the authority. For instance, although the agency produces studies describing the anti-competitive behaviour of some firms, some contend that its relatively small budget gives it little enforcement power (Égert and Goujard, 2014: 16). Furthermore, there can be significant delays in judicial decisions pertaining to anti-competitive behaviour. An especially significant criticism asserts that the competition authority lacks independence, as the president of the agency is both appointed and dismissed by Poland's prime minister, hence exposing the agency to political pressures (Wise, 2003; Égert and Goujard, 2014).

But given the controversy surrounding active competition policy, perhaps the most effective strategy would be to eliminate anticompetitive government-granted privileges. For example, as noted in the section on state-owned enterprises above, Poland still has a large number of SOEs (even if they employ a relatively small share of the workforce). If the competition authority could break up or privatize these firms it would ameliorate the problem of state ownership and enhance competition. Poland could also pare back other forms of state aid that have the potential to limit competition across industries.

Poland has mostly used tax concessions and grants as tools of state support, and total state aid has often been higher in Poland than in other EU member nations. Figure 6.10 shows state aid as a share of GDP from 2000 to 2020 in Poland and in the average EU member nation. In most years, Poland has given more in state aid than the average EU nation (on average, about 0.3 percentage points more), a trend that was only exacerbated by the COVID-19 pandemic. State aid has primarily been channeled toward the agriculture sector and toward maintenance of employment, with lower levels of support for research, development, and environmental aid (Égert and Goujard, 2014).

Before we leave this section, we venture to offer two conclusions. First, Poland's struggle to recover from the pathologies of privilege suggest that Tullock (1975) was right to describe privilege as a trap. Once a society has fallen into it, it is very difficult to get out. Second, the distinction between socialism and capitalism seems to be one of degree and not kind. Ostensibly free economies are still subject to interventions such as government-granted privilege and, as a result, they suffer from a milder version of the pathologies that plagued socialist economies.

Figure 6.10: State Aid as a Share of GDP



Source: European Commission, 2022

## The financial sector

The transition to a more market-oriented system reinvigorated Poland's financial system, permitting the emergence of a variety of financial institutions including banks, insurance companies, and investment and pension funds. Importantly, the National Bank of Poland ceded its role as the primary financial intermediary and took on the new role of a modern central bank in charge of monetary policy. Moreover, financial markets were deregulated and barriers to private banking and investments were significantly eased for both domestic and foreign firms. Under these new rules, private clients were free to choose their own financial intermediaries. As a result, by the end of 2001, most of the 71 commercial banks in Poland were in private hands; only 7 were under state control (Bednarski and Osinski, 2002: 171).

Restrictions on capital flows to countries within the EU and to other countries in the OECD have also been lifted, allowing residents to open accounts with foreign banks and to deposit funds in these accounts. These developments were aided by the establishment of the Warsaw Stock Exchange in 1991, which reached a capitalization of nearly 30 percent of GDP in 2020 (World Bank, 2022).

As a result, the transition has allowed private individuals increased access to financial resources, as both domestic and foreign investors have equal access to Polish domestic

markets and can now place funds in deposits, stocks, bonds, futures, and derivatives (US Department of State, 2020).

More recently, in 2007, the government eliminated restrictions on the “disposal and acquisition of securities and participation units of joint investment funds by non-residents from third countries, as well as granting and taking loans and lending facilities in trading between residents and non-residents” (Marszalek and Janc, 2015: 198). These changes have made it easier for Poland’s domestic banks to lend to foreign and domestic companies, while domestic firms can now raise capital both at home and abroad.

Poland fares well in terms of access to credit, as indicated by its 37<sup>th</sup> position in the 2020 *Doing Business* index (World Bank, 2020). This is significantly higher than the OECD average ranking, which is 65<sup>th</sup>, and either comparable to or better than fellow Visegrád rankings (Hungary is also ranked 37<sup>th</sup>, while the Czech Republic and the Slovak Republic are tied for 48<sup>th</sup>). Poland’s relatively high ranking is due to its above-average strength of legal rights to credit, and top ratings for credit information and credit bureau coverage. These developments suggest that Poland has found it easier to deregulate its financial sector than other sectors.

### Fiscal policy

In this section we discuss Poland’s fiscal policy since its transition to a mixed economy. Let us begin the discussion with the main objectives of public finance. In his classic treatment of the matter, economist Richard Musgrave contended that there were three main objectives of public finance: allocation, distribution, and stabilization (Musgrave, 1959). The allocative objective refers to the selection of the desired bundle of public goods and the allocation of financial resources to fund their provision. Public goods are not necessarily publicly provided goods. Instead, they are goods that are difficult for private businesses to provide profitably because they are non-excludable and non-rivalrous.<sup>9</sup> The distributive objective refers to the attempt to redistribute income in order to obtain a “fairer” outcome.<sup>10</sup> Finally, the stabilizing function refers to fiscal policy aimed at achieving better macroeconomic performance as measured by indicators such as unemployment, inflation, and growth.

Though Musgrave’s view was highly influential, it was not without its critics. James Buchanan, a founder of the sub-field of economics known as public choice, argued that Musgrave’s view failed to account for the incentives of government actors. In Buchanan’s view, a more realistic understanding of these incentives should cause us to be more skeptical of what government will do with the powers we grant it. He therefore suggested that citizens should impose constraints on what government is allowed to do. In broad terms, Buchanan believed that government should neither have the power to dominate its citizens nor to discriminate between them.<sup>11</sup> He suggested that certain constitutional provisions such as a balanced budget rule and non-discriminatory rules could help achieve these ends.

With the respective views of Musgrave and Buchanan in mind, we will now take a closer look at Polish fiscal policy. To contextualize contemporary fiscal policy, we begin with a brief overview of fiscal policy before the transition.

### **A brief review of fiscal policy in socialist Poland**

The main sources of government revenue during the socialist period were profit taxes on enterprises, sales (turnover) taxes, and social security contributions. Most profit taxes were derived from state-owned firms simply due to the miniscule size of the private sector. Thus, the government was heavily dependent on public enterprises and the tax revenue they generated in order to cross-subsidize other projects. Under these arrangements unprofitable enterprises were essentially living off of profitable firms. The structure also entailed consumer and social welfare subsidies in the form of family benefits, pensions, and other programs.

The administrative structure of the Polish fiscal system during the socialist period was also important. Most of the official economic activities of Poland's firms were dictated by the plan, so the ledgers and accounts of state-run firms were easily available for the purposes of taxation. This made the enforcement of tax rules relatively costless (Barbone and Marchetti, 1994).

### ***The modern fiscal policy framework***

The fiscal system in post-transition Poland is quite different from the fiscal system of the socialist era. Throughout the transition period, leaders worked to bring expenditures in line with revenue. Under the new system government entities operate under a hard budget constraint.

Moreover, the budget has been decentralized. Before the transition, the state budget included the central budget, regional budgets, and local (city) budgets. But the division was a formality and regional budgets were essentially inseparable from the central budget. Before the transition, extra-budgetary funds, like the Social Insurance Institution (ZUS) financed separate programs, but the funds lacked independence and relied on the state.

While the general framework of a state budget with extra-budgetary funds and extra-budgetary units remained, reforms in the early 1990s decentralized budgetary responsibilities. For instance, local budgets and the budgets of newly established local self-governments were separated from the central budget. Local authorities started receiving part of their tax revenue and payments that had previously been directed to the central budget (though they continued to rely on grants for specific projects from the central government).

Furthermore, most extra-budgetary funds were liquidated, and extra-budgetary units were divided up between central and local authorities. The reforms also created a deficit financing structure, in which the central budget deficit could be financed with financial resources left over from previous years, using bank credit and government securities. The central government's budget specifies a certain volume of government securities that may be issued

with a redemption period exceeding one year, as well as a certain level of deficit financing that may be supplied by the national bank. Like the central government, local authorities have the right to issue securities, although the cost of servicing securities over a given year cannot exceed 10 percent of local government expenditures in the same year (Dabrowski et al., 1997). Together, these changes have encouraged fiscal discipline and greater efficiency.

Poland's budget is formulated within the constraints of several important institutions, some of which encourage the sort of fiscal discipline that Buchanan emphasized. Capital and operating budgets are integrated. Budgetary plans are first proposed by the executive branch's decision-making body, the council of ministers. Parliament may amend the budget, so long as its amendments do not change the proposed deficit or surplus. If the budget is not approved by the legislature before the beginning of a fiscal year, the executive's proposed budget is implemented (OECD, 2019a).

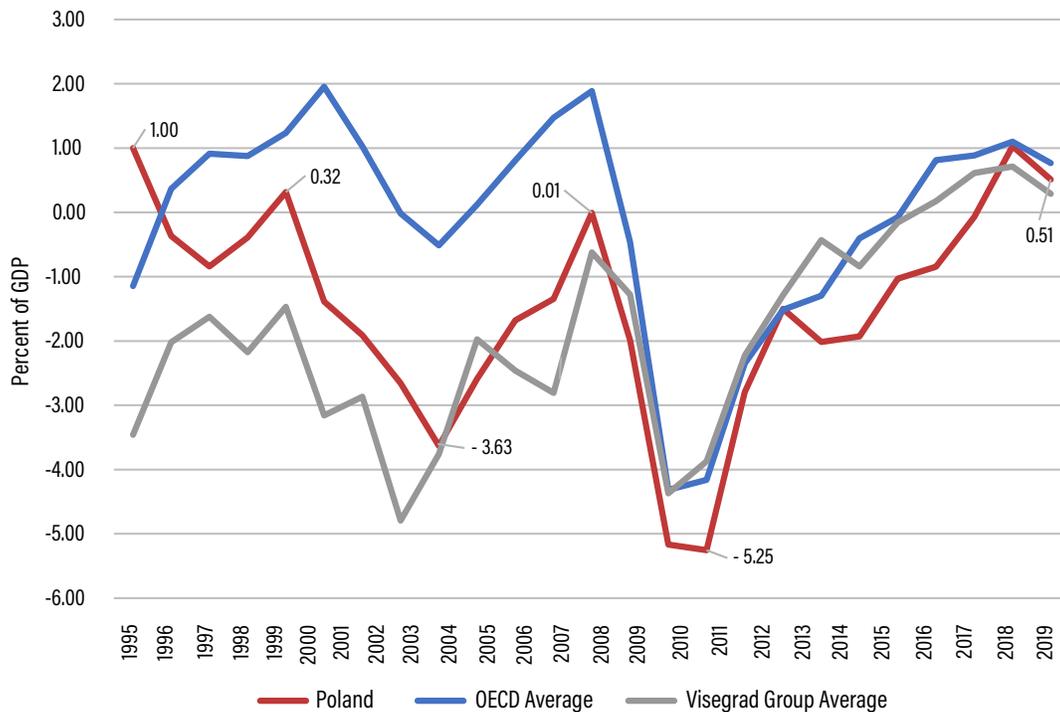
Importantly, fiscal decisions are constrained by a debt rule and a stabilizing expenditure rule.<sup>12</sup> The debt rule, which was enacted in 1997, is embedded in Poland's constitution and remains the world's only national debt limit. According to the rule, public debt may not exceed 60 percent of GDP.<sup>13</sup> The expenditure rule, on the other hand, is statutory. It was adopted in 2013 and went into full force in 2015. The rule aims to ensure the stability of the fiscal system by stabilizing general government fiscal balance in the medium term. It applies to 90 percent of general government expenditures (it excludes the expenditure of EU funds and of funds that cannot generate high deficits) (Zawadzka-Pak, 2014: 55). According to the expenditure rule, the budget is not allowed to grow faster than real medium-term GDP (Korniluk, 2016: 351). It does permit counter-cyclical fiscal policy, but it restricts expenditure growth by formula as certain debt-to-GDP thresholds (43, 48, and 55 percent) are reached (OECD, 2019a: 229). Contrary to the constitutional debt rule, which only imposes limits once a threshold has been reached, the expenditure rule implements fiscal restraint on an annual basis. Together, these rules constrain the budget in the spirit of Buchanan's fiscal constitution.

### **Budget deficits**

The Polish government has attempted, with partial success, to limit the expansion of government expenditures in order to avoid potentially unsustainable deficits and the high costs associated with financing government securities (Krajewski and Krajewska, 2011). But while post-transition Poland has occasionally achieved a primary balance, it has more typically run structural deficits.<sup>14</sup> Consistent with Musgrave's stabilizing function these deficits grew larger when economic growth slowed (recall from Figure 4.5 that Poland did not experience a single year of negative growth from 1992 through 2019, even in the midst of the worldwide Great Recession).

Figure 6.11 shows the country's general government primary balance as a share of GDP from 1995 to 2019 (OECD, 2021c). For comparison, it also shows the average primary balance of OECD nations and the Visegrád group (Poland is included in both averages). Poland's fiscal position declined from 1995 to 2003, then improved in the years before

Figure 6.11: General Government Primary Balance as a Share of GDP in Poland vs. Other Nations, 1995-2019



Source: OECD, 2021e.

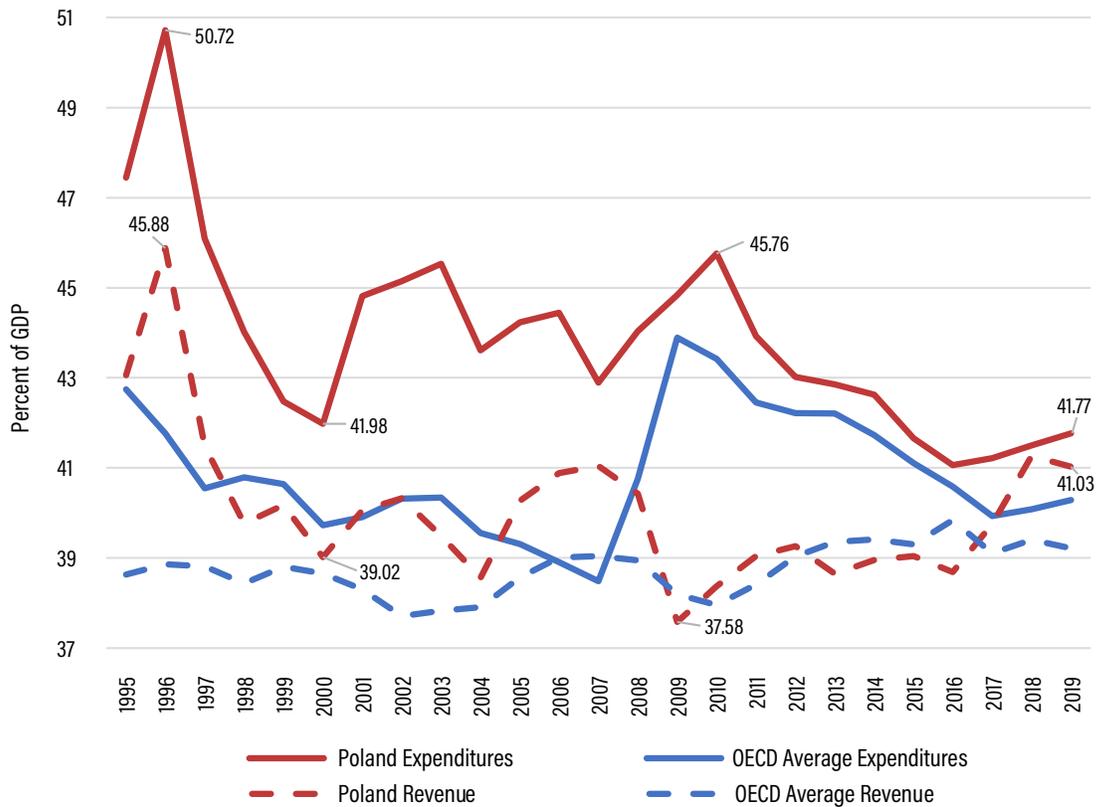
the Great Recession, declined again during the recession, and has since recovered. Over time, Poland's fiscal position has come to more closely resemble that of other nations, and it has steadily improved in the years since the Great Recession. It is beyond the scope of the current analysis to assess the effects of Poland's debt limit and expenditure rule on these developments. But it is interesting to note, however, that deficits rose following the adoption of the debt limit (almost certainly because of the Great Recession), while they shrank and turned to surpluses following the adoption of the expenditure rule.

### **Spending and revenue as a share of GDP**

A country's primary balance only tells us so much. It doesn't tell us, for example, whether a declining balance is due to falling revenue, or rising spending, or both. To gain a better understanding of what is behind Poland's improving fiscal position, see figure 6.12. It shows the country's general government revenue and expenditures as a share of GDP from 1995 through 2019.<sup>15</sup> For comparison, it also shows these figures for the average OECD nation.

Several trends are evident. Note, first, that for all this period Poland spent more as a share of GDP than the average OECD nation, and for most of it Poland raised more revenue than the average OECD nation. It is also clear that, over time, both Polish revenue and spending have come to more closely resemble the OECD average. Both Polish revenue and expenditures fell as a share of GDP over the course of the quarter century, but the pace

Figure 6.12: General Government Total Revenues and Expenditures as a Percent of GDP, 1995-2019



Source: IMF, 2021.

has slowed in recent years. While Polish spending as a share of GDP was over 50 percent in 1996, it was down to about 42 percent in 2019. And while Polish revenue as a share of GDP was nearly 46 percent in 1996, it was down to 41 percent in 2019.

The slowdown associated with the Great Recession clearly drove spending up and revenue down as a share of GDP (thus, the deficit was due to changes on both sides of the ledger). While spending resumed its downward trend following the Great Recession that trend has recently reversed. Moreover, revenue did not resume its downward trend following the Great Recession; for the last decade, revenue has steadily gone up as a share of GDP. Before the Great Recession, most of the improvement in Poland's fiscal position seems to have been driven by spending reductions rather than revenue increases, while after the recession both sides of the ledger seem to be contributing to deficit reduction (though spending has recently been on the rise).<sup>16</sup>

With the spending and revenue data shown in figure 6.12 in mind, the size of government component of economic freedom shown in figure 6.2 above now makes more sense. Poland spends and taxes more than other OECD nations, and this explains Poland's relatively low score for the size of government component of economic freedom over much of the last quarter century. As both spending and revenue fell in the years before the Great

Recession, the country's size of government score improved. The Great Recession caused spending to spike, temporarily lowering Poland's score. Then as spending fell again, the score improved. And in the last few years as both revenue and spending have climbed, the score went down again.

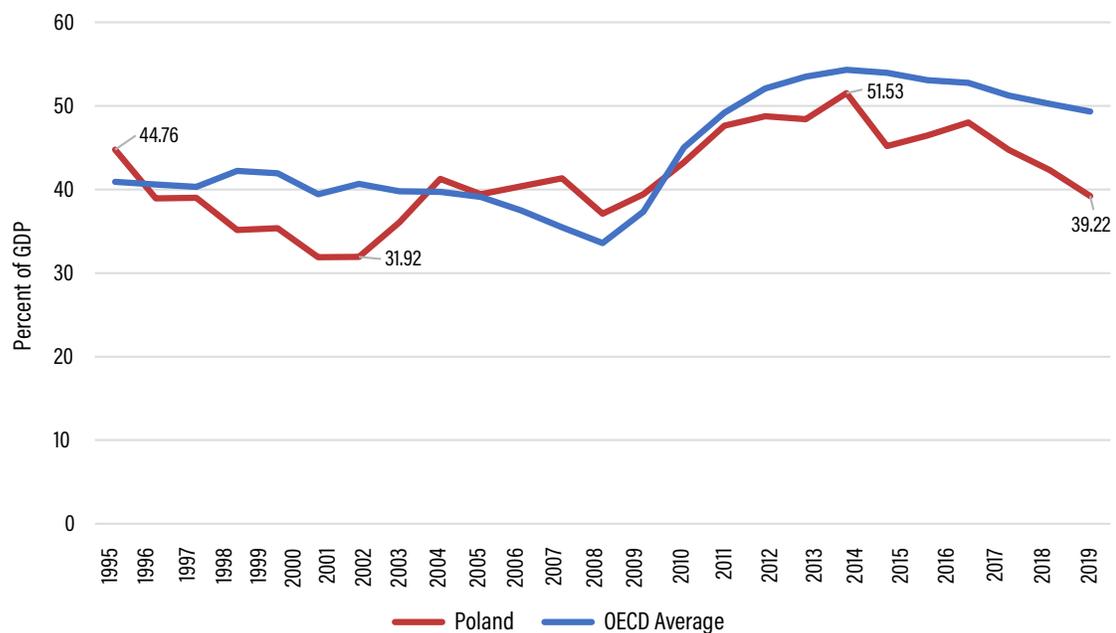
### Net debt

Figure 6.13 shows Poland's net debt as a share of GDP from 1995 through 2019, along with the OECD average over that period. Surpluses at the beginning of the period allowed Poland to reduce its debt load from 1995 to 2000. But after the turn of the century, structural deficits caused the nation's debt to rise. This trend was exacerbated by the onset of the Great Recession, so that by 2013, Poland's net debt was over 50 percent of GDP. In the years since, the nation's improving fiscal position allowed it to reduce its debt-to-GDP ratio down to below 40 percent by 2019.

### The tax system

The revenue side of the budget has also been altered as the tax system underwent a comprehensive redesign, with turnover and payroll taxes replaced by an income tax in 1992, and a VAT and excise tax in 1993 (Green, Holmes, and Kowalski, 2001).<sup>17</sup> During the transition, temporary taxes on excess wages in state enterprises, custom duties, and other indirect taxes initially made up for lost revenue. Over time, other taxes, like the wage equalization tax for high wage incomes, the income tax for individual economic activity, and some parts of the agricultural tax were phased out.

Figure 6.13: General Government Net Debt as a Share of GDP in Poland vs. OECD Average, 1995-2019



Source: IMF, 2021.

Poland has a flat personal income tax rate. Though it was originally set at 45 percent, Prime Minister Donald Tusk, whose 2007 campaign platform emphasized free enterprise and reducing the role of the state in the economy, reduced the rate to 32 percent (Purvis, 2008). Figure 6.14 shows Poland's personal income tax rate from 1995 through 2021, as well as that of the OECD average (from 2000 through 2021 as these are the only years for which these data are available). Poland's current personal income tax rate is about three-fourths as high as the average OECD top rate. Capital gains, including dividend and interest income, are taxed at a flat rate of 19 percent.

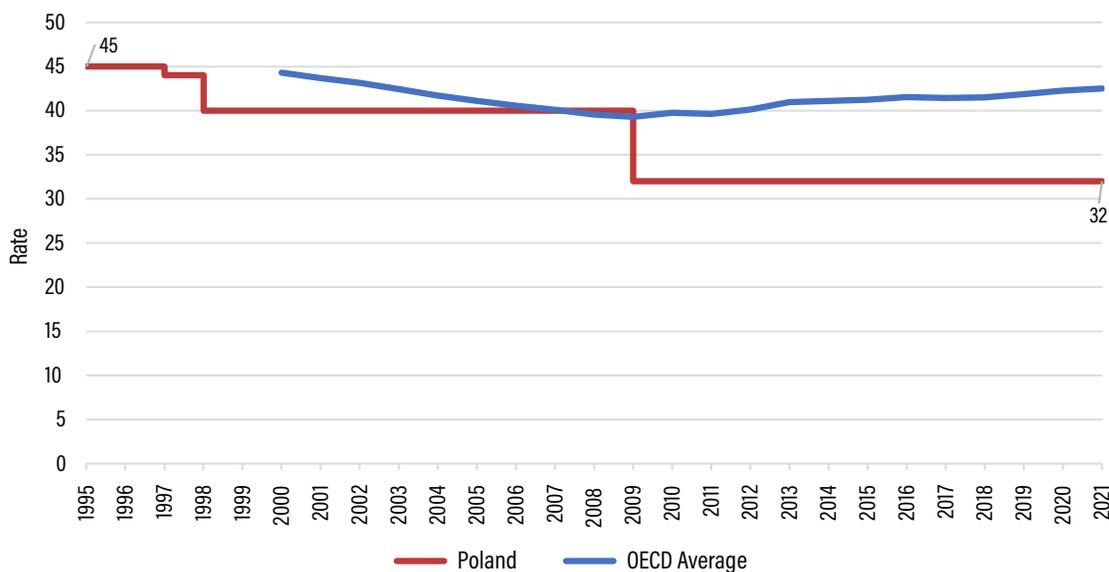
The corporate profits tax rate was reduced from 85 percent for private firms and 65 percent for state firms in 1989 to 40 percent for all firms in 1991. As figure 6.15 shows, the rate has been lowered further to 19 percent in several steps between 1997 and 2004, so that it, too, is now lower than the OECD average. The government also closed loopholes and established a tax compliance office (Balcerowicz, 1994).

In summary, as Poland moved from a socialist to a mixed economy, it shifted to a more incentive-compatible tax system with slightly below average personal and corporate income tax rates and slightly above average payroll and VAT rates.<sup>18</sup> It has also adopted a relatively broad base which, ideally, minimizes evasion.

#### *A summary of Poland's modern fiscal policy*

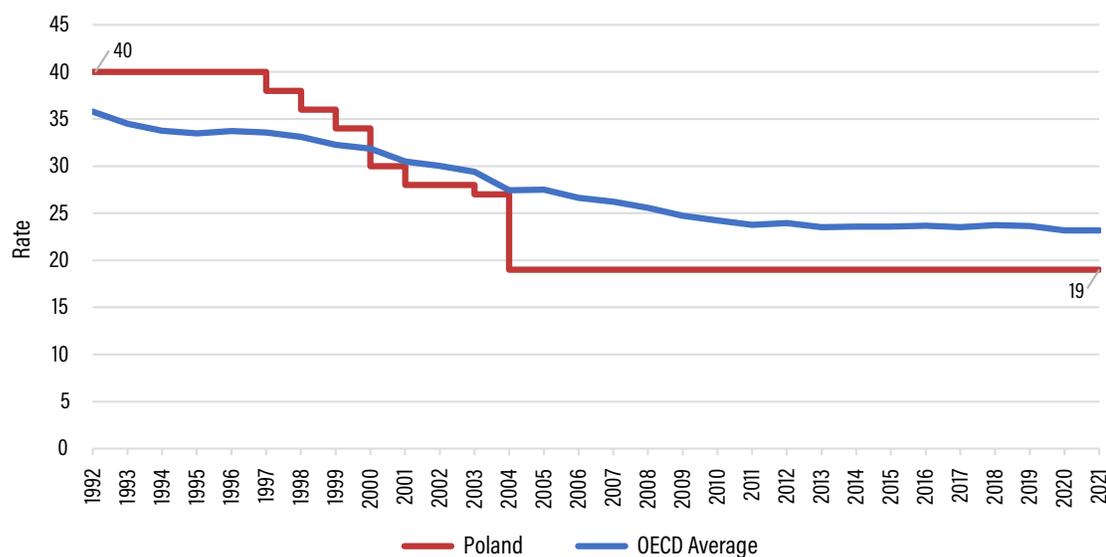
Poland's fiscal policy has in many ways come to embody the not entirely compatible notions of both Richard Musgrave and James Buchanan. On the one hand, its policymakers have attempted to fund public goods, to redistribute income through a generous social

Figure 6.14: Top Statutory Personal Income Tax Rate in Poland vs. OECD Average, 1995-2021



Source: OECD.Stat, 2022a: Table 1.7 (as of May).

Figure 6.15: Corporate Income Tax Rates in Poland vs. OECD Average, 1992-2020



Source: Bray, 2021.

safety net, and to counter the fluctuations of the business cycle. These spending patterns are financed by higher than average VAT and payroll taxes and lower than average personal and corporate income tax rates. On the other, Poland's leaders have attempted to reduce the nation's comparatively high spending by adopting some novel fiscal constraints including the world's only constitutional debt limit and a unique expenditure rule that attempts to automatically reduce spending as the country reaches certain debt thresholds. Over the past quarter century, Poland has managed to reduce spending and revenue as a share of GDP, to rein in deficits, and to reduce its debt-to-GDP ratio.

## Notes

- 1 For reference, these are Albania, Bulgaria, the Czech Republic, Hungary, Latvia, Romania, Russia, and the Slovak Republic.
- 2 The index gauges the restrictiveness of a country's FDI rules by looking at the four main types of restrictions on FDI: 1) foreign equity limitations; 2) discriminatory screening or approval mechanisms; 3) restrictions on the employment of foreigners as key personnel; and 4) other operational restrictions, e.g. restrictions on branching and on capital repatriation or on land ownership by foreign-owned enterprises (OECD, 2021c).
- 3 The collapse of FDI in the average OECD nation in 2018 was driven by 20 percent or more declines in just four nations: Hungary (-40 percent), Luxembourg (-37 percent), the Netherlands (-38 percent), and Switzerland (-22 percent). In a relatively small nation, modest swings in FDI can create large changes in net FDI as a share of GDP.
- 4 1995 is the earliest year for which we have data on the OECD average.
- 5 This once consensus view had admittedly been challenged in some quarters by the new-found popularity of industrial policy.
- 6 Act of January 28, 1987, On Counteracting Monopolistic Practices in the National Economy.
- 7 Act of December 15, 2000, On Competition and Consumer Protection.
- 8 Act of February 24, 1990, On Counteracting Monopolistic Practices and Protection of Consumers' Interests.

- 9 It is difficult to exclude non-payers from using or enjoying a non-excludable good. This makes it difficult to stop free riders from using the good without paying for it. And this makes it difficult to recoup the costs of providing the good. With a non-rivalrous good, multiple people may use or enjoy the good without diminishing the value that others obtain from it. The classic example of a non-excludable and non-rivalrous public good is national defense. See Samuelson (1954) and Buchanan (1965) for more details.
- 10 Large literatures in both economics and philosophy debate the desirability of achieving social justice through redistribution as well as the feasibility of even defining social justice. See, for example Rawls (1971), Hayek (1960), Nozick (1974), Schmidtz (2006), and Tomasi (2012).
- 11 For a lively debate, see Buchanan and Musgrave (1999). For more on Buchanan's views, see Buchanan and Tullock (1962), Brennan and Buchanan (1985), and Buchanan and Congleton (1998).
- 12 For the logic behind institutional constraints on fiscal decisions, see Brennan and Buchanan (2000).
- 13 It reads: "It shall be neither permissible to contract loans nor provide guarantees and financial sureties which would engender a national public debt exceeding three-fifths of the value of the annual gross domestic product. The method for calculating the value of the annual gross domestic product and national public debt shall be specified by statute" <<https://www.sejm.gov.pl/prawo/konst/angielski/kon1.htm>>.
- 14 A primary balance excludes interest payments on consolidated government liabilities.
- 15 Note that in contrast with the primary balance shown earlier, these figures include interest payments, which is why expenditures always exceed revenue in this figure.
- 16 A large literature on fiscal adjustments finds that spending reductions are more likely to achieve fiscal balance than are revenue enhancements and that spending reductions are less likely to entail economic pain than are revenue enhancements. For an overview, see de Rugy and Alesina (2013).
- 17 See the appendix for more details on contemporary fiscal policy.
- 18 An incentive-compatible tax structure tends to have low rates and a broad base. By contrast, high marginal tax rates discourage work, savings, and investments, while a narrow base creates opportunities to game the system through tax avoidance.

## PUBLICLY PROVIDED SERVICES BEFORE AND AFTER THE TRANSITION

In this penultimate chapter we dig deeper into three services that both socialist and mixed regimes typically provide—social safety nets, health care, and education. For each of these three publicly provided services, we compare its provision in socialist Poland to its provision in the country’s modern, mixed economy.

### Social safety nets

#### *Social safety nets in socialist Poland*

In this limited space we cannot capture all of the twists and turns in the development of Poland’s socialist-era social safety net. We will attempt, however, to give a brief account of the system so that we can compare it with the one that emerged after the country’s transition to a mixed economy. The history of socialist Poland’s approach to social safety nets can be thought of as a push and pull among five distinct forces.

1. The system was built upon the pre-socialist framework for safety nets and it represented a not-always-coherent attempt to layer programs on top of one another.
2. Especially during the Bierut and Gomułka years, Stalinist party leaders made a strong drive to prioritize economic development and industrialization. The advocates of this approach tended to push for more austere safety nets in the interest of tightening belts and maximizing the incentive to work.
3. There were also intellectuals and party officials who advocated for the socialist ideal of a generous and egalitarian safety net. These voices became more powerful over time. But despite their efforts, they met with only limited success due to the counter-balancing forces of party elites and nomenklatura, the advocates of a more austere safety net, and the gradual erosion of benefits through inflation.
4. As in so many aspects of the socialist era, party elites, the nomenklatura, and “ministerial lobbies” pushed for special concessions and privileges. As Murrell and Olson’s (1991) theory predicts, these special interests grew more effective over time and succeeded in extracting more and more benefits from the system.

5. Finally, regime leaders, irrespective of their ideological instincts, routinely boosted the generosity of the safety net to quell the latest cycle of civil unrest. Once the crisis subsided, these measures were then typically either repealed or allowed to be eroded through inflation (Inglot, 2008: 147-75).

With these forces in mind, we will now offer a brief account of the history of the Polish welfare system. It originated during the interwar period, provided limited financial support to the population, and was relatively inegalitarian by modern standards (Cerami, 2010; Inglot, 2009). Though Poland established social insurance legislation as early as 1918, the system covered only 7 percent of the population and was limited in the scope of services it offered (Cerami, 2010: 236). For instance, social insurance primarily covered pension and health care provisions to a limited number of Poles. And these pension and health care policies were linked to one's professional status, with benefits depending on relative earnings and payments in cash or health insurance premiums. As we shall see, the inegalitarian nature of these welfare institutions continued in the socialist era.

Upon the socialists' ascension to power, the government sought to restructure the system to expand upon the existing welfare institutions and to increase access to benefits. According to this reorganization, social policy programs were put under the control of central authorities, specifically the Ministry of Labor and Social Affairs that developed social policies and supervised their implementation. Responsibility for implementing policies was then delegated to supporting agencies, like ZUS (Social Insurance Institution). In addition to social insurance operations, ZUS was also responsible for funding hospitals, clinics, and rehabilitation centers (Inglot, 2009).

Reforms in 1954–55 split social insurance into two broad categories: pension systems that were run by local bureaucracies and short-term transfer programs run by trade unions at the enterprise level (Inglot, 2008: 152). Welfare policies were primarily funded by social insurance contributions from both state firms and the government itself, with benefits then redistributed among the population.<sup>1</sup> Though employers and the state were ostensibly responsible for the bulk of these contributions, standard economic analysis teaches that employees likely paid most of the tax through lower wages.

Throughout this period, alterations in the welfare system were closely associated with contemporary political developments (Cerami, 2010; Inglot, 2009). Social policy was often used to temporarily pacify the public's discontent with the standard of living. And as we have seen, the standard of living throughout the socialist era was occasionally brought desperately low by periodic economic crises and endemic shortages. Since expansions in the safety net were not funded by ordinary economic growth, an expanded bundle of social services was typically pared back at the conclusion of each social crisis. As the political scientist Tomasz Inglot has put it, "welfare state development in communist Poland followed an extremely convoluted path of frequent changes or alternating periods of expansion, retrenchment, and reform" (Inglot, 2008: 147).

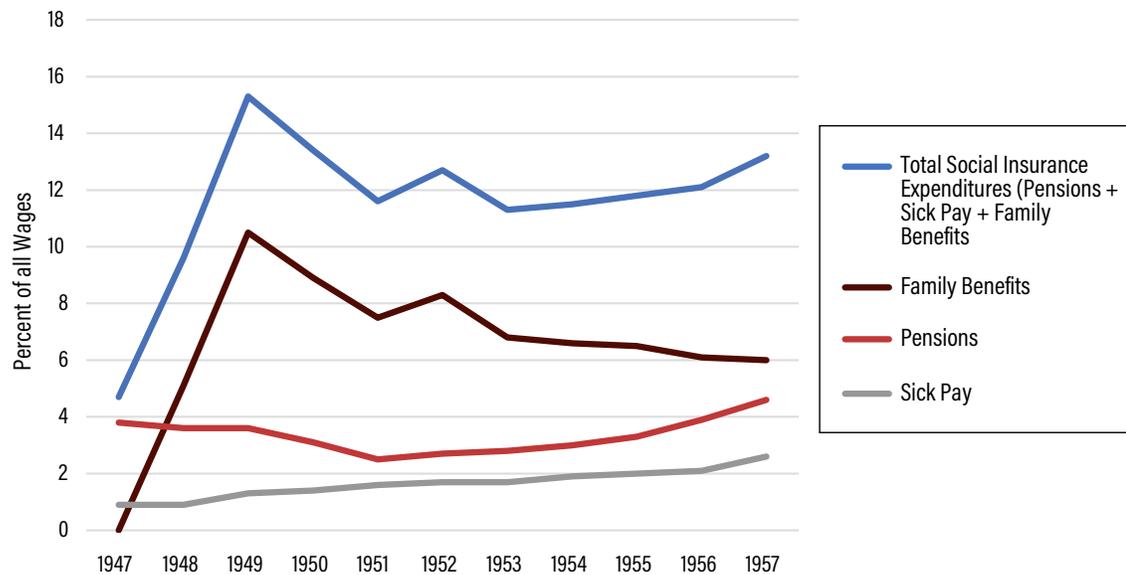
At the beginning of socialist rule in the 1940s, social welfare programs focused on modestly supplementing the low standard of living that prevailed in post-war, newly-socialist

Poland. Since Boleslaw Bierut and other Stalinist party leaders prioritized industrialization and economic development, social programs were relatively insignificant. Leaders worried that too much emphasis on the state's welfare functions might be politically risky given the "intensifying class struggle" (Inglot, 2008: 151). Planners were therefore directed to pursue a policy of "belt tightening" (Inglot, 2008: 151).

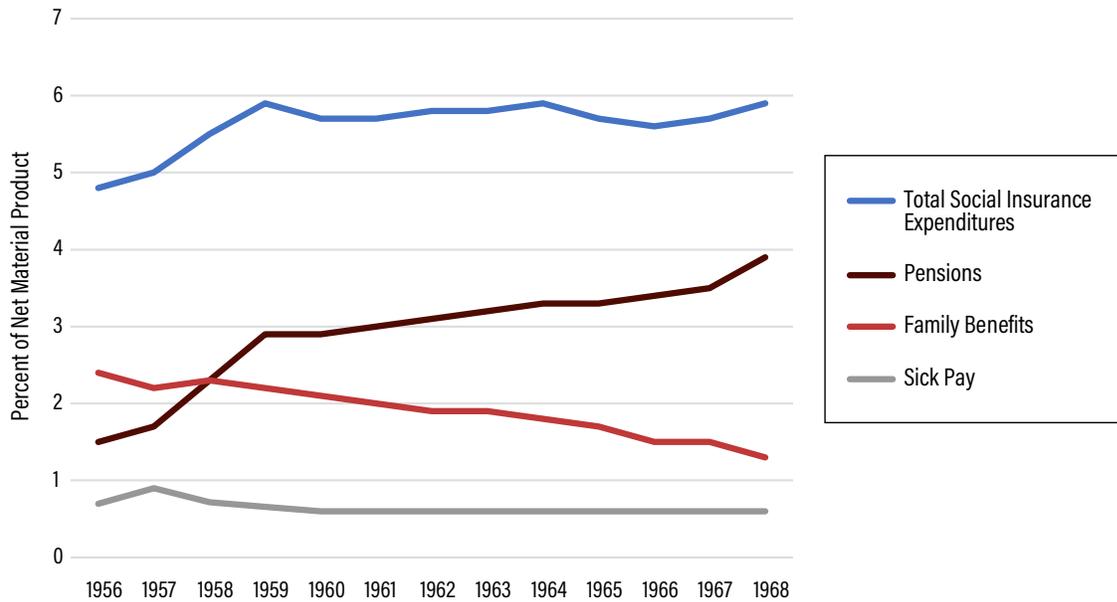
Despite these aims, the programs still entailed perverse incentives. Family benefits were the primary mechanism for social support during that time. These benefits were introduced in 1947 and covered full-time employees in the public sector, pensioners, and orphans. Agricultural workers were added in 1949. The average payment per family was 26 percent of the average (economy-wide) wage (Inglot, 2008: 149), thus "many married women and young people now had a powerful incentive to stay out of the labor market" (Inglot, 2008: 149). Figure 7.1 shows expenditures on the three main social insurance programs—family benefits, pensions, and sick pay—as well as total social insurance spending as a share of all wages from 1947 through 1957. Though family benefits were the most substantial portion of social insurance through 1957, they declined as a share of all wages from 1949 onward. Meanwhile, pension expenditures as a share of all wages rose throughout the 1950s.

Throughout this period, critics worried that the welfare system was inadequate and officials responsible for social insurance policy repeatedly warned the communist leadership of growing public discontent with the state of the social support system (Inglot, 2008: 156-57). As evidence, these officials could point to neighbouring Czechoslovakia, where programs were more generous, more coherent, more stable, and more competently

**Figure 7.1: Social Insurance Expenditures as a Percent of all Wages, 1947-1957**



Source: Inglot, 2008: 150.

**Figure 7.2: Social Insurance Expenditures as a Percent of Net Material Product, 1956-1968**

Source: Inglot, 2008: 159.

administered (Inglot, 2008: 152). Though the government moved to boost benefits, especially on public pensions, these reforms were modest and failed to mollify critics.

Figure 7.2 again shows the three main components of social insurance along with total social insurance spending. But these figures are from 1956 through 1968 and show spending as a share of Net Material Product. (Net material product or NMP was the main macroeconomic indicator that socialist countries used. It is comparable to GDP except that the value of fixed asset depreciation is subtracted from it, and it excludes most service sectors, which the socialists deemed “non-productive.”) Total social insurance expenditures averaged 5 to 6 percent of Net Material Product during this period. Note the change in the composition of expenditures. At this point, the state was spending more on pensions than on family benefits and sick pay and the trend would continue throughout this period.

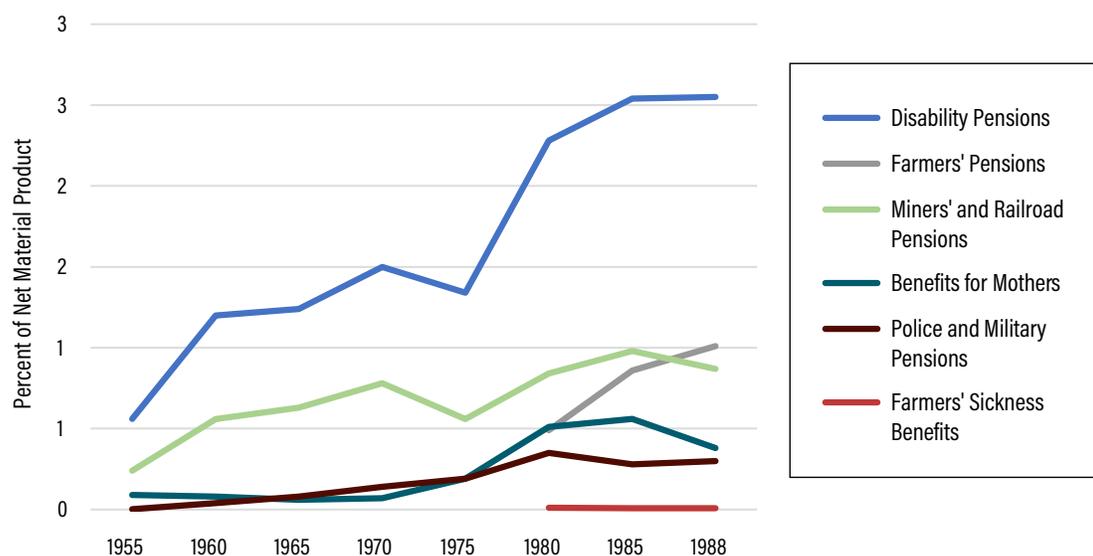
The rise of pension spending and the decline of family benefits was emblematic of the inegalitarian divergence between various groups in Poland. As Inglot put it, “two new hierarchies of pensioners emerged in Poland, one distinguished according to the category of occupation and the other determined by the type of regulation in force at the time of retirement” (Inglot, 2008: 153). The first and more privileged category included miners, state officials, military, and the police, all of whom were permitted separate and more generous pensions with lower retirement ages. Workers outside the manufacturing sectors—in trade, transport, services, and other sectors—all received lower pensions, even though all state enterprises paid the same social insurance tax of 15.5 percent. In 1955, just 7.6 percent of all pensioners qualified for the higher benefits. The other 92.4 percent obtained benefits that were, on average, 40 percent lower (Inglot, 2008: 153)

There was an ideological rationale for this. In a Marxist-Leninist state, the thinking went, social benefits should be a function of public employment and not tax contributions, and party leadership saw no problem if those benefits were unequal so long as every public employee received something (Inglot, 2008: 153). But these changes were also consistent with Murrell and Olson's (1991) theory that, over time, special interests tend to become better organized, capturing more and more of the state's resources. The public, meanwhile, may not have put up much resistance, believing that these taxes were paid by the employers instead of employees.<sup>2</sup>

The trend continued into the 1960s and 1970s. Throughout this period, universal benefits such as the family benefit declined in real terms, going from 13.3 percent of the average net wage in 1960 to 8.5 percent in 1970 (Inglot, 2008: 160). Benefits for the working population similarly declined. For example, as the labour force participation rate of female workers increased from 1960 to 1970, spending on maternity and childcare benefits declined 12.5 percent. Expenditures on family benefits experienced a similar decline, falling by half from 1958 to 1970 (Inglot, 2008: 161). These benefits were not indexed to inflation, so officials were able to reduce real spending without taking responsibility for lowering nominal benefits. As Inglot puts it: "The only meaningful exception to the serious deterioration of the quantity and quality of practically all types of benefits was the steady expansion of pension rights and privileges for several select but growing categories of employees" (Inglot, 2008: 160).

Figure 7.3 shows social insurance expenditures for select categories as a share of Net Material Product from 1955 through 1988. Though about half the Polish workforce were women and most of them mothers, note that spending on benefits for working mothers

**Figure 7.3: Social Insurance Expenditures as a Percent of Net Material Product, 1955-1988**



Source: Inglot, 2008: 155.

was dwarfed by spending on special interest pensioners. In 1970, for example, the Social Insurance Institution spent 50 percent more on 38,000 military and police pensions than it spent on all benefits for all working mothers, a population that numbered in the millions (Inglot, 2008: 161). This pattern makes sense when we consider how important it is for socialist systems to address the control problem.

In some cases, special privileges were granted on an individual, discretionary basis:

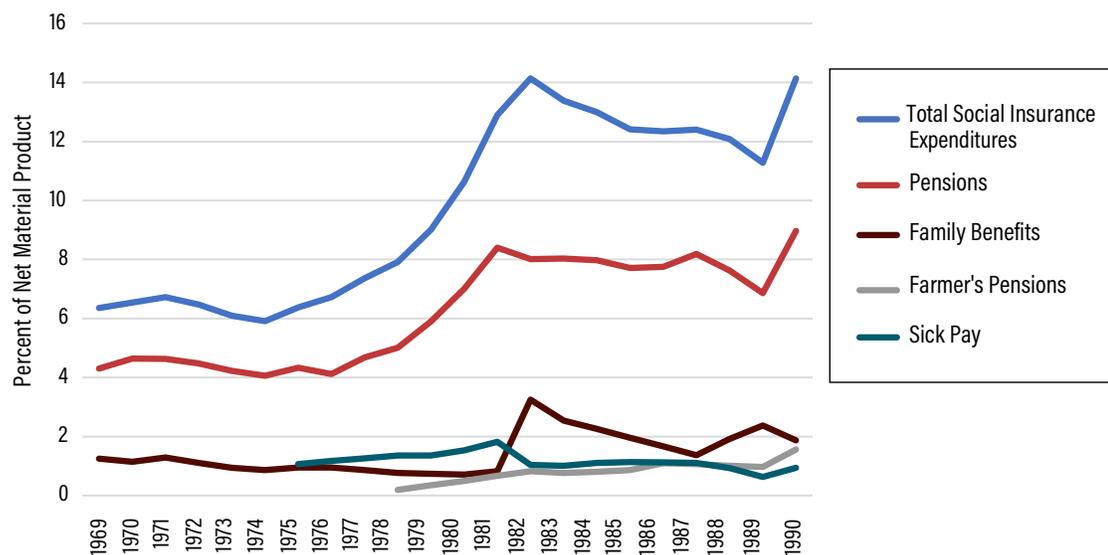
The Gomulka regime tolerated and even implicitly encouraged informal lobbying for social rights and privileges, favoring prominent individuals and influential categories of employees sponsored by top officials of the party and government.... Gomulka and his fellow members of the Politburo and the Central Committee frequently intervened personally with the ZUS and the Committee on Labor and Wages on behalf of numerous individuals and groups, such as veterans, retired teachers, intellectuals and party officials, who constantly petitioned the authorities for pension increases. (Inglot 2008, 160-61)

By the early 1970s, it was clear to Polish leaders that the country's social safety net was not only inferior compared to the more generous and egalitarian social safety nets of the West, but also compared to the safety nets of other Soviet bloc nations such as Czechoslovakia (Inglot, 2008, 163-65). For comparison, Poland spent 6.54 percent of Net Material Product on social expenditures in 1970 (Figure 7.4) while Czechoslovakia spent 13.27 percent of Net Material Product on social expenditures in that year (Inglot, 2008: 133). Outside Comecon countries, in 1970 the United Kingdom dedicated 13.2 percent of GDP to social spending, Netherlands 22.45 percent, France 16.68 percent, and the United States 10.38 percent (OECD, 2021b: 80).<sup>3</sup>

As a result, Soviet leader Leonid Brezhnev encouraged Edward Gierek to address the deficiencies in the system. Rejecting the earlier Stalinist (and Bierutist) emphasis on growth at all costs, he believed that a strong social safety net was an important aspect of the implicit social contract and would help ensure regime stability (Inglot, 2008: 165). Under Gierek the government attempted to expand benefits, but once again, inflation eroded the nominal gains (Inglot, 2008: 166-67). Hence, time and time again, bad economic governance undermined whatever good intentions that socialist leaders had.

The theme of expansion and retrenchment continued until the collapse of the socialist regime. That is, every time the public grew more dissatisfied with the state of the economy and the existing income support institutions, the government moved to expand the bundle of social benefits. But as political unrest subsided, previously expanded benefits would be reduced or would not be indexed to reflect changes in the cost of living. As Inglot put it, "the Polish regime combined violent repression of the strikes and demonstrations with emergency social spending for wages and worker benefits" (2008: 164).

The cycle continued through "the final, most consequential surge from the late 1970s through the early 1980s" (Inglot, 2008: 172). Figure 7.4 shows social insurance spending

**Figure 74: Social Insurance Expenditures as a Percent of Net Material Product, 1969-1990**

Source: Inglot, 2008: 162, 174.

as a share of NMP from 1969 through 1990. By 1982, social insurance expenditures had soared to more than 14 percent of Net Material Product (Inglot, 2008: 174). But at this point, as the economy was reeling, the pension fund found itself in a deficit for the first time in its history. The government responded by increasing insurance taxes, from 15.5 percent to 30 percent in 1980 and then to 43 percent in 1982. This, unfortunately, further depressed the already poorly performing state sector of the economy (Inglot, 2008: 172).

Meanwhile, as the surge in spending and taxes threatened the economy, workers found themselves no better off:

This massive... increase in social insurance spending and improved access to many old and new benefits during the most severe post-war economic crisis of 1979-1982 could hardly compensate the impoverished population for the shortages of consumer goods, deterioration of social services, price inflation, and ultimately for a subsequent drop of real wages under the martial law regime. (Inglot, 2008: 172)

Ironically, by the time party leaders had decided that a generous social safety net was in the public's interest (and therefore the regime's interest), it was too late. By the late 1970s, the inefficiencies of central planning and the privileges afforded to special interests had left the state with too few resources to fund a generous safety net. In the end, the Polish social safety net in the socialist era came to symbolize the broader system's inability to deliver on its two main promises. It neither eradicated want from the human experience nor ensured material and social equality.

### *Income support system in post-transition Poland*

The transition to a market-oriented system and the growth that it has unleashed have enabled Poland to offer its citizens a significantly more generous social safety net than was offered during the socialist era. In what follows, we will briefly delineate three major stages in the development of the income support system in Poland since the collapse of the socialist regime. We then offer a brief discussion of Poland's contemporary pensions, unemployment benefits, social assistance, family benefits, and disability benefits.

As we discussed earlier, Poland—like all formerly socialist countries—entered what came to be called a transformational recession as it transitioned to a market economy. GDP declined in 1990 and 1991 and unemployment rose from 6.3 percent in 1990 to 16.4 percent in 1993 (IMF, 2021). While Poland's transformational recession was smaller than that of most other transition economies and it recovered sooner than others, its unemployment rate remained well above the OECD average until the second decade of the 21<sup>st</sup> century (see figure 4.4 above). The reformers thus had to navigate both political and economic challenges to adjust social benefits to the new economic structure. At the same time, they also had to address the longstanding problems with the support structure that we discussed in the previous section.

The first stage in the evolution of social welfare institutions in Poland's Third Republic involved expanding social benefits to compensate for the social costs of the transition (Cerami, 2010). In order to gain public support for the reform process, the new regime offered short-term benefits to supplement people's incomes. For instance, the regime introduced early retirements to increase the number of people eligible for benefits, and provided relatively generous unemployment and social assistance programs (like extensive family policies) to cushion the costs of the transition (Cerami, 2010: 242). In addition to these short-term remedies, long-term reforms were beginning to take shape.

The regime reduced the socialist-era family benefit system. It raised the retirement age and increased pension insurance contribution rates to reduce the system's reliance on pay-as-you-go. It introduced a new public health insurance program, and the state guaranteed public support for uncovered individuals. The government continued to offer Poles incentives to have children and continued to provide extensive child care support. Borrowing from the German model, reformers created a system of unemployment insurance with three components: unemployment benefits, unemployment assistance, and social assistance. Finally, they created a basic safety net for those at risk of poverty (Cerami, 2010: 233).

The second stage in the evolution was prompted by the realization that the new social benefits were unsustainable, especially as the rate of unemployment increased in the first decade of the transition and social security expenditures came to consume 16 to 17 percent of GDP between 1991 and 1997 (Inglot, 2009: 80). Poland's creditors' demands to improve the country's fiscal conditions reinforced the impetus for change. (Recall that the IMF had temporarily suspended its aid in 1991 over the nation's failure to improve

its finances.) Hence the second stage of the welfare system's development was marked by retrenchment of social benefits in order to reduce spending. Both center-right and left-wing parties supported this retrenchment as everyone saw it as necessary (Cerami, 2010: 244).

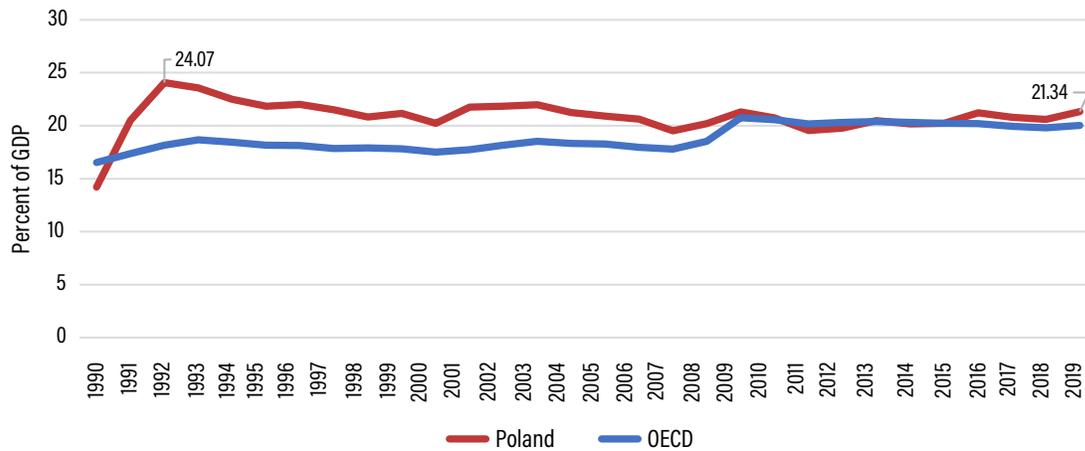
Despite the necessity of these measures at the time, a new problem arose as large numbers of unprotected citizens attempted to collect social insurance from the heavily indebted funds (Cerami, 2010: 244). The third phase, less significant than the earlier changes, entailed modest recalibrations in the plans (Cerami, 2010: 251).

The specific measures added a mandatory privately managed defined-contribution pension to the existing public pension system and attempted to make the system more equitable across professions (Cerami, 2020; Jakubowski, 2016). While younger cohorts were required to participate in the plan, older cohorts had the option to remain in the old system. Since 2014, however, participation in the plan has been voluntary. The financing arrangements have also been altered. The flat rate of social insurance contributions has been gradually increased, while non-contributory programs have increased in their scope. Employer and employee contributions primarily fund old age pensions, unemployment insurance, and disability benefits, while general government revenues finance other programs such as family benefits and social assistance (European Commission, 2020).

The payroll tax funds the system. Employers and employees each contribute 9.76 percent of remuneration (total contributions of 19.52 percent) (European Commission, 2020). Women are able to receive pensions at age 60 after 20 years of work and men at age 65 after 25 years of work (Patek, 2019: 36).<sup>4</sup>

Unemployment benefits were initially an important element in Poland's income support system. They were created in the early 1990s to support the growing unemployed population. Though generous at first, the unemployment benefits have been pared back and administrative barriers for receiving benefits have increased over time.<sup>5</sup> As a result, fewer than one in six unemployed individuals (15.8 percent) obtained unemployment benefits in 2018 (Patek, 2019: 131). The Polish government also provides vocational guidance, training, and subsidized jobs to prevent long-term unemployment.

In addition to pensions and unemployment benefits, Poland also supplies citizens with social assistance programs that are intended to support individuals and families in satisfying basic needs. The social assistance programs take the form of both cash and in-kind transfers. Cash benefits include permanent or temporary allowances and a purpose-specific one-time allowance to cover expenses on essential goods like food or medicine, and income support for education and economic independence.<sup>6</sup> In-kind transfers include coverage of funeral expenses, social work, shelter, food, clothing, care services, family therapy, and contributions for health insurance (European Commission, 2020). Both cash and in-kind benefits are funded through general government revenue and are organized jointly by national and local levels of government.

**Figure 7.5: Public Social Expenditures as a Percent of GDP, 1990-2019**

Source: OECD, 2019d. Aggregated data.

Family benefits and maternity allowances supplement the social assistance programs. Some of the child support policies in the form of monthly allowances are provided to families regardless of income.<sup>7</sup> Other policies offer per-child benefits to families below a certain income threshold (European Commission, 2020). The family allowance may also be supplemented by a parental benefit. All of these benefits are financed through general government revenues. The government also offers paid maternity leave to parents covered by social insurance.<sup>8</sup>

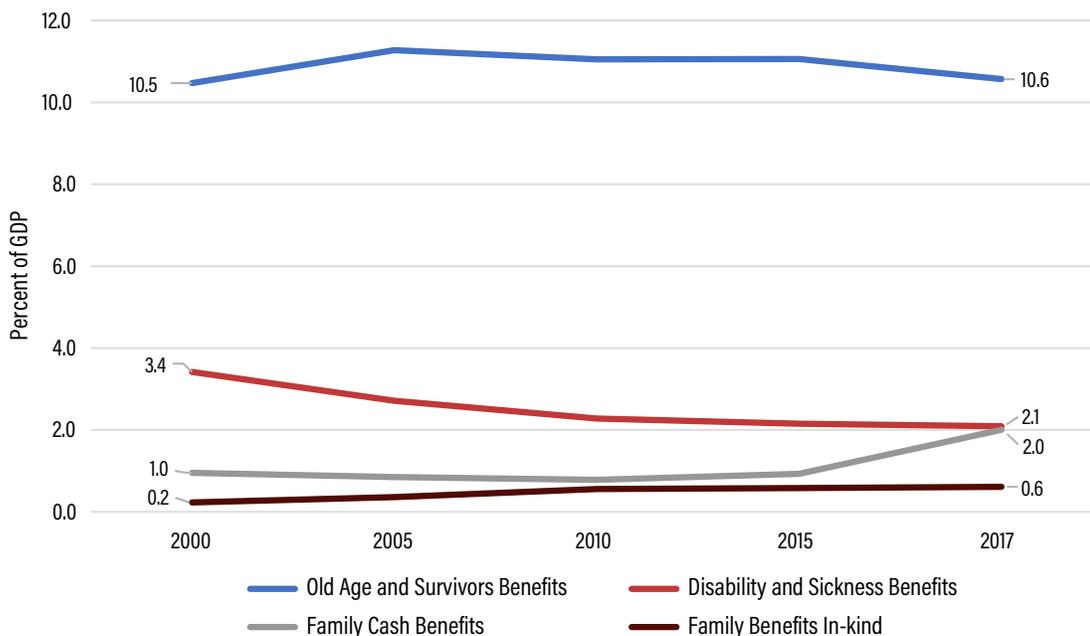
Poland's income support system supplies complete or partial disability pensions.<sup>9</sup> It is estimated that in 2018 20.3 percent of all cash benefits were spent on some form of disability pension.<sup>10</sup> Workers are eligible to receive work accident insurance benefits paid through the FUS if they are injured on the job or contract an occupational disease.<sup>11</sup>

Figure 7.5 shows total public social expenditures as a share of GDP in Poland and in the OECD from 1990 through 2019. It shows the initial, steep rise in spending following the transition, followed by a gradual reduction in spending as a share of GDP for the next two decades. By 2009, Poland's social expenditures as a share of GDP were broadly comparable to those in the OECD.

Figure 7.6 shows the composition of major social expenditures in Poland from 2000 through 2017, while figure 7.7 shows the same data for the OECD as a whole. As a share of GDP Poland spends more on old age and survivors' benefits, disability and sickness benefits, and cash family benefits than the OECD, though it spends less on in-kind family benefits.

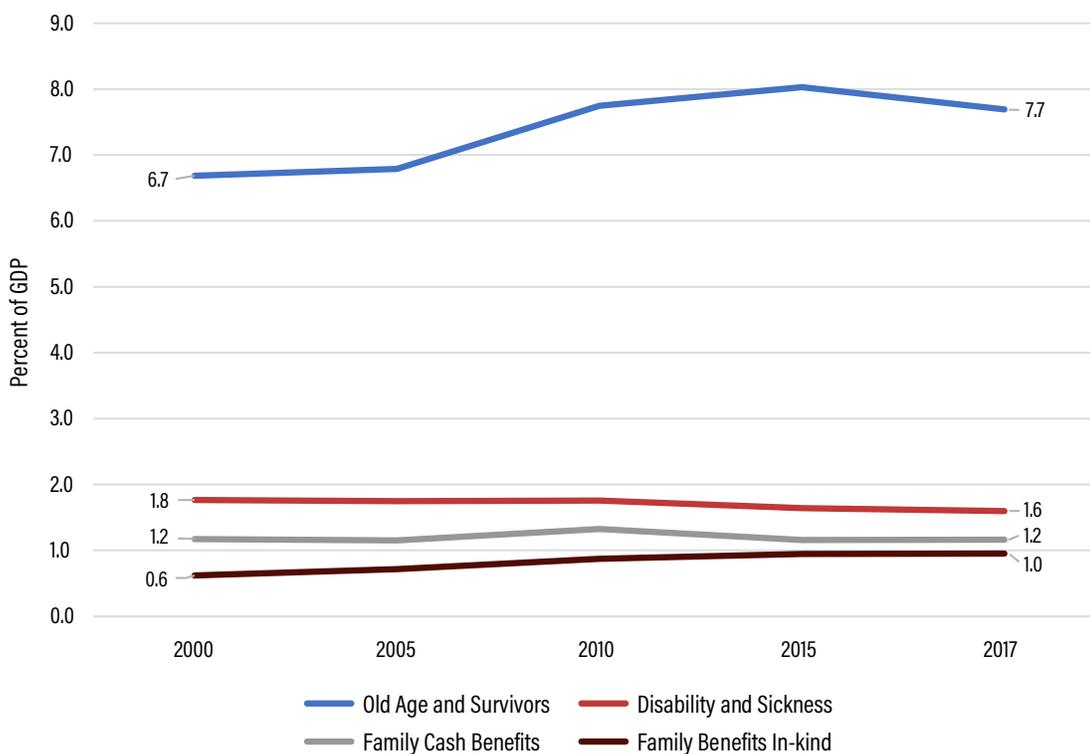
There is no question that post-transition Poland spends more on its social safety net than did socialist Poland. At its maximum, social safety net spending in socialist Poland was just over 14 percent of Net Material Product. In the modern era, by contrast, social

Figure 76: Select Components of Social Expenditures in Poland as a Percent of GDP, 1990-2017



Source: OECD, 2019d

Figure 77: Select Components of Social Expenditures in OECD as a Percent of GDP, 1990-2017



Source: OECD, 2019d.

safety net spending averages about 20 percent of Gross Domestic Product. Recall that GDP includes the service sector while NMP does not. So when we divide spending by GDP instead of NMP, we are dividing by a significantly larger number. Since the service sector is more than 50 percent of Poland's GDP, these figures suggest that the share of Poland's economy devoted to social services is more than twice as large as it was during the socialist era.<sup>12</sup>

As measured in 2015 US dollars, Poland's real social expenditures per capita increased from \$1,557 in 1990 to \$6,719 in 2019 (OECD, 2019d), a 430 percent increase. The Polish experience underlines the importance of economic growth. Not only does growth lead to rising living standards—and, ideally, fewer people in need of social assistance—it also permits a more generous social safety net.

## Health care

### *Health care in socialist Poland*

The Polish health care system has followed something of a similar path as the social safety net system, in that it was similarly subject to waves of counteracting reforms. But compared with the welfare programs, Poland's health care system has exhibited more consistency over time. And compared with other aspects of Polish society, post-transition changes in the health care system have been more modest.

State involvement in Polish health care dates to 1918 with the establishment the Ministry of Public Health, Social Assistance and Work Protection. The ministry was responsible for fighting infectious diseases and maintaining public hygiene. In addition to the ministry, the 1920 law on health insurance supplied health coverage to about 7 percent of the population (Sagan et al., 2011: 16). The system provided benefits that varied across professions.

The socialist government created the Ministry of Health in 1945 and worked to ensure that the health care system covered more people. The government altered the system further in 1950, to be modelled after the Soviet system (which had been created by Soviet Commissar of Public Health, Nikolai Semashko). Under this highly centralized administrative structure, the state came to employ the vast majority of medical workers (Popovich et al., 2011: 14-15).

Health care was offered free of charge to all state employees, though it was limited in rural areas; private farm owners and their families were not covered until 1972 (Kusze-wski and Gericke, 2005: 7). The ministry was also responsible for establishing health units and educating doctors and nurses. The main emphasis was on maternal and child health (Sagan et al., 2011: 16). Despite the efforts to centralize the system and to eliminate private initiatives, private medical practices were never formally abolished, and in fact private medical and dental practices grew over time (Kusze-wski and Gericke, 2005; Sagan et al., 2011).

There were several changes to the system since its establishment in the 1940s. Reforms in 1960 focused on providing each district with comprehensive health and social services (Kuszewski and Gericke, 2005: 7), and in 1972 the government established integrated health care management units. The integrated units managed “hospitals, outpatient clinics, specialist and primary health care” (Kuszewski and Gericke, 2005: 7). The final set of pre-transition reforms in the 1980s aimed to decentralize the system by devolving power and administrative responsibilities to regional bureaucracies and integrated health units (Kuszewski and Gericke, 2005: 7).

Overall, Poland’s health care system during the socialist era failed to live up to expectations. As with every other sector, the health system was plagued by “an almost permanent shortage in drug supplies” (Łotysz, 2014: 537). One strategy that doctors adopted to cope with these endemic shortages illustrates the creative but wasteful workarounds that were necessary under socialism: Doctors would keep patients in the hospital who didn’t need medication just so they could obtain their quota of drugs and reallocate those medicines to patients who did need them (Woodall, 1982: 186). There were also frequent acute shortages of medical equipment (Ostrowska, 2008: 338). And like social services more generally, health care was constantly underfunded as the regime prioritized industrial development (Ostrowska, 2008: 338; Wnuk-Lipinski and Illsley, 1990: 835).

Poor health was exacerbated by “a very high degree of air and water pollution by industrial chemicals, unsatisfactory work conditions, poor and overcrowded housing, frustration and depression caused by the existing economic conditions and fears about the future, malnutrition or one-sided diet, alcoholism” (Fallenbuchl, 1991: 117).

These effects combined to produce increasing mortality among both male and female populations:

between 1970 and 1986 the number of cases of death per 1000 inhabitants increased from 8.1 to 10.1 for the total population, from 8.8 to 10.9 for the male population and from 7.5 to 9.2 for the female population. Among the male population the increases were from 3.7 to 4.2 in the age group 35-44 years, from 7.6 to 11.2 in the age group 45-54, from 15.6 to 20.0 in the age group 55-59 and from 25.5 to 29.4 in the age group 60-64. (Fallenbuchl, 1991: 117).

These trends help explain the stagnant—and at times, even falling—life expectancy shown in figure 2.13 in chapter 2 above. As with all aspects of socialist Poland, there was also great inequality and corruption in the health care system (Wnuk-Lipinski, 1990). Along with their access to luxury resorts and consumer goods, the nomenklatura also had access to their own, superior, health care services (Bloom, 2013: 20).

### *Health care in post-transition Poland*

The transition to an alternative economic and political structure has produced some changes in the health care system in Poland. But in many ways, Polish health care remains one of the most socialized aspects of the economy. According to the 1997 Constitution of the Republic of Poland, regardless of their financial circumstances, citizens are guaranteed the right of equal access to health care services, financed from public funds (Sagan et al., 2011a: 13). Several laws delineate the scope and operations of national health care. First, the 2004 Act on Health Care Services Financed from Public Sources sought to regulate the work of agencies like the National Health Fund (NHF), while the 2011 Act on Therapeutic Activity regulates the activities of private and public therapeutic entities as well as the employment of medical professionals (Sagan, Sowada, and Kowalska-Bobko, 2019: 16).

The two central actors in Polish health care are the Ministry of Health and the National Health Fund (NHF). Since the late 1980s the Ministry of Health has drifted away from its initial mandate to fund and provide health benefits to becoming more directly involved in policy-making and determining regulations (Kuszeński and Gericke, 2005: 11). The ministry continues to fund and is responsible for supervising the National Health Fund, administering medical professional development, implementing health programs, and reimbursing for drugs and medical devices (Ministry of Health [Ministerstwo Zdrowia], 2019).

Created in 2003, the National Health Fund operates at arm's length from the Ministry of Health. It is responsible for financing health care services to insured persons. Hence, as part of its responsibility, the NHF contracts with service providers to purchase and supply services (Sagan, Sowada, and Kowalska-Bobko, 2019). Since 2015, health services contracts have been determined on the basis of regional health needs and priorities “for regional health policy, available financial resources and experience from previous years” (Sagan, Sowada, and Kowalska-Bobko, 2019: 80). The NHF is prohibited from profit-making or owning firms that operate health care institutions or pharmacies.

The current system is the result of two counteracting waves of reforms. The first wave, which began shortly after the transition, decentralized. The second wave re-centralized.

The process of decentralization began in 1991 when the Ministry of Health transferred authority down to regional and local authorities (Sagan et al., 2011). These lower administrative actors then had the ability to establish their own health care units. Public health facilities were “given substantial autonomy and responsibility for managing their own budgets” (Sagan et al., 2011: 17). They focused on developing “private medical practice and upgrading the infrastructure of public providers” (Sagan et al., 2011: 17). The reforms sought to decentralize the responsibilities of participating agencies, as well as the funding and delivery of services.

Later in the 1990s, the administrative level of *powiats* (similar to counties) were reintroduced, and subsequently took over the management of hospitals (Kuszeński and Gericke, 2005). The 1997 Law on Universal Health Insurance established 16 regional sickness

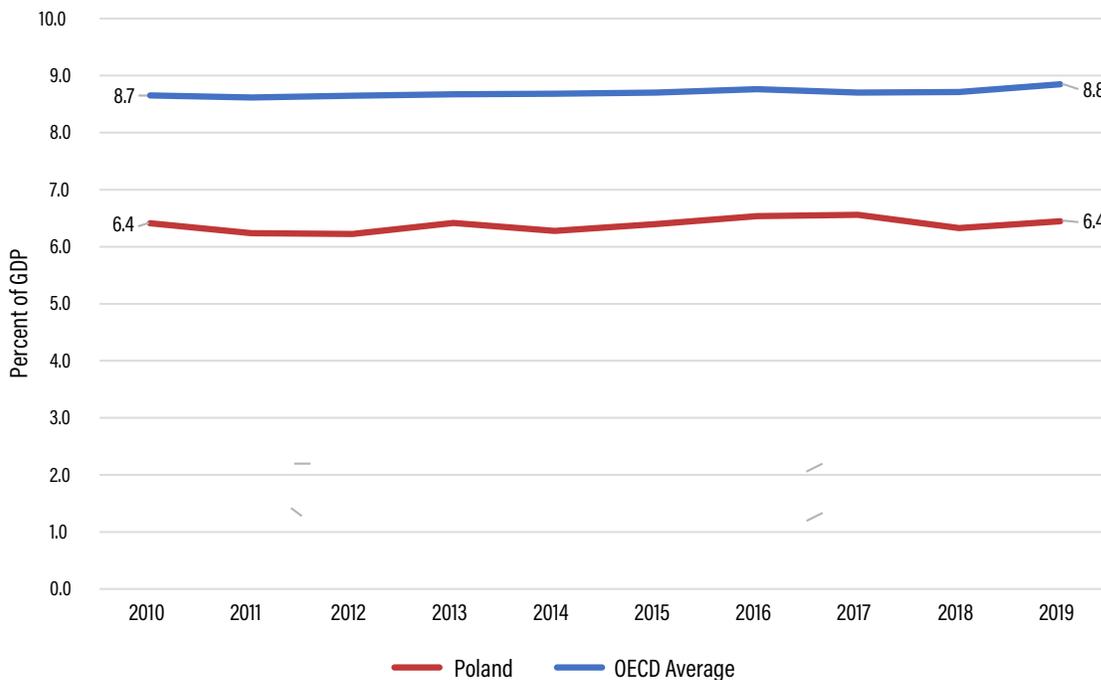
funds and replaced the former Soviet-style system with one that relied on health contributions from the payroll tax. This and subsequent legislation introduced two main sources of health care financing in Poland: 1) universal insurance contributions, and 2) expenditures from the state and regional budgets (Kuszeński and Gericke, 2005).

However, this 1990s decentralization was followed by a subsequent period of re-centralization. Undertaken at the beginning of the 21<sup>st</sup> century, these changes aimed to address regional differences in access and service quality that some attributed to the lack of a “unified strategy and contracting principles for the sickness funds as well as the application of different payment mechanisms for contracted services” (Sagan et al., 2011: 17). Legislative proposals sought to fix these regional disparities, established regional branches of the National Health Fund, and merged previous sickness funds. Other reforms divided responsibility for maintenance and organization of the health care system between the Ministry of Health, the National Health Fund, and territorial governments (Kuszeński and Gericke, 2005: 9).

Funding of health care benefits gradually moved away from the Soviet Semashko model where benefits were dispersed through the state budget and financed with general tax revenues, to sickness funds financed by mandatory universal health insurance (Sagan, Sowada, and Kowalska-Bobko, 2019). Just three years after the introduction of these sickness funds, however, they were replaced by a single institution, the National Health Fund, which was put in charge of health care financing and contracting with public and non-public health care providers (Sagan et al., 2011: 18).

The current version of the system has settled on financing the mandatory social health insurance plan through employee contributions via tax withholding with the state covering vulnerable groups. The contribution rates vary depending on the groups of insured persons, with the general rate set at 9 percent of gross income after deducting social security contributions, pensions, and unemployment benefits (Sagan, Sowada, and Kowalska-Bobko, 2019).<sup>13</sup> As a result, as of 2017, 35.5 million individuals were eligible for NHF funded services: “about 26 million (73%) paid mandatory health insurance contributions or had their health insurance contributions covered by the state (or territorial self-governments) and 7.9 million (22%) were covered as co-insured family members” (Sagan, Sowada, and Kowalska-Bobko, 2019: 73; Dubas-Jakóbczyk, 2017).

The Health Insurance Institutions (ZUS) and the Agricultural Social Insurance Fund (KRUS) collect contributions and transfer funds to the NHF. The NHF then allocates funds to each of the 16 provinces (*voivodeship*). This allocation is determined by formulas that take into account the size, gender composition, and age structure of the insured population, as well as the amount of previous allocations (allocations in one year may not be lower than those of the previous year (Sagan, Sowada, and Kowalska-Bobko, 2019: 80). Once the regional branches receive the funds, they are tasked with spending the funds and contracting health services for their respective populations. The state budget no longer plays an important role in the supply of health services and is used instead in

**Figure 7.8: Health Expenditures as a Percent of GDP in Poland vs. OECD Average, 2010-2019**

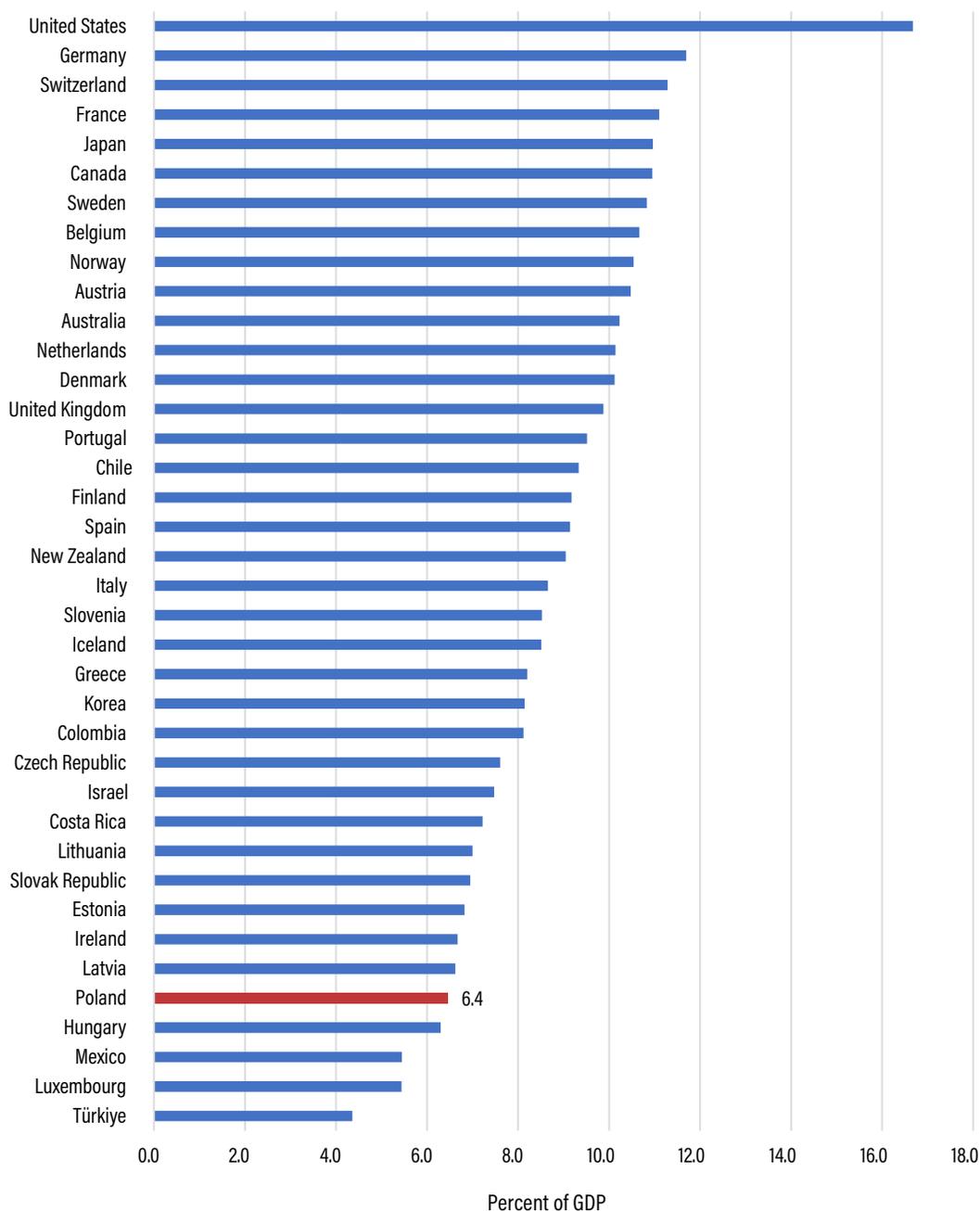
Source: OECD.stat, 2022b.

a supplementary capacity to support specific population groups like small farmers, the unemployed, and refugees (Sagan, Sowada, and Kowalska-Bobko, 2019: 72).

Figure 7.8 shows Polish health care expenditures as a share of GDP from 2010 through 2019. For comparison, it also shows the OECD average over this period. Neither figure has changed much in a decade. Poland consistently spends about 2.5 percentage points less on health care than the average OECD nation. Figure 7.9 shows the same figure for each OECD nation in 2019. As a share of GDP, Poland spends less than all but four OECD nations (note that all of the formerly socialist nations are below the average).

We now turn to coverage. A majority of the population is obligated to participate in the public insurance system. Hence, according to the OECD, 92.6 percent of the population had the right to receive health benefits in 2019. Eligibility is determined by regulations put out by the Ministry of Health that specify

guaranteed benefits within primary health care, ambulatory specialist care, hospital care, therapeutic rehabilitation, psychiatric care and addiction treatment, nursing and long-term care (LTC), dental care, health resort treatment, emergency medical care, palliative and hospice care, highly specialized medical services (e.g. transplants), and publicly-financed health policy programmes. (Sagan, Sowada, and Kowalska-Bobko, 2019: 74)

**Figure 79: Health Expenditures as a Percent of GDP, 2019**

Source: OECD.stat, 2022b.

Patients are generally not expected to share in the cost of primary care, outpatient specialist care, or hospital care provided it is offered “within the publicly financed system” (Sagan, Sowada, and Kowalska-Bobko, 2019: 85).

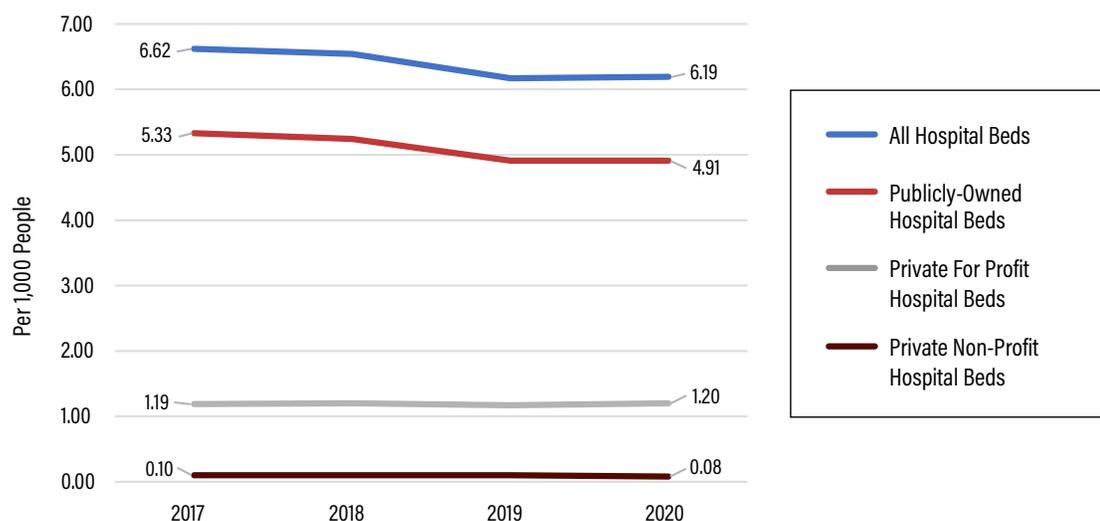
Given the state’s large role in health care, it is not surprising that the voluntary (private) health insurance market in Poland is limited. Hence, as of 2017 just 2.27 million Poles had private health insurance—with 3 million people holding “medical subscriptions” a

different form of private quasi-insurance (Sagan, Sowada, and Kowalska-Bobko, 2019: 90). The voluntary health insurance market is primarily focused on supplementary coverage, including both in-kind benefits in the form of primary and specialist ambulatory care, dental care, elective hospital procedures, rehabilitation, home visits and vaccinations, and cash benefits in the form of a lump sum for hospital days, refunds for the cost of pharmaceuticals, hospital stays, surgery and serious illnesses (Sobczak, 2016: 110). Private medical subscriptions provide “faster access to and better quality of outpatient services” with basic packages usually covering occupational health services like “ambulatory specialist consultations and procedures, and diagnostic procedures” with some companies in recent years offering “inpatient treatment (in their own or cooperating hospitals), rehabilitation, medical transport, nursing care, dental care, higher hospitalization standards and auxiliary products” (Sobczak, 2016: 110).

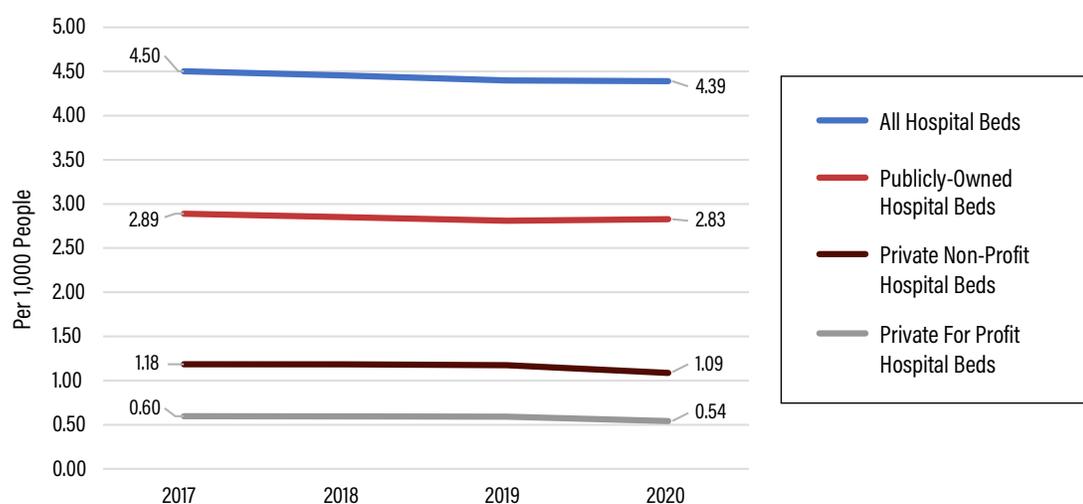
The hospital infrastructure in Poland is quite poor and “many hospitals struggle to meet the technical and sanitary requirements set by the Ministry of Health” (Sagan, Sowada, and Kowalska-Bobko, 2019: 106). The NHF has operated the supply of physical resources and it is the sole purchaser of health services. Its regional branches are expected to purchase contracting services within their internal markets, which are open to a variety of institutions with different forms of ownership, including public, non-profit, and business entities. Some major changes to hospitals’ contracting processes were instituted in 2017 with the introduction of the hospital network. Before these changes, regional NFH branches initiated and awarded contracts on a competitive basis. Now, qualifying hospitals are automatically granted a contract with their affiliated NHF branch for four years, eliminating competitive tenders.

As of 2016, Poland had 926 hospitals. The majority (600 or 65 percent) were publicly owned, and 326 (or 35 percent) privately owned. Among public hospitals, the majority (71 percent) operate as independent public health care units (SPZOZ). Ownership of public hospitals is split between the three administrative levels of Polish regional government, ministries, and universities. Polish territorial governments own the majority of public hospitals. SPZOZs have been under significant financial pressure in the past decade due to the accumulation of debt “with impunity” (Sagan, Sowada, and Kowalska-Bobko, 2019: 35). SPZOZs are known for their lack of accountability and for their mismanagement, resulting in the accumulation of PLN 12.7 billion of debt in 2018, with 14.5 percent of the amount being overdue liabilities (Sagan, Sowada, and Kowalska-Bobko, 2019: 35).

The private hospitals are typically small; 52 percent of them had fewer than 50 beds in 2016, and often operate as single specialty units (Sagan, Sowada, and Kowalska-Bobko, 2019: 102). Private hospitals are thought to be more financially stable and are growing in number while SPZOZs are dwindling (Sagan, Sowada, and Kowalska-Bobko, 2019; Dubas-Jakóbczyk, 2017). This shift has been attributed to mergers and liquidations and to the transformation of independent public health units into companies via the Commercial Companies Code (Sagan, Sowada, and Kowalska-Bobko, 2019: 102).

**Figure 7.10: Hospital Beds Per 1,000 People in Poland, 2017-2020**

Source: OECD.stat, 2022c.

**Figure 7.11: Hospital Beds Per 1,000 People in the Average OECD Nation, 2017-2020**

Source: OECD.stat, 2022c.

Figures 7.10 and 7.11 show the total number of hospital beds per 1,000 people as well as the number of beds by ownership type per 1,000 people from 2017 through 2020. The data in figure 7.10 is for Poland while the data in figure 7.11 is for the average OECD nation. Poland has more hospital beds per 1,000 people than the average OECD nation. Most of this difference is due to the nation's relatively high number of beds in publicly owned hospitals.

Finally, let us consider the state of human resources in Polish health care. Generally, the Polish health care workforce was thought to be underdeveloped. There are pronounced

shortages of health care workers, as the employment in health and social work as a share of total employment in Poland was 6 percent in 2017, compared to 10.1 percent for the OECD average (OECD, 2019c). The training and hiring of health care professionals is under the purview of the Ministry of Health in collaboration with the Polish Ministry of Higher Education. In 2017 Poland reported 90,284 practicing physicians in the country.<sup>14</sup> This works out to 2.38 per 1,000 people, ranking Poland 28<sup>th</sup> out of 31 OECD countries for which we have data (the OECD average is 3.5 physicians per 1,000 people).

Nurses are also in short supply. While the ratio of nurses increased from 4.41 per 1,000 people in 1980 to 5.1 per 1,000 in 2017, Poland ranks 24<sup>th</sup> out of 30 OECD countries for which we have data (the OECD average ratio is 9.0 nurses per 1,000 residents (OECD, 2019c)).

Health care workers are employed and paid in numerous ways. Physicians in primary care have been paid on the basis of patient rosters, on a fee-for-service basis, with monthly lump-sum payments for specific services, and through pay-for-performance-schemes (Sagan, Sowada, and Kowalska-Bobko, 2019: 95-96). While specialists working on an outpatient basis are paid fee-for-service, the “majority of health professionals work under employment contracts... and receive a salary,” with the minimum basic salary regulated for all medical workers (Sagan, Sowada, and Kowalska-Bobko, 2019: 98).

For patients, access to health care typically begins with a primary care physician. Patients have a choice of enrolling for free with any general practitioner with no territorial restrictions and are able to switch twice a year with no penalty. And while a physician’s referral is typically required for specialist treatment, patients can see several different types of specialists with no referral. Once referred, patients are also free to choose a specialist provider if the physician has a valid contract with the NHF. In addition to public health care, however, patients may also opt for private providers and treatment, with the only constraining factor being a patient’s ability to pay (Sagan, Sowada, and Kowalska-Bobko, 2019: 49).

As of 2019 Poland had a lower life expectancy at birth—78 years—than the OECD average (81 years), ranking 32<sup>rd</sup> among 38 nations. In a similar vein, Poland has the 11<sup>th</sup> highest infant mortality rate in the OECD (out of 37) and the 6<sup>th</sup> highest rate of treatable mortality (out of 25) (OECD, 2019c). Poland reported higher 30-day mortality rates following hemorrhagic and ischemic strokes, and lower cancer survival rates (OECD, 2019c). Compared to the OECD average, Poles experience relatively lower mortality rates 30 days after a heart attack.<sup>15</sup> Poles report relatively long wait times, with 66 percent of patients waiting more than 3 months for a hip replacement, 72 percent waiting more than 3 months for a knee replacement, and 71 percent waiting more than 3 months from specialist to treatment (OECD, 2019c).

In summary, the transformation that has swept over the Polish economy in the past 30 years has, in many ways, passed the health sector by. The state dominates the health insurance market as well as the hospital market. Large state bureaucracies still determine the allocation of human and physical capital. And, as in the socialist era, a relatively small share of GDP is devoted to the health service sector. The main difference is that economic growth

has permitted the state to allocate more resources, in absolute terms, to health care. The transition to a market economy has permitted a rising standard of living, and, as a result, life expectancy is no longer in long-term decline (see figure 4.9 from chapter 4). But compared with other modern mixed economies, Poland's health care system has much room to improve.

## The education system

### *Education in socialist Poland*

The socialist takeover of Poland had an almost immediate effect on its education system (Wojcik, 2010). By 1950 Polish education had been altered to fulfill the aspirations of the socialist leadership. According to Charzyńska, Anczewska, and Świtaj (2012) four major traits characterized the newly established educational structure. First, education was strongly ideologized and politicized to create “the new socialist man” with a different kind of thinking. Students were expected to know the tenets of Marxism and to be vigilantly on guard against the enemy class (Wojdon, 2018). Second, the educational system aimed to create a new social structure based on the working industrial class. As with so many other aspects of planning, Polish central planners prioritized their country's industrialization over almost all other goals. Third, education was strongly centralized with identical standards, curriculum, and textbooks across the nation. Finally, independent and private educational establishments were essentially eliminated, as “authorities were determined to control the ideological transmission in educational process” (Charzyńska, Anczewska, and Świtaj, 2012: 95).

The overall structure changed little throughout the socialist reign (Baranowska, 2008). Education was divided into primary, secondary, and post-secondary. Until reforms in 1969, primary education consisted of seven years of classes, and was later changed to eight years of schooling. After completing primary school, students could choose basic vocational, general secondary, and vocational secondary programs. Upon completion of the general secondary and vocational secondary programs, a student could opt to take a final examination and apply to university for a post-secondary degree. In post-secondary education, students had two primary options. They could either take three years of courses and obtain a non-university level degree (and become teachers, nurses, paramedical personnel, and the like), or they could spend four to six years in a traditional course of higher education.

With their focus on industrialization, central authorities increasingly pushed for a greater supply of technical specialists like engineers. Thus, the Planning Commission at the Council of Ministers set up enrolment targets each year to produce the necessary manpower needed to fulfill the plan's goals.

Educational conditions worsened over time, reflecting the general decline in economic conditions throughout Poland. As the economy deteriorated, educational resources became more limited. Schools and universities increasingly found themselves understaffed and without the appropriate teaching materials, while personnel had to survive on meager salaries (Baranowska, 2008).

As with other aspects of socialist life, the education system was hardly egalitarian. Simonová and Antonowicz (2006) report that out of all higher education graduates in Poland from 1945 to 1973, “34% were from working class families, 23% from peasant families, 40% from families of the intelligentsia, and 3% from the former middle or upper classes” (Simonová and Antonowicz, 2006: 518). But “secondary and post-secondary school graduates represented just 20% of the working population in 1972, of which 10% were the children of peasants and less than 10% were the children of workers” (Simonová and Antonowicz, 2006: 518). Ironically, though they had greater access to schools, the party elite may have received a lower-quality education than others. This is because, as Anne Appelbaum puts it “‘political consciousness’ was considered far more important than the ability to read and write well.” She reports that “In 1948, the Central Committee Secretariat complained that some 20 percent of the students at the Central Party School course...couldn’t finish the course because they weren’t competent enough to take lecture notes.” (Appelbaum 2012, 456).

The socialist leadership tolerated very little independence. Not unexpectedly, school choice was essentially non-existent, as independent, private, and religious schools were mostly eliminated. Schools and universities were aggressively used as propaganda machines to perpetuate the communist ideology. And though underground movements made several attempts to gain a degree of autonomy, no significant changes ensued until 1989. Some reforms were proposed in the 1970s and early 1980s to revive the crumbling system, but the substantial and necessary changes would only come about after the transition to the Third Polish Republic.

### ***Education in post-transition Poland***

In-school education in Poland is compulsory from age 5 to 16, including the final year of pre-primary education, eight years of primary education, and three years of lower secondary education. Students 16 to 18 years of age are obligated to continue their education, either full-time or part-time, in or out of school. Students may opt for either general or vocational/technical educational paths (OECD, 2015). Regulations stipulate that Poles have the right to an education that consists of eight years of primary school and four or five years of upper secondary school until the student reaches the age of 18.

The Polish education system has changed dramatically since the collapse of the socialist system. The first round of reforms in 1989 sought to restore educational autonomy by granting authority over curriculum content to schools and teachers and permitting the operation of private and independent schools. The propaganda that had been incorporated into the teaching material was also eradicated. These steps planted the seeds for the subsequent reforms of 1999, which decentralized the education system and granted significant powers to localities. Under the new structure, public schools are fully funded by the state, while private schools are only partially funded by taxpayers. And though the central authorities exercise a degree of power in terms of setting the standards for education, most decision-making regarding school operations is made on the local level.

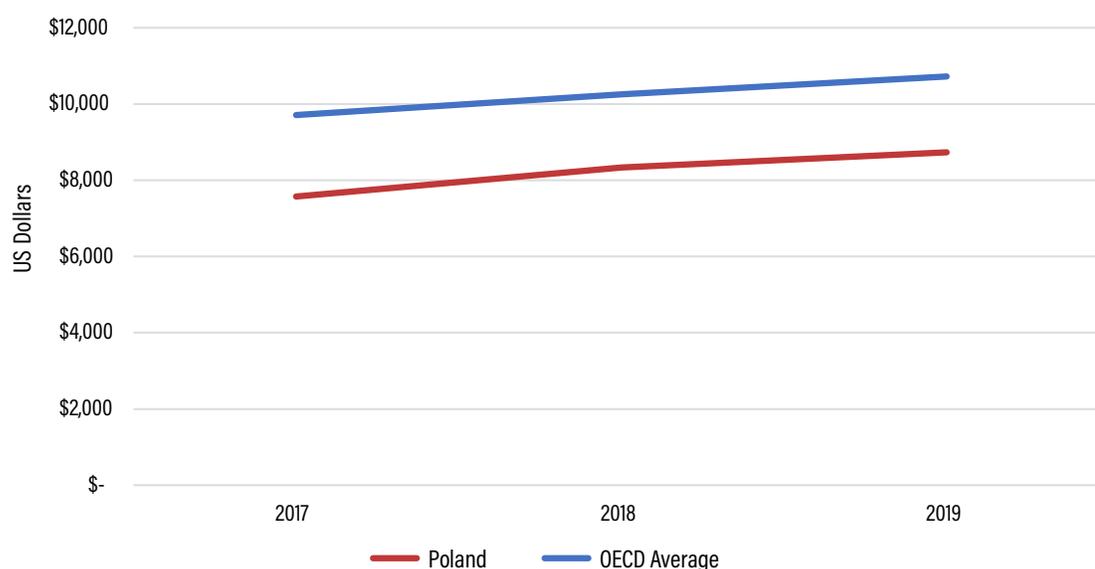
According to former National Education Minister Miroslaw Handke, who served from 1997 to 2000 and led the charge for the second wave of reforms, reformers set out to achieve

three major goals (Handke, 2015). First, they aimed to improve the quality of education, and to simultaneously prepare students to become productive members of the new market-based economy. Second, they sought to close the educational gap between wealthier and poorer students and present disadvantaged groups with more opportunities. Finally, and perhaps most importantly, the reformers hoped to alter the balance between central authorities and local discretion. For these purposes, the central educational authority was charged with setting up nationwide exams, establishing educational guidelines for curricula, and providing the necessary financing, while local governments were granted a certain degree of freedom to meet these expectations (Baranowska, 2008). For instance, although there were binding national curricula standards, schools were permitted to design their own curriculum within the existing framework, and to use their preferred selection of textbooks.

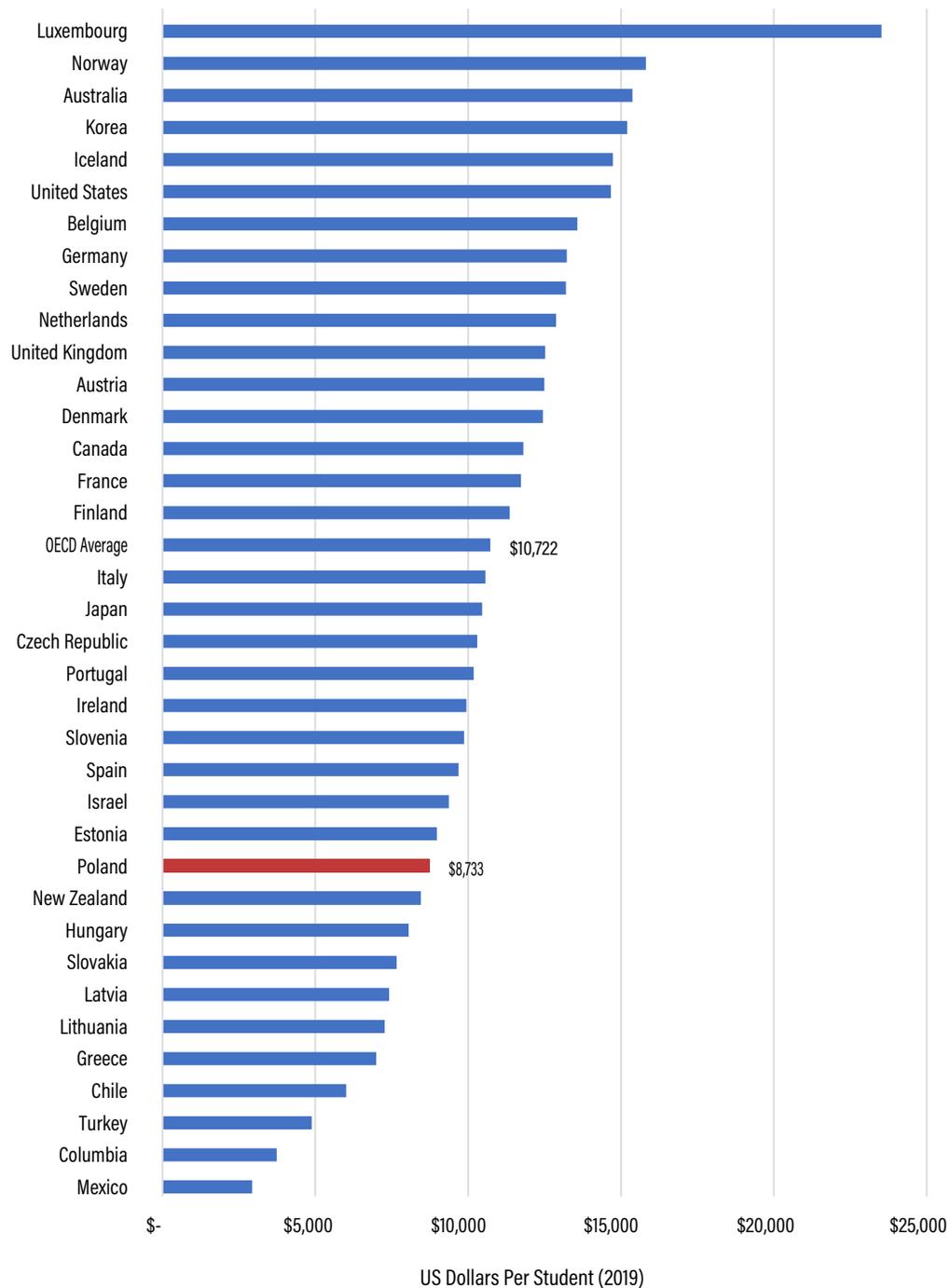
Recent amendments have shifted the educational format to eight years of primary school and four to five years of upper-secondary education (Eurydice Network, 2021). The goal of the amendments was to increase the quality of education and to diversify the options available to students for alternative career paths. Now students may select either general or vocational secondary education upon completion of lower-secondary school, with an option to return to the pursuit of tertiary education if desired. The consequence has been an increased enrolment in tertiary education, especially in business and service fields, corresponding to the demands of the modern economy. In 2008, 32 percent of young adults attained tertiary education; by 2018, 44 percent of young adults had attained a tertiary education. This is about average among OECD countries (OECD, 2019b: 2).

Poland ranks above the OCED average in terms of local autonomy over curriculum and assessment in schools, while it ranks below average in terms of local autonomy over

**Figure 7.12: Primary to Post-Secondary (non-tertiary) Education Spending Per Student, 2017-2019**



Source: OECD, 2022b.

**Figure 713: Primary to Post-Secondary (non-tertiary) Education Spending Per Student, 2019**

Source: OECD, 2022b.

the budget and resource allocation (OECD, 2018b). The relatively high degree of local autonomy over operations is not surprising. Governance in Poland is shared between central and local authorities. Local authorities are responsible for managing primary and lower secondary schools, while districts run schools above the lower secondary level. This delegation of power to local authorities tends to increase the quality of education as local

agencies possess more knowledge about the needs of their constituents and the demands of the labour market. Regions are responsible for pedagogical supervision and application of national education policy. And teachers are hired by schools directly, with schools making less than half of the independent decisions at the lower secondary level (OECD, 2015).

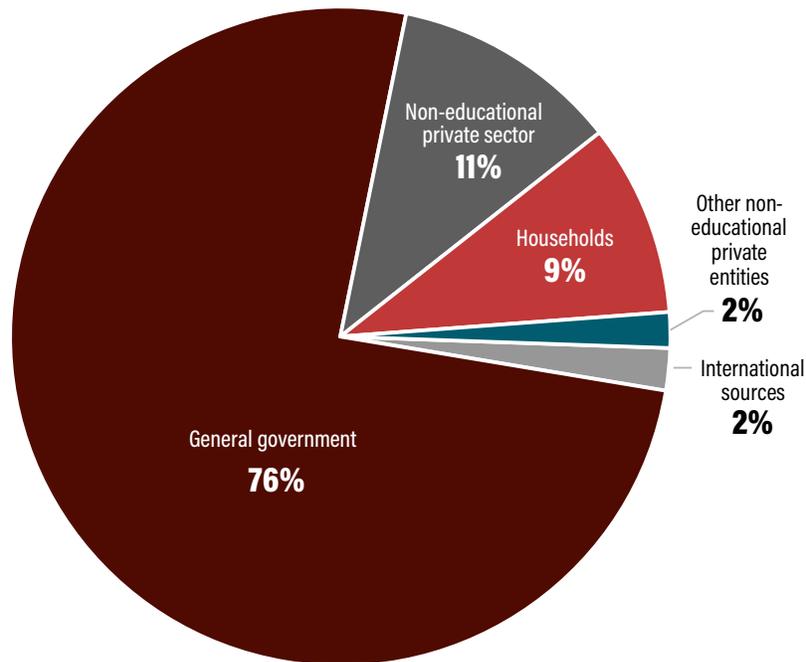
Figure 7.12 shows Polish and OECD average education spending per student from 2017 through 2019 in current US dollars. Figure 7.13 shows the same figure for every OECD nation in 2019. Poland consistently spends about \$2,000 less per student than the average OECD nation.

Figure 7.14 shows the sources of education funding in Poland while figure 7.15 shows the same data for the average OECD country. Compared with the OECD average, a slightly larger share of Polish education funding comes from the general government (76 percent vs. 71 percent) while the private sector plays a smaller role (funding 11 percent of education in Poland and 14 percent in the average OECD nation).

Public schools are taxpayer funded and tuition free. Private schools are primarily privately funded but do receive taxpayer support. They charge tuition but offer scholarships. Though students are assigned to schools in their areas, they may apply to attend an outside school depending on space availability.

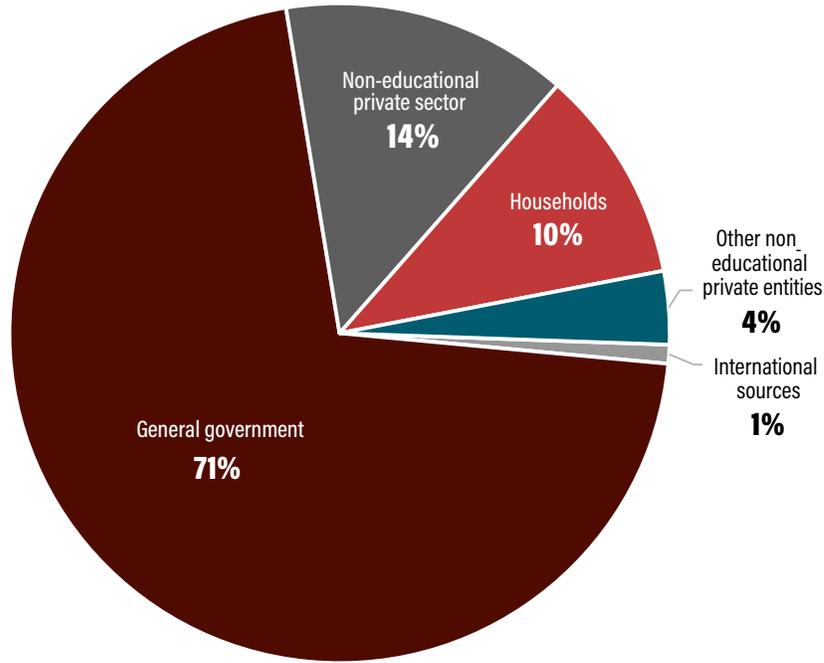
By international comparisons, Poland's students seem to receive a relatively high quality education. The OECD's Programme for International Student Assessment (PISA)

**Figure 7.14: Sources of Education Funding in Poland, 2019**



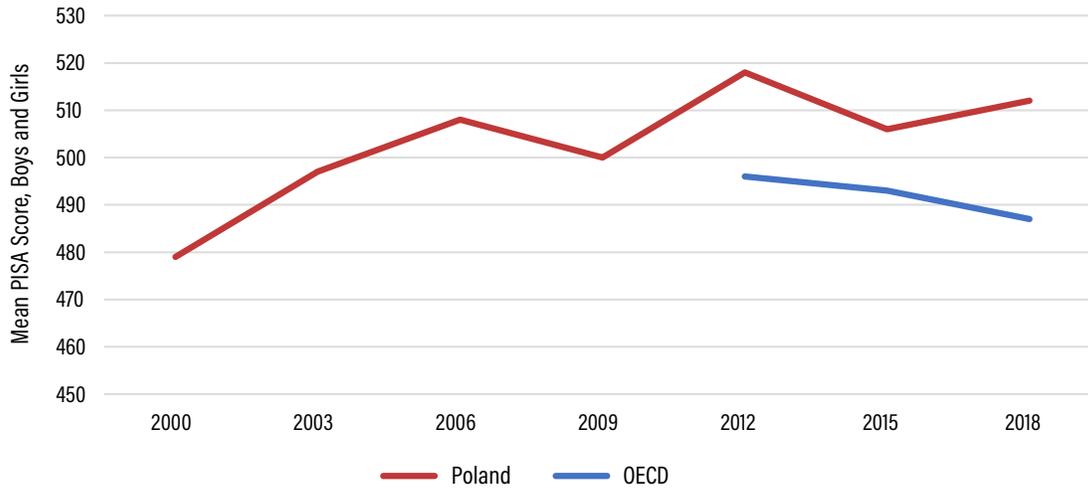
Source: OECD.Stat, 2022d.

Figure 7.15: Sources of Education Funding in Average OECD Nation, 2019



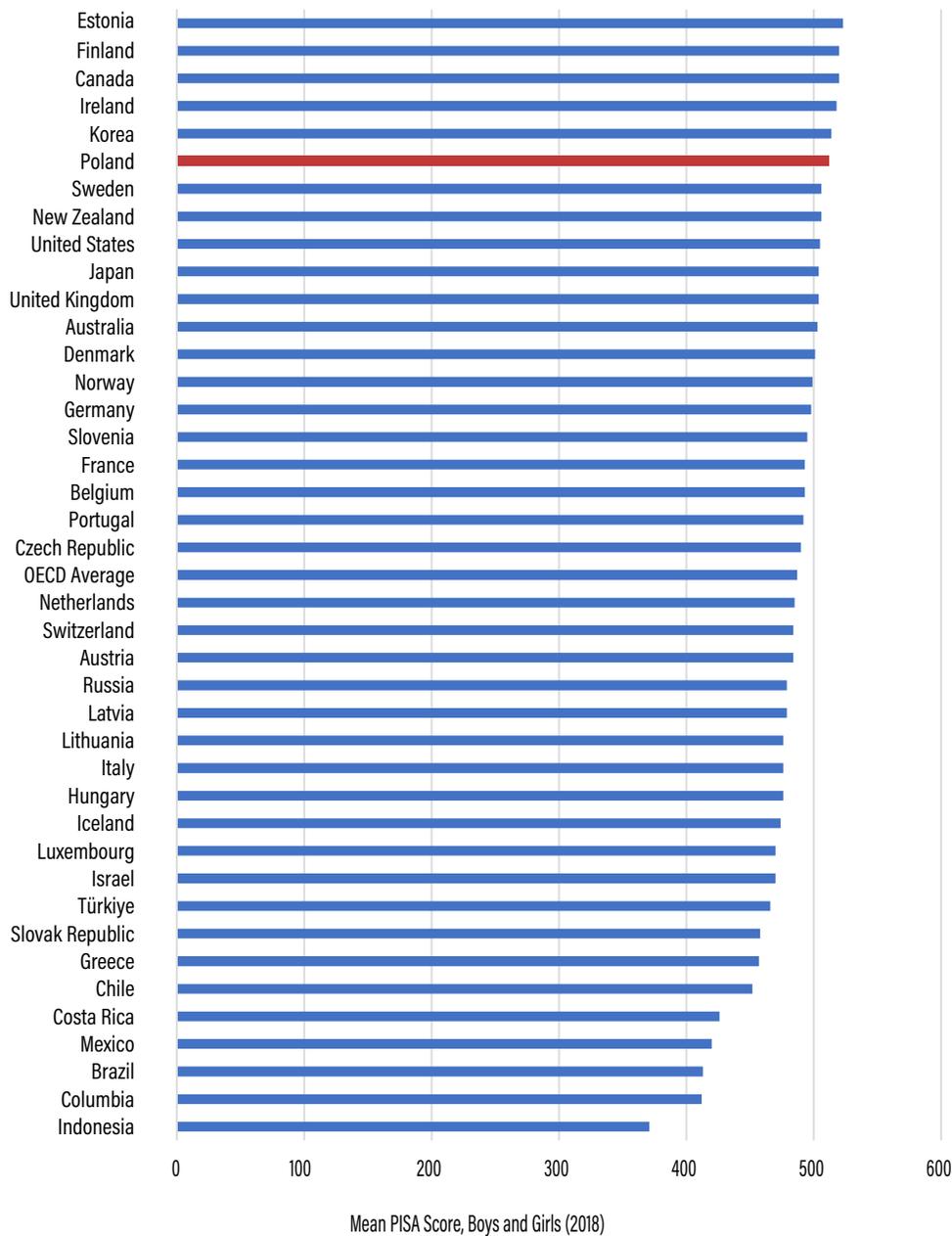
Source: OECD, 2022b.

Figure 7.16: Reading Performance (PISA)



Source: OECD, 2022c.

measures 15-year-olds’ reading, mathematics, and science knowledge in each of the OECD nations. Figure 7.16 shows Poland’s reading performance from 2000 through 2018, as well as the OECD average for 2012 through 2018 (the only years for which the average is available). Not only is Poland’s score consistently higher than the OECD

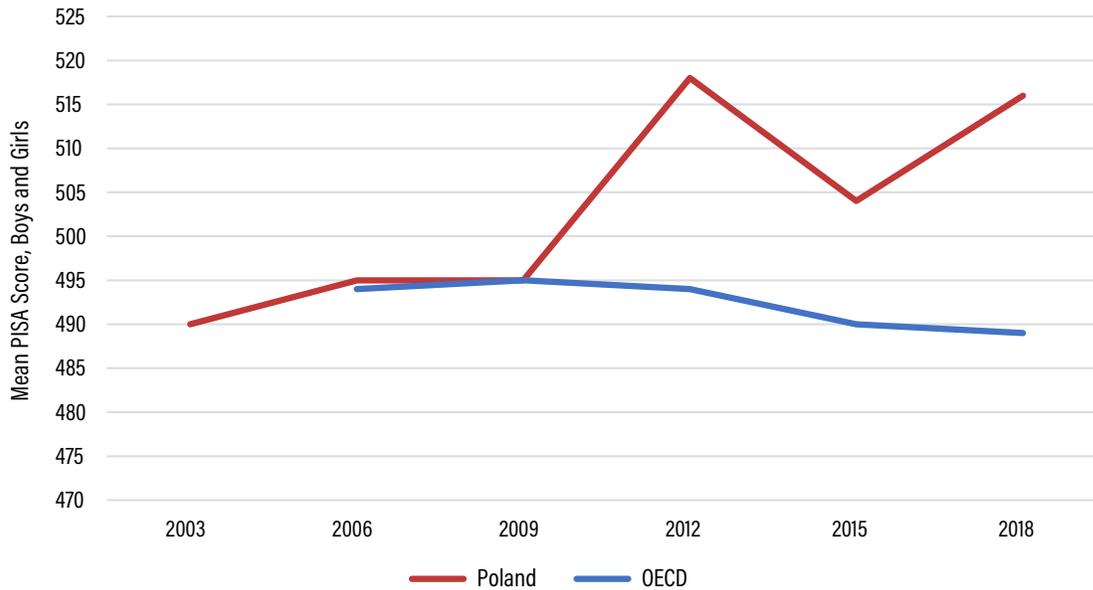
**Figure 7.17: Reading Performance (PISA), 2018**

Source: OECD, 2022c.

average, but, with some variation, it is improving over time. Figure 7.17 shows reading scores across the OECD in 2018. Poland's were the 6<sup>th</sup> highest in the OECD.

Figures 7.18 and 7.19 show a similar pattern for mathematics. In 2018, Poland's math scores were the 4<sup>th</sup> highest in the OECD. Poland's science scores (not shown) are similarly impressive. In 2018, the country's 15-year-olds scored the 6<sup>th</sup> highest in the OECD.

Though 16 to 65 year-olds in Poland score below the OECD average in literacy and numeracy skills, 16 to 24 year-olds score above average in literacy and around the

**Figure 718: Mathematics Performance (PISA)**

Source: OECD, 2022d.

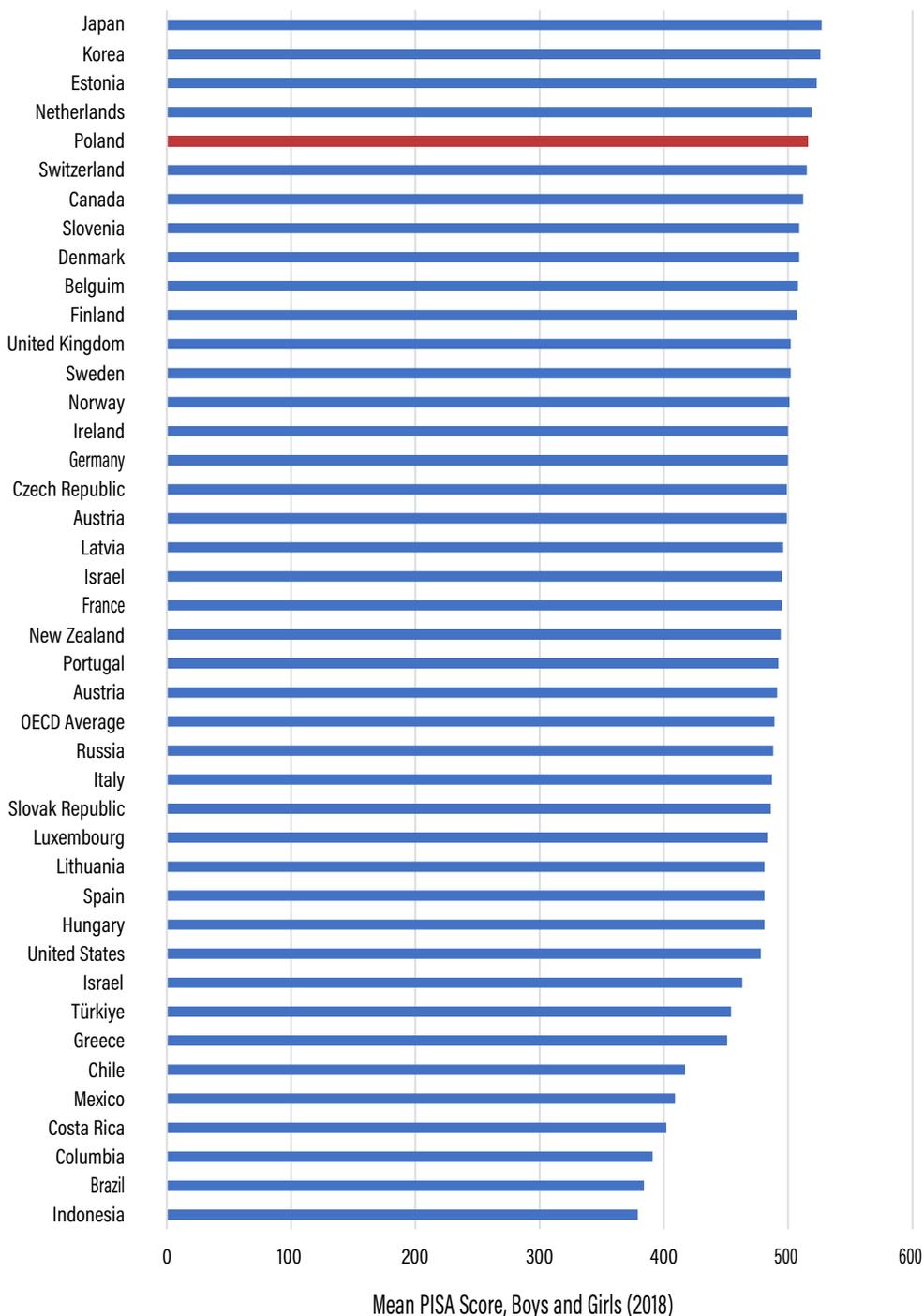
average in numeracy (OECD, 2015). This suggests that education outcomes are improving over time.

Primary and secondary enrolment remained consistently above 90 percent from 1991 to 2017, while the secondary education graduation rate hovered around 83 to 85 percent between 2010 and 2018 (OECD, 2018b). As of 2015 Poland had one of the highest levels of attainment of upper secondary education or above among 25 to 34 year-olds in the OECD. An above-average proportion of students in Poland have been enrolled in vocational and training programs, while tertiary attainment of 25 to 34 year-olds has been above the OECD average and increased significantly during the past few decades.

Still, as in all countries, some students in Poland are left behind. For instance, in 2018 the proportion of Polish children from the bottom quartile of the OECD's index of economic, social, and cultural status (ESCS) that achieved a PISA level of 2 or greater in reading was 19 percent lower than that of children from the top ESCS quartile.<sup>16</sup> This gap, however, was larger (29 percent) in the average OECD country (OECD, 2021a: 1).

In summary, Poland's modest education budget seems to purchase a relatively high quality education for a large majority of its students. Though some students are left behind, the achievement gap is smaller in Poland than elsewhere. And over time, outcomes seem to be improving. As with so much in Polish life, the education system is significantly better than that in the socialist era.

Figure 719: Mathematics Performance (PISA), 2018



Source: OECD, 2022d.

**Notes**

- 1 Pension benefits were flat rate rather than based on contributions as had been the case during the interwar period (Cerami, 2010).
- 2 This is an example of what the Italian economist Amilcare Puviani called “fiscal illusion” (Puviani, 1903).

- 3 The OECD (2021b) includes health expenditures in the social spending category, hence inflating social safety net expenditures in comparison to Inglot's (2008) analysis, which does not take health expenditures into account. But even with this consideration in mind, including health in the social spending category for Poland gives us social spending in 1970 of approximately 9.4 percent of NMP (OECD, 2021b: 80). It is also important to keep in mind that, by construction, GDP is a larger number than NMP, so the denominator is larger in these Western nations.
- 4 The benefits that retirees receive depend on average contributions for social insurance in the last 10 consecutive years or 20 years selected from the whole insurance period. According to recent estimates, as of 2018 expenditures on pension benefits in Poland amounted to roughly two-thirds of all government cash benefits (Patek, 2019: 36).
- 5 The benefits vary and depend on the length of a worker's employment. For instance, those unemployed with 5 to 20 years' work experience receive 100 percent of the standardized basic monthly benefit, whereas individuals with less than 5 years' experience are only eligible for 80 percent of the basic monthly benefit (European Commission, 2020). Fixed-rate contributions that amounted to 2.3 percent of remuneration in 2019 financed unemployment support (Patek, 2019: 129).
- 6 In order to be eligible for cash benefits in the form of permanent or temporary allowances, a recipient's net income must not exceed a monthly threshold of PLN 701 for an individual or PLN 528 per person for a family (European Commission, 2020). The allowance is equal to the difference between a person's monthly income and the income thresholds.
- 7 For instance, the "Family 500+" program entitles families to a monthly payment of PLN 500 per child under the age of 18, regardless of net income. Similarly, the "Good Start" program pays PLN 300 per child to parental guardians of children between 7 and 20 years old at the beginning of the school year (Patek, 2019: 119).
- 8 The maximum period of maternity leave is 32 weeks for one child and 34 weeks for multiple children (European Commission, 2020). And though both parents may take the leave simultaneously, the total period of maternity cannot exceed these limits. During the leave, the allowance is equivalent to 100 percent of monthly income for the first 6 to 8 weeks, decreasing to 60 percent for the remaining period (European Commission, 2020). In 2018 alone, maternity allowances amounted to PLN 8.3 billion, or 3.6 percent of total expenditures for the Social Insurance Fund (Patek, 2019: 35). The benefits were financed through contributions to sickness insurance (part of FUS) at a rate of 2.45 percent of remuneration (Patek, 2019: 30).
- 9 The complete disability benefit entitles an eligible person to a minimum benefit of PLN 1,100 per month, while partial incapacity to work provides a smaller minimum monthly benefit of PLN 825 (European Commission, 2020). The average monthly disability pension amounted to PLN 1,762 per recipient in 2018 (Patek, 2019: 43).
- 10 And it is estimated that in 2018 779,000 people received some form of disability pension, cumulatively amounting to PLN 45.7 billion, or 20.3 percent of all cash benefits in the country (Patek, 2019: 36). Contributions to the Social Insurance Fund at a rate of 1.5 percent for insured individuals and 6.5 percent for contribution payers such as employers finance these benefits (Patek, 2019: 30).
- 11 Contributions for work accident insurance range from 0.67 percent to 3.33 percent of remuneration and are fully financed by employers (European Commission, 2020).
- 12 Poland's service sector is about 55 percent of GDP. So 14 percent of NMP is closer to 8 percent of GDP. Thus, as a share of the economy, social spending is about two and a half times greater in modern Poland than it was at its maximum during the socialist era.
- 13 Rates vary depending on whether one is employed, self-employed, unemployed, or a farmer.
- 14 A significant increase from the 63,577 (or 1.79 per 1,000 population) reported in 1980.
- 15 The age-sex standardized rate is 4.1 per 100 patients compared with the OECD average of 7.2, ranking 7th best out of 36 countries.
- 16 The ESCS index measures students' socio-economic status. The index combines students' responses on their parents' occupations and educational attainment, and their reports on the cultural possessions and educational resources available in the students' home (OECD, 2021a).

## CONCLUSION

For more than two centuries, socialism has captured the hearts and minds of thinkers, activists, and politicians. Its promise to eliminate want from the human condition appeals to the instinct for survival and to our desire to improve our standard of living. Its promise to deliver social and economic equality, meanwhile, appeals to our innate sense of fairness and to our instinct to care for society's most vulnerable (Haidt, 2012; Bloom, 2015).

For four decades in the latter half of the 20<sup>th</sup> century, socialism captured more than hearts and minds. Here, we have told the story of the socialist capture of Poland and the Polish economy. First, the socialists seized territory. Initially in collaboration with and later in opposition to the National Socialists of Germany, the Red Army of the Soviet Union invaded Poland. Then, the socialists captured the democratic process, staging fraudulent elections and establishing a one-party puppet dictatorship, supported by the secret police and their network of informants, and backed by the ever-present threat of another Soviet invasion. Once in control, the socialists seized property, nationalizing businesses, farms, land, and capital. In their campaign to force the Polish people to submit, 84,200 Poles were sent to forced labour camps between 1949 and 1954 (Paczkowski, 1999: 382). In the decades that followed, the lives and labours of tens of millions of Poles belonged to the Polish United Workers' Party.

It is sometimes said that socialism works in theory but not in practice. It is more accurate to say that it works neither in theory nor in practice. Even if they had the best of intentions, central planners would still have to contend with the control problem, the incentive problem, and the knowledge problem. The control problem arises because people have their own plans. Even a well-intentioned central planner must override the plans of his subjects to make the central plan cohere. Secret police, informants, forced labour camps, deportations, and political prisoners are the inevitable accoutrements of socialism.

The incentive problem arises because the interests of subordinates do not align with those of the state, and, in the long run, no one's individual interests align with the interests of society at large. When he first comes to power, a dictator may have an incentive to maximize the productivity of the society he oversees, even if he ruthlessly predares upon it. But over longer periods of time, as he grows less secure, his interests increasingly fail to align with those of the rest of society.

Subordinates, on the other hand, never have an encompassing interest in the productivity of society. Their own interests are served by capturing a larger piece of the economy—by overseeing a larger bureaucracy or commanding more resources—not by adding value that enlarges the economy as a whole. Their incentive is to engineer shortages so that they may capture bribes from rationed consumers. And their quest to capture these privileges can be extraordinarily wasteful.

In the short run, the incentive problem may seem surmountable. In the aftermath of a purge or an ideologically driven revolution, the incentives of bureaucrats are relatively in synch with those of the dictator. But over time, their incentives diverge, and these ministerial lobbies tend to get better at seeking their slice of the pie, obtaining more privileges at the expense of overall productivity.

The knowledge problem arises because central planners lack the local knowledge to coordinate the activities of millions of people in a way that permits each to fit his plans in with the plans of everyone else. Without relative prices emerging from the free choices of individuals, central planners are left to guess at the subjective preferences and opportunities of their subjects. And without the signals of prices, profits, and loss, managers are unable to determine which endeavours will create net value for society and which will be a waste. Even if someone with an entrepreneurial spirit sees an opportunity to create a product or service for her fellows, she has no way to profit by bringing it to fruition, so the idea will go unrealized.

Like the incentive problem, the knowledge problem may seem surmountable for a time. For example, in the aftermath of a conflagration like World War II, it is obvious—even without market-determined prices—that the nation needs to rebuild its capital stock. Once this task is complete, however, it becomes much more difficult to guess at what needs to be done.

But theory is not our only guide. For 45 years, the Polish people were the subjects of a grand national experiment. And as Mark Zakharov, a stage director and People's Deputy of the USSR put it in 1990, "A negative result experiment enriches science no less than a successful one. This view is shared by all serious scientists" (Clark and Wildavsky, 1991: 303).<sup>1</sup> The Polish experiment with socialism was unquestionably a negative result experiment.

While the central planners were able to engineer brief episodes of growth—for example in the years following WWII—these episodes were few and far between. Over the long run, the Polish economy stagnated. While real incomes grew at a sluggish pace, shortages of necessities—meat, electrical appliances, even toilet paper and sanitary napkins—were endemic. And while the regime channeled more and more resources toward heavy industry, basic products and services that Westerners take for granted were ignored.

Occasionally shortages turned into political unrest as workers went on strike and protesters took to the streets, as they did in 1956, 1970, 1976, and 1980-82. Each time, the

state responded with a mix of carrots and sticks, temporarily beefing up social services while cracking down on political dissent.

In the meantime, the promise of social and material equality was never realized. The nomenklatura—elite bureaucrats and party leaders—were immune from the privations of socialism. They shopped in their own shops stocked with goods that were unavailable to the masses. They vacationed in their own resorts, relaxed in their own spas, and hunted in their own hunting grounds. They had their own pension plans and their own health care. And if they played by the rules, they could have passports and leave (Paczkowski, 1999: 385-86).

In time, the system collapsed in on itself. Weighed down by foreign debt, hamstrung by corruption and privilege, stagnating under sluggish growth and spiraling inflation, and stalked by the ever-present threat of mass shortages, the economy fell apart in the early 1980s. Emboldened by a new Polish pope, workers in the Lenin Shipyard in Gdańsk organized an independent trade union which they called Solidarity. Within a year, one-third of Poland's working-age population were members. The regime held on to power for a few more years. But once the Soviet Union made it clear that it would not invade if Poland abandoned socialism, change was inevitable.

Under the leadership of Minister of Finance Leszek Balcerowicz, the nation embarked on a bold plan to transform itself back into a mixed economy. The Balcerowicz plan was backed by all major domestic parties as well as by international organizations like the IMF and the World Bank. Balcerowicz and his team privatized assets, liberalized trade, opened industries to competition, and strengthened private property rights. While much of the nation's foreign debt was forgiven, its macroeconomic policies were stabilized. In truth, the Balcerowicz plan was not as sweeping or as fast as its critics or its boosters claimed. Other countries have liberalized faster. But few nations have found themselves in such dire straits as Poland did in the late 1980s.

The reforms were not without pain. Poland, like all formerly socialist countries, entered a transformational recession. Unemployment spiked and remained elevated for nearly two decades. But Poland's recession was smaller and shorter than those of other transition economies. And once growth resumed, real per capita GDP grew at more than twice its pre-reform rate. Shortages that had plagued the economy for decades disappeared within weeks. Hyperinflation was tamed. Living standards—and even life expectancy—rose.

Today, Poles enjoy a relatively high level of economic freedom. They are taxed and regulated, but not significantly more so than most. The Polish social safety net is comparable to that of other OECD nations and manifestly better than the safety net of the socialist era. In sum, the Polish experience demonstrates the value of economic freedom and the immiserating consequences of its denial.

## Notes

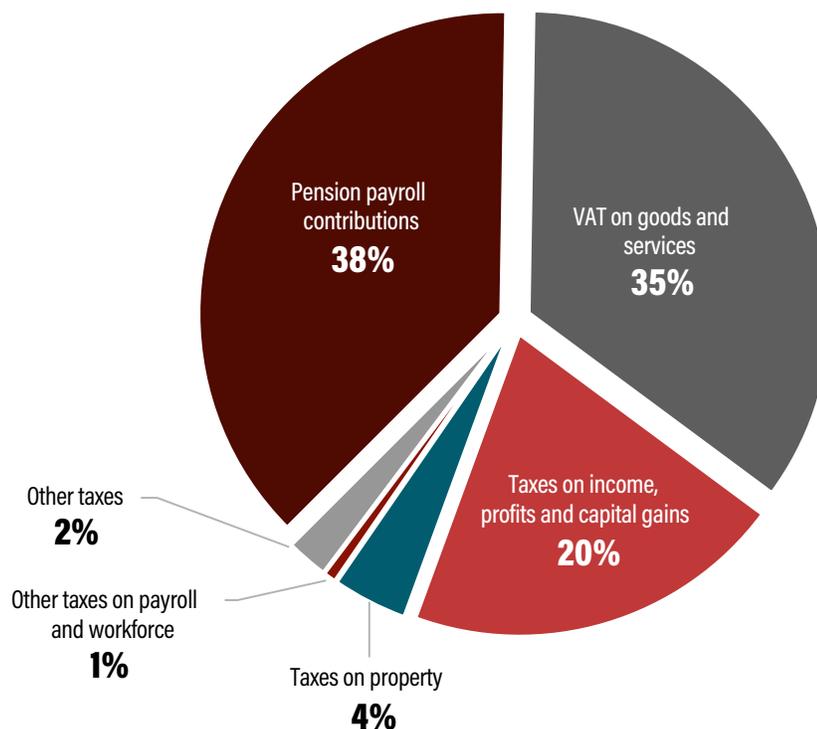
- 1 Zakharov went on to say: “Many of our inventions, including Agroprom (State Agro-Industrial Committee), Minfin (Ministry of Finance), sotssovnovaniye (Socialist emulation), and the like, were made in the interests of all mankind and as a warning to it. My hope is that grateful humanity will repay our efforts—preferably in hard currency, and also thank us from the bottom of its heart for all that we have done.”

## APPENDIX: CONTEMPORARY FISCAL POLICY

Figure A1 shows the composition of Polish tax revenue, averaged over the years 2014 through 2019, while Figure A2 shows the same figures for the average OECD nation (these proportions have remained relatively constant since the turn of the century). The figures show that Poland is not far outside the OECD norm in its reliance on pension-funding payroll taxes, VAT taxes, and income taxes. Compared with the average OECD nation, however, a larger share of Poland's tax revenue comes from its pension payroll taxes, while a smaller share comes from its income tax.

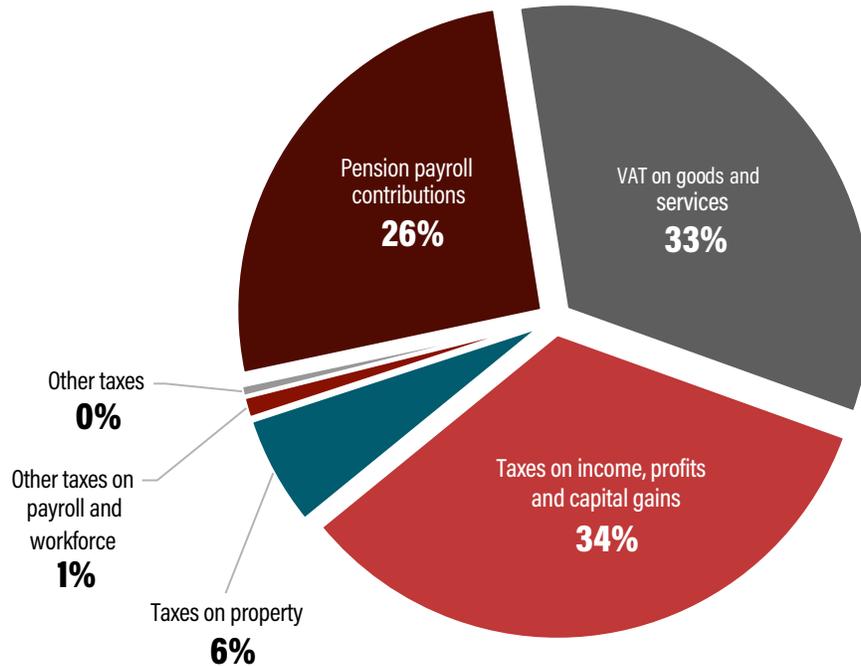
Poland's current value added tax rate, shown in figure A3, is 23 percent. This is higher than the OECD average (21.5 percent), but not by much. However, several types of goods and services, including pharmaceuticals, books, and basic food, are taxed at reduced VAT rates of 0.0, 5.0, and 8.0 percent.

Figure A1: Composition of Taxes in Poland, 2014-2019 Average



Source: OECD, 2020.

Figure A2: OECD National Composition of Taxes, 2014-2019 Average



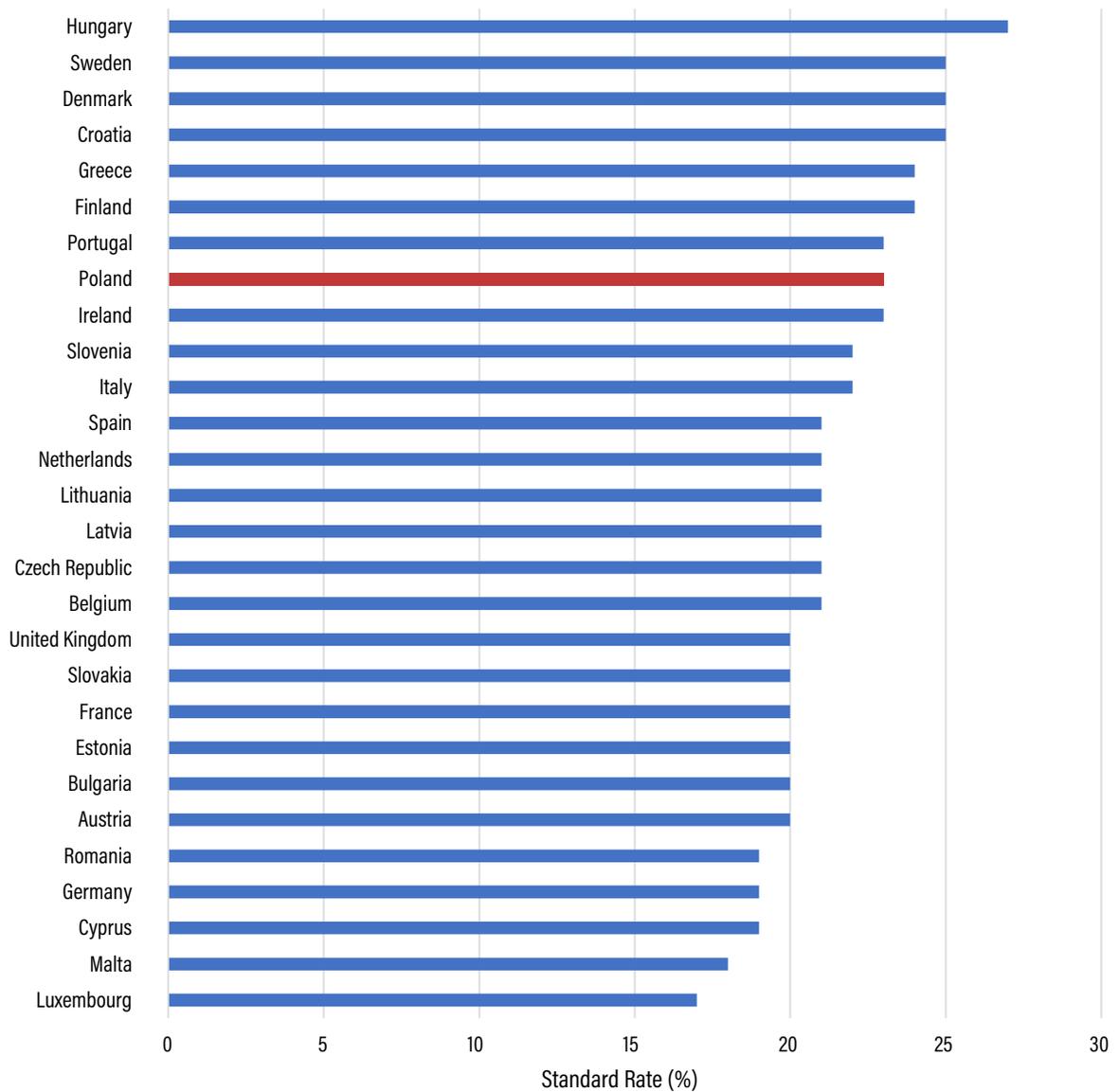
Source: OECD, 2020.

Figure A4 shows payroll tax rates throughout the OECD. The average combined rate is just under 30 percent while Poland's combined rate is 35.85 percent. About 60 percent of the tax is imposed on employers, but standard economic theory teaches that almost all of the tax is borne by employees in the form of lower wages.<sup>1</sup>

Figure A5 shows the composition of Poland's general government spending as a share of GDP from 1995 through 2019. The figures in parentheses in the key show the percentages for each category in 2019. Throughout this period, the largest category of spending by far has been social protection, which includes social benefits such as sickness and disability, old age and survivors' pensions, family and children benefits, unemployment benefits, and housing benefits (see OECD, 2021d: appendix C). In recent years, spending on this category has averaged about 17 percent of GDP.

The next largest categories of spending are education (about 5 percent of GDP in recent years), health (5 percent), economic affairs (4.8 percent), and general public services (4.2 percent).<sup>2</sup> The smallest spending categories include public order and safety (2.1 percent of GDP in recent years); defense (1.6 percent); recreation, culture, and religious spending (1.4 percent); housing and community amenities (0.5 percent); and environmental protection (0.5 percent).

Figure A3: Standard Value Added Tax Rate in the OECD, 2022

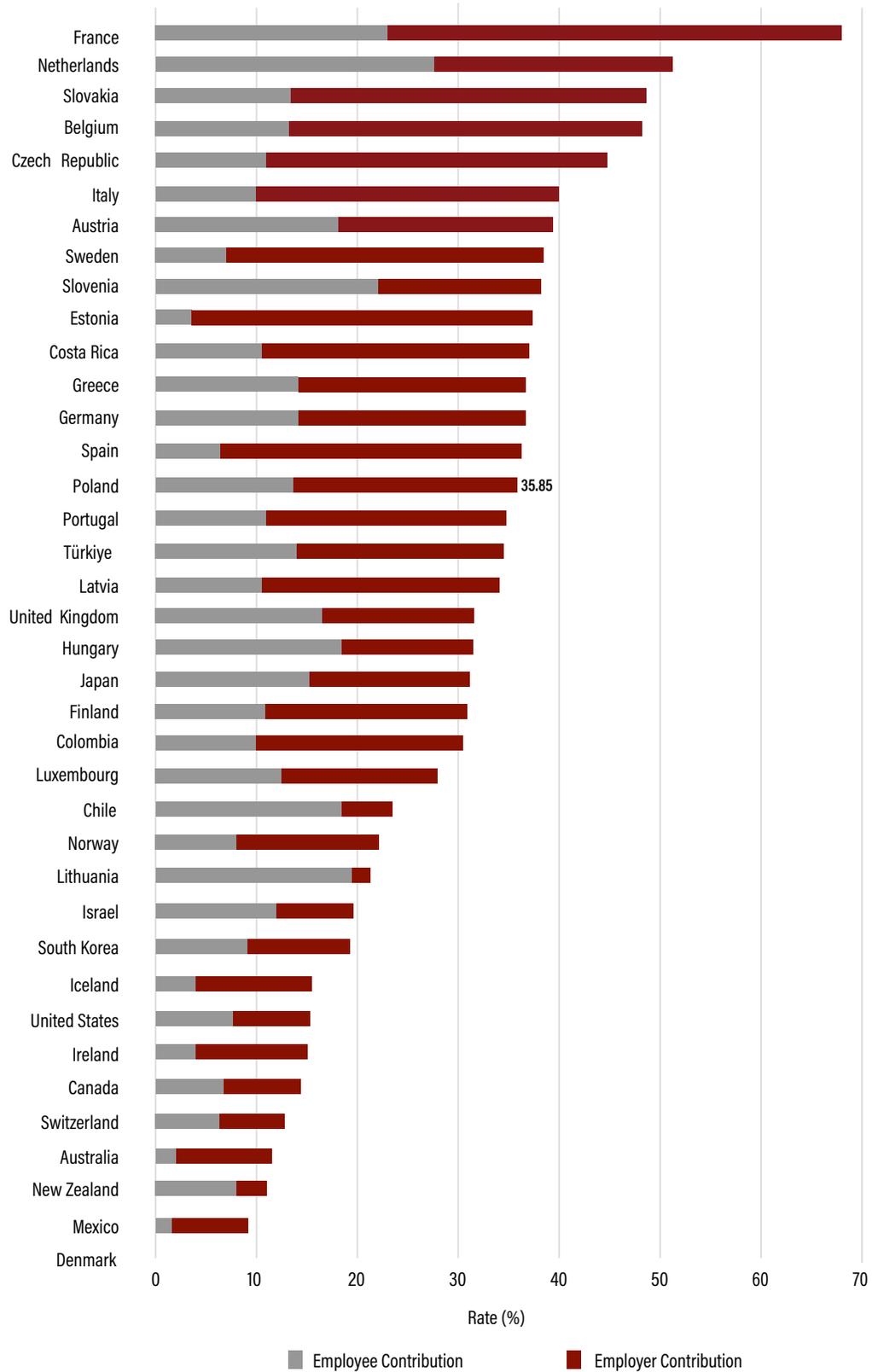


Source: Enache, 2022

By far the fastest growing component of spending has been for health care, more than doubling from 2 percent of GDP in 1995 to 4.9 percent of GDP in 2019. The other areas that have risen as a share of GDP are spending on recreation, culture, and religion (growing from 0.6 percent of GDP in 1995 to 1.4 percent in 2019); and economic affairs (growing from 3.4 percent of GDP in 1995 to 4.8 percent in 2019). Spending on public order and safety has remained constant for much of this period. Spending on environmental protection, social protection, education, general public services, defense, and housing and community services have all declined.

Given its size, the relative decline in spending on social protection is noteworthy. Spending on this category declined from 19 percent of GDP in 1995 to 16.7 percent of GDP in 2019.

Figure A4: Payroll Tax Rates in the OECD, 2022



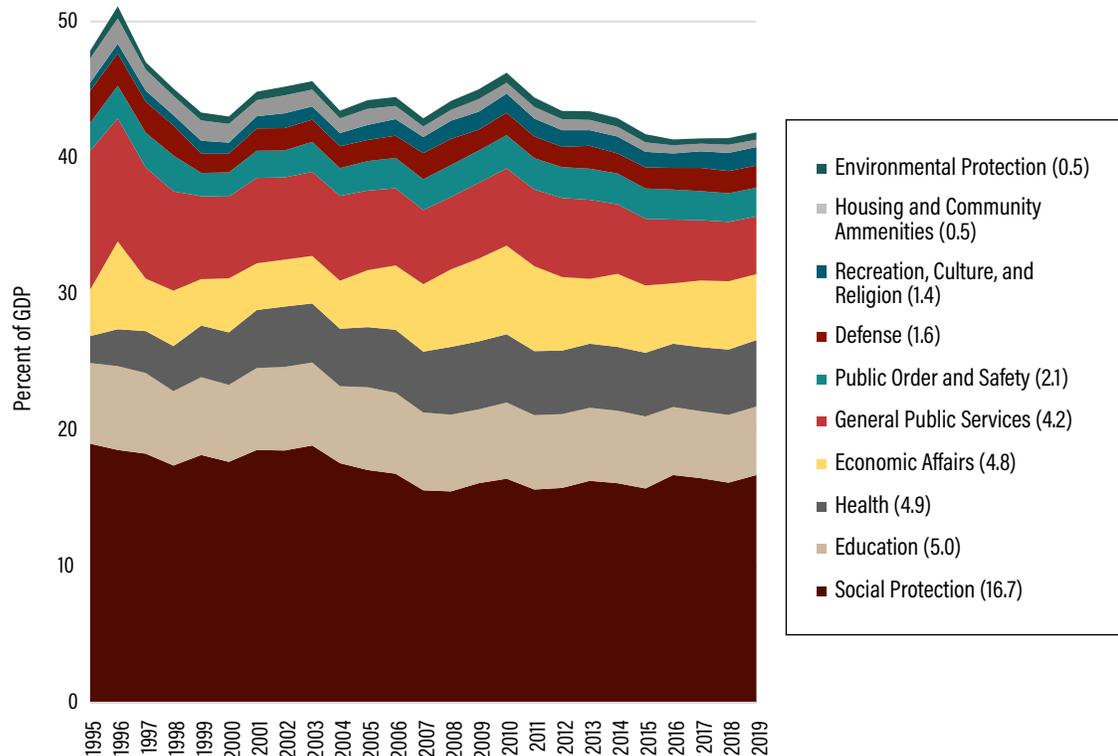
Source: Trading Economics, 2022a; 2022b.

As we discussed in chapter 7, this relative decline has occurred even as social benefits have become more generous. According to the OECD’s Social Expenditure Database (OECD 2019d), Poland’s real social expenditures per capita increased from \$1,557 in 1990 to \$6,719 in 2019 (OECD 2019d) as measured in 2015 US dollars. Thus, bolstered by strong post-transition real economic growth, Poland’s government has spent significantly more on social protection programs, even though spending on that category consumes a smaller share of real GDP.

Poland’s pension plan may pose a challenge to the country’s finances. In October 2017 the government backtracked on a 2012 reform that had raised the retirement age. According to the OECD, “The new child benefits has [sic] doubled public support for families to about 3.8% of GDP, well above most other OECD countries. The additional payment for pension and the reversal of the retirement age reform are set to push public pensions pending to close to 12.0% of GDP in 2020” (OECD, 2020). Given these developments, the long-term decline in social spending as a share of GDP seems unlikely to continue.

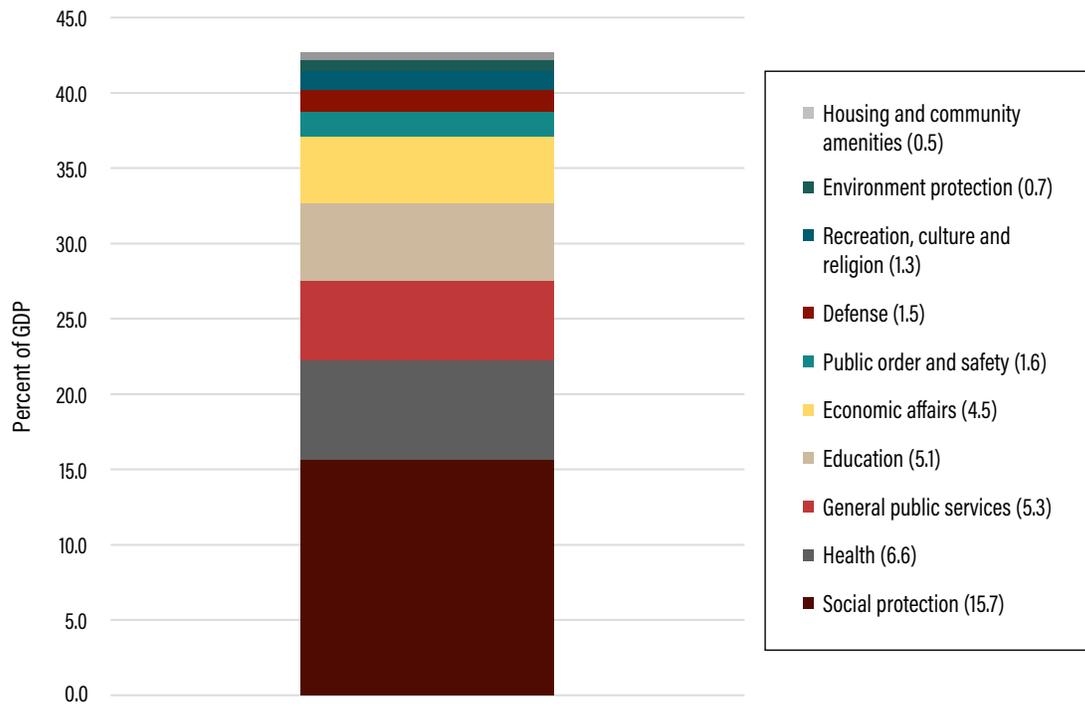
To put the data in figure A5 in context, figure A6 shows the composition of general government spending in the average OECD nation in 2019. Poland spends more than the average OECD nation on social protection (16.7 percent of GDP for Poland, compared to 15.7 percent for the average nation), economic affairs (4.8 percent compared to 4.5

Figure A5: Composition of General Government Spending in Poland as a Share of GDP, 1995-2019



Source: OECD, 2021f.

Figure A6: Composition of General Government Spending as a Share of GDP in Average OECD Nation, 2019



Source: OECD, 2021f.

percent), public order and safety (2.1 percent compared to 1.6 percent). It spends about the same amount as the average OECD nation on education, on defense, and on recreation, culture, and religion. And it spends less than the average OECD nation on health (4.9 percent in Poland compared to 6.6 in the average nation), general public services (4.2 percent compared 5.3 percent), and environmental protection (0.5 percent compared to 0.7 percent).

## Notes

- 1 The inelastic side of a market bears most of a tax and in labour markets the employee side is less elastic.
- 2 The economic affairs category includes spending on items such as commerce, agriculture, forestry, fishing, hunting, energy, mining, manufacturing, and transportation (see OECD, 2021d: appendix C).

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*Note: Unless otherwise stated, all links live as of May 2, 2023.*

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