

## REFLECTIONS ON THE BALCEROWICZ PLAN

„Commit all cruelties at once”<sup>1</sup> Nicolo Machiavelli.

If one were to reflect on the economic changes that were to be taking place in Poland starting 1989 and being carried out through the subsequent years, it would be necessary to look at what the plan of the open market economy was and how was it to be carried out. The free elections in Poland of 1989 saw a partial transition of power from the PZPR to NSZZ Solidarność and their allies in the Sejm. The word partial is used because, although the NSZZ won a decisive victory winning all of the 35% of the seats that they were allowed, they were not permitted to have a majority of seats in Sejm due to arrangements which had been made previously that year.<sup>2</sup> The plan of an open market economy was to be adapted and the main organiser of the Plan was to be Leszek Balcerowicz.

The entire concept of Polish transition was based on the models and works of Balcerowicz, who put down the ground work for the economic, and to a lesser degree political changes, that would occur in Poland. The objective of this work is to analyse the Balcerowicz plan and how effective it was in achieving its goals.

The plan was to be passed through the Polish Parliament, the Sejm, yet this was not an easy task. In a series of Acts, stretching from 1989 to 1992, the NSZZ Solidarność later called the OKP and its allies, and to lesser agree opponents, all worked together to pass this program as efficiently and as successfully as was possible. Through this time, a number of Parliamentary Acts were passed in order to cover all the objective of the plan. On October 6th the program was presented on public television and in December the Sejm passed a packet of 11 acts, all of which were signed by then President General W. Jaruzelski, on December 31, 1989. Premier Tadeusz Mazowiecki said, ” *Our plan will be neither perfect, nor easy, but from this will come in years will be better* ”.<sup>3</sup> These were:

1. *Act on Financial Economy Within State-owned Companies, which allowed for state-owned businesses to declare bankruptcy and ended the fiction by which companies were able to exist even if their effectiveness and accountability was close to none.*

<sup>1</sup> N. Machiavelli, *The Prince*, Pelican Books, 1977. pp 28.

<sup>2</sup> A. Garlicki, *Rycerze Okraglego Stol*, PWN, Warszawa, 1991. pp 64-78.

<sup>3</sup> T. Mazowiecki, TVP, October 31st, 1989. (News Broadcast)

2. *Act on Banking Law, which forbade financing the state budget deficit by the national central bank, NBP, and forbade the issue of new currency.*
3. *Act on Credits, which abolished the preferential laws on credits for state-owned companies and tied interest rate to inflation.*
4. *Act on Taxation of Excessive Wage Rise, introducing the so-called 'popiwiek tax' limiting the wage increase in state-owned companies in order to limit hyperinflation.*
5. *Act on New Rules of Taxation, introducing common taxation for all companies and abolishing special taxes that could previously have been applied to private companies through means of administrative decision.*
6. *Act on Economic Activity of Foreign Investors, allowing foreign companies and private people to invest in Poland and export their profits abroad.*
7. *Act on Foreign Currencies, introducing internal exchangeability of the Zloty and abolishing the state monopoly in international trade.*
8. *Act on Customs Law, creating a uniform customs rate for all companies.*
9. *Act on Employment, regulating the duties of unemployment agencies.*
10. *Act on Special Circumstances Under Which a Worker Could be Laid Off, protecting the workers of state firms from being fired in large numbers and guaranteeing unemployment grants and severance pay.<sup>4</sup>*

The acceptance of the open market economy plan by the Polish Sejm clearly indicates that Parliament was willing to allow this approach to occur. Public opinion for the plan was also very high as the Poles felt that the only thing keeping them back from economic prosperity was the socialist/communist system.

## **1. Price Liberalisation/ Liberalisation of Domestic trade**

The first major change of the Plan was the freeing of prices, production quotas, subsidies and the opening up of trade to competition. The question arises about the possible impact on the economy of the freeing of these prices.

State subsidies were given out by the Polish government in order to soften the impact of the price on the consumer. Note that Polish history had had many revolts in the past, and perhaps most important were the strikes at the Gdańsk shipyard in 1970. These strikes were over an increase in the price of food. Keeping the price of food low, particularly staples such as potatoes or bread were important.

In this example the production of more bread requires more resources, and these resources must be drawn from other uses. To get the extra bread, consumers must do with less of other goods. Production of this extra bread requires resources that have more value than the value of the extra bread. Marginal cost is the value that must be paid to resources in order to produce one more loaf of bread, and this value exceeds the value of the loaf with the subsidy. The extra cost will be the area under the old supply curve, or area **a+b+c+d**. Therefore, the subsidy causes businesses to take valuable resources and to transform them into less valuable output.

<sup>4</sup> Dz. U. 1989, nr 74-75, grudzień 1989.

This area is known in economics as welfare loss. There is a waste in this process, and the triangular area **A** measures this waste.<sup>5</sup>

Hence, this is also very similar to the establishment of the price floor. The difference being is that the government picks up the cost in the example of a price subsidy. However, it is important to remember that in Poland there were a myriad of price ceilings, price floors and price subsidies. However, because almost all prices were set or fixed, the only effective way of figuring out what the real price of a good was from the black market, but even that is a contraband good itself. However the most common were price ceilings, which were less expensive for the state to maintain than were price floors. As mentioned earlier, these phenomena were inherent in the socialist systems of soviet style economies, of which Poland was one.

The greatest impact that the removal of these subsidies on the country of Poland would be inflation (Gomułka, 1987; Balcerowicz, 1991; Kornai, 1980, 1992; Lavigne, 1993). The reason being would be due to the shortage of the good provided in the previous system. This is on the supply side where a shortage of production causes a material increase in price. The suppressed price under the socialist system would of course move then to the higher price equilibrium, which would not necessarily mean an increase in production in the short-term as firms could maximise prices. In a closed economy this could end up leading into spiral inflation, which was a problem in Poland and would need to be controlled.

Balcerowicz believed that the price liberalisation was necessary and creates further benefits which were to “*remove widespread shortages quickly, which is in turn not only for the consumers benefit, but also to enable enterprises to operate more efficiently and to be more attracted by socially useful innovations*”.<sup>6</sup> Did price liberalisation help curb inflation. Yes it did, but the process was slow and remained in the double digits during all of the early Balcerowicz years. One could state that the initial jump of price liberalisation was not that significant anyway. The hyperinflation which had existed in 1989 was of little comparative change to the inflation after the Balcerowicz Plan. Clearly by 1991, there had been a significant drop in inflation. However, there was more than just price liberalisation that had an impact in price changes in Poland during this time.

**Table 1. Inflation in Poland 1989-1993**

1989	1990	1991	1992	1993
377.1%	417.2%	64.9%	44.7%	33.5%

GUS, Government Statistics Poland, 1995. pp 57-103.

Inflation was also not as bad as had been anticipated. The belief that state monopolies would take advantage of their situation and go for profit maximization did not occur because state owned monopolies could not be likened to market type monopolies due to an inability to have a global view and access the consumer

<sup>5</sup> R. Schenk, “*Overview: Efficiency and Monopoly*” Saint Josephs Education, 1997-1998 pp 34.

<sup>6</sup> L. Balcerowicz, *Capitalism, Socialism, Transformation*. PWN, Warsaw & London, 1995 pp 256.

market. The other result of this was the elimination of the monetary overhang which was anticipated due to a wiping out of household savings.<sup>7</sup>

The greatest advantage of the price liberalisation was the eliminating of shortages in a very short period of time. The problem was now that, yes the stores were filled with goods, but did you have the money to buy them. Hence the poverty of the individual became noticeable. When the product was not present they did not care, but now the product was in front of them and they could not afford it.

## **2. Balancing the Government Budget/ Fiscal Responsibility**

Why was fiscal responsibility necessary? There were both economic and international reasons for bringing a balanced budget. Dealing with international reasons we can look back to the past and the amount of money that Poland had borrowed from abroad. Obviously this had to be taken care of and creditors would have to be pacified. The best way to do this was to bring in a balanced budget. Additionally this was one of the points stressed in the Washington Consensus (Williamson, 1985).

Another reason for bringing in a balanced budget was the fear of the ‘*soft-budget constraint*’ (Kornai, 1983; Gomulka, 1986). Here the belief was that allowing deficits to occur, or the providing of soft taxation. The idea of soft is not in reference to the rate of taxation. Even with a low tax rate the taxation system can be hard, if rules are uniform, fixed for a long period and the payment of taxes rigorously enforced. In contrast taxation is soft, even with a high tax rate, if the rules are negotiable, subject to bargaining, political pressures. The tax rates are not uniform, but almost tailor-made according to the financial situation of different sectors or different regions or different forms of ownership. The fulfillment of tax obligations is not strict; there are holes, ad hoc exemptions, delay, etc.<sup>8</sup> However, 1989 there were few taxes in existence and it was up to Balcerowicz to create them, taking into account the works of Gomulka and Kornai.

Therefore the goals of a balanced budget are: 1) interest rates fall, 2) trade deficit to shrink 3) economy to grow faster over the long term 4) increase living standards over the long term. However, there is also the possibility of demand side negative shock, in a Keynesian model that would actually stimulate a recession. If this were to occur you could have increased unemployment as the price to pay for lower inflation and fiscal responsibility. (Keynes, 1937; Fisher, 1937).

Balcerowicz was determined to bring in a budget surplus in 1990, or at least a balanced budget, in order to help the stabilization of the Polish Zloty (the national currency), as well as to help curb inflation. The automatic elimination of government subsidies to state companies and farms was to be ended, hence they would no longer be a drain on the finances of the state. Furthermore, in 1990 unemployment insurance and pensions did not account for a large part of the state budget, because in 1989 firms had not reformed themselves and they were still very much overstaffed. This was because of the previous communist system where everyone

<sup>7</sup> M. Lavigne, *Economics of Transition*, Macmillan Press, London, UK. 1995. pp29-47.

<sup>8</sup> J. Kornai, *The Soft Budget Constraint*, KYKLOS, Vol 39. Fasc 1-30. Hungary. 1986. pp 7-14.

was supposed to have a job. The result of which meant that over employment accounted by as much as 1,000,000 jobs.<sup>9</sup> Hence there were only basic expenditures that Finance Ministry had to worry about, transfers to unemployed individuals or pensioners was few, it was a saving, but would not be so in the future once the firms started letting go redundant workers. In what could be scene as an economic miracle on the fiscal policy side, Balcerowicz was able to bring in a small surplus in the beginning of 1990.

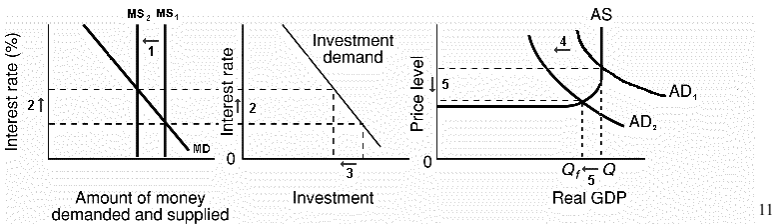
A major problem that Balcerowicz had in 1990 was that there was no tax system that corresponded with the needs of a market economy. In 1989 the government had not passed laws for taxation, this meant that there was basically no income tax, no sales tax and no corporation tax. The was only a turnover tax which was paid for by institutional organisations. Obviously as can be seen, without tax revenue, balancing a budget can indeed be a very difficult task. Taxes could be used as also a way of marking the profitability of a company by holding them accountable to the state for producing annual reports. Taxes eventually came into existence, but only starting from 1991. Had the government installed these taxes before shock therapy, say in 1989, then they would have had lots of revenue and would not have had to worry about balancing the budget. Furthermore, taxes could be used to stop run-away inflation and therefore help the NBP in controlling this. Because there were no effective taxes in 1990, the government would encounter serious problems in planning their budget. The government was relying only on profits from state run companies as a form of revenue, and with privatisation, these profits were becoming fewer and fewer<sup>10</sup>.

### 3. Restrictive Monetary Policy

The objective of restrictive monetary policy is to slow down growth, by having higher real interest rates and reserve rates set by the national bank, in this case the NBP. Knowing that there would be a contraction in the economy, Why would the Balcerowicz Pland want to do this? This can be explained for two reasons: 1) curbing inflation, which was spiral, 2) elimination of soft credit. 3) Possible decrease in investment. Though the plan was a restrictive monetary policy, the fact that the interest rate were soft during initial transition to a market economy, can be an indication that the policy was actually soft and not restrictive at all. The graph below shows the possibility of what would have happened if there had have been a restrictive monetary policy, where in actuality such a policy was not used until 1991. However, the major objective of such a plan is the elimination of soft credit and the reduction of possible inflationary pressure within the country.

<sup>9</sup> S. Basu, *Employment determination in Enterprises under Communism and in transition* " Evidnce from Central European Discussion Paper, No 1370. IZA Bonn Germany. October, 2004. pp 4-7.

<sup>10</sup> E. Garland, *Getting Rid of Red*. SWPW, Plock. 2014. pp 97-103.

**Graph 1. Restrictive Monetary Policy: Decreasing the MS to decrease IN:**

The planned reduction of inflation has already been stated. However, we must return again to Gomulka and Kornai in their work on soft budget constraint. Here the question is soft credit. „Again softness does not refer to the magnitude of the interest rate. The credit system can be hard even with a low interest rate (provided that the credit market generates a low rate), if the fulfillment of credit contracts is strictly enforced. The creditor lends money expecting discipline in debt service and not for the sake of assistance to an ailing firm which will not be able to service its debt. Enforcement of the credit contract continues to the bitter end; harsh sanctions in the case of insolvency, including receivership, bankruptcy, forced merger, sell-out or other similar legal means. In contrast, the credit system can be soft even with high interest rates, if the fulfillment of a credit contract is not enforced, unreliable debt service is tolerated and postponement and rescheduling are in order. Soft credit is used to assist firms in great and chronic financial trouble, without real hope of repayment of the debt.”<sup>12</sup>

The question is, why have the elimination of soft credit? This would help the government, as stated by Kornai, but it would also help banks. Remembering that Polish banks would lend money, predominantly to Polish state run firms, the elimination of these credits would force state run firms to become more fiscally responsible. This fiscal responsibility could mean improving the quality and amount which they would produce, also at market prices due to the liberalisation of the domestic market. However, the other result would be that firms would have to lay-off workers, thus causing unemployment, cut back expenditures, which could have an effect on total GNP as all firms would slash budgets throughout the country. The short-term effects of this would be negative, but the long term effects would allow the survivors to be market competitive in the global environment.

One of the ways to maintain a restrictive monetary policy would be by anchoring the Zloty against the US Dollar. Another was to maintain high relative interest rates in the domestic economy. Although the first policy was used, by setting the USD at 10000Zloty= 1USD was attempted to be maintained, the other policy, of encouraging savings by having high interest rates was not. Savings were allowed to be depleted as consumers purchased more goods, this was due to

<sup>11</sup> Restrictive Monetary Policy Graph: <http://www.harpercollege.edu/mhealy/eco212i/lectures/ch16-18.htm>

<sup>12</sup> J. Kornai, *The Soft Budget Constraint* ... j.w., pp 22.

inflation and stock piling, both of firms and of individuals. Also the fact that the banking system was basically unsustainable in Poland and would cause problems.

#### **4. Income policy aimed at inflation, done through a weak indexation of nominal wage**

The program here was to have wage increases which were weak, that is below the rate of inflation. Incomes policies vary from “voluntary” wage and price guidelines to mandatory controls like wage freezes. One variant is “tax-based incomes policies” (TIPs), where a government fee is imposed on those firms that raise wages more than the controls allow. This is seen as internalizing the external cost of raising wages, solving a market failure that encourages inflation. This could be implemented in two ways: 1) the government tries to control the amount of wage increases of government employees 2) establishing a tax on wages, such as a payroll tax, in order to reduce inflationary pressure. In the case of Poland both instruments were used. (Lavigne, 1994; Balcerowicz, 1995).

Should the policy of low inflation be the goal of the government through the usage of weak nominal wage increases, than this could in the future lead to higher wage pressure in the future and possible higher unemployment point of equilibrium<sup>13</sup> (Akerlof, Dickens and Perry, 1996, 2000; Holden, 1994; Wypłosz, 2001). However, the other opinion tells that existence of downward nominal wage rigidity (DNWR), may further result in possible macroeconomic benefits (Gordon, 1996).

The government tried to have a weak indexation of the nominal wage by not allowing wage increases to surpass inflation. This would accomplish the goal of possible age spiral inflation, but could also lead to a decline of the living standard below a basic minimum (Nutti, 1993). Note that in 1990, due to delayed privatisation, most people in Poland were collecting wages from the government of Poland; either as direct employees, such as in health, education, military or law enforcement for example, or through state run companys that were still in the hands of the government. Hence, the ability of the Balcerowicz to put in place a wage control on employees could be done effectively and effect a majority, over 60%, of the population (GUS,1994).

The other instrument that the state used in order to achieve this goal was through establishment of a payroll tax . This tool was also used to help curb inflation, but why? (Slutsky, 1934; Hicks, 1932) One of the major objectives was the liberalisation of the economy. A low nominal wage increase, as well as inflation above the wage hike would cause individuals to look elsewhere for improving their livelihood. Hence an increase in unemployment by redundancies and retirement would further push down wages of some individuals. Also the weak nominal wages would further cause some individuals to ‘ go private’ and resign from their state job. These people would then look for work in the private sector, or start their own business. This is exactly what the Balcerowicz Plan had intended them to do anyway.

<sup>13</sup> S. Holden; *Nominal Wage Rigidity in Europe*; University of Oslo Paper For Norges Bank, 2003, pp4.

However, the problem was of course the implementation of a fair payroll or wage tax on these individuals. A payroll tax had existed in Poland prior to reform, “*Before reform, fiscal revenues came mainly from three taxes collected through the state enterprise sector: the profits tax, the turnover tax, and the payroll tax, which was used to fund social services.*”<sup>14</sup> Hence the establishment of a payroll tax was nothing new for the Balcerowicz plan.

When individuals would enter the market as private firms they would of course register their activity with the state office. Once registered they would then pay a payroll tax in order to prevent runaway inflation. However, although registration was mandatory, it did not prevent individuals from starting business enterprise without paying the tax. Hence the objective of paying the tax was not fully realised. Yes there was punishment if you did not pay, but there did not exist at that time a way to successfully find those people who were conducting business, but not paying the tax (M. Grabowski, 1998).

## 5. Foreign Trade Liberalisation

Why was it necessary to open up foreign trade to the Polish economy? The IMF states that: “*Policies that make an economy open to trade and investment with the rest of the world are needed for sustained economic growth. The evidence on this is clear. No country in recent decades has achieved economic success, in terms of substantial increases in living standards for its people, without being open to the rest of the world. In contrast, trade opening (along with opening to foreign direct investment) has been an important element in the economic success*”<sup>15</sup>

How was this goal going to be achieved? It was going to be realised through the lifting of export and import licenses, and the permission to give all enterprises the right to engage in foreign trade. Additionally, tariffs that had had little relevance or meaning in the previous soviet style socialism of regulated trade were now to become active tools of trade policy. Tariff barriers were to be lowered, both direct and indirect, in order to enhance greater competition and business in trade.<sup>16</sup> Comprehensive trade liberalisation means the removal of quantitative restrictions, granting all firms the right to engage in foreign trade, eliminating the state monopoly on foreign trade, introducing currency convertibility and also eliminating foreign exchange restrictions.

What would be the consequences of such a measure? The major consequence would be the elimination of the shortage inflation (Kornai, 1980; Gomulka, 1988; Balcerowicz, 1993) due to the presence of foreign goods on the market. Introduction of western made goods could successfully compete on the local market in order to offset the effect of a shortage of supply. Where local suppliers did not have enough on the market, Poles could purchase necessary goods in most likely Berlin or other western countries.

<sup>14</sup> L. Balcerowicz, *Socialism, Capitalism Transformation...* j.w., pp 222,

<sup>15</sup> International Monetary Fund; *Global Trade liberalisation for developing Countries*, IMF, 01/08. Nov, 2001,

<sup>16</sup> M. Lavigne, *Economics of Transition ...* j.w., pp 114.



Other benefits of free or open trade deal also with the companies themselves. By exposing Polish state firms to foreign competition they can not price gouge or set up monopolistic or oligopolistic institutions. Additionally, where products would be of an inferior nature, that is not desired by the consumer, they would be eliminated. As well as the waste of resources of inputs to make the product. Equally, firms which had an ability to export to western countries but were unable to do so due to previous restrictions, were now able to sell their products abroad. This would allow Polish firms to export to foreign countries and, as a result, bring in foreign currency as a means of exchange. This foreign currency could then be used to purchase improved technology or as a cash instrument to help soften total net outlays, or trade deficit.

Micro distortions to relative prices and hence the pattern of consumption and production; tariffs affect household welfare directly by distorting prices and leading to less consumption of some goods and more of others than would otherwise be desired. Equally they would lead business to produce more of some goods and less of others than it would otherwise be profitable to do. There are also macroeconomic impacts on productivity. These are more uncertain and rely on the structure of the economy and such things as the responsiveness of the demand for exports in relation to changes in price. Furthermore, like any form of government policy or tax, the implementation of the policy results in what is known as deadweight administrative losses (Hicks, 1932). These are all partly dependent on the complexity of the system of trade at hand and the government policies. Additionally, dynamic productivity effects, firms in protected industries are less likely to innovate or seek new markets (Bergson, 1983 & 1987; Poznanski, 1984; Vogel, 1983). Currently, evidence across OECD countries from recent years suggests that firms in protected sectors have lower rates of innovation and productivity growth than firms in areas that face the full force of international competition (Krajewska, 1984).<sup>17</sup>

Other benefits to free trade are also increased transportation. That is, governments need to invest in infrastructure, such as road and rail, in order to increase their potential to trade abroad. An improvement of means of transportation mean that products would be delivered faster, thus reducing time cost. They would also be safer, because of better quality roads would mean a decline in accidents and damage not only to the products, but also to the people who deliver them.

Still another advantage of trade is safety and security. As countries work together professionally, mutual respect for the countries' customs and cultures increase. Fears and prejudices diminish, and countries are less likely to fight each other, both militarily and diplomatically (McGee, 2010). This could also mean a decline in defense spending which in turn would help reduce budget pressure from the national department of defence of respective countries.

One possible problem would be currency exchange rate mechanisms which could cause problems for international trade. In Poland, the state monopoly of currency exchange was freed, this was done to allow a current account convertibility

<sup>17</sup> Centre for International Economics, *Benefits of Trade and trade Liberalisation*; CIE, Canberra Australia, May 2009, pp 9-15.

of the domestic currency, the zloty. This meant that firms and individuals were able to purchase and trade freely foreign exchange currencies. Poland had a kind of internal convertibility with some limitations introduced before transition had begun (Lavigne, 1995). Free currency convertibility is important for a country in order to do trade, but in Poland the Zloty was anchored at a very high price 10000 zloty= 1USD, which was difficult to maintain.

Households and firms could also stock pile foreign currencies without spending it. Why would they do this. Fearing inflation and devaluation could mean that individuals and firms would purchase foreign currencies, not using the converted currency to buy goods but rather store it either in a bank or in cash at home. Therefore, they could then speculate on the value of the currency in the future and convert the currency at a later date. The demand for hoarding of foreign currencies could place additional strain on the zloty.

Perhaps the idea behind having the current account currency availability to the public was to allow the average Polish person be able to afford products from the west. Hence they would feel richer by being able to buy western goods. Pegging the zloty strongly would allow Poles to purchase goods abroad. This would also allow state firms to accumulate foreign capital as an anchor against the zloty as well as purchase resources and technology abroad, for possible future development. The down side of this would be the enormous stress on both the zloty and the economy that such a measure would create. Yes trade would benefit and become more viable, but there would be a cost.

The last reason for setting the zloty high against the USD would be the plan to help curb off domestic inflation, which was considered to be probably the major target of Balcerowicz. Joanna Herczynska states, "*The fixed rate of exchange until May 1991 and wage controls throughout 1990-93 helped to break inflationary inertia*"<sup>18</sup>

## 6. Privatisation

Why privatise in Poland? The open market economy plan required that privatisation was a necessity, and therefore had to determine how to carry out such a program. Models of privatisation had been established already in Britain (Pirie, 1983 & 1985) and could be used or adopted in Poland.

Some of the major objectives of privatisation, and benefits were: 1) to shift the economy from a centrally planned system to a completely developed market system, therefore encouraging the development of a competitive and vibrant private sector; 2) to facilitate the economic performance of enterprises through a greater efficient use of the factors of production; 3) to decrease the scope of the public sector (termed demonopolization) and reduce and eventually eliminate the burden on the public budget caused by the payment of state subsidies to unprofitable and failing state owned firms; 4) to provide capital from the sale of state-owned-enterprises or their shares (termed commercialization) for use in the transition process; 5) to

<sup>18</sup> J. Herczyńska, *Heritage and Economic Transformation; The Case of Poland*; University of Padua, 1998. pp 9.

guarantee a wide diffusion of ownership of privatized assets; and 6) to provide an effective system of corporate governance of newly privatized enterprises.<sup>19</sup> Or as Balcerowicz stated, “*Private firms, having a greater capacity to generate profits, also have a greater capacity to finance investment and create jobs*”.<sup>20</sup>

How to carry out privatisation, what are some general rules that the Balcerowicz team was to use (Hunter & Ryan, 2008; Puntillo & Ibsen 1994). They were outlined in the works of Roman Frydman and Andrzej Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away*, who came up with four necessities for a successful privatization program. 1) Privatization must be as fast as possible; 2) Privatization must be socially acceptable and command a broad base of support amongst the populace; 3) Privatization must provide effective “private” control over the management of the newly privatized enterprises; and 4) Privatization must allow and encourage access to significant foreign expertise and capital inflow.<sup>21</sup> Indirect privatization was when the government would sell assets of the state to private individuals or small groups of individuals. The plan was to transfer the assets to people who had the capital and know how to transfer these companies to free market entities. This was also known as asset privatisation, which was also the downsizing of the state enterprises carried out by their managers by liquidating assets or sub-contracting. Also through micro privatisation, the selling of small shops or leasing out of buildings to private firms. The indirect firms would of course increase competition against state run firms and also help reduce inflation as well as increasing product mix. (Balcerowicz, 1994; Garland, 2014). Indirect privatization (often referred to as commercialization), accomplished through a publicly announced offer, a public tender, negotiations commenced following a public invitation, and acceptance of the offer by the subject announcing the privatisation call.<sup>22</sup>

There is also direct privatisation which is the selling of a complete state run company to a foreign firm, an individual, a group of managers, issuing shares on the stock market, or a combination of all those parts mentioned. This is also known as transformation privatisation (Jasinski, 1992) and has attracted most attention not only due to the volume of assets the companies have, but also due to social and political concerns. Direct privatization (Hunter & Ryan, 2008) which is mainly used in cases of small and medium sized companies, can be accomplished through the sale of a state firm, merger of an enterprise into an existing company through an acquisition activity, and “*giving over an enterprise for use against payment*”, a traditional lease arrangement. All of these arrangements may include state run firms in which a majority of workers are state employees.<sup>23</sup>

<sup>19</sup> R. Hunter, L. Ryan; *The Legacy and Prospects of Polish Privatisation*; International Research Journal of Finance and Economics; Issue 21, 2008. pp 3.

<sup>20</sup> L. Balcerowicz, *Socialism, Capitalism Transformation...*j.w., pp 181.

<sup>21</sup> R. Frydman & A. Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away*. CEU Press London.1994, pp 14-15.

<sup>22</sup> R. Hunter, L. Ryan; *The Legacy and Prospects of Polish Privatisation...*j.w., pp 5

<sup>23</sup> Dz. U. 1996, nr 171, poz. 1397, sierpień 1996.

It is generally believed that mass privatisation came late to Poland, initialised in 1992 with the final adjustments being made by Minister of Finance Lewandowski in 1994. However, asset privatisation was almost instantaneous in 1990. So whether Polish privatisation was delayed is a question of debate. Large, or mass privatisation was, but indirect privatisation came first and had local inhabitants benefit the most from the dismantling of the state system (Garland, 2014).

The method of mass privatisation *could take many different approaches* (Hashi, 2008). One such method could be the voucher privatisation. It is a method where citizens are given or can inexpensively buy a book of vouchers that represent potential shares in a state run company. Voucher privatisation has been used extensively in Czech Republic (Ellermen, 2008; Kozeny, 1994). Another method is Manager/ Employee buy-out, but is limited to the amount of capital that the worker and managers can put up for investment. A third method is by sale to an existing company or sale to a foreign company, the latter being more controversial and there is a question of nationalism. However, either are effective for it provides the state with cash and further allows the purchaser to immediately do any investment or improvement which needs to be done. The last method is a floatation on the stock market of the share of the state owned company, which would provide equity and a new board of directors to allow for corporate governance. However, the Polish stock market did not exist in 1990 so this method would have to be delayed. Lastly there was of course a combination of all or some of the methods listed.

As early as April 1993 the Act to Establish National Investment funds was created (Ustawa Narodowy Funduszy Inwestycyjne) whose primary goals were to allow every adult citizen in Poland to acquire assets of the state privatisation program at a nominal amount. The funds were to be controlled by 15 separate institutions who were supposed to control the privatisation of the assets of the state. In the fund were 512 state companies whose governance was to be controlled jointly by the state and the Funds themselves. It was the goal of these institutions to prepare these companies for privatisation.

**Table 2. Division of Share Equity in Privatisation Plan**

<b>Initial Shareholding of NIF's</b>	<b>Percent of Shares Allotted</b>
Lead National Investment Funds	33%
Other National Investment Funds	27%
Employees	15%
State Treasury	25%
Total	100%

Source: Dziennik Ustawa 44, nr202, May 31st. 1994.

This was done in order to provide accurate corporate governance for the funds. The lead NIF would be the main institution who would be in charge of restructuring the firm. They were allotted a 33% stake, giving them controlling interest in the management of the firm. The other 27% would be allotted to the other 14 funds if they wanted to have ownership. The employee's would be the workers of

the company to be privatised and the state would hold 25% ownership in the firm, but the state would act more like a 'silent partner' rather than an active manager.

How could the NIF's make money? They were given 1% of profits allotted to the firms stake in the company (the share price) in addition an additional 0.5 % of a performance fee also based on profits and stock price. However, they did not actually own the firms, they just were the managers. Once this had been set-up, the second phase of the privatisation was to take place. The second phase consisted of two steps. First of all a distribution of certificates of ownership was created (CO) and the initiation of trading of firms on the Warsaw Stock exchange (WIG) would be established. The process actually began in November of 1995. This certificate allowed the bearer to purchase a portion of the NIF as a form of shares in the institution offering the privatisation. The actual exchange of these shares didn't begin until spring of 1997. Of the some 27.8 million Poles who could apply for these shares 95% of the adult population took part, thus indicating great interest in the program. From the economic side, the privatisation of the program was a success. These certificates covered 85% of the ownership of the funds and allowed the NIF's to keep 15% of the shares if they wanted them.

Note that it is important to remember that the sale of assets to private individuals is the true dismantling of socialism for it is the relinquishing of the state on the means of production. From this undoes all the retrictions that a societ style economy had prohibited during the years from 1945-1989. One could say that it was like an unbound prometheus that would be able to take advantage of a booming economy due to the lifting of restraint imposed by state control.

## 7. Banking, Financial and Tax Reform

Prior to 1990, one could say that the Polish banks had little experience in lending money. Why was this so? The soviet style economy used banks a an instrument for transferring capital to sectors that they beleived deemed it necessary. Very often loans were based on political ties, friendship, and importance in the PZPR rather than on actual credit worthiness. The old system did not require that banks be either profitable or responsible while handing out credit. "*At the start of the stabilisation programmes banks were typically inexperienced creditors. Rollovers of loans and capitalization of unpaid interest have lead to a dual financial system in which loans are heavily concentrated among a few, usually less profitable enterprises.*"<sup>24</sup>

One of the major problems of the banks is possible political interference from state authourites to the detriment of the nation due to a misuse of funds (Frye and Shleifer 1997; Hellman 1998; Ganev, 2001; Barnes, 2003; Gould, 2003). The lending out of soft credit (Kornai, 1988) could occur in order to target plans or alleviate economic problems, or still yet favour populism of politicians.

Therefore the target of the banking system was to seperate the banks from the state. This does not only apply to commercial banks and lending institutions, but

<sup>24</sup> L. Balcerowicz, *Socialism, Capitalism Transformation...*j.w., pp 223

also to the Central National Bank, in this case the NBP (Narodowy Bank Polski). On commercial banks, loan decisions made independently of government influence would allow these banks to seek out creditors that are most likely be able to pay back the credit. Knock on positive effect of this would be the establishment and development of personal loans, mortgage loans, small business loans and micro-credit. This was necessary to separate the two, as states George Blazyca and Janusz M. Dąbrowski, "*The bank in the centrally planned economy was an administrative agency and had almost no common features with any commercial bank. Money was an accounting tool only and the central planner decided on capital allocation and production levels.*"<sup>25</sup>

The independence of the Central Bank was also important. The government, being politicians, could no longer intervene to affect interest or reserve rate ratios. Additionally, it was forbidden for the state to print money in order to fill in short falls of the government budget (such an event would of course stimulate inflation). The money supply, that is Monetary Policy, would be determined by the NBP to fit the needs of the market. The establishment of a two tier system of banking could help the economy. This would therefore allow the Central Bank to influence monetary creation by the commercial banks setting interest rates (Lavigne, 1994).

There were a few problems that was facing commercial style banks in 1990 (Calvo & Frenkel, 1991). The first problem was the inherited bad loans of the previous communist style system. This drain on performing loans would of course eat into banks revenues, additionally bankruptcy of the state run firms could actually cause a liquidity crisis. The second problem was a lack of competition in the banking industry. The third was of course a run on bank assets due to hyperinflation and nominal wage increases and interest rates that were below the rate of inflation. According to Palubinskas, "*A pattern of bank failures due to bad loans, lack of banking skills, lack of regulation, deposit insurance, mismanagement, and corruption has hampered the transition process.*"<sup>26</sup>

Actually inflation would work beneficially to the banks. The hyper-inflation of 1990 could actually give an excellent way of banks to clear out their bad debts. Why was this so? Assuming a rate of inflation of around 450% in 1990 could mean that all loans made under the soviet style economy would then have less than a 20% exposure to total deposits of banks by 1991. The soft interest rate policy would also discourage individuals from depositing in banks, but this could be considered good because it would take time for the now independent banks to train their staff on loan procedures and therefore replace non-performing debt with performing loans. The drop in deposits, comparison to the Savings Rate, would further stimulate the economy. Hence, poorly performing commercial banks could benefit from such a situation. The findings of Calvo & Frenkel are as follows, "*The lack of information necessary to assess risk and creditworthiness complicates the conduct of*

<sup>25</sup> G. Blazyca, J. M. Dąbrowski, *Monitoring Economic Transition: The Polish Case* (Brookfield, VT: Ashgate Publishing Co.), 1995. pp123.

<sup>26</sup> G. Palubinskas; *Common Causes of Bank Failures in Post-Communist Countries*; The Institute of Public Policy George Mason University, 1999. pp 5.

credit polity. The analysis illustrates the benefits of an early development of such markets, and of finding appropriate ways to “clean” the balance sheets of enterprises and banks from bad loans.<sup>27</sup> Run-away inflation could be such a method in clearing the balance sheets. Negative interest rates were used in Poland during early transition (Calvo, 1991).

There were great problems in establishing an effective tax system in Poland (Cnossen, 1991; Iyckes & Slemrod, 1993; Tanzi, 1993). The task was to establish a broad based tax system which would include: Income tax, Corporation tax, Sales tax, Excise taxes and Customs taxes. The difficulty resulted in the legal preparedness of the country (McClure, 1995) as well as the ability to have a trained civil service to carry out the task (Cnossen 1991, Hussein & Stern 1995). Still another problem with taxes is of course tax evasion and collection.

## 8. Reforming the Social Safety net system

One can define the Social safety net system as social welfare services provided by a community of individuals at the state and local levels. These services are geared toward eliminating poverty in a specific area. These services may include job placement, housing re-assignment, subsidies for household finances and other cash equivalents for food. Social safety net works in conjunction with a number of other poverty reduction programs with the major goal of reducing/preventing poverty.<sup>28</sup>

The development of the social safety net in Poland was to be based on a payroll tax of 45% plus another 3% given to a Labour Fund<sup>29</sup>. The Labour fund was a non government entity consisting of workers and managers of a particular unit. The money raised could be dispersed by this body to the workers as they so determined. The other 45% of the tax was to go to ZUS and Kasa Chorych. ZUS would be responsible for accident insurance, retirement plan, disability outlays and unemployment insurance<sup>30</sup>. Kasa Chorych would be in charge of medical outlays through the NFZ (Narodowy Funduszy Zdrowie) the national health fund.<sup>31</sup> Still added to this there would be a third fund for farmers known as KRUS (Kasa Rolniczego Ubezpieczenia Społeczności). The amount for independent and state farmers would be considerably lower and set a fixed amount, yet they would still receive full benefit from the health plan and partial benefit very similar to the ZUS plan.<sup>32</sup>

It was predicted that mass unemployment would occur due to state firm restructuring as would also an increase in outlays for early retirement. In order to combat short term unemployment (Ubezpieczenia dla bezrobotnych) unemployment benefits were set up and headed by the populist *Solidarity* leader Jacek Kuron. The amount of money given to workers was at first moderately generous, but then was cut back during the early 90's as the Polish budget became strained (Graham,

<sup>27</sup> G. A. Calvo, J. A. Frenkel; *From Centrally-Planned to Market Economies: The Road from CPE to PCPE*; NBER Working Paper No. 3698 Issued in May 1991 pp 1 Overview.

<sup>28</sup> Sept 2012, <http://www.businessdictionary.com/definition/social-safety-net.html>

<sup>29</sup> M. Lavigne, *Economics of Transition* ... j.w., pp 184-190

<sup>30</sup> Sept 2012; [www.zus.pl/](http://www.zus.pl/)

<sup>31</sup> Sept. 2012; [www.nfz.gov.pl/](http://www.nfz.gov.pl/)

<sup>32</sup> Sept. 2012; [www.krus.gov.pl/](http://www.krus.gov.pl/)

1994). The intent was to help the poor and also those who had been displaced by redundancies, it also offered immediate relief of food in the form of state run soup kitchens similar to those of depression era USA.<sup>33</sup>

## 9. Initiation of Industrial Plan to Identify Winners and Losers

It is essential for a country to get rid of the deadweight that was or would be causing economic loss. Not only by determining what those sectors of the economy are, and firm that are involved, but also the gradual elimination of these industries that would not be able to compete in both Poland and also globally. Why was this required?

The major reason for the elimination of state run money losers was of course to prevent a strain on the government budget, who in 1990 were still the major stakeholders of the firms. If a firm were to be loosing money it would have to draw on assistance from the state in order to keep operations going. Another reason was of course trade, which prior to 1990 was linked to the old USSR and the Comecon organization.

Ecomecon, also known as Comecon, was the Eastern European equivalent of the EEC (European Economic Community) and was no longer a strong economic force, nor had they really been. The Ecomecon system was based on a state planned economy, with regulated prices, products and fixed amount of production, and imports and exports were also regulated (Wallace & Clark, 1998; Bidelux & Jeffries, 1998). Price disparities existed within the regulated communist trade of Eastern Europe and the USSR<sup>34</sup>. By 1989, Russia could not afford to buy the goods that Eastern Europe was producing and trade with Russia was economically distorted. The elimination of Comecon basically set free prices for many of the goods traded-but Russia could not afford most of the goods being produced. Russia could offer for the satellite countries of Eastern Europe, raw materials, such as oil, but in light manufactured goods for consumer use, Russia had little to trade. The Poles could no longer count on Russia, or other eastern block countries, on buying their goods.

Poland had to find a new market to sell it's goods, and that market would have to be the west. Poland was not used to trading with the west, products that they were producing were, generally speaking, of a lower quality than the goods offered by the western one. These countries in the east, with Poland included in the market, also needed capital, and that could only be raised by selling their products on eastern markets.

In industrial policy this meant that a company that had been trading with Russia and having suppliers and distributors located in that area, it was easier. But because trade moved west, the only ones who had money to buy their goods. Poles would have to set up a whole retail, wholesale, marketing and logistic system from the start. Compounding this problem was the lack of infrastructure in Poland to do this, roads were designed first for military purposes, not commercial. Firms were told usually who they could sell to, now the firms had to go and find their own

<sup>33</sup> J. Kuroń, *Moja Zupa*, Polska Oficyna Wydawnictwo. Warsaw. 1991. pp 32-38.

<sup>34</sup> S. Mydrans, *Comecon outline closer ties*; New York Times, Moscow, June 15th, 1984.



market and do everything by themselves. The opening up of the west has caused a substitute for industrial policy, with the result of less than competitive average of firms being supported (Hughes & Hare, 1992) and the elimination of this causing Polish firms exposure to western trade.

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**Summary**

This article looks at the Balcerowicz Plan, which was undertaken in Poland between the years 1989 to 1995. It is entitled so because Leszek Balcerowicz was the man who was responsible for overseeing Polish transition from a state planned economy to a free market one.

The Plan was based on the Washington Consensus theory, put forth by Williamson with assistance from Sachs and Lipton. It was a rudimentary model of how transition should be followed.

The article looks at different aspects of the plan, which are the following. First of all, price liberalisation and the freeing of domestic trade. Secondly, fiscal responsibility which means the balancing of the national budget. Then it covers restrictive monetary policy used to control inflation and improve Polish competitiveness. This is followed by income policy aimed at inflation, done through a weak indexation of nominal wage. The next section deals with foreign trade liberalisation and the impact of importation of western goods on the Polish market. Also the role of privatisation, done late in comparison to other transition economies.

Furthermore, changes in banking, financial and tax reform are also analysed. Lastly, the changes of the social safety net system which were adopted, rather poorly and unfairly, is compared to western models.

The work uses the view and theories of different authors both from Europe and abroad. Such economists as Boyko, S. Gomułka, Zukrowska and Balcerowicz himself from Poland. As well as foreigners such as Lipton, Sachs, Hunter, Lavigne, A. Smith Williamson and most importantly Kornai.

**Key words:** transformation, fiscal and monetary policy, inflation, privatisation, liberalisation