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Transformation Process After Five Years:
Behavioral Adaptation and Institutional Change
- The Polish Case

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I. Introduction

A short view into the ever increasing literature on transformation and transition obviously demonstrates that there is a general complain on the lacking transformation theory,[1] whereas the practical transformation processes have already yielded several clear lessons. After five years even without a general theory economists are able to define some general and country-specific features, where the latter seem to be more important than the former. The wide-spread complains could be taken as a circumstantial evidence that the economic profession is puzzled that things are improving without its support - neglecting the fact that this is a quiet normal situation in our Western democracies. Perhaps all the complains for more theorizing the problems are due to the hope that the demand for jobs and reports could be stabilized or even increased, thus improving the conditions for the whole profession. Out of a polit-economic view the motives to help the countries in transition or the own profession are often mixed and complex.

However, some simple and powerful theoretical knowledge does exist; here one has just to mention the discussions on methodological individualism and collectivism, on open and closed societies,[2] and last but not least Hayek's ideas on spontaneous order which delivers an appropriate explanation for the radical behavioral adaptations which have taken place in the states of Central and Eastern Europe (CEE), leading to a dramatical institutional change. Because the citizen of CEE put more trust into freedom and market system than into paternalism and central planning, perhaps mainly determined by the better performance of the market economies to satisfy material preferences, the peaceful or velvet revolutions took place. The overstated hopes on democracy and market economy have made the hardships of the big bang bearable at least in the first phase of the transition process. Disillusions and sobering in the next phases have changed behavioral patterns as well as the sequencing of institutional change and reforms, but up to now not endangered the overall development.

[1]See, e.g., PORTES (1995).

[2]For more details, see PETERSEN (1993).

In view of the enormous risks involved in the transformation process, the Polish example seems to be a very promising one. In contrast to nearly all other countries of the former Eastern Bloc in Poland already in the 70ties, but especially in the 80ties a powerful political opposition developed from the underground to the political surface, thus leading to a strong influence of democratically oriented trade unions. Therefore, Poland had already made several experiences with economic instabilities[1] which, e.g., in the Czech Republic and the German Democratic Republic (GDR) were unknown. These experiences might have been helpful for the stabilization process on the one hand, but also might have formed an obstacle for a rapid privatization on the other hand. With regard to limited space and time only a brief selection of some most important facts and trends are presented which is obviously a personal one due to the experiences made in some empirical research projects carried out during the last years.

II. Monetary Stabilization and Budgetary Reforms

The discussions in Poland and abroad on the stabilization process are highly controversial. On the one hand the slow down of the inflation rate from more than 600 % in late 1989 to less than 14 % in the first half of 1995 is regarded as an enormous achievement. The success seems to be even more impressive if one has personal experiences with the situation in fall 1989; all indicators then pointed in the direction of hyperinflation: In addition to large amounts of surplus money a tremendous mistrust in all governmental institutions existed. The situation within the shops was comparable to a total clearance sale: there were less commodities than salespersons. The impoverishment of large parts of the population reminded of the situation in Germany in early 1923. But - thanks God - Poland was not hit by hyperinflation. The question to be answered is: why did hyperinflation not arise or, better, how was it avoided?

The conventional textbook definition of inflation is the following: inflation is the permanent increase in the general price level (above a certain minimum level of 1.0 to 1.5 %).

[1] A good and detailed description of these development patterns are given in SOWADA (1993) and (1995).

Usually the consumer price index (CPI) is referred to when talking about inflation. Most economists agree that in the long run no major inflation can take place without money growth: "The answer to the question whether inflation is a monetary phenomenon in the long run is yes" (DORNBUSCH/FISCHER 1984, p. 440). But beside the monetary cause there are many others extensively discussed in all macroeconomic textbooks explaining short- and medium-run inflationary phenomena. Another repetition is not the purpose of our paper. With regard to the transformation process we will analyze price increases that are not inflation according to the above mentioned definition of inflation, yet, they are usually treated as such because of difficulties in separating these increases from true inflationary increases. Even monetarist authors like JOHNSON (1969, p. 115) pointed out that within a market system a lot of price increases take place which do not have inflationary character.

In functioning market economies these index problems lead to an upward bias in the official inflation rate of the above assumed 1 % -1.5 %. This means that only increases in the general price level above this minimum level can actually be interpreted as inflation. For the former socialistic countries in their very first transformation phase the correct interpretation of the official inflation rate is essential to enforce the appropriate monetary policy. Prices, wages and interest rates did not result from free market transactions but used to be fixed by central planning offices. It is well-known that such price formation has effects comparable to price and wage stops in market economies. In case of a price stop, commodity prices (at least on official markets) cannot increase, and sooner or later the former open inflation will become suppressed inflation (CASSEL 1992, p. 268).

In an economy of short supply (Mangelwirtschaft) of the former real existing socialism the price stop lasted for several decades, in the former GDR up to fall 1989. Therefore, it is obvious that a tremendous potential of suppressed inflation existed. And connected with a dangerous monetary surplus it would result in exploding open inflation if prices and wages were determined by market forces. Furthermore, due to the social policy of the former socialistic countries the relative prices deteriorated. Basic commodities (as foodstuff, rents, energy etc.) were highly subsidized whereas superior commodities ("luxuries") were highly burdened with specific turnover taxes. Compared to prices in Western market economies, e.g., bread was six times cheaper, but a TV-set ten times more expensive. Cheap prices for foodstuff led to public waste (bread was fed to the animal instead of crop) and shortcome, whereas the production of superior commodities was insufficient to meet the enormous demand, both having as consequence the formation of ever growing queues. All that tried the people's patience until the peaceful revolution swept away the socialistic nomenclature.

It is not surprising that the removal of the false price structures and the switch to scarcity-adjusted Western market prices - by abolishing the social subsidies - led to an explosion of the prices and had a tremendous shock effect on the society. The main part of the increase in the Polish price level of late 1989 and early 1990 was due to the adaptation to a realistic price system especially in the field of basic commodities. Therefore, the resulting increase in the price level should rather be called structural effect than inflation.

Taking all these shortcomings into account our analysis still supports the view, that the rise in the price index of 1989/1990 was mainly caused by the shock therapy, which lifted the price controls, and not by monetary reasons; even since 1991 a large part of the price increases occurred because of the now gradual relaxation of administered prices and today this is still true.[1] The gradualism was to avoid yet another shock while further adapting to world market prices especially in the area of housing, energy and transportation. If one eliminated all these price increases from the commodity prices used for price index estimation, the resulting inflation rate would be much lower. In short: the Polish inflation is more an index problem than a real phenomenon, or - to put it the other way around - the real phenomenon is the price shock, which cannot be called inflation!

But the more serious problem is originating from the fact that index illusions did influence economic policy. Experts of the IMF - obviously in accordance with most economists - recommended the Polish central bank to pursue a restrictive policy, much more restrictive than the bank was able to manage. That can be demonstrated with regard to the 1990 development of the money stock and inflation. The proposal of the IMF was to increase the zloty money stock by 41.2 billion zloty (this amount was agreed upon in the Letter of Intent, see INSTYTUT FINANSOW 1991, p. 30), but the actual increase was 103.9 billion. The actual increase was necessary because of three reasons: (a) the above mentioned price shock, (b) the rapidly growing monetary transaction volume, and (c) the reconstruction of the real cash for

[1]For more empirical details see PETERSEN/SOWADA (1995, pp. 386-397).

transaction purposes by the Polish private households after the price shocks during the first quarter of 1990.

Under socialistic conditions the monetary transaction volume was comparatively small because of the existence of large combinats. A large part of trade was carried out through internal deliveries according to internal clearance prices. And as monetary theory states the fewer stages of production exist within an economy the less money is needed. But the decartelization of the combinats and ongoing privatization led to a strong increase of interfirm transactions creating a further necessity for additional monetarization, which obviously had been ignored by the IMF experts when fixing the monetary expansion path for 1990.

Our figures even support the monetarist view once the price shock and administered price increases lost importance; in 1992 the inflationary potential is more or less higher than the increase in the price index. Here one has to mention that again some administered price increases were still included in the price index, so that the actual inflation rate was even lower. Whereas in many quarters from 1989 to 1991 the monetary expansion was too low, in 1992 it was too high, which might cause an increase in the inflation rate in 1993. It is quite clear that Poland has to follow a very careful monetary policy. The Polish experts were tumbled and tossed between necessities and IMF recommendations, thus often changing from restrictive monetary policy to expanded Keynesian measures, following the well-known stop-and-go policy. Naturally, for the future a much steadier expansion of the money stock is necessary in order to enable private firms and households to develop stable expectations and to redevelop what they have lost because of the shock therapy: trust in public institutions, especially in the State and in the Central Bank.

Another cause, why shock therapy was successful and hyperinflation (like in 1923 Germany) avoided, is to be seen in the fact that in Poland a stable parallel currency did exist. Since the late 70ties because of the freedom to travel to foreign countries many Polish people at least temporarily worked outside Poland, especially in the shadow economies of the Western European countries. Therefore, a large inflow of foreign currency took place. If anecdotal evidence is taken into consideration, it is likely that a large part of all private savings were hold in $ or DM. Step by step the US-$ became the character of a parallel currency in Poland.[1] Together with the zloty the US-$ was used for transaction purposes, but especially as store of value and as a means for speculation (for making profits with revaluations). Because of the multiple functions of the US-$ within the Polish economy it seems to be very senseful to define the Polish money stock (at least) including bank deposits in US-$ (for details see SOWADA 1993). By defining the money stock in such a comprehensive way the currency substitution between the US-$ and the zloty is taken into consideration. In 1989 the US-$-money-stock in deposits rose to about 7 000 million US-$, and it is important to mention that realistic estimations exist that another 2 000 million US-$ were held in cash within the Polish private households.

Compared to 1988 in 1989 the total money stock increased much more than the zloty money stock because of numerous revaluations of the US-$ exchange rate. It is very important to mention that the income velocity in this period rose from 2.93 to 4.18, mainly caused by the zloty-velocity increase (7.17). Here it becomes obvious that the zloty was used for transactions, whereas the US-$ was used as store of value. In 1990 the growth rate of the zloty money stock was much higher than that of the total money stock, whereas both velocities remained nearly unchanged. The reason of the reversal of the 1989 development was that in 1990 people had to liquidate US-$-savings to buy commodities for their personal survival during the structural recession. In 1990 the currency deposits of the private households increased by 9.2 billion zloty (966 million US-$) or 20 %. But the structure of households saving changed; whereas in January 1990 more than 80 % of the savings were held in foreign currency, this part decreased to 60 % in December 1990 (see NATIONAL BANK OF POLAND 1991, p. 13). From a theoretical point of view it is very interesting that this development is a verification of a certain wealth effect which is often discussed in macroeconomic textbooks (see PETERSEN 1988, p. 203). The macroeconomic consumption function

$$C = C\,(Y/P,\; R/P,\; M/P,\; \$ * e/P)$$

[1]Like the famous cigarette currency in Germany before the 1948 currency reform. For details see PETERSEN/SOWADA (1995, p 387).

is dependent on real income Y/P, real assets R/P, real money stock M/P, and real US-$ holdings $ * e/P .[1] An increase in the exchange rate e is a positive wealth effect for Polish people owning US-$; the revaluations of the US-$ in 1989 increased their purchasing power and supported the Polish demand of 1990 - an excellent example of a wealth effect induced by exchange rate changes.[2]

In 1991 the situation became more normal; the price shock of late 1989 was overcome represented by the sudden drop in the price indices. Many experts, who were of the opinion that only a currency reform could cure inflation, now learned that the same is possible by inducing a price shock, with the only difference that prices will have some more zeros. In addition the existence of a parallel currency as well as the currency substitution between the US-$ and the zloty had a stabilizing effect on the Polish economy.

Summing up all effects, there is strong evidence that the extremely tight monetary policy and temporarily too high real interest rates put another strong burden (beside the structural deteriorations) on the Polish economy. This view is even supported if the budgetary policy is taken into consideration.[3] In the presence of the chaotic economic situation in 1989, due to the rules of the IMF, it is a bit surprising that already in 1990 a small surplus (0.4 % of the GNP) within the Polish budget existed. The greater part of this surplus can be led back to the profit of the NBP in 1989 and 1990. But even if this profit was subtracted, the budget would still be more or less balanced.

Because many public expenditures were postponed until the end of 1990, the gap between tax revenue and expenditures increased already in early 1991. In the political discussions in Poland this situation was taken much more serious than it was adequate in view of the actual problem. Again the reason in the background was the IMF idea of a sound monetary policy: Financing the budget gap by central bank credits was rejected in early 1991. Then it became

[1]The American price level is not considered here as its changes are negligible compared to those of the Polish price level.

[2]Later on in 1990 and 1991 when the exchange rate was fixed at 9 500 zloty (up to April 1991), an opposite wealth effect took place because of the fixed exchange rate but still ongoing price increases. In May 1991 a currency basket (45 % US-$, 35 % German mark, 10 % British pound sterling, 5 % French franc, and 5 % Swiss franc) was introduced, supplemented by a crawling peg in October 1991, which caused an increase in the exchange rate from 10 242 zloty to 11 075 zloty in December 1991.

[3]For general problems of budgetary policy see CALVO/FRENKEL (1991b, p. 290 -294).

obvious that without such credits the state financing would collapse; already in March 1991 the actual deficit was much higher than planned. In August the deficit was fixed at 24 billion zloty, and this number was corrected in December to 31.9 billion zloty, which was 3.9 % of GNP - compared to the deficits in the Western countries and with regard to the economic malaise nearly nothing!

The NBP was pressed to finance this deficit by the liquidation of a special fund and by short-term bonds on the virginal capital markets.[1] This was the attempt to follow the "principle hope" and had nothing to do with reality. Because of the mistrust in government, private people as well as firms were neither prepared nor willing to lend their money to the state, instead they lent it to commercial banks. As no financial sources could be found, the tight monetary view had to be changed due to the real pressures: 60.8 % of the deficit was financed by the central bank, thus leading to another necessary increase within the money stock. The just established capital markets were not strong enough to finance the budget gap. Again we have strong evidence that in transformation times the simple rules for countries with stable institutions do not hold true. But good to know that facts are often stronger than the misleading ideas of international organisations and experts.

In 1992 the deficit increased to 69.3 billion zloty, which was - in view of the tremendous structural problems and recessive tendencies - a justifiable amount. An increasing part could be financed by commercial bank credits and state bonds; together with the relative stabilization the trust in the institutions increased. All this might be contributed to the fact that in 1992 an average real growth of 1.0 % could be observed. As mentioned above, in 1992 first signs of a too expansive monetary policy were observed, especially if the administered price increases were subtracted from the price index estimation.

Since the successful introduction of a VAT- and income tax system (both topic of our next chapter), the tax revenue has been improved substantially. The real growth of industrial outout is not interupted and has reached 12.8 % in the first half of 1995. The unemployment rate reached the maximum of almost 17 % in July 1994 and came down to 14.7 % in May 1995. The budgetary deficit is increasing slightly, while the interest payments on the public debt

[1]For details on the capital markets problems see CALVO/FRENKEL (1991a).

rose sharply (by 69.4 % in 1994).[1] This development is still caused by high real interest rates, at least partially due to the insecurities which are still involved in the ongoing inflationary process. A stabilization and consolidation of the public budgets by simple budgetary cuts is almost impossible because of the fact that public expenditure including subsidies to the social security system have already been decreased to a minimum. And the wages in the public sector are the lowest in the whole economy. Pressures for wage increases are growing as well as the subsidies to the state-owned enterprises (SOE). Therefore, prospects are gloomy but not hopeless, especially if the interventionism of the current administration would be substituted by a markets improving economic policy.

III. Restructuring the Tax System

One of the key elements of the transition from a centrally planned to a market economy is the deep reform of state financing. Market economy requires a different tax and transfer system and new instruments and institutions that are not used in a centrally planned economy. With respect to taxation, transition calls for a reform of income tax and the implementation of a Value Added Tax (VAT). The need for changes in income taxation results from changes in the ownership structure of the economy. In a centrally planned economy, the bulk of tax revenue is carried by state-owned enterprises, individuals are (in general) not taxed explicitly. In Poland, the state-owned sector started to decrease while the private sector grew rapidly. This called for an overall taxation of society. Another fundamental change in the Polish taxation system is the introduction of a VAT, which should create the basis for a possible integration into the EU,[2] stimulate the growth of small businesses and contribute to a decrease of the shadow economy.

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[1]See SOWADA (1995a).

[2]The VAT implies the possibility of tax compensation concerning exported goods, which is an important feature for international trade.

In Poland, the Income Tax of Natural Persons was introduced January 1, 1992. It replaced five different taxes,[1] of which the most important were the 20 % Flat Rate Wage Tax paid by employers, and the so-called Equalization Tax levied on incomes exceeding a certain multiple of the average wage. However, the Income Tax of Natural Persons was still accompanied by the Tax on Supranormative Wage Increases, which was implemented in 1990 in order to fight inflation caused by excessive wage increases (the so-called wage anchor or Popiwek).[2] The introduced income tax system was quite simple. There were 3 tax zones with marginal tax rates of 20 %, 30 %, and 40 %, respectively. The annual tax allowance amounted to 840 000 Zl.[3] Exemptions were mainly limited to housing expenditure. Income from capital gains, interest and dividend payments, as well as income from agriculture were free of income tax. Therefore, the so-called income tax fulfilled a lot of the features which are typical for an expenditure tax system. Spouses were allowed to file joint tax returns.

The introduction of a Value Added Tax, or in general, changes in the tax rate, scope, and structure, have distinct impacts on the redistribution of income.[4] The old Polish tax system can be characterized by its very limited scope of taxation combined with high tax rates.[5] This resulted in progressive income taxation, but also in disproportions in the tax burden between the different types of households, with a high preference given to the households of pensioners. The new system is more comprehensive, as it encompasses far more goods and services and thus reduces all kinds of differences. Consequently, the new tax system is no longer progressive (with respect to income), as the progressive effect of taxing luxury goods cannot

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[1]See BIELAWNY et al. (1991), p. 4.

[2]For a detailed description of the income tax, see BOLKOWIAK (1995); and for a description of Popiwek, see SOWADA (1995). Popiwek was first introduced in 1986.

[3]January 1, 1994, a new tax tariff was implemented. Up to then the tax-schedule read as follows (x as taxable income):

$t = 0.2x - 864\,000$ Zl	for $x > 64\,000\,000$ Zl
$t = 0.3\,(x - 64\,800\,000 \text{ Zl}) + 12\,096\,000$ Zl	for $64\,000\,000 \text{ Zl} < x < 129\,600\,000$ Zl
$t = 0.4\,(x - 129\,600\,000 \text{ Zl}) + 31\,536\,000$ Zl	for $129\,600\,000 \text{ Zl} < x$.

Because of the tax allowance this tariff can be called indirect progressive. To deduce progressivity mathematically the first derivative of the average tax rate function has to be greater than zero, i.e. the average tax rate increases with increasing income, see PETERSEN (1993a), p. 229.

[4]Extensive empirical analyses on the revenue as well as redistributive effects of the VAT have been made by NAGEL/NENEMAN (1995), using the tax simulation model of the „Forschungs- und Arbeitsgruppe Umwelt-Steuern-Transfers“ (FAUST), Potsdam.

[5]Mostly luxurious goods were taxed, combined with subsidies on goods for the basic needs.

offset the regressive effect of taxing necessities. For the same reason, the differences between households of different social status or size are smaller now. The role of luxury taxation, although reduced, is still significant, both from the redistribution and the budget revenue point of view.

Concerning the budget as well as efficiency, the change is with no doubt positive. The new/higher taxes are levied on goods with low price and income elasticities, which results in relatively less tax-avoidance and therefore fewer losses in government revenue. The potential loss in revenue is also reduced by the more uniform scope of taxation and tax rates. In the long run, this should stimulate a better allocation of resources, as prices should more accurately reflect scarcity and demand. Also international allocation is improved as tax compensation at the border is facilitated.

Besides the improved efficiency of the new tax system, the social consequences of such a reform should not be neglected. While the old system transferred income from the rich to the poor, the new system is far more neutral. The fundamental question here is whether sales taxation should have some redistributional effects or not. One may argue that it is more efficient to redistribute on the income side than on the expenditure side. The former could take place in the form of progressive income taxation and/or social transfers. On the other hand, when the analysis is carried out in terms of lifetime income and consumption, the analyzed effects of value-added taxation are reduced. This means that the system of the VAT still implies some redistribution of income, even though to a much smaller extent than in the turnover tax system.

For an analysis of the total effect of taxation on the different socio-economic groups, the tax burdens resulting from both direct taxation and indirect taxation should be analyzed. Inequality resulting from income taxation can either be enforced or compensated for by VAT-taxation. Due to data limitations only rough conclusions can be drawn. If we combine the results of the both studies (VAT and income tax)[1] we have made within our joint research project we can state that with respect to all socio-economic characteristics the differences in the relative tax burden (in between the old and the new systems) resulting from VAT are much

[1]The simulations on the effects of the income tax were done by KRAMER/NENEMAN (1995).

smaller than the ones resulting from direct taxation.[1] This is why the redistribution of income by direct taxation is much stronger than that by indirect taxation. Whereas income taxation is progressive throughout all income classes, the effect of the value added tax is not as uniform: it puts the highest relative tax burden on the lowest income class and is regressive in the highest income classes. The shift from turnover tax to VAT clearly has an overall regressive effect. Although, after the implementation of the VAT, the group of pensioners carries an relative tax burden slightly below average, it is hit hardest by the reform of indirect taxation as its members consume mainly goods which used to be tax-free before. As pensioner households pay relatively more taxes than they receive income, compared to the average Polish household, and this relation has even become more pronounced by the implemented income tax reform, this is the social group that is hit hardest by the reform of the tax system. Comparing the relative tax burden resulting from the reform of the VAT and of income taxation for households of different size we can see that both relative burdens have the same bell-shaped distribution over the households. Hence the reforms do not counterwork, but reinforce the distribution of the tax burden among the households. The middle-sized households have to carry most of the tax burden.

The simulation of the Polish income tax system allowed to analyze some distributional effects of income taxation for different socio-economic groups. Summarizing the results of our simulation it can be said that the aim of an overall taxation of the society is not at all realized with respect to the social status in a society, because of the narrow definition of taxable income, especially by exempting agricultural income from being taxable. The majority of the tax burden is levied on the groups of employee and also pensioner households whereas farmer households hardly have to pay any income tax. On the other hand, the income tax system can be called progressive as the average tax rate increases with increasing income. Also the relative tax burden of households with many members is lower than for households of smaller sizes, which justifies to some extent to call the tax system socially adjusted as the bigger households are usually families with many children.

The freezing of the tax brackets in 1993 (before they were indexed to inflation) leads to an increased tax burden for all socio-economic groups. But the relative position of households of

[1]See Figures 14, 17, and 21 in NAGEL/NENEMAN (1995) in comparison to Figures 8, 9, 10, respectively, in KRAMER/NENEMAN (1995).

different size and different social status hardly changes at all. The analysis with respect to different income classes shows that the income tax system becomes more progressive solely as a result of cold progression but the income distribution is not changed essentially.

As the group of the self-employed becomes more important in transition processes the absence of this group in the database distorts any distributional analysis. In the newly implemented survey in 1993, however, this group is included. Additionally, as the inflation rate continuously decreases in Poland, the data of the new survey should become more reliable for empirical studies. The results of a simulation study grounded on a more comprehensive data base should give interesting results on the effect of tax-reform in the Polish transition.

In order to analyze the total effect of the tax reform with respect to the different socio-economic groups a study of the overall tax burden, combining the distributional effects of the reform in direct as well as indirect taxation is called for. This will allow to identify the overall winners and losers of the newly implemented tax systems.

The last remark enables us to draw some dynamic conclusions, as the tax reform takes place in a rapidly changing economic environment, where not only taxes but also income is subject to changes. The transition to a market economy inevitably means a less equal distribution of income. Combined with our model, these results would mean that, in the long run, the new form of indirect taxation is favorable for the better-off. The long-run position of pensioners will worsen as they will be taxed more heavily.

With these additional remarks on income, our model can show - to a certain extent - the winners and the losers of the transition to market economy. As expected, the higher-income employees will be the winners. This may of course be controversial in terms of social equity, but has to be accepted as an unavoidable and necessary feature of market economy because inequality of income is one of its incentive schemes.

IV. Privatization

A functioning market economy is characterized by private property of means of production and by effective competition. Demonopolization and privatization of production and trade structures were thus particularly important in the economic program of the Mazowiecki Government.

Demonopolization was to be achieved by four different methods. First, company federations, large whole sale and retail trade associations as well as federations of co-operatives were dissolved. Second, Polish monopolists were exposed to foreign competitors by the opening of the Polish economy, i.e., by drastically reducing duties and non-tariff trade barriers. Third, building up domestic competition was encouraged by special support to newly-founded middle-sized companies. Finally, monopoly exploitation was to be eliminated by the Anti-Monopoly Commission and Anti-Monopoly Court.

In 1989 most industrial enterprises and trade companies were owned by the state or by state co-operatives. The aim fixed in the Balcerowicz-Plan was to adapt the property structure in Poland to that of the EC-countries within 5 to 7 years through various measures. A classification of privatization strategies into four groups seems to be helpful. The first group of measures comprises the "small-scale privatization", aiming at a new constitution of ownership of small enterprises (esp. in the sectors of construction, trade and transport). This form of privatization was basically completed until the end of 1990. The second area of privatization concerns those changes in property structure of the economy that are due to the foundation of private enterprises. This is an especially positive development, since - as a general rule - it is accompanied by the creation of new jobs and an increase in the stock of capital. After phasing out nearly all bureaucratic barriers which had hampered the foundation of enterprises, lack of capital is now the biggest obstacle to a quick success of this privatization strategy.

Most difficulties are observed concerning the third strategy which comprises the "large-scale privatization". The notion of "large-scale privatization" is to represent the different techniques of property change in large companies. The most important technique, which could be called a "commercial technique", concerns the transformation of state-owned enterprises into private companies through direct sale or by transforming them into corporations, selling the shares to private persons. A very similar method is privatization through liquidation, which is realized by selling the company's assets or by leasing those assets to other companies. Transferring property to the work-force and management at a low price is also part of this method. A third possibility is mass privatization, which indirectly leads to the transformation of state-owned enterprises into corporations. The strategy is a mixture of the commercial method - one part of shares are to be sold - and free distribution of property. In the different projects, however, ideas strongly differ about the share of property to be distributed and the social groups that should participate in this distribution. Although mentioned in the Balcerowicz-Program, this strategy was put in concrete terms only in the privatization guidelines of late 1990 and early 1991 (Monitor Polski 1990, No 43, item 333 and Monitor Polski 1991, No 13, item 86).

The fourth method contains all measures of reprivatization, i.e., the return of or the compensation for property nationalized during socialism. This method was not mentioned in the Balcerowicz-Program and was tabooed until today.[1]

The most important barrier to Polish privatization processes is the lack of capital.[2] Recognizing this obstacle, Balcerowicz called for an instant amendment of the laws on state-owned enterprises and the self-administration of these enterprises.[3] It was clear that "large-scale privatization" could only be realized in the long run and that interim regulations had to be adopted. Such an interim solution was the "commercialization" of state-owned enterprises, which means their transformation into corporations, the state being the sole shareholder. These companies were then to act on the market just like private economic subjects, their managers being equipped with a large scope of action.

However, in comparison to other CEE countries (especially the Czech Republic) the success of the „large-scale privatization“ is often mentioned as insufficient (see, e.g., BELKA/KRAJEWSKI, 1995, p. 23). Because of the improvements in the stock exchange currently the first SOEs are privatized by selling shares. But the limited success can also be led

[1]Perhaps Poland had made the right decision because the German restitution of physical property to previous owners is sharply criticized by a growing number of economists: „And even if property ownership is deemed to be a higher value, surely the imperatives of wealth creation should have dictated compensation in cash rather than in kind“ (PORTES, 1995, p. 14).

[2]For a detailed analysis of privatization barriers, see RAPACKI/LINZ (1992, pp. 20 - 23).

[3]See "Das Wirtschaftsprogramm" (1991, p. 18).

back to political and psychological obstacles against an immediate privatization process. In the first phase a strong resistance against foreign capital was observed due to the fears of trade unions and workers that the working conditions could be deteriorated by the new foreign management or a large number of workers could be fired.[1] Additionally a serious lack of reliable managers became obvious which was solved in Germany by an enormous migration of highly educated human capital into the five new states.

Because Poland could not rely on a „big brother" neither with regard to manpower nor to capital and the social security system nearly collapsed (see the next chapter), the SOEs had to fill the gap. Whereas in Germany unemployment could not be avoided but mitigated by the social network of unemployment insurance and social aid, in principle in Poland an even higher unemployment has been prevented by subsidizing employment in the SOEs. Doubtlessly the price of this policy was high and to be paid in form of a slow down in privatization. But in return the social consensus has been less impaired as in the case of a stronger impoverishment of the population. Therefore, the reform of the social security system is an important requirement for the future success of privatization.

V. The Open Gap: Transfers

During the years 1989 to 1992, three different trends characterized social expenditure from the state budget:[2] (1) The systematic elimination of price subsidies to consumer goods (the „price shock" as mentioned above) which had been subsidized in Poland for several decades. These were subsidies to foodstuff, communication and transport, housing, fuel and energy, medicine, goods for children, and books. (2) A drop in expenditure on social services, i.e. education, health care, culture, recreation and sports, which all means a reduction of transfers in kind. Both these measures have reduced the real income positions of the lower income classes. This was at least partially compensated by the third trend: (3) An increase in subsidies

[1]The „clearance sale of Polish property to foreign firms" was a popular expression for those fears.

[2]For more details see GOLINOWSKA (1995).

to social insurance and social assistance funds, part of which is „hidden expenditure" related to increasing unemployment and growing scale of poverty. Simultaneously, new social questions have emerged, as mainly unemployment,[1] which claims an ever growing part of budgetary expenditure, leaving drastically reduced funds for other purposes.

Laws on employment and unemployment were among the first legal regulations in the social sector in the transition period. Poland established in 1989 labor funds, introducing unemployment benefits and setting up an administration for job promotion schemes. The laws were subject to frequent amendments resulting in a reduction of individual cash benefits with growing overall unemployment. At the same time, more and more money has been allocated on programs which actively combat unemployment.

The high rate of unemployment also affected the decisions concerning social insurance. Like in other CEE countries, Poland introduced the right to early retirement or pre-pension benefits. However, the budgetary consequences of such regulations were most negatively felt. Similarly costly has been the introduction of the indexation of the pension scheme (proportional inflation adjustment). As pensioners represent an influential electoral group, they were able to put forward their problems better than other social claimants. With regard to the increase of the gross pension payments the losses because of the price shock and the introduction of the VAT have been more than compensated, so that pensioners overwhelmingly do not belong to the losers of the transition period.

Principally social insurance has become one of the most difficult areas of the general reform. „Despite loud declarations of the necessity and urgency of social reforms, changes are slow and full of conflicting issues" (GOLINOWSKA/OCHOCKI, 1995, p. 272). As in the Western welfare states the basic direction of changes has been the introduction of the insurance principle, especially for pension schemes. This means that the entitlement to receiving a pension and the amount of it must depend on the length of the contribution period as well as

[1]Here one has to mention that more than onethird of the Polish labor force is still occupied in the agricultural sector, often on jobs with extremly low productivity. As in the SOEs a large extent of hidden unemployment might be involved.

on the size of the premium paid. The requirement is the introduction of a new pension formula for calculating the benefits. It would result in a different amount of the individual pension payments. The losers of such an operation would protest vehemently. In Poland, despite a good start in fall 1991, next steps were paralyzed by social protest and the reluctance of politicians to take risky actions.

Another important field of transition is health care, where also attempts have been made to replace the state provision system by a system partly based on the insurance principle. Another important change within the financing of health care is the restriction of full cost coverage by the health insurance fund to only basic health care services. In 1993 such a division and the respective draft act have been prepared. Implementing this act would, however, mean abandoning the principle of free medical services which is part of the Polish Constitution. Nevertheless, the practice of health care services in Poland includes many fees paid by patients, and not all of them are illegal. The financial problems have resulted in various charges on patients, first on food and laundry services by hospitals, then for transport and costly medical equipment. After the reduction of state subsidies to the pharmaceutical industry, charges for medication have also considerably risen.

The political obstacles involved in the reform process are enormous; therefore, critical voices are doubtfull about the path of reform which obviously leads in direction to the Western welfare states. Since at least two decades those states are also in serious troubles, especially because of the exploding costs connected with an ever increasing redistribution of income, overwhelmingly from one into the other pocket of the same individual. Skepticism on the efficiency of compulsory state provision and insurance schemes has risen because such schemes are often accompanied by a socialization of individual responsibilities, thus increasing the influence of public bureaucracies. A diminishing market sector was substituted by public activities, giving political interventionist the opportunities for further influence to support newly defined group interests with the aim of maximizing their votes. As a result, moral hazard, rent-seeking, and free-rider behavior became dominant, not to mention all the complains on tax morality, avoidance, and evasion as well as transfer fraud.[1]

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[1]For more details see PETERSEN (1995).

A promising alternative could be a strategy to secure the basic needs by a social aid system, while additional protection is supplied by a private insurance system which reflects the individual preferences much better than any compulsory system could do. Such an alternative could be much easier implemented because most of the current public provision has already come down to a minimum level. In addition, the existing income tax system which is comparatively easy could be used as an integrating anchor in between the tax and transfer system. The introduction of a negative income tax (NIT) as measure to supply basic needs for the real poor could be a superior measure to overcome the current problems in social security - ironically not only in the former socialistic countries but also in the Western democracies, in which the egalitarians of all political parties have cause the current malaise of the welfare states.

VI. Social Reform: Acceptance and Feasibility

Because of the collapse in social security especially the firms subsidies to the SOEs have been used to cure the consequences of the serious unemployment problem connected with the transition period. To a much larger extent than in the former GDR industrial policy is dominated by social aims. Whereas in Germany the sense of industrial policy is under serious criticism, in Poland because of the lack of a functioning social aid system (and because of its enormous costs) industrial policy is an inevitable instrument to overcome the current structural problems. For the development of a competitive industrial structure the firms sector has to be liberated from social targets - the main prerequisite for privatization and direct investment from abroad. Senseful subsidies schedules have to be developed, including the subsidization of low skilled work at best by a NIT system.

Obviously industrial and social policy have to be linked closely; social peace is another important prerequisite; consequently social acceptance of the planned reform measures is of utmost importance. The continuous progress of the transformation process requires the further existence of a social consent, as it was the case before, during and directly after the radical change in the countries of the Eastern Bloc. At that time, the social consent was based primarily on the citizens' rejection of the state's making up their minds for them. Secondarily, it was based on the vague hope for greater possibilities to satisfy material needs in case of a re-organization of the economic order by adding market system elements or building of a free market system.

The improvement of the possibilities to satisfy material needs is still to come true for great parts of the population. This itself as well as in connection with distributional problems arising as a result of strong increases in income of single groups in the population, endangers the social consent, that is to say the acceptance of the transformation. At the present moment, this loss of acceptance cannot be compensated by the aversion to the old centrally planned economic system, which used to be shared by the great majority of the population. As a return to the old system is regarded now as impossible or extremely improbable, it means, it is not feared and has, therefore, no integrating effect. From that arises the task for the economic and social policy, which is essential for the progress of the transformation process. The task is to counteract the problems of acceptance, which appear in the course of the transformation process, by building a social security system.

The process requires (1) information about the population's expectations towards the state (attitudes) in the course of the transformation process and (2) information about the possibilities regarding the arranging and organization of a tax and transfer system that compensates the hardships caused by the transformation process. Additionally, information concerning the allocative, accumulative and, especially, the distributive goals and consequences, which are connected with the different tax and transfer systems, and information about the trade-offs between these goals are necessary.

If the state attempts now, within the bounds of its economic policy, to take into account the predominant desire for improved possibilities to satisfy material needs, the people in the countries of the former Eastern Bloc will be confronted for the first time with the conflict between the efficiency and distribution goal, a conflict that has been known for a long time in market economy. The measures to increase productivity, which are indispensable for an increase in efficiency, will lead to unemployment, inflation and a very unequal distribution of the productivity returns. While some groups of the population by showing flexibility and willingness to take risks as well as by luck have already brought their present standards of living closer to the Western standard (which they are striving for), other groups will maintain their old level of prosperity; possibly there will even be absolute deteriorations. These strong differences concerning the shares in the productivity and transformation yields will lead to a decline in the identification of the (relative) losers with the desire for transformation, which was initially shared by all citizens; the social consent in favor of the transformation process will be lost. If there are no appropriate measures to compensate the hardships of the transformation process and if the economic subjects called in to finance these measures are not willing to do so, dangers for the progress of the transformation will be the consequence.

The distributional effects, for instance, which are connected with the establishment of markets, do face a strong social rejection. The exploitation of chances on the market, of arbitrage transactions (or "speculations"), and the takeover of risks will inevitably lead to a heavily increasing inequality in societies in which equality used to be regarded as the highest ideal. Additionally, this inequality is not made less severe by a tax and transfer system - as in the Western states -, but it is even increased by the old state institutions not being in the least able to ward off criminal practices. Furthermore, the wealth of the "nouveau riche" is demonstrated openly (in the form of palaces and limousines); the discrepancy between "poor" and "rich" is, therefore, much more obvious, the acceptance of inequality much lower than, for instance, in the Federal Republic of Germany. In view of the outdated orientation in values, which has not been given up from one day to another, it seems quite human that envy and hate start to play a decisive role in social life.[1]

The starting point for a reformulation of the role of the tax and social state lies in the state-philosophical and state-political field. In the course of this, we do not follow a liberal-anarchistic approach - as it is especially supported by Nozick -, but we assume that in the course of history state institutions have always played a decisive role, though the basic values have always been subject to permanent social change. Starting point is, therefore, the Model of Open Society (by Popper); on ground of this model one can define the aims and instruments of the state and emphasize the value judgements connected with them.[2]

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[1]See McKINNON (1991, pp. 107 - 122).

[2] For details see PETERSEN (1993).

This starting point is time- and place-related; that means, its validity for the Polish state is to be examined and modified. In this respect the project is, on the one hand, concerned with picking out the difficulties and problems of changing values in the transformation process as a central theme; the attempt is to be made to introduce the moral-ethical way of looking at issues in the discussion in Poland, especially in academic and scientific circles, but - if possible - in the broad public, as well. The change in values occurring in the transformation process is regarded as an evolutionary process.[1]

Based on these investigations, the main emphasis lies on the analysis of the functioning of the state instruments; without confidence in "the" state and without acceptance of the state monopoly of power, the transfer as well as the main revenue instruments will fail. If tax avoidance, tax evasion and the obtainment of transfers by devious means become a predominant behavior, a social security system cannot be built. The immense differences in income will be maintained; obvious and pressing poverty will become an everyday phenomenon, which restricts even more the consent ability of the society and endangers the continuance of the transformation process. State-philosophical, ethical and moral arguments are, therefore, directly connected with very practical and realistic questions of how to organize the tax and transfer system and determine the acceptance and political feasibility of social policy measures.[2]

VII. Some Public Choice Remarks

The feasibility of social reforms and even reforms of the Western welfare states is mainly dependent on the behavior of politicians. It is quiet obvious that the old nomenclature of the Eastern Bloc - which today is overwhelmingly still in office - has a Weltanschauung which is determined by paternalism or even dictatorial preferences. The former behavior is also typical for a majority of Western politicians who are heavily engaged in social policy. The thinking of both groups is extremely conservative in that famous sense that „old (tax) systems are good

[1]See Conference Papers of the Conference of the European Association of Evolutionary Political Economy (1991) and ZON (1991).

[2]See MÜLLER/PETERSEN (1995).

ones". And such a thinking is quite rational, because old and well known systems can be exploited by the experienced politician for his own sake.

Assuming the politicians as the most important group then the today's success of a politician is dependent on the prevailing picture which the society has developed. The popularity mainly depends whether a politician maximizes his interventions into public or - even worse - private sector activities. Even if the politicians would be fully aware about the shortcomings of his personal resort - an assumption which is in view of the current personalities slightly too optimistic - no rational incentives do exist to abolish the failures of the system by a fundamental reform; in the contrary, such a behavior would be a serious mistake. On the one hand the politician has to intervene into the personal interests of the involved persons, thus impairing his popularity. On the other hand a fundamental reform would lead to the fact that the politicians has destroyed the base for his own job - the necessity of permanent interventions. From the politicians point of view it is rational not to cure the causes but the symptoms and this strategy is in accordance with the moral hazard theory.[1] Their pretended preference for market solutions is a pure lip-service.

Instead of a fundamental market oriented reform temporarily effective measures to decrease the costs of the social security system are much more promising which only work until all involved persons and groups have adapted their behavior to the new regulations. If these reforms are coordinated with the re-election cycle, the short-term effects are realized appropriately to increase the personal popularity. The next cost explosion several month later does not terrify an experienced politician, it is possible for him in hearings, interviews, TV talk shows, etc. to demonstrate his importance again which newly strengthens his popularity. If such political behavior cannot be led back to lack in information, ignorance, indolence or simply stupidity - all not very attractive attributes for a politician - it must follow a certain system. And that could be seen in the fact that the politician is able to exploit the systemic failures for his own interests. Every fundamental reform would block his possibility for the political self-representation. Therefore, efficient and frictionless tax and transfer systems are

[1]See PETERSEN (1995).

politically counter-productive because of the political self-interests.[1] To sum it up: we are surrounded by moral hazard.

The integrated tax and transfer strategy connected with the NIT approach is in accordance with a revival of the „Ordnungspolitik“ - namely by a reformulation of the institutional settings to obtain a reduction of the discretionary interventions via a strategy of de-politicization. An improvement of the institutional framework also includes strengthening the ethical behavior of the responsible persons. Institutional ethics have a higher degree of universal acceptance than individual ethics; therefore politicians and bureaucrats, acting in social institutions, should have a higher societal obligation than private persons. Corruption and scandals are pointing to the fact that many are overstressed by this claim. The consequence of this moral hazard cases can only be: immediate reprivatization.

Is it time for such de-politicization strategies? This is the general question of feasibility. Politicians are gradually facing the fact that during the last decades they took over too many duties formerly solved by self-responsible actions within families or on markets into the political responsibility. Because of spreading information and a growing discontent and annoyance of the citizen they are increasingly unable to solve the complex societal problems. The arrogance of knowledge (*Hayek*) what is good for the people or what is pretendedly unnecessary, the merit and demerit argumentation, is recognized by well educated citizen who mention the limited abilities of political planing procedures. The last euphoria should have been destroyed by the fundamental political change of the last years, but still the interventionists within the political class are dominating. But some politicians have become aware that they would like to get rid of the ghosts they have called. The international discussion on privatization and an improved efficiency of a reduced public sector is only one proof. The standard role of a successful politician should be changed from interventionism to causal therapy of the imperfect contemporary institutions and instruments. Permanent and overwhelmingly blind activism is no character or political proof of the quality of democratical leaders.

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[1]Here one has just to mention the discussions on the formula flexibility instead of discretionary interventionism in connection with the business cycle policy some decades ago which ended in favor of the latter.

In view of these shortcomings within our Western and highly developed welfare states Poland and the CEE countries do now have all opportunities to construct a much more efficient system of social security in which self-responsibility plays a dominant role. Low labor costs and low wage extra costs are an enormous comparative advantage which will lead to a reallocation of capital in Europe in favor of those states. The competitive pressures on the European welfare states will be steadily increased. Beyond that, one can have the hope that the Polish system (as well as the reformed systems in the other Eastern countries) could become a yardstick for the reform of the tax and transfer systems within the EU member countries. Only in a transitional period such challenges exist and only in such periods the chances for fundamental reforms are given. In a settled mixed economy with hundreds of effective interest groups such reforms are much more difficult or even impossible. To overcome these obstacles, competition from the East (in form of effective tax and transfer schemes) could be one possible argument to support the reformers in Western Europe and to overcome the welfare state sclerosis.

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