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Public Debt and Its Impact on the Polish Economy and Society[1]

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Abstract

Purpose: To analyse the issue of public debt in Poland and examine its effect on other areas of socio-economic life as well as government policy.

Approach: The question of public debt is placed in its historical context by looking at how it grew during the Communist system and influenced the transition period. The article draws on a range of secondary economic statistics and considers in detail a number of public policy issues, such as the reform of the pension system.

Findings: One result of the large debt incurred by the end of the 1970s was that Poland became indebted to creditors in the West. This dependency helped to shape its economic policy at the end of the 1980s. The transition to a market economy placed new burdens on the country's public services, primarily due to the resulting large deactivation of labour. Furthermore, the creation of a compulsory private pension system at the end of the 1990s diverted significant funds out of the government's budget and swelled the country's public debt. Since the outbreak of the economic crisis, Poland has avoided a recession by increasing public investment by utilising available European Union funds. However, due to internal and external limits on the size of its public debt, the government is being pressured to reduce this spending. In order to create more fiscal room, the government has partly dismantled the compulsory private pension system as a short-term solution to the growing debt crisis.

Value: In the wake of the global financial crisis and economic turmoil in the European Union, the matter of public debt has taken on increased importance. This paper considers this question from a long-term perspective in a country that has been relatively successful during the international economic downturn. By examining public debt from this broad perspective, we can better understand the economic situation in Poland and the European Union, whilst also shedding light on some of the surrounding academic perspectives and public policy debates.

Keywords: Public debt, economic crisis, transition, communism, European Union, pension reform, hidden debt

JEL: H6

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Economic Crisis and Public Debt

The global economic crisis that began in 2008 has been accompanied by a huge increase in public debt. Between 2007 and 2010, aggregate net public debt in the world increased from $23trillion to $34 trillion, with the IMF predicting that this will rise to $48,000 in 2015. This growth of public debt has been most pronounced in the world's advanced economies. For example, public debt per capita is predicted to grow from $19,400 in 2007 to $41,000 in 2015 in the USA, and the same is expected to reach $75,900 in Japan in 2015 (Financial Times, 2013).

The growth in public debt has been particularly pronounced in the European Union (EU), where it has become the major factor of the economic crisis in many countries. In the first quarter of 2013, public debt had reached 85.9% of GDP in the EU and 85.2% in the Eurozone. Public debt has also soared in many of the Southern European countries (and Ireland), which have been disproportionately affected by the economic crisis: Greece (165%), Italy (130%), Portugal (127%) and Ireland (125%). On the other hand, some EU countries (including some that were severely hit by the economic crisis) maintain very low levels of public debt as a proportion of their GDP (Estonia, 10%; Bulgaria, 18%; Luxemburg, 22%). As this paper will show, Poland currently has a ratio of public debt that is significantly below the EU average.

In light of these events, the relationship of public debt to economic growth has become a matter of intense discussion. Neo-classical economists have tended to argue that public debt is a cause of economic slowdowns and persistent recessions, as high levels of public spending and debt crowd out the private sector and reduce its profits. Reinhart, Reingart and Rogoff (2012) have argued that countries with large public debt experience persistent stagnation and that the line of causality runs from large public debt to economic slowdown (with the tipping point being when public debt crosses 90% of GDP). These ideas have been replicated by Kobayashi (2013), who states that large public debt discourages governments from tackling fiscal consolidation, which in turn represses economic growth. These theories of 'crowding out' and 'debt overhang' have been disputed by some economists, who have found no long-term causal connection between public debt and economic growth (Hendon et al., 2013). The huge rise in public debt following the global financial crisis was partly caused by the bailout of many banks and financial institutions that found themselves on the verge of collapse.[3] The ensuing economic slowdown and rise in unemployment further suppressed

[3] By 2009, it was estimated that the global cost of the bank bail-out had reached around $11 trillion – equal to $10,000 for each citizen living in the world's richest countries (BBC, 2009).

government income and increased expenditures, which swelled public debt and government deficits. Many governments introduced policies of austerity (i.e., raising taxes and cutting public and social spending) as a means to reduce levels of public debt. The experience of the past few years has shown that, rather than reducing government deficits and debt, austerity policies tend to have the opposite effect as economic growth is suppressed and the situation on the labour market worsens.

Sources of Poland's Public Debt

Poland's public debt can be traced to four main sources, which help to explain its size and composition. By looking at these sources, we can also understand the interconnection between public debt, the wider economy and the situation of different social groups. The four main sources of Poland's public debt are:

1. The debt crisis that occurred during the period of the Polish People's Republic (PRL) from the 1970s and the subsequent writing off of part of this debt. The indebtedness incurred during this time partly instigated a wave of economic reforms that started to be introduced from the end of the 1980s.
2. The socio-economic consequences of the shock-therapy reforms introduced at the beginning of the transition from Communism, particularly the huge deactivation of labour.
3. The introduction of a compulsory private pension pillar at the end of the 1990s, which helped to swell public debt and the partial dismantling of which became one of the government's main strategies for reducing public debt.
4. The effects of the recent global economic slowdown.

Public Debt During Communism

Beginning in the mid-1970s, the Polish government embarked upon a strategy of economic development, using credits from Western banks to fund investment projects and raise living standards. Boosted by the flow of petrodollars, Western banks were offering cheap loans to pro-Western countries in the third world and to relatively autonomous governments in Central and Eastern Europe (e.g. Poland and Romania). Although it was envisioned that these loans would help Poland to modernise its industrial sector and produce high-quality consumer goods, the credits tended to be spent on supporting old industries, increasing salaries and importing raw materials and products from the West. This spending brought about a partial increase in eco-

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nomic growth, but it also resulted in the balance of trade deficit shifting from a surplus of 451.2m zloty in 1971 to a deficit of 8.9m zloty in 1975, with foreign debt growing from $1.2bn to $7.6bn during the same period (Slay, 2000).

In the second half of the 1970s, Western banks began to pressure the Polish government to repay its loans. In 1976, the government announced a series of food price increases that were halted by a wave of strikes and demonstrations. In the late 1970s, Western bankers were urging the government to reduce subsidies on certain basic consumer products and pay off its debts through exports. This helped to spark the huge Solidarity strikes at the beginning of the 1980s, which eventually resulted in the Polish government implementing Martial Law from December 1981 until July 1983.

Between 1982 and 1989, Poland only paid around 20–30% of its required debt repayments. Poland's indebtedness had made it increasingly dependent upon western banks and financial institutions. In 1986, Poland joined the IMF and was required to introduce a series of structural reforms in order find resources to repay its debts. During the second half of the 1980s, the government introduced a package of wide-ranging market reforms, and Poland was the only country inside the Eastern Bloc to undergo an economic recession during the Communist period.

Transition From Communism

The transition from Communism, negotiated at the round-table talks in 1989, both resulted in a reduction of the debt incurred during Communism and paved the way for the creation of new public debt. Poland became only the second European country in the post-war period to have large parts of its public debt written off.[4] In 1991, it made an agreement with the Paris Club (which represented the main state creditors) to reduce its debt by half; three years later, it came to a similar arrangement with the London Club of commercial banks, agreeing that its foreign debt would be paid off by 2024.

The cancellation of large parts of the debt incurred during Communism was replaced by the growth of new public debt created as a result of policies introduced at the end of the Communist period. The introduction of the shock-therapy reforms in 1990 led to a huge deactivation of labour that has remained a hallmark of contemporary Polish

[4] Germany was granted a waiver on its external debt, including the deferral of interest payments, from 1947 to 1952 as the Marshall Plan was implemented. In 1953, the U.S. also imposed the London Debt Agreement on its wartime allies, which wrote off Germany's external debt (Sfakianakis, 2012).

socio-economic life. Table 1 shows how a large section of the labour force has been de-employed over the past couple of decades. Unemployment rose to nearly 15% of the workforce, peaking at almost 18% just prior to EU entry. Over the next few years, unemployment steadily declined, although it began to rise again following the outbreak of the global economic crisis; in in 2013, it stood at more than 13%. Large, entrenched structural unemployment exists in Poland, with 46% of the jobless defined as being long-term unemployed (Central Statistics Agency, 2012).

The unemployment figure only reflects part of the overall deactivation of labour. At the end of Communism, 83.5% of those over 15 were in paid employment, whereas at present this figure is just over 50%, having fallen to just 45% prior to EU entry. This can be further understood by considering the activity rate in Poland (which includes all citizens over 15 years of age who are neither employed nor registered as unemployed), with over 40% of the Polish workforce defined as being economically inactive throughout the transition.

Poland also has the highest number of workers in the EU employed on so-called 'junk contracts' (i.e., non-fixed, temporary contracts). Whilst the average share of workers employed on such contracts in the EU stands at less than 15%, in Poland it exceeds 27%. Furthermore, this has increased more than fivefold since the beginning of the century, with just over 5% of workers employed on these 'junk contracts' in 2000. Over 60% of workers aged under 25 are employed on 'junk contracts'. This is further compounded by the large number of self-employed workers in Poland. Of all those working, 19% are self-employed, which is the fifth highest self-employment percentage in the EU, after Greece, Italy, Portugal and Romania.

Therefore, a large section of employees in Poland have little social protection, and many employers are not required to pay social insurance and cover the benefits of their workers, as these benefits are for those employed on permanent full-time contracts. The self-employed usually opt to pay the lowest level of national insurance. An inevitable consequence of this situation is that a significant group of workers simply opt out of the system altogether and operate partly or entirely on the black market. This leaves them without any health or social insurance and further reduces the amount of money going into the National Insurance Institution, thus contributing to the growth of public debt.

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Table 1. Employment, Activity and Unemployment Rates by Gender

	1995	2000	2005	2010
Employment Rate				
General	50.7	47.4	45.2	50.4
Men	58.5	55.2	58.5	58.1
Women	43.7	40.3	43.2	43.4
Activity Rate				
General	58.4	56.4	54.9	55.8
Men	66.5	64.3	62.8	63.4
Women	51.1	49.2	47.7	47.3
Unemployment Rate				
General	14.9	15.5	17.6	12.3
Men	13.6	14.2	16.6	
Women	16	18.1	19.1	

Source: Central Statistics Agency.

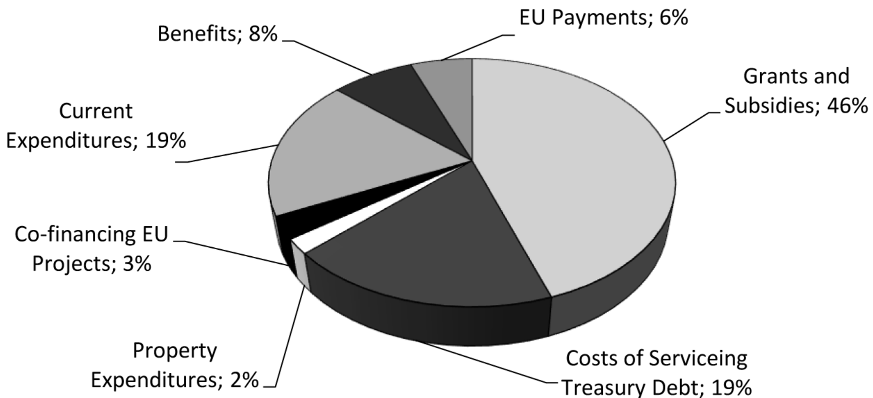
Income and Revenue

This deactivation of labour has meant that a large share of government income is spent on supporting those without work. Figure 1 shows the breakdown of current government expenditures in Poland. We can see that 46% of all spending is allocated to grants and subsidies, which primarily includes payments to the Social Insurance Fund. If we then analyse how social spending is distributed (Figure 2) in relation to other EU countries, we can see that a very large relative share of expenditures is allocated to pensions, while very little is spent on unemployment benefits. Also, we can see how health care spending is well below average for the EU and Central and Eastern Europe. This distribution of public spending has a significant impact on the living standards of different social groups, an issue to which we shall return later in this paper.

The other side of public finances, which influences public debt, is government income. Table 2 compares the Polish taxation system to that in Western Europe, as well as neighbouring countries in Central and Eastern Europe, as of the first quarter of 2012.

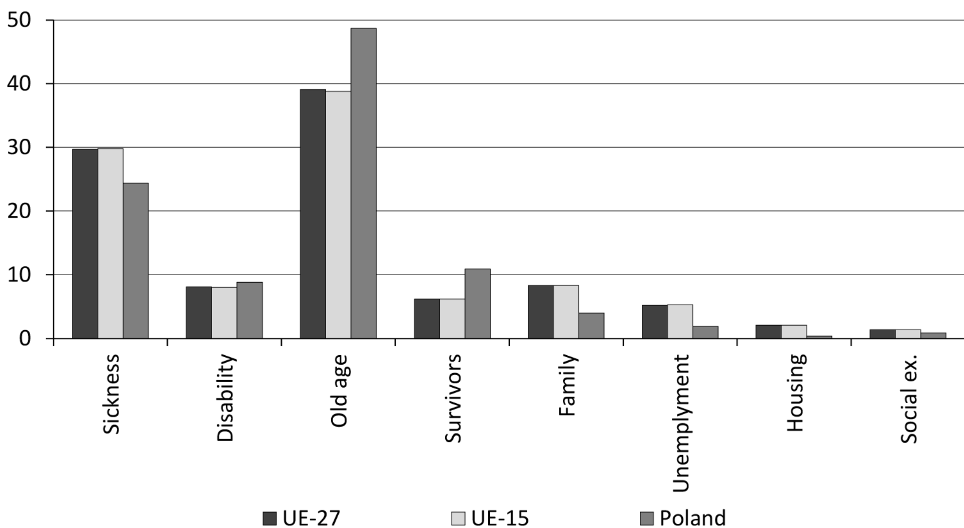
In general, the income tax rate and corporation tax rates are far higher, whilst VAT is slightly lower, in Western Europe than in Central and Eastern Europe. The Polish tax system is close to the Central and Eastern European model, although its top rate of income tax is relatively high compared to some other Central and Eastern European countries; however, only a very small percentage of taxpayers enter this band.

Figure 1. Structure of State Expenditures IIQ 2013



Source: Eurostat.

Figure 2. Social Spending (% of total)



Source: Eurostat.

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Table 3 shows how a progressive income tax system was maintained in the mid-1990s, with the top income tax rate raised to 45% in 1994, although this had been reduced back to 40% by 1998. However, a decisive shift towards a more regressive income tax system came in 2008, when the personal income tax system was changed from three to two bands. The top income tax rate was cut by 8% to 32%, whilst the bottom band was lowered by just 1% to 18%. Although the top rate of personal income tax is relatively high compared to some other Central and Eastern Europe countries, this reform essentially introduced a flat-tax rate in Poland, as just 1.5% of income taxpayers now pay the top rate (while previously 10% had done so) (Szumlewicz, 2011). A similar trend is observable in changes to the business tax (CIT). Until the mid-1990s, CIT was actually higher in Poland (40%) than the average in Western Europe. In 1997 and 1998, the business tax rate was progressively cut, eventually reaching 27% in 1998. However, the most fundamental change occurred just as Poland was entering the EU in 2004, when it was reduced to 19%.

Table 2. Top statutory income tax rates and standard VAT rates (%)

	Personal Income Tax	Corporation Income Tax	VAT
EU 15 Average	49	28	21
EU 10 Average	21	17	22
Poland	32	19	23
Highest	*Sweden: 56.6*	*France: 36.1*	*Hungary: 27*
Lowest	*Bulgaria: 10*	*Bulgaria: 10*	*Luxemburg: 15*

Source: Eurostat.

Table 3. Personal Income Tax Rates in Poland (%)

1992	19	30	40
1994	21	33	45
1997	20	32	44
1998	19	30	40
2008	18		32

Source: Eurostat.

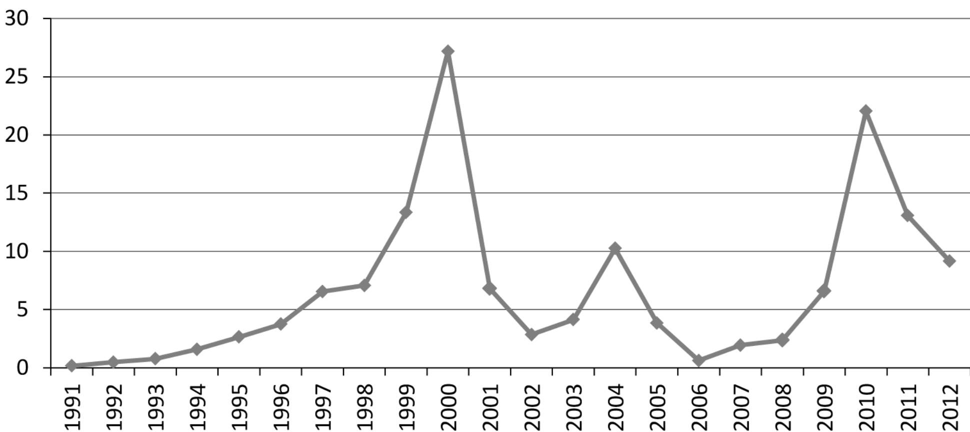
Table 4. Corporation Income Tax Rates in Poland (%)

1990	40
1997	38
1997	36
1998	34
1998	30
1998	28
1998	27
2004	19

Source: Eurostat.

In addition to taxation, a major source of government income over the past couple of decades has come through the privatisation of assets inherited from Communism. Figure 3 reveals how there have been two major peaks of privatisation. The major surge in privatisation was from the late 1990s, with the proceeds from privatisation reaching around 27bn złoty in 2000 before falling sharply in 2001. The second peak occurred following the outbreak of the global economic crisis, rising to more than 21bn złoty in 2010 (see Figure 3).

Figure 3. Government Income from Privatisations (bln PLN)



Source: Polish Ministry of Treasury.

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Pension Reform

Between 1997 and 2001, a new package of economic reforms was introduced, which significantly worsened public finances and has had a long-term impact upon public debt. The increase in privatisation beginning in the late 1990s meant that the size of the state sector declined by more than 50% during this period. This coincided with a sharp slowdown in economic growth (declining from 7% in 1995 to 1% in 2001) and a rapid rise in unemployment (up from 10.3% in 1997 to 17% in 2001). In turn, social expenditures rose from 4.5% of GDP in 1996 to 6% in 2001.

The slowdown in economic growth and increase in social expenditures worsened the state of public finances. However, this issue was initially controlled by harnessing the proceeds gained from privatisations. Beginning in 1998, new regulations stated that money earned through privatisations could not be used as a source of revenue for the government but rather must be used a means for financing its budget deficit. Up to and including 2000, the budget deficit was maintained at around just 2% of GDP, despite worsening economic conditions. However, by 2002, this figure had more than doubled to more than 5% of GDP, as revenue from privatisations slumped (Figure 3).

During this time, a new constitution was introduced that includes a balanced budget amendment, which caps public debt at 60% of GDP and states that the government cannot take on any financial obligation that could cause this limit to be exceeded. In order to ensure that this level is not breeched, Poland has a self-imposed debt threshold of 55% of GDP, and the government must take action to balance the budget if this level is crossed.

During this period, a series of reforms intended to further liberalise the country's public services were also introduced. For the purposes of our discussion on public debt, the most important of these is the pension reform.

As discussed above, the transition was accompanied by a huge deactivation of labour. Soaring unemployment was partly controlled, at the beginning of the transition, through a corresponding increase in the number of pensioners and retirees, in a bid to maintain the necessary social stability in order to complete the shock-therapy reforms.[5] The worsening situation in the labour market, along with the lack of sufficient unemployment benefits, also ensured that some groups of workers (e.g., miners, teachers, police officers and soldiers) exercised their right to retire early.

[5] *Retirees* here refers to those who had retired from work due to illness or disability and receiving state benefits.

All of these pressures meant that the dependency ratio – that is, the ratio of pensioners and retirees to employees – rose sharply. Between 1989 and 1995, this ratio grew from 18% to more than 23%; whilst there were 39 pensioners and retirees per 100 employees in 1989, this number rose to more than 60 by 1995 (Zawadzki and Ciura, 1997). In turn, this led to a steep increase in public expenditures on pensions, doubling as a percentage of GDP from 6.6% in 1989 to 12.6% in 1991. As a percentage of government expenditures, funds devoted to pensions had reached 54% by 1994. The state was forced to increasingly cover the pension funding gap, with subsidies to the National Insurance Institution, as a share of total pension expenditures, growing from 1% in 1991 to 10% in 1995 (Cain et al., 1999).

The growing strain on state budgets increased pressure for public pension spending to be cut. In 1999, a far-reaching reform of the pension system was implemented, which introduced a compulsory private pension pillar.[6] Advocates of this reform assumed that this would bring a number of benefits such as:

- valorising pensions;
- decreasing state expenditures on pensions and controlling public spending;
- encouraging people to work longer;
- linking one's future pension to individual contributions and thus inciting people to invest more in their own pensions;
- helping to build capital markets in Poland by providing new sources of capital to be invested on the country's burgeoning stock market.

One of the major incentives for this reform was the desire to lessen the long-term burden upon the state to provide for people in their retirement. However, in doing so, the system placed new pressures on the government's budget. This is because, while part of people's salaries has been transferred to private pension funds, the government has continued paying for current public pensions. This double burden upon the pensions system has had a considerable impact upon the country's public debt.

Essentially all of the assets and shares of the private pension companies have been financed through increasing public debt. Since the introduction of the compulsory private pension scheme in 1999, around 40% of all pension payments have gone to the

[6] The blueprint for the private pension system evolved in Latin America, specifically in Augusto Pinochet's Chile in 1980. In 1994, the World Bank published a key report – 'Averting the Old Age Crisis' – that supported the establishment of a three-pillar pension system, and it began to openly promote this model. Between 1981 and 2007, more than 30 countries fully or partially replaced their state-funded pension systems with individual private savings accounts. This included a number of CEE countries, such as the Baltic States, Bulgaria, Hungary, Poland and Slovakia.

private pension companies (i.e., the financial markets), whilst the government has been required to borrow more to meet its obligation to pay current pensions (Oreziak, 2013).

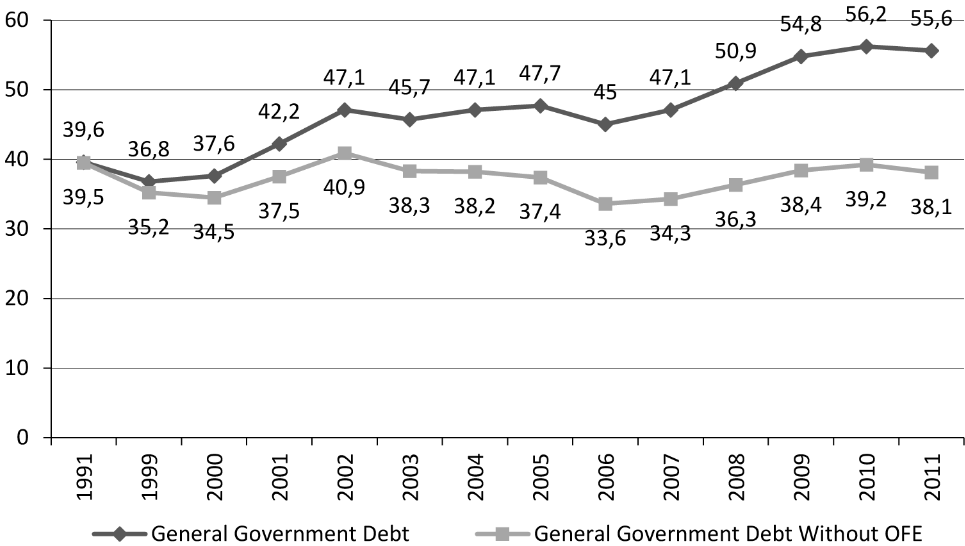
Table 5 displays the Finance Ministry's estimates of how much payments to the compulsory private pension pillar contributed to Polish public debt between 1999 and 2012. By 2012, the accumulated amount added to public debt by transfers to the private pension funds had reached over 279bn złoty, or 17.5% of total GDP. Figure 4 shows the size of public debt in Poland with and without these payments. As we can see, by 2011 public debt had reached 55.6% of GDP; however, if the transfers to the private pension funds had not been made, this would have stood at only 38.1% of GDP.

Table 5. Effect of the 1999 Pension Reform on Public Debt

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bln PLN	2.6	12.0	24.1	37.7	52.0	68.3	87.1	109.2	137	163.7	196.5	232.9	260.6	279.4
% GDP	0.4	1.6	3.1	4.7	6.2	7.4	8.9	10.3	11.4	12.8	14.6	16.4	17.1	17.5

Source: Ministry of Finance.

Figure 4. Public Debt 1999–2011 With and Without OFE



Source: Polish Ministry of Finance.

A Slowdown in Growth

Poland enjoys the status of being the only EU member state not to have undergone a recession since the outbreak of the global economic crisis in 2008. Poland's GDP rose annually on average by 3.7% between 2008 and 2011, with growth slowing to just 1.6% in 2009. Poland was able to avoid an economic recession due to a unique combination of internal and external factors, the most important of which was its ability to increase government spending and, in particular, to raise public investment, thereby at least partially offsetting the decline in private investment.

Government expenditure continued to increase in Poland throughout the crisis, rising from 15.1 billion euros in 2008 to 16.5 billion euros in the first quarter of 2012. The level of government expenditure in Poland is slightly above the EU average, standing at around 49% of GDP. One of the most important actions of the government was to increase public investment by utilising available EU funds. Poland was the single largest recipient of EU funds from the 2007–2013 budget, as it was able to receive up to 67 billion euros in structural and cohesion funds. This sum increased to 82 billion euros once the designated national government funds were added. This helped the government to instigate large investments in the country's infrastructure, particularly in preparation for the Euro2012 football championships. As a share of overall investment, public investment increased from 35% in 2005 to 43% in 2010. This ensured that although private investment fell sharply throughout the crisis, Poland's overall investment rate only declined slightly (by 0.08%) in 2009, whilst in other years it continued to rise. The biggest increase in investment was in the area of buildings and infrastructure, which increased from 1.8 billion euros in 2005 to 3.1 billion euros in 2010.

Although Poland avoided a recession, economic growth slowed and the situation on the labour market worsened following the beginning of the crisis. Furthermore, the rate of economic expansion began to slow again beginning in 2012, after rising in 2010 and 2011. This decline in economic growth was primarily due to a sharp fall in public investment. Between 2011 and 2012, public investment shrank from 5.7% to 4.6% of GDP. Financial pressures are leading to local governments reducing their investments to 36bn złoty in 2013, a decrease from 40bn 2012 and 41.2bn in 2011. This lull in public investment was caused by the ending of EU funds coming to Poland from the EU 2007–2013 budget, whilstthose from the 2014–2021 budget had not yet begun to arrive.

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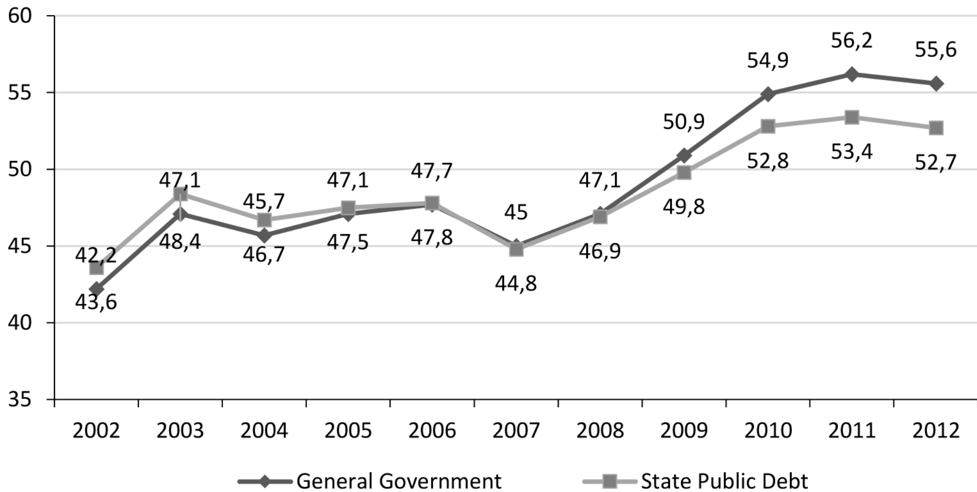
Rising Government Deficit And Debt

As a percentage of GDP, public debt grew in Poland by around 10% between 2008 and 2012 (Figure 5). This was significantly less than in most other EU countries, where it rose on average by around 25%.

Figure 5. Public Debt 2002–2012 (% GDP)



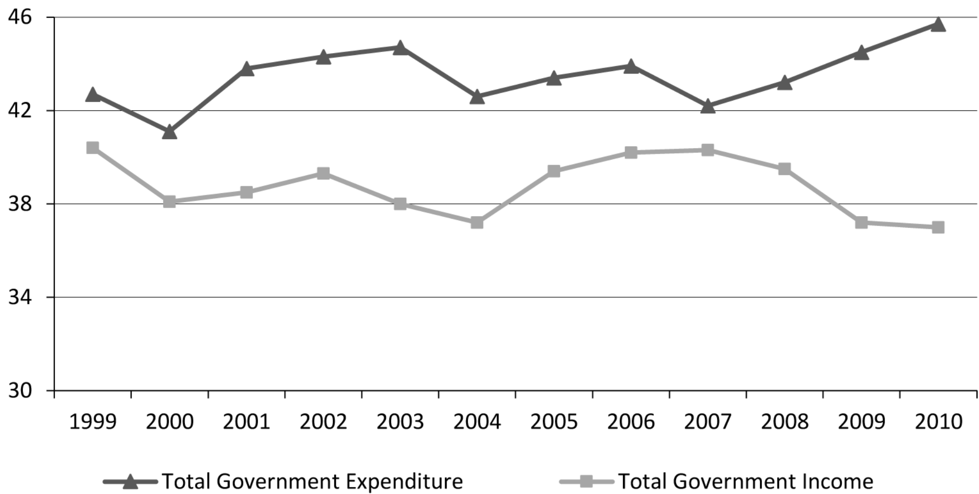
Source: Polish Ministry of Finance.

A country's public debt is strictly connected to its budget deficit. The deficit, in turn, is strongly dependent upon macro-economic factors, which determine government income and expenditures. The ability of the Polish government to maintain public debt within the existing external and internal limits over the long term is therefore largely dependent on whether it can increase economic growth and improve the situation on the labour market. Poland's budget deficit grew sharply from 1.9% in 2007 to 7.9% in 2011 but then fell to 3.5% in 2013. The government has predicted that this figure will decline to 1.5% in 2016 – a prediction based on the premise that economic growth will then exceed 4% (Puls Biznesu, 2013).

The decline in the budget deficit was achieved neither through increased economic growth nor via a rise in government revenue, with income from taxation and particularly privatisations shrinking (see Figures 3 and 6). Rather, the budget deficit was brought down primarily by reducing local government expenditures. More than one third of all government expenditures are made by local governments, which provide funds for a number of essential public services, spending the most on education (29%),

transport and communication (18%) and social help (12%). Furthermore, the public investment was partly funded by local governments, through which the majority of EU funds have flowed. Local governments carried a large share of the cost of preparing for the Euro2012 football championships, including paying for the building of stadiums in the cities where the tournament was held, some of which continue to make a loss.

Figure 6. Government Income and Expenditure (% GDP)



Source: Eurostat.

Figure 6 shows that, during the economic crisis, local government debt rose from 7.8% to 16.6% of GDP between 2007 and 2012. The number of local governments with a budget deficit increased from 1,046 in 2007 to 2,490 in 2010, before falling to 1,952 in 2011. Beginning in 2011, the government instituted a new regulation that all local governments must balance their income and current expenditures. In this way, the central government was attempting to pass the responsibility for cutting its budget deficit and debt onto local governments.

These new restrictions have meant that many local governments have decreased their spending in recent years. Local government investments fell from 44.24 bln złoty in 2010 to 35.61 bln złoty in 2013. The problems for local governments are compounded by their lack of income. This has been caused not only by the effects of the economic slowdown but also by changes to the tax laws enacted in 2009 (see above), which caused a decline in revenue from PiT and CiT that is shared between central and local governments. However, whilst the central government has been able to partly offset

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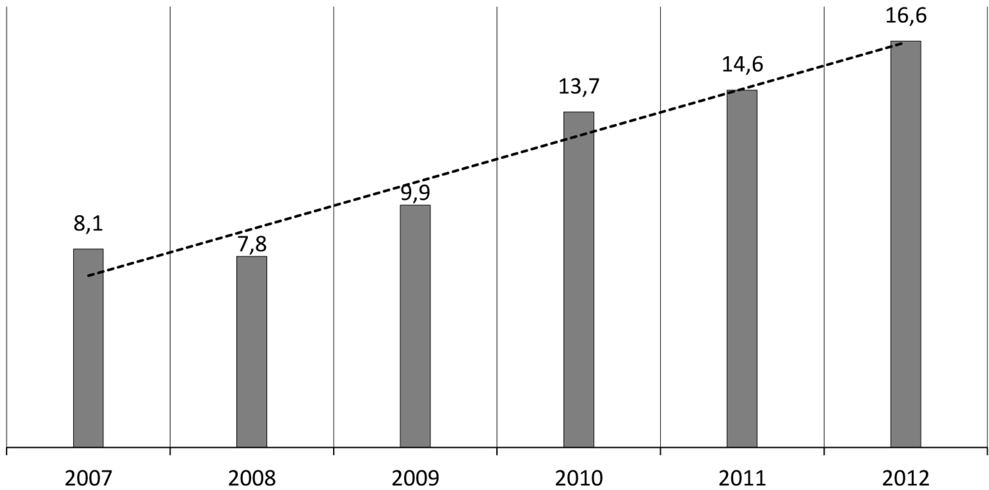
this loss by raising indirect taxes, local governments do not have similar powers (Obserwator finansowy, 2013).

Figure 7. Local Government Debt (bln euro)



Source: Eurostat.

Pressures To Reduce Public Debt

Despite having relatively low public debt in comparison to most other EU countries, there are still a number of pressures on the Polish government to further decrease debt. These include:

1. The rising costs of servicing the debt, which are accentuated as an increasing share of it is held abroad;
2. External and Internal regulations that place limits on the size of the country's public debt.

As shown in Figure 5, public debt rose sharply following the outbreak of the global economic crisis, with the cost of servicing the government's debt rising from 2% of GDP in 2008 to 2.6% in 2012. In June 2013, the share of public debt held in foreign currencies crossed the 30% mark, with the percentage held in euros rising to more than 69%. The relatively healthy state of the Polish economy has meant that the country has been generally positively assessed by the international rating agencies and that the profitability of its bonds has reduced, meaning it pays less when borrowing

abroad. However, the volatility of the global economy means that this can quickly change, and international markets and institutions continually exert pressure upon the Polish government to decrease its public debt and enact reforms desirable reforms.

The second pressure on the government to reduce its public debt comes from internal and external regulations. We have already considered the public debt rule, anchored in the Polish constitution, which prevents public debt from rising above 60% of GDP and requires governments to introduce a balanced budget if it exceeds 55%. Additionally, Poland has recently introduced four-year rolling fiscal plans, in order to provide medium-term fiscal guidance.

Poland is also required to follow the public debt regulations of the EU. According to art. 26 of the Treaty of the European Union, an excessive debt procedure may be carried out against a member state if its government deficit is above 3% of GDP or its general government debt is above 60% of GDP. If the Council of the European Union decides to initiate this procedure, it issues recommendations of actions that the country should take to reduce its deficit. Although not a member of the Eurozone, Poland has also voluntarily signed up for the EU's fiscal compact, which states that a country's annual structural deficit must not exceed 0.5% of its nominal GDP. Non-complying countries could be fined by the European Court of Justice, with a penalty equivalent to up to 0.1% of the country's GDP.

A structural deficit is defined as that portion of a country's budget deficit that is not caused by changes in its economic cycle. In 2013, Poland's structural deficit stood at around 3% of GDP, with the government predicting that it will fall to 2% by the end of 2014 (TMS Brokers, 2013). In April 2013, the Polish government submitted its convergence programme for 2012–2016 to the European Commission. Due to the economic slowdown, the Commission judged that the Polish government's forecasts for deficit reduction were overly optimistic and that it would not be able to meet its medium-term objectives of decreasing its structural deficit (European Commission, 2013).

Demographic Trends And 'Hidden Debt'

As discussed at the beginning of this paper, the idea has been propagated that growing public debt is the root cause of the global economic crisis. This point of view is usually combined with arguments for cutting public spending and reducing social welfare services and benefits. It is also sometimes argued that the actual size of public debt is higher than it appears, as there is a large amount of so-called hidden debt. This

hidden debt is made up of implicit liabilities, connected to demographic projections, which add up to future obligations of the state to make payments on, for example, pensions and health care.[7] It is argued that this is effectively debt, despite the fact that no bond is associated with the promise. Hidden debt is formed once the future benefits that a generation is expected to receive amount to less than the payments that it is currently making. Such arguments have been deployed in Poland, due to negative demographic trends and projections.

We can identify two major demographic trends in Poland over the past two decades. On the one hand, life expectancy has steadily increased, rising from 77.6 for women and 69.7 for men in 1990 to 80 for women and 72.1 for men in 2011. On the other hand, the birth rate fell from 2.0 children per woman in 1990 to just 1.38 by 2011. Combined with the mass emigration of Poles following the country's entry into the EU in 2004, this has caused a sharp fall in the growth rate of the population; whilst the population of Poland increased from 32.7m in 1970 to 38.1m in 1990, over the next 10 years it only grew by 100,000, to 38.2m (Polish Statistics Agency, 2012). One major social effect of this demographic change has been the disproportionate increase in the number of people above the age of retirement. During the past two decades, the proportion of those aged under 14 has reduced almost by half, whilst the number of those who are 65 or above has increased by just over 3%. If this trend were to continue, it would result in a major challenge to the government and the public sector.[8] According to the estimates of the Polish government, the proportion of citizens of working age compared to those over the age of retirement is set to decline from 2.6 in 2006 to 1.5 in 2030 (Chancellery of the Prime Minister, 2008).

The idea that Poland's public debt is higher than it appears, due to negative demographic trends, has sometimes been used as an argument for urging the government to implement new economic reforms in order to bring down its unsustainable level of debt. The most consistent representatives of this point of view are close to the former Finance Minister (and architect of the shock-therapy reforms at the beginning of the 1990s) Leszek Balcerowicz in his think-tank Civil Development Forum (FOR).[9] In recent years, they have proposed a package of reforms that include: speeding up privatisation,

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[7] The idea of hidden debt has developed out of *generational accounting,* which emerged at the beginning of the 1990s and claims to predict the future fiscal effects of payments to current and future generations.

[8] Those above the age of retirement in Poland currently account for 13% of society (EU average 17%), which is predicted to rise to 26% in 2030 (EU average 27%). In line with present trends, the Polish population is expected to decline by 7 million people between by 2060. During this time, those of working age (15–64) will fall by 11 million, and those above the age of retirement will grow by 6 million. This would mean that those above the age of retirement in Poland would equal 36% of society, which would be the highest in the whole of the EU (Szumlewicz, 2012).

[9] http://www.for.org.pl/

halting salary raises for teachers, abolishing subsidies for mines, abolishing subsidies for newborn children, reducing unemployment benefits, raising the retirement age and making this equal for men and women, withdrawing pension privileges for farmers, miners and uniformed workers, not increasing maternity leave and reducing subsidies for funerals (Rae, 2011).

FOR has been critical of the Citizen Platform (PO) government that has been in power since 2007, which avoided implementing a sustained programme of austerity during its first term. After returning to office in 2011, the three largest rating agencies made it clear that if the new Polish government did not introduce the structural reforms that it deemed necessary, then the country could face a downgrade. It was in this atmosphere that PM Donald Tusk made his opening speech to the new parliament, setting out his government's priorities for its next term in office. He prioritised the reduction of the government's debt, aiming to bring public debt down to 42% of GDP by the end of 2015 and the budget deficit to just 1% by the end of its present term in office. A series of reforms were introduced, one of which concerned raising the pension age. This law came into effect at the beginning of 2013, with the pension age increasing by one month every four months (i.e., three months annually). This will lead to the retirement age reaching 67 by 2020 for men and by 2040 for women (these had previously stood at 65 and 60, respectively). The government hoped that this would reduce pension expenditures and increase labour activity, particularly for the elderly. The government also implemented a series of further public spending cuts (such as freezing public sector wages and moving away from some universal benefits) and pushed ahead with the commercialisation of some public services (e.g., health, education and the postal service). However, these fall short of many of the austerity programmes introduced in other EU countries and have not been at a sufficient level to significantly reduce public spending and decrease the deficit and debt. The short-term strategy for decreasing public debt, deployed by the Civic Platform government, has actually been to partially reverse one of the major reforms from the 1990s: the introduction of a compulsory private pension pillar.

Reversing the Pension Reform

The issue of private pensions has become one of the main dividing points in Polish politics and has taken centre stage in the discussion on how to control public debt. The call from within the government to at least partially reverse the private pension reform first came from the Ministry for Work and Social Policy in 2009. Despite opposition from some within the government, the Minister of Finance then identified it as

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a means to decrease public debt, describing the private pension system as 'a cancer, which attacks reform and has risen to a gigantic size, damaging the whole pension system and now public finances.'[10] The government decided in 2010 to reduce the payment from ZUS to OFE from 7.3% to 2.3% of a person's income, with the proviso that this percentage would rise to 3.5% by 2017. This resulted in public debt falling in 2011 for the first time in six years.

Despite this partial reform, the government still had to bear the burden of paying for current state pensions whilst transferring a significant proportion of its income to the Private Pension Funds. At the end of 2013, the parliament approved a new reform of the private pension system that came into force in February 2014, which significantly reduced public debt. This involved shifting 51.5% of the assets held by the Private Pension Funds (which are mainly government bonds) to the Social Insurance Company, immediately reducing public debt by around 130bln złoty (or 9% of GDP) (Polska Times, 2014). Further planned actions include prohibiting the Private Pension Funds from investing in treasuries and treasury-guaranteed fixed income securities, while allowing them to more freely invest in other more risky equities. Furthermore, during the ten years prior to an individual's retirement, his or her savings held by a Private Pension Fund will be transferred to the Social Insurance Company. Finally, between April and July 2014, every client of a Private Pension Fund had to decide whether they wanted to continue investing in a Private Pension Fund at all or have the whole of their pension payment put into the Social Insurance Company. If an individual did not declare their preference during this time, then their payments were automatically directed exclusively to the Social Insurance Company. Around 2 million (14%) of those individuals paying social insurance decided to continue paying into the compulsory private pension funds (Forbes, 2014). Thus, the experiment of a compulsory private pension scheme had largely been abandoned in Poland by the middle of 2014.

Does Public Debt Matter?

Prior to the outbreak of the global economic crisis, private debt soared, as credit became available to ever-widening sections of society as a temporary means to keep the economy growing. In the USA, by the end of 2007, private (i.e., household and non-financial company) debt equalled 168% of GDP – three times more than government debt. The

[10] Rostowski's criticism of the OFE is particularly striking, considering that he both served as economic adviser to Leszek Balcerowicz when the latter was Finance Minister from 1989–1991 and ran the macro-economic council in the Ministry of the Economy between 1997 and 2001 (i.e., when the pension reform was implemented).

major debt bubble instigating the economic crisis was therefore private, not public. Nevertheless, alongside the disproportionate rise in private debt, public debt also continued to increase. For example, central government debt within the Eurozone countries grew (in 2011 prices) from just under €4.6bn in 1999 to over €7.8bn in 2010.[11] As we have seen above, central government debt also rose steadily in Poland prior to the crisis. However, the major increase in public debt, in most cases, has been a result of the economic crisis, due to depressed growth, rising unemployment, increased social expenditures, bank bailouts and quantitative easing.

There is no decisive evidence to suggest that high levels of public debt in and of themselves repress economic growth. Governments are sovereign bodies with authority and powers that others do not have (e.g., through raising taxes or issuing money). Debt can be a means to accumulate resources needed to instigate investments that can have huge future economic and social benefits. There is a logical argument for supporting the government increasing its debt during a period of economic regression or stagnation, in order to fund the public investments needed to counter negative economic cycles and depressed rates of private investment (Kalecki, 2010).

The reasoning that hidden debt is a threat to economic stability, as well as that such things as public expenditure on pensions need to be slashed, is also questionable. There is no justification for setting a target for the debt-to-GDP ratio as a goal of economic policy. There is also no reason that one part of the government cannot run perpetual deficits (such as on pensions) as long as others have surpluses. The advocates of intergenerational accounting do not take into account the real assets (such as infrastructure) left by other generations (Galbraith et al., 2009; Williams and Rhodes, 2011). This perspective also tends to focus on demographic trends (which can change) rather than on the labour activity rates. Much of the potential fiscal gap being created by the ageing of society could be closed if the employment rate (particularly that of young people) were raised.

However, no country lives in an economic bubble; rather, all are incorporated into a globalised economy. Those countries that lie on the peripheries of the global economy (such as Poland and other countries in Central and Eastern Europe) are especially threatened by a flight of capital and/or a withdrawal of foreign investment. International financial institutions and transnational bodies (such as the EU) place pressure

[11] Paradoxically, the introduction of neo-liberal policies has tended to increase public debt. While, for example, the Thatcher government managed to reduce government spending in the UK (with total managed expenditure (TME) decreasing by 5.9% (£83bn) during the first ten years in government), total government debt actually increased from £98bn to £157bn during this period. Furthermore, this all occurred during a time when government finances were boosted by soaring North Sea oil revenues, which accounted for 3.2% of GDP in 1984/85.

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on these countries to decrease their public debt and introduce prescribed economic reforms. Whilst its present level of public debt should not be of particular concern to Poland, the pressure placed on it by international markets and institutions (reflected in its own constitution) compels it to prevent this debt from rising, thus restricting its public spending.

Conclusions

The size and character of public debt has historical origins reaching back to the period of Communism. The accumulation of large debt through loans from abroad placed the Polish economy in a dependent relationship with its creditors in the West. Although a large proportion of this debt was written off in the early 1990s, Poland had already embarked on a course of economic reform before the collapse of Communism, which was then continued in the early 1990s. One result of these reforms was the huge deactivation of labour, which placed an unbearable pressure upon the country's public finances as income decreased and expenditures soared. Also, the introduction of a compulsory pension system towards the end of the 1990s contributed to the subsequent steady growth in public debt.

The strict laws on controlling public debt adopted by the Polish government have placed great pressure on it to reduce public spending. Despite these compulsions, Poland has been able to avoid a recession since the outbreak of the global economic crisis, largely by increasing government spending and raising the rate of public investment. This has been possible partly due to the large sum of EU structural and cohesion funds that have come into Poland since it joined the Union in 2004. However, the possibility of Poland being able to maintain its public spending, as well as to take advantage of the EU funds available in the 2014–2021 budget, is threatened as public debt nears its constitutional limit. It is for this reason that the government began dismantling the compulsory private pension system, which immediately reduced its level of public debt.

The reform of the private pension system has eased rather than solved the problem of public debt. Poland remains under pressure to maintain its public debt below levels laid out in its own constitution and by international institutions. It is likely that public debt will continue to grow over the next few years, which could result in a future fiscal crisis, thus potentially threatening its economic and social stability. The major factor preventing Poland from decreasing its deficit and debt continues to be the poor state of its labour market, which both reduces government revenue and increases expenditures.

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