Summary of the Proposed Economic Program of Solidarity

The economic program of Solidarity will seek to resolve the major economic problems facing Poland through a sudden and comprehensive jump to a market economy. This strategy can be called a "shock" approach to Poland's economic crisis, in contrast to the muddling-along approach of the Coalition Government. The program will cause many sharp changes in prices, but within a few months prices will be stable and shortages will be eliminated. The real incomes of workers will be cushioned during this process. The program will also produce a dramatic marketization of the economy, in a process that will begin immediately and be carried out over several years.

The combination of a shock return of prices, stabilization, and marketization, will halt the downward spiral of the economy and will restore economic growth, producing a sustained rising trend in living standards. The goals, strategy, and timetable for the proposed program are summarized in the tables that are attached. Another table describes some of the fundamental weaknesses of the economic plan of the Coalition Government.

Price Reform

Solidarity will eliminate subsidies and price controls immediately, to establish meaningful prices in the economy. This is necessary so that Poland can function as a market economy. Without freeing prices, Poland will continue to suffer from severe shortages, black markets, and wasteful investments. New businesses will not arise, or will arise in the wrong sectors that benefit from the perverse set of prices. After the price liberalization, food prices and energy costs will rise sharply. In fact, the coal sector will earn enormous windfall profits, since coal prices will rise substantially. A special windfall profits tax will be imposed on the coal sector and other export sectors in order to cushion the effects of higher prices on wages.

A key step toward market-determined prices will be a single, stable exchange rate for the zloty, which will guarantee that all prices of internationally traded goods (both imports and exports) will be determined by the prices in the world markets. The stabilization program will ensure that the exchange rate will remain stable (if stabilization were carried out today, the exchange rate could stabilized at about 213600=US$1).

Stabilization
After the one-time change in prices, the economic program will quickly stabilize the economy, putting an end to inflation and shortages, and establishing a stable exchange rate. Chronic and accelerating inflation in Poland has resulted from the excessive emission of zlotys by the Central Bank and the ensuing conversion of zlotys to US dollars. The emission of zlotys has been used by the Government to finance the budget deficit and permit the granting of large amounts of cheap credits to state enterprises. The key to stabilization, therefore, will be to eliminate the government budget deficit and to control credit.

The approach to stabilization taken by the Coalition Government has been to try to cut the budget deficit at the expense of the workers, by relying on sharp increases in food prices. Solidarity will offer a more balanced and therefore successful approach, which will not unduly punish workers. Solidarity will cushion the impact of higher food prices through compensatory wage adjustments, and will cut much of the budget deficit by eliminating wasteful investment spending and reducing the burden of the payments on the foreign debt.

The economists of Solidarity have already outlined a proposal to reduce the external debt burden and to secure foreign financial assistance for restructuring of the economy. By following those proposals, Poland will begin to receive net resources from abroad, rather than to pay large amounts abroad, as has been necessary during the past eight years. The savings from reducing the foreign debt burden will provide a very substantial relief to the budget, thereby easing the pain of cutting the budget deficit. Only Solidarity has the international credibility to secure this cushion and to attract major new loans from the International Monetary Fund, the World Bank, and friendly foreign governments.

The Coalition Government has never prepared a comprehensive stabilization program, in which the budgetary and credit measures are carefully quantified and explained to the public. Solidarity will prepare a detailed set of budgetary measures to be able to assure the public that the measures will achieve the desired result of stopping the inflation and eliminating the shortages, and maintaining a stable value of the zloty.

The Shock Program and Living Standards

To some people, a shock program looks too dangerous because of the fear that it will produce a sharp decline in living standards. In truth, a carefully designed shock
program can protect living standards despite the major adjustments of prices. Right from the beginning, the shock program will bring in new resources to the Polish economy from abroad, so overall there will be more goods to go around. In the Solidarity program, Solidarity will pay less on the foreign debt and will receive new loans from abroad.

Moreover, at the start of the program few of the goods produced in the economy will be devoted to wasteful investment, leaving at least as many goods or even more to be consumed. Of course, price reform will benefit some sectors and harm others. Tax measures and partial wage disinflation will help to even out the burden.

Even in cases where wage increases lag behind price increases, real living standards will probably be maintained or rise at the beginning of the program. First, many goods are not available at today’s price, but only at black market prices. Therefore, raising these prices does not really reduce living standards, as long as the new prices are at or below the black market prices, which is likely to be the case for many goods. Second, the wasted time spent in queues will be eliminated. Third, the end of inflation will increase the purchasing power of workers. Since the value of the money in their wallets will no longer be eroded every day.

Even though the shock program will cause disruptions in the short run and no doubt pain for some in the society, the jump to a market economy will deliver a dramatic rise in productivity and therefore living standards over the next five years.

In any event, there is no viable alternative. Unless Poland jumps to a market economy, the current misery and chaos will surely continue. The approach of the Coalition Government will never halt the inflation and the economy will explode into a hyperinflation. Poland’s low productivity will simply fall further and further behind Western Europe.

Marketization

Solidarity will move aggressively to create a vigorous private sector economy. Solidarity will encourage a wide range of private activities, including sole-proprietorships, partnerships, joint-stock companies, and cooperatives. It will be necessary and possible to move very quickly to prepare the basis for private activities, something that the Coalition Government has not done. Immediately, Solidarity will eliminate a wide range of restrictions and punitive tax policies that hinder the private sector.
Import and export licensing will be removed, and the right of private enterprises to import and export will become automatic. Capital will be allowed to flow freely into and out of Poland, which will help Poland to attract foreign direct investment.

As Poland becomes more and more a market economy, its trade and overall economic integration with Western Europe will inevitably increase. The share of trade with the CMEA economies will decrease accordingly. To the extent possible, trade with the East should be conducted on a market basis, rather than on the basis of government plans.

There are many other immediate measures that will be taken. Foreign investment banks and commercial banks will be encouraged to participate directly in the Polish economy. Now private domestic banks will be chartered, to compete with the existing banking institutions. A new Fair Trade Commission, reporting to the Parliament, will be created to make sure that private firms enjoy equal treatment to state enterprises (in receipt of credits, in access to inputs, and so forth).

The existing state sector will be made more competitive in three ways. Workers councils will increase their participation in the management of state enterprises, to ensure that such enterprises are run efficiently and honestly. Also, an Anti-Monopoly Commission, reporting to the Parliament, will move quickly to break up large state enterprises into smaller, more competitive units. Finally, and over a period of several years, major parts of the state sector will be privatized. Small enterprises (such as in the service sector) can be privatized quickly, while larger enterprises will require a more complex and therefore time-consuming process. Of course, many enterprises will remain in the public sector.

The Benefits of the Shock Program

--An initial, dramatic change in the structure of prices will cause some disruptions, but also the basis for a market economy.
--A reduction of debt payments, now loans from abroad, a cutback in wasteful investment spending, and partial wage indexing will all be used to cushion the effects of the initial shock.
--Within a few months, prices will be stable and shortages will be eliminated.
--During the first year, a vigorous private sector will be encouraged and many new business and work opportunities will emerge.
--During the following few years, the public sector will be cut back in size and made more competitive.
Table 1. Goals of Stabilization and Marketization

Stabilization
Stable prices without shortages
Balanced budget
Elimination of excessive credit expansion to state enterprises
Solution of the external debt crisis through reduction of the debt burden

Price Reform
Elimination of price controls and subsidies
 Stable, unique, and convertible currency
Compensatory wage adjustments in conjunction with price reforms

Marketization of Economy
Reform of tax and legal basis for a vigorous independent sector
Break up of large state enterprises into smaller, more competitive units
Privatization of many state enterprises
Table 2. Strategy to Achieve Stabilization, Price Reform, and Marketization

Stabilization

The strategy to eliminate price inflation has several elements. They all aim to eliminate the emission of money by the Central Bank, and thereby to stabilize the value of the currency. With a stable currency, together with free markets, domestic prices will also remain stable. The strategy will protect the consumption levels of the population. This will differ from the government's strategy of trying to balance the budget mainly through food and energy price increases.

To eliminate the emission of money, the government will quickly:

Eliminate subsidies to enterprises and the population, with partial compensation through higher wages
Cut back sharply on investment spending, focusing on firms that make losses at the new free-market prices
Impose strict controls on credit allocations to state enterprises from the Central Bank and commercial banks
Eliminate net payments to foreign commercial banks (either through refinancing of interest, a formal resolution of the debt via the Brady Plan, or emergency bilateral actions)
Obtain fresh credits from the IMF and the World Bank

Price Reform

The strategy is to establish market-based prices in the economy. To do this, the government will quickly:

Eliminate subsidies and price controls
Unify the exchange rate and liberalize trade (that is, eliminate licensing restrictions on imports and exports).
Domestic prices of tradable goods will thereby be determined according to prices in world markets.

Some sectors (such as the coal industry) will enjoy large windfall profits after the changes in relative prices. Some of these windfall profits will be taxed away in order to collect government revenues in order to compensate workers for the price increases.

Marketization of the Economy
The strategy for marketizing the economy includes:

- Establishing the bases for a vigorous independent sector;
- Breaking up existing state enterprises so that they operate as smaller, competitive firms;
- Privatizing parts of the state enterprise sector, beginning with smaller firms in the service sector and continuing later with large industrial firms.

To promote the independent sector, the Government will quickly:

- Eliminate restrictions on the creation of independent enterprises (self-propriabilities, partnerships, joint-stock companies, cooperatives);
- Guarantee fair treatment of independent enterprises by the state sector;
- Create a Fair Trade Commission, responsible to the Senate, for the promotion of the independent sector;
- Eliminate licensing and other trade restrictions for exports and imports of independent firms;
- Establish low and flat rates of taxation for individuals, state enterprises, and independent enterprises;
- Charter independent commercial banks, including branches of foreign banks;
- Invite foreign investment banks to establish branch offices in Poland;
- Eliminate restrictions on foreign direct investment.

To make the state sector more competitive, the Government will:

- Break up state monopolies into smaller independent units (an anti-monopoly commission, subject to Parliamentary oversight, will be established to design and implement this process);
- Strengthen worker councils so that they may participate in the management of state enterprises and assist the Government in the monitoring of the enterprises’ financial activities.

The Government’s privatization program will be based on the idea that the extent and pace of privatization will differ among economic sectors. Small-scale enterprises, particularly in the service sector, can be privatized most quickly and simply. Large enterprises will require detailed investigation to determine whether they are good candidates for privatization. In such cases, the Government will use the “market monopoly” method to allow a larger-scale of production to remain public enterprises.

To carry out privatization, the Government will:

- Seek technical assistance from the World Bank;
- Invite foreign investment banks to suggest schemes and
prepare valuations for enterprises to be privatized
Prepare within one year a program for extensive
privatization of the state enterprise sector
Table 5. Approximate Chronology for the Economic Program

Pre-program Period

Task Force preparation of economic program (see Table 4.)
Informal discussions with IMF, World Bank, and official creditors, to accelerate new lending in support of the economic program
Informal discussions with foreign investment and commercial banks
Senate Economic Committee hearings on future economic reforms (with the goal to identify the impediments to independent sector activity in Poland)

Program Period: Immediate Measures

Unify and fix the exchange rate, with a sharp devaluation of the official exchange rate (today, the appropriate new rate would be about 213000=US$1)
Following the devaluation, budgetary and financial policies will be pursued to make sure that the exchange rate is kept stable, and that there is no gap between the official rate and the unofficial rate
Foreign exchange operations can be conducted freely by all enterprises, households, and financial institutions (there will be no requirements to surrender foreign exchange earnings)
Eliminate virtually all subsidies
Earnark 1/2 to 3/4 of subsidy savings to increased wages
Create special windfall profit tax on coal sector to compensate for the sharp rise in internal coal prices
End preferential interest rates for all Central Bank credits to the non-housing enterprise sector
Raise interest rates above inflation
Cut back sharply on central bank investment credits, particularly to loss-making sectors
Eliminate import and export licensing for independent enterprises
Eliminate excess wage tax on enterprises
Introduce low flat import tax (20 percent on import value)

Initiate formal negotiations with the IMF and the World Bank for financial support for the economic program
Notify commercial bank creditors of the need to initiate debt reduction negotiations in the context of the Brady Plan, and request interim financing to cover interest obligations falling due over the next 12 months
Suspend all interest payments to the commercial banks pending the arrangement of the interim credit lines
Notify the Paris Club (official bilateral creditors of the need for a comprehensive three-year rescheduling of interest and principal obligations
Request debt relief from the CMEA countries

Program Period: Months 1 - 3
Formulate system for privatization of small-scale enterprises (e.g., restaurants, shops, transport)
Begin operations of Anti-Monopoly Commission and Fair Trade Commission
Legislate low and flat rates of taxation for individuals and independent enterprises
Submit legislation on eliminating restrictions on foreign direct investment
Begin participation of workers councils in the financial management of the major state enterprises
Emergency credit lines will be available to firms only for the purposes of making wage payments. For these firms, all credits for investment spending will be cut off during the period in which loans for wage payments are being made
Maintain high real interest rates in support of price and exchange rate stability
Create an inter-enterprise short-term lending market
Sign letter of intent with IMF for three-year Extended Arrangement
Sign program with World Bank for Structural Adjustment Loan
Open local offices of the IMF and World Bank for resident representatives

Program Period: Months 3-12
Initiate tax reform legislation (especially the replacement of the turnover tax by a value added tax mechanism, and the creation of a low flat income tax)
Allow the chartering of new independent banks
Strengthen tax administration and request technical assistance from the World Bank and IMF on improving tax collections
Establish a Superintendency of Banks to formulate and maintain prudential standards for banking operations
Introduce legislation to support privatization, joint ventures, and the formation of joint-stock corporations

Sign new Paris Club agreement
Obtain new bilateral credits (in particular, parallel lending and co-financing from Japan)
Negotiate with the European Community for access to West European markets

Program Period: Beyond First Year
Establish local stock exchange
Establish additional institutions for local capital market (e.g., interbank lending market, short-term commercial loan market)
Complete debt reduction agreement (under Brady Plan) with the commercial banks
Implementation of privatization program
Proceed with the break-up of state enterprises by the
Anti-Monopoly Commission
Proceed with liquidation of unprofitable state enterprises
Table 4. Agenda for Task Force to Prepare Economic Program

The main role of the Task Force should be to prepare in detail the policies for the first three months of the stabilization program, and to prepare a rough outline of measures for the period that will follow beyond the first three months. The hardest part of the preparation will be to establish the current state of the budget and credit policies, in order to establish how firm the measures must be in order to balance the budget and restrict the emission of money. It is very important that when the program is started there be a high probability that the budget deficit will be eliminated by the measures being carried out.

The Task Force will have two tasks: to formulate the outlines of policy and to prepare the technical analysis to support the policy decisions. We will provide in this memo a listing of some of the information that will soon be necessary for the Task Force to carry out the technical work.

The technical team must begin with a careful accounting of:

- budgetary expenditures on wages, materials, payments on foreign debt
- all existing subsidy programs, with a careful enumeration of spending under each program
- budgetary revenues, and forecasts of revenues, by type of taxation
- all existing tax exemption schemes, such as those for importers
- credit allocation to state enterprises, by sector, and by stated purpose
- the sectors in which it is expected that investment spending will be sharply curtailed (for this purpose, it will be necessary to have a breakdown of investment spending across sectors in the economy)
- the sources of money supply growth (for example, the amount of money supply increase owing to the budget deficit or to the extension of central bank credit to enterprises and households)

It will also be crucial to understand the likely effects of exchange rate unification (e.g. at 112500 = US$1) on all aspects of the economy, including the prices of various goods, the incomes that will be earned in various sectors, and the budget. For this purpose, the Task Force should focus on the following matters:

- which sectors currently import at the official exchange rate (11250), and at what level of imports
- which sectors currently import at the auction exchange rate
(Z15000), and at the free exchange rate (Z16000), and at what levels of imports (at least approximately) which sectors export at the official, auction, and free exchange rates, and how much, and which sectors export at some combination of these rates (for example, through a partial retention of export earnings).

In order to formulate wage policies, it will be important to know the size of the overall wage bill by various parts of the public sector (e.g., central government, state enterprises, etc.).

After these data are assembled, it will be possible to formulate a budgetary and credit plan that will allow for small growth of the money supply, and that will thereby be consistent with low inflation and a stable exchange rate. It will also be possible to judge the amounts that wages can or increased after the removal of subsidies (the wage increases must be consistent with a balanced budget).

Longer-term issues of structural reform (such as privatization) can be discussed over a longer time period, and with less urgency. In any event, the structural policies will require a heavy input by the legislature, while the stabilization policies will be carried out mostly by the executive branch.
Table 2. Some Doubts Concerning the Economic Strategy of the Coalition Government

In recent weeks, the various aspects of the Government's plans have been revealed in public discussion. We note several fundamental problems with the proposals that are under discussion. These problems raise profound doubts about the ability of the Government to formulate and carry out a successful program of stabilization and marketization.

The bulk of fiscal adjustment is supposed to come out of a reduction of living standards of workers, by raising the price of agricultural goods and by raising tax revenues. Workers will bear excessive costs in the stabilization.

1) The Government has failed repeatedly to negotiate any debt relief from the foreign commercial bank creditors. Once again, the deal signed between the banks and the Polish Government in recent weeks is thoroughly inadequate, and fails to incorporate recent advances in the debt strategy.

2) The Government seems to have made no attempt to cut back on wasteful investment spending. The program seems rather to rely entirely on cuts in real consumption levels. To limit the fall of real wages, it should be possible to cut wasteful investment spending by several percent of GNP.

The Government has not presented a comprehensive accounting of the fiscal sector. Most of the analysis focuses only on the central government, and the budgets of the state enterprises and the financial institutions are not generally included in the accounting. Even the analysis of the central government appears to be seriously incomplete.

The Government has not made a detailed analysis of how its credit allocation policies contribute to the overall emission of money. Thus, the analysis of inflation is seriously incomplete.

The Government is assuming that a major increase in tax revenues will occur later this year that will help to balance the budget, but such forecasts have often proved to be incorrect, and under the conditions of high inflation the forecast this year also seems to be dubious. For administrative and social reasons, it is unlikely that the Government will really achieve a large increase in tax revenues.

The Government is apparently not planning to unify the exchange rate at any time in the near future, in the sense of eliminating the gap between the official exchange rate (Zloty) and the market clearing rate (the black market). Under these conditions, exporters will continue to be penalized by the
exchange rate system, since they will have to sell their foreign exchange at less than the market clearing rate.

The Government proposes a very gradual process of marketization, which will leave many barriers and inefficiencies for the next several years, and will leave open the question of whether the plan will ever really achieve the development of a market economy.

The Government does not discuss the issue of how to promote the expansion of the independent enterprise sector, despite the fact that the independent sector is vital for Poland's future growth.

The Government is planning to maintain very high marginal rates of taxation on individuals and small enterprises, a policy which is unnecessary to raise revenues, and which stifles the development of new enterprises.

The Government's discussion of privatization is unconvincing, with there being legitimate concern that the Government will try to maintain real control over the enterprises undergoing privatization. Also, there is reason to worry about who will reap the financial benefits from the process of privatization.