

Warsaw, 18 March 2020

FOR Communication 8/2020: Coronavirus and What Next? FOR'S Economic Prescription

Synthesis:

- **Diagnosis:** The coronavirus epidemic in the country will have a negative impact on companies producing for the domestic market (e.g. commerce, gastronomy, hospitality), while restrictions in world trade and problems of our main trading partners will hit companies focused on external markets (e.g. transport, industrial manufacturing). The economic impact will depend on the duration of the epidemic. In the case of a quarter-long epidemic, given the negative impact of the global economy, this could mean a **drop in growth to around zero**.
- **Good medicine:** **Government action should be primarily aimed at making it easier for companies to survive the epidemic and maintain employment.** The scale of the intervention should depend on the duration of the epidemic - **the emphasis should first be on deferring taxes and contributions, then on guarantees and loans**, and only at the end on writing off part of the liabilities.
- **Bad medicine:** The nature of the economic shock caused by the coronavirus means that **attempts to stimulate demand are doomed to failure in advance**, and the response of economic policy must be much better tailored to individual industries. For a number of sectors, demand reduction is directly linked to the prevention of the epidemic. In such sectors, the key action should first be to ensure liquidity, allowing companies to preserve their jobs. In the case of changing global supply chains, the economic policy response will be more difficult - it is unclear whether they will return to their current form once the epidemic is over. Therefore in addition to temporary liquidity support, **it will be important to create favorable conditions for the companies operating in them to adjust to the new reality.**
- **How to get stronger after the illness:** Globally, in the coming quarters, a number of companies will restructure their supply chains, diversify them and perhaps relocate part of their production closer to domestic markets. If Poland is to benefit from the opportunities created by these changes, the following reforms will be needed:
 - **improvement of public finances**, so that the high deficit and uncertainty related to it does not discourage citizens and foreign investors from investing in Poland;
 - tax and contribution reform to **reduce the abnormally high taxation of low wages (sixth highest in the OECD) and their time consuming nature (second highest in the EU)**;
 - **increase economic freedom**, so that new business models are not blocked by the old regulations and the limitation of politicization of the largest companies in the country;
 - **reform of the judiciary to restore its independence while increasing its efficiency**, so that disputes between entrepreneurs are resolved fairly and promptly by independent courts.
- The coronavirus epidemic in the country will have a negative impact on companies producing for the domestic market (e.g. commerce, gastronomy, accommodation), while restrictions in

world trade and problems of our main trading partners will hit companies focused on external markets (e.g. transport, industrial manufacturing). Based on Taiwan's experience after the outbreak of SARS, the epidemic in the country, depending on its length, will reduce GDP growth by 0.7-3.5 percentage points. The recession in the global economy, if it occurs, will reduce the rate of growth by another 1.4-2.9 percentage points. Even if the interaction between these shocks is omitted, this will result in a 2.1-6.4 percentage points decline in the growth rate. Taking into account that even before the epidemic, growth forecasts for this year ranged between 2% and 3%, this means for Poland a decline in growth around zero, at best. Of course the effect will be much smaller if the epidemic ends within the next few weeks.

- A temporary drop in economic activity is even desirable - you cannot encourage people to #zostańwdomu (stay at home) and expect sales in cinemas, restaurants or hotels not to suffer, and production in companies will remain undisturbed despite the closure of borders. However, it is important that companies affected by this unexpected shock do not collapse and their employees do not lose their jobs. Although Poland in the coming years is primarily threatened by a lack of workers rather than high unemployment, the collapse of hitherto prosperous companies could make it difficult for the Polish economy to recover from the pandemic.
- The government's actions should be primarily aimed at making it easier for companies to survive the epidemic and maintain employment. The scale of the intervention should depend on its duration and the scale of its economic consequences - firstly, the emphasis should be on deferring the payment of taxes and contributions (both the entrepreneurs themselves and their employees), then on guarantees and loans, and only at the end on writing off part of the liabilities. All actions should be carried out in accordance with the existing fiscal rules, which allow for a temporary increase in the deficit in exceptional situations like the present one. At the same time, adherence to these rules will prevent the deterioration of public finances after the end of the epidemic, reducing uncertainty and encouraging faster growth of the Polish economy.
- The epidemic will change the way both the Polish and global economy operates. In Poland, for example, the popularity of remote working is growing rapidly, and contacts between the administration and citizens are moving to the Internet at an accelerated pace. In the world, in the coming quarters, many companies will restructure their supply chains, diversifying them and perhaps moving part of their production closer to domestic markets. In order for Poland to take advantage of the opportunities this brings, the following reforms will be needed:
 - improvement of public finances, so that the high deficit and uncertainty related to it does not discourage citizens and foreign investors from investing in Poland;
 - reform of taxes and contributions to reduce abnormally high taxation of low wages (sixth highest in the OECD) and their time consuming nature (second highest in the EU);
 - increase economic freedom, so that new business models are not blocked by the old regulations and the limitation of politicization of the largest companies in the country;
 - reform of the judiciary system to restore its independence while increasing its efficiency, so that disputes between entrepreneurs are resolved fairly and promptly by independent courts.

Impact of the epidemic on the economy

The coronavirus will have a negative impact on GDP - in 2020 the Polish economy will produce fewer goods and services. On the one hand, some services will not be in demand, and some will not be produced as a result of administrative decisions (e.g. going to the cinema or restaurants or staying in hotels). On the other hand, some sectors will have problems with maintaining production (mainly due to supply disruptions, but also as a result of the fact that employees will be on sick leave and other leave: the sick, the quarantined or child care employees). Since we do not know the future course of the epidemic - its duration or the number of people infected - it is impossible to predict its full impact on the economy at the moment. However, we know that it will vary greatly from one industry to another and will differ in the short and long term.

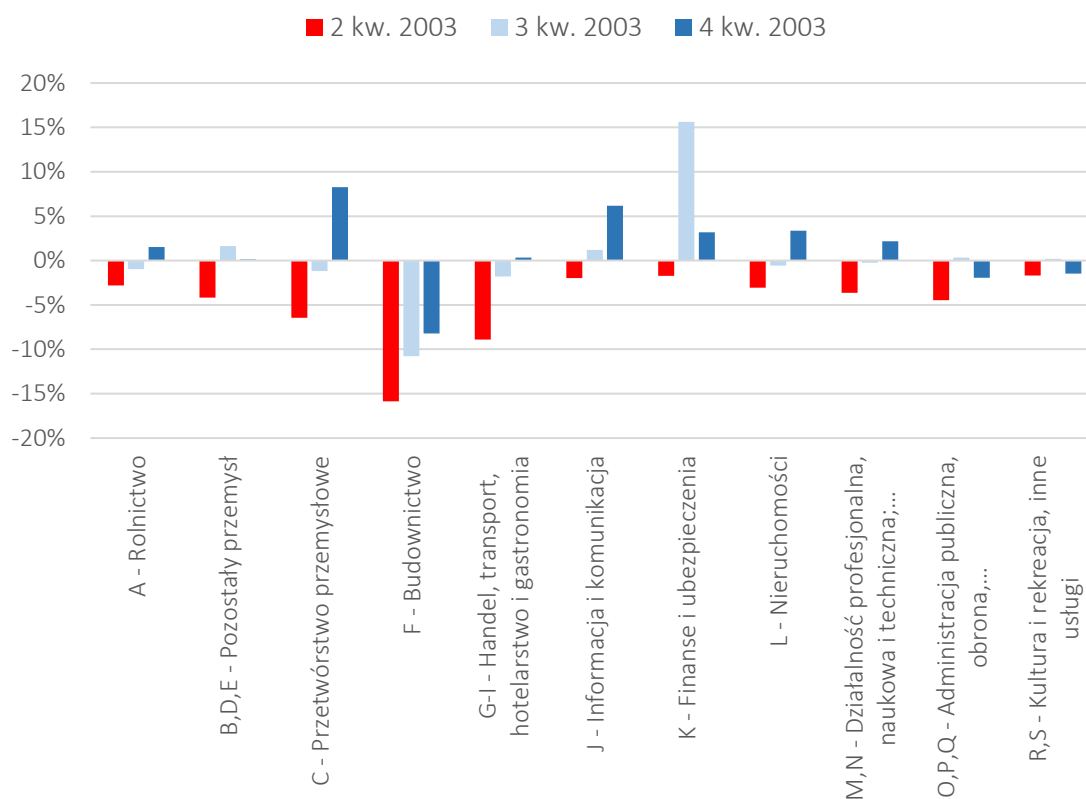
A direct consequence of the epidemic is a sharp drop in demand for many services due to both changes in consumer preferences and new government regulations and production distortions in other sectors. The drop in demand affects a wide range of services that people are afraid to use or whose provision is directly restricted by regulation (e.g. cinemas, theatres, restaurants, training or transport).

Taiwan's experience with the 2003 SARS epidemic may provide some indication as to which sectors of the economy will be most affected by falling demand (we base our experience on Taiwan's experience as Chinese statistics are more aggregated). The peak of the incidence in Taiwan was in the second quarter of 2003, so in our estimates we take the first quarter of 2003 (the last quarter without SARS) as a benchmark and check how the dynamics of added value in the individual sectors changed in the following quarters. Between the first quarter of 2003 and the second quarter of 2003, the activity in the construction industry slowed down the most (down 16 percentage points), broadly understood services, i.e. trade, transport, catering and hotel industry (sections G-I, -9 percentage points) and industrial manufacturing (4 percentage points). There are significant differences in the dynamics in subsequent quarters:

- In industrial manufacturing, the strong rebound in the fourth quarter of 2003 made it possible to make up for the declines in the second quarter. Taking into account that the epidemic affected many countries in the region, it may have been related to the restoration of normal functioning of supply chains.
- In services, the growth rate returned to its previous level by the end of the year, but no recovery was made. Taking into account the nature of some of these services, this seems to be a fairly natural reaction (it is difficult, for example, to make up for the backlog of visits to restaurants or stays in hotels).
- In the construction industry, the growth rate remained lower, which may have been due to purely sectoral factors.

Change in the rate of added value growth in Taiwan after the SARS outbreak

Change in relation to the growth rate in the first quarter of 2003, i.e. in the last quarter without SARS; the largest number of incidence was in the second quarter of 2003



2 kw. 2003	Q2 2003
3 kw. 2003	Q3 2003
2 kw. 2003	Q4 2003
A - Rolnictwo	A - Agriculture
B, D, E – Pozostały przemysł	B, D, E - Other industry
C – Przetwórstwo przemysłowe	C - Industrial manufacturing
F- Budownictwo	F - Construction
G, I – Handel, transport, hotelarstwo i gastronomia	G, I - Trade, transport, accommodation and gastronomy
J – Informacja i komunikacja	J - Information and communication
K – Finanse i ubezpieczenia	K - Finance and insurances
L – Nieruchomości	L - Real estate
M, N – Działalność profesjonalna, naukowa i techniczna	M, N - Professional, scientific and technical activities
O, P, Q – Administracja publiczna, obrona narodowa	P, Q - Public administration, national defence
R, S – Kultura i rekreacja, inne usługi	R, S - Culture and leisure, other services

Source: FOR own elaboration based on data from the Taiwanese statistical office

With the Polish structure of the economy, a shock similar to that associated with the SARS epidemic in Taiwan would reduce GDP growth by 1.4 percentage points. By applying a change in the dynamics of value added similar to Taiwan to the sectoral structure of the Polish economy, a decrease of 1.4

percentage points per year could be expected in relation to the scenario without such a slowdown. The effect, however, will be strongly differentiated - while manufacturing will end up at a level 0.6% higher than it would have resulted from pre-crisis growth, the value added in services (trade, catering and transport) will be 2.6% lower per year. However, if the disruption caused by COVID-19 continues for a longer period of time - not for one, but for two quarters - this will reduce the annual growth rate by 3.5 percentage points, including 5 percentage points in services.

As the quarter chosen as the benchmark (Q1 2003) may not be representative, we make alternative calculations, taking the average growth rate of 2002 as the benchmark. In such a case, a one-quarter epidemic will reduce the GDP growth rate by 0.7 percentage points, while a two-quarter epidemic will decrease the GDP growth rate by 2.7 percentage points.

The economic problems will be further aggravated by disruptions in supply chains. In the country, this may be due to more workers being made redundant and unforeseen problems with work organisation. However, the disruption of world trade - on the one hand, supply restrictions and, on the other hand, falling end-user demand - will be much more significant. Here, a certain, although very imperfect, approximation of the shock may be the decrease in economic activity in Poland in 2009 resulting from the global financial crisis. Such a comparison is obviously problematic for two reasons - on the one hand, since 2009, the degree of integration of the Polish economy into the global economy has increased, making it more sensitive to the fluctuations of the global economic situation; on the other hand, if the epidemic lasts one or two quarters, its effects on the global economy may turn out to be smaller than the financial crisis of 2009. Nevertheless, the scale of the slowdown observed in 2009 may provide some indication of the scale of the problems. If the change in GDP growth between 2008 and 2009 is taken as a benchmark, it would be a slowdown of 1.4 percentage points with the current structure of GDP, while if the period from 2004 to 2007 is taken as a slightly longer benchmark (without 2008, when the crisis was already visible), the scale of the slowdown would be 2.9 percentage points.

The consequences of the coronavirus for the economy will be particularly painful, as it will affect both domestically oriented sectors (decline in demand for services) and those related to foreign markets (effect of the global slowdown). Taking the SARS's impact on Taiwan as a starting point, the domestic epidemic will reduce our growth rate by 0.7 to 3.5 percentage points (however, in the case of Taiwan, we could only talk about regional problems caused by SARS, but not the global recession). However, when looking at the fall in GDP caused by the global financial crisis, we are talking about a slowdown of 1.4 to 2.9 percentage points. In total, this means a reduction in the GDP growth rate by 2.1 to 6.4 percentage points. Such a simple summing up ignores the feedback and ignores economic policy responses, but allows us to assess the scale of possible problems. Taking into account the fact that even before the outbreak of the epidemic, forecasts for 2020 for Poland indicated GDP growth below 3%, this means that the total shock caused by the coronavirus may lead to a 3% drop in GDP or - at best - a growth of around zero.

The nature of the economic shock caused by the coronavirus means that attempts to stimulate demand are doomed to failure in advance, and the response of economic policy must be much better tailored to individual industries:

- For many sectors, the reduction in demand is directly linked to the prevention of epidemics. At the same time, it is not possible to encourage people to stay at home and stimulate the

demand for cinema or concert tickets, restaurant visits, training or travel. In such sectors, the key action should first and foremost be to ensure liquidity, allowing companies to maintain their jobs. Such an approach is based on the diagnosis that in Poland we do not have structurally too many cinemas or restaurants and after the end of the epidemic it will be in the interest of their employees and customers to resume operations.

- With global supply chains changing, the economic policy response will be more difficult - it is not clear whether they will return to their present form once the epidemic is over. Thus, apart from temporary liquidity support, it will be important to create favourable conditions for the companies operating in them to adapt to the new reality.

Many measures can help maintain jobs in businesses, which would facilitate the recovery of the economy after the epidemic. In Poland, the lack of workers is currently a bigger problem than the unemployment rate, and given the demographic forecasts, this problem will only grow. Nevertheless, as far as possible, bankruptcies of companies that have functioned well under normal conditions should be prevented and job losses that would be associated with a temporary increase in unemployment. The scale of support should depend on the length and scale of the crisis, and further action should be taken gradually.

- Firstly, the deferral of tax and contribution obligations should be considered (for a significant part of companies, the biggest burden for them are taxes and contributions on employees' salaries). In pandemic conditions, it is worthwhile to temporarily change the regulations on sickness benefits so that their financing from the first day on is on the side of ZUS (Social Insurance Institution). This will reduce costs for employers. At the same time, we should consider benefits for the self-employed - on the one hand, these people, paying mostly symbolic contributions, chose lower benefits themselves, but on the other hand, during a pandemic, it is in the public interest that people even with slight symptoms or suspicion of illness should remain at home.
- The next step may be loan guarantees or loans to companies that do not reduce employment. This may be combined with a temporary reduction in wages, which in practice would mean that the cost of maintaining the job would be shared between the employee, the employer and the state budget.
- In the event of a prolonged crisis (e.g. maintaining restrictions for a few months), a cancellation of part of the companies' liabilities should be considered - for example, restaurants or cinemas, deprived of revenue for a few months, will have little chance to make up for such large losses in the foreseeable future. However, due to the fiscal costs, these measures should be introduced only as a last resort and in a possibly well-considered manner.

Expenditure increases related to these measures should be carried out within the existing fiscal framework. The amount of PLN 33 billion allocated by the European Union to Poland in the face of the epidemic for the purchase of medical equipment, liquidity support for companies and labour market programs (PLN 5 billion of unused cohesion policy funds, which the government no longer has to reimburse, and PLN 28 billion transferable from other cohesion policy spending), is not subject to the constraints of a stabilizing spending rule. If necessary, the government should declare a state of natural disaster or emergency, which will automatically suspend the rule. In this way, the increase in spending will be realized without undermining Poland's creditworthiness, which will be important both now, at

a time of capital flight to "safe havens" in developed countries, and after the epidemic, when Poland's borrowing needs may be much higher than today. During the epidemic, in addition to liquidity support, it will also be important to reduce regulatory uncertainty and administrative obligations imposed on businesses as far as possible. This is the direction of appeals from business associations (2020 - the year of regulatory calm) and so far also some government actions (e.g. postponement of the introduction of sugar tax). Also as a FOR, in Communication 6/2020 we pointed out the need for the government to limit all legislative activities, except those related to the reaction to coronavirus¹.

The fact that the National Bank of Poland, by announcing the purchase of treasury bonds on the secondary market, has started unconventional actions in monetary policy may be of concern. This is a risky move. First of all, the NBP does not have the same high credibility as the Federal Reserve and the European Central Bank, which have actually carried out such actions since the global financial crisis. Such opportunities always create a moral hazard. Secondly, it is difficult to withdraw from unconventional activities. The central banks that introduced such measures during the global financial crisis continued them to some extent throughout the next decade, slowing down the necessary structural adjustments in the economy. Thirdly, during an epidemiological crisis more than during a classical collapse, fiscal rather than monetary policy will be crucial. Monetary policy has no impact on supply-side barriers.

Once the epidemic is over, it will be crucial to create the conditions for the economy to recover as quickly as possible. The mere end of the coronavirus in Poland will not mean the end of the shocks - we do not know how the epidemic will develop in other countries or in what state the global economy will be. What is more, in response to the current crisis, many companies may change their way of functioning, e.g. by shortening supply chains and moving some production closer to their home markets, which will open new opportunities for competitive economies. Moreover, such a shock may convince companies and citizens to rethink their actions, e.g. by increasing the importance of remote working. In this context, "The Economist" highlights, for example, the long-term effects of the strikes on the London Underground, as a result of which 5% of passengers have permanently changed their way of commuting. However, for Poland to benefit from the changes in the global economy after the end of the epidemic, reforms are needed, above all:

- **Improvement of public finances.** We entered the current crisis unprepared. The Law and Justice government has spent the last 5 years of good times on new social transfers. As a result, even without the crisis, the government's planned public finance deficit would have reached 2.2% of GDP. The crisis will certainly worsen the state of public finances (due to a drop in revenue due to a slowdown in the economy and additional, crisis-related expenditure). Therefore, when introducing temporary aid measures (e.g. tax deferrals or sectoral subsidies), one should also remember about the plan to withdraw them. What is important is that while it may be justified to support jobs in companies that are experiencing temporary problems related to the epidemic, subsidizing companies that will not adapt to the new situation after the epidemic will be not only costly but also harmful, as it will slow down the structural adjustment of the Polish economy. Already now we can indicate potential places to look for savings - the thirteenth and fourteenth pensions, which we could no longer afford at the time

¹ <https://for.org.pl/pl/a/7638,komunikat-6/2020-finanse-publiczne-nieprzygotowane-na-koronawirusa>

of the adoption, or a reduced retirement age. The entire system of support for families with children (including 500+), which supports the richest households to the greatest extent, also requires changes.

- **Reform of the tax and social security system.** The Polish tax system (broadly understood, together with social security contributions) is not adapted to contemporary economic conditions. Labour taxation is very high (in the case of people earning half the average salary - the sixth highest in the OECD), the system is complicated and time-consuming (the second most time-consuming in the EU). Both the level of taxation and its complexity are the result of numerous privileges and exceptions to which farmers, miners, artists, uniformed services, judges and prosecutors or the self-employed, among others, are entitled. The easiest measure to reduce labour costs would be to eliminate the quasi tax, which is a contribution to the labour Fund, and increase the tax deductible costs for working people, financed by increased taxation of consumption. However, this is a minimum plan, because the whole Polish tax and social security system, like the labour Code, is becoming less and less compatible with contemporary, dynamic reality, as it was created for large factories and work organization in the second half of the 20th century.
- **Increasing economic freedom.** A profound regulatory reform will be required in many areas to enable entrepreneurs and employees to take advantage of the new opportunities. In addition to the withdrawal of harmful regulations introduced by the current government (e.g. the ban on trade on Sundays, the ban on the establishment of pharmacy chains), a broad review of numerous regulations restricting economic freedom will be necessary. For example, the existing regulations on remote working in Poland have been extremely rigid, and the possibilities for citizens to contact the administration by electronic means have been limited. Meanwhile, over the past week it turned out that many things can be done remotely. This applies not only to the administration itself, but also, to some extent, to other areas, such as health care or education. But nowadays it often requires bending the rules, which would be impossible in normal times. Therefore, instead of going back to the pre-crisis situation, it will be better to adapt the rules to the new reality.
- **Limitation of state ownership.** An important aspect of broadening the scope of state ownership should be the limitation of state ownership. State-owned companies, guided by political rather than economic considerations, are for the most part less efficient than private companies, and they pass on the costs of their inefficiency to their consumers (they are able to do so thanks to their monopolistic position, which they often maintain).
- **Reform of the judiciary system.** In addition to reversing the harmful changes that have been made to the independence of the judiciary over the last 5 years, it will be equally important to increase its effectiveness. Even before 2015, FOR pointed out that the excessive duration of court proceedings is a significant barrier to the development of Polish economy. Over the last 5 years, the actions of the Law and Justice Party government have not brought about any improvement in this respect (or even made it worse), while at the same time creating an even greater problem - the growing politicization of the justice system. Meanwhile, the prolonged state of the epidemic will create even more backlog.

The Civil Development Forum (FOR) was founded in 2007 by Prof. Leszek Balcerowicz to effectively protect freedom and promote truth and common sense in public discourse. Our goal is to change the awareness of Poles and the current and planned law towards freedom.

FOR accomplishes its objectives through the organization of debates and the publication of reports and analyses that address important socio-economic issues, in particular: the state of public finances, the situation on the labour market, economic freedom, justice and law-making. On the initiative of FOR, a public debt counter was launched in the centre of Warsaw and on the Internet, which draws attention to the problem of growing national debt. FOR's activities also include projects in the field of economic education and participation in campaigns to increase voter turnout.

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