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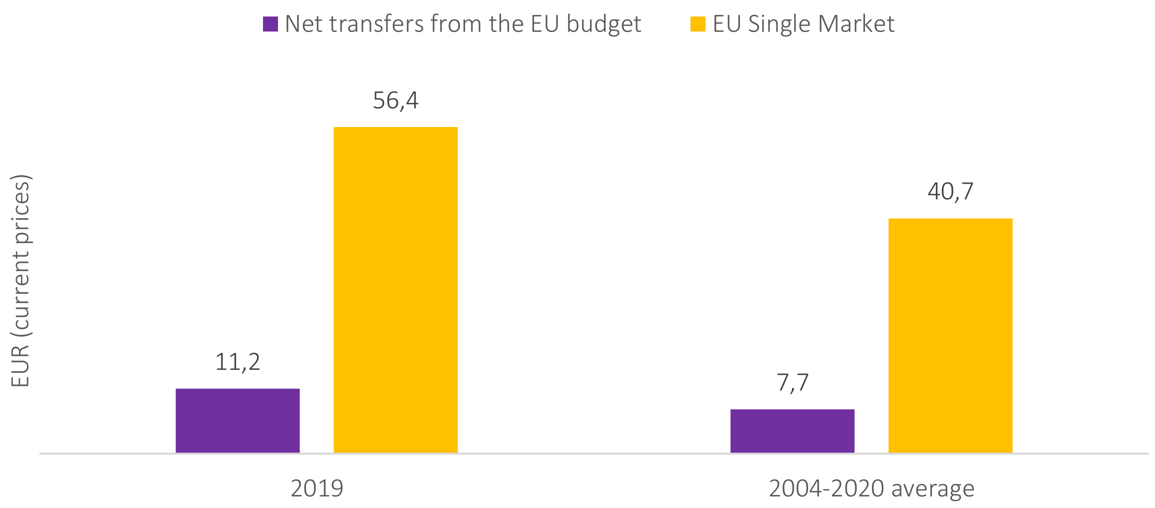
FOR Communication 37/2020: Single Market and the rule of law more important for Poland's development than the EU funds

- Poland's membership in the European Union means not only the EU funds, but above all access to the Single Market, whose four freedoms (movement of goods, services, capital and people), competition policy and the prohibition of state subsidies, common product standards or mutual recognition in case of their absence are safeguarded by the EU Court of Justice. The primacy of EU law over national law ensures uniform application of rules throughout the Single Market.
- Poland's benefits from access to the Single Market are five times higher than from subsidies from the EU budget. In 2019 we received net transfers of EUR 11 billion from the EU budget. But, thanks to access to the European Single Market, Poland's GDP was 56 billion euros higher. A larger market allows for a wider range of specialization and, consequently, higher productivity, which translates into higher wages and living standards.
- For foreign companies operating in Poland, our greatest asset is membership in the EU, subjecting us to common and predictable European rules and principles, which also include the rule of law. After the COVID-19 pandemic, international corporations can be expected to move their production closer to the target markets (*nearshoring*). However, in order for Poland to benefit from these changes, it is necessary to create transparent business conditions for investors to choose Polish market.
- Above all defending the rule of law is in the interest of Polish entrepreneurs. While foreign investors can count on the support of their governments, which was visible recently when the American Ambassador intervened in the case of US companies, for Polish companies the only protection against the government's arbitrariness remains the independence of courts. As a result, between 2015 and 2018, with the attack on the rule of law and crackdown on tax evasion by means of unclear new rules and high penalties, investments by Polish companies dropped by 4% and investments by foreign companies increased by 22%.
- In the long run, what matters for Poland's development is to push for completing and strengthening the Single Market for services, including digital services and transport. The lowest level of private capital in the EU makes it difficult for Polish companies to compete in industry, but the average performance in terms of human capital, i.e. education and health of employees, shows a high potential in services. International Monetary Fund also estimates that we have an advantage in exporting professional and technical services, which require further liberalization in Europe. In their case, adherence to transparent rules may, due to the greater complexity of disputes concerning intangible goods, be even more important than for commodities.

Thanks to the European Union, Polish companies can operate not only on the domestic market, where 38 million Poles produce 1% of the world's GDP, but on the European market, where 528 million Europeans produce 22% of the world's GDP (for comparison, the United States produces 24% of the world's GDP, and China 16%). A larger market allows for a wider range of specialization, and thus leads to an increase in productivity, on which workers' wages and living standards directly depend.

The European Single Market is much more than just a trade agreement. The four EU freedoms aim to fully liberalise the movement of goods, services, capital and people. EU competition policy prohibits governments from subsidizing national industries and companies, and EU institutions seek to harmonize regulations to remove non-tariff barriers to trade. Customs duties have been low in most countries for years thanks to the World Trade Organization, and the biggest obstacle often remains non-tariff barriers, such as regulations on product admission. For example, the EU allows 27 substances to produce sunscreens, while the US allows only 16. This way, European sunscreens protect better than US ones, but due to their composition they cannot be sold on the US market (Reisch, 2015). Many American sunscreens are not allowed to be sold in the EU because they guarantee too little skin protection. The European Single Market eliminates such trade barriers between Member States and subjects the enforcement of its rules to common institutions. Although Iceland, Liechtenstein, Norway and Switzerland have access to the Single Market without EU membership, this access may be limited in certain areas when compared to the Member States. These countries must also apply the rules established in the EU without having a voice in creating them.

Figure 1: Poland's benefits from net transfers from the EU budget and the EU Single Market



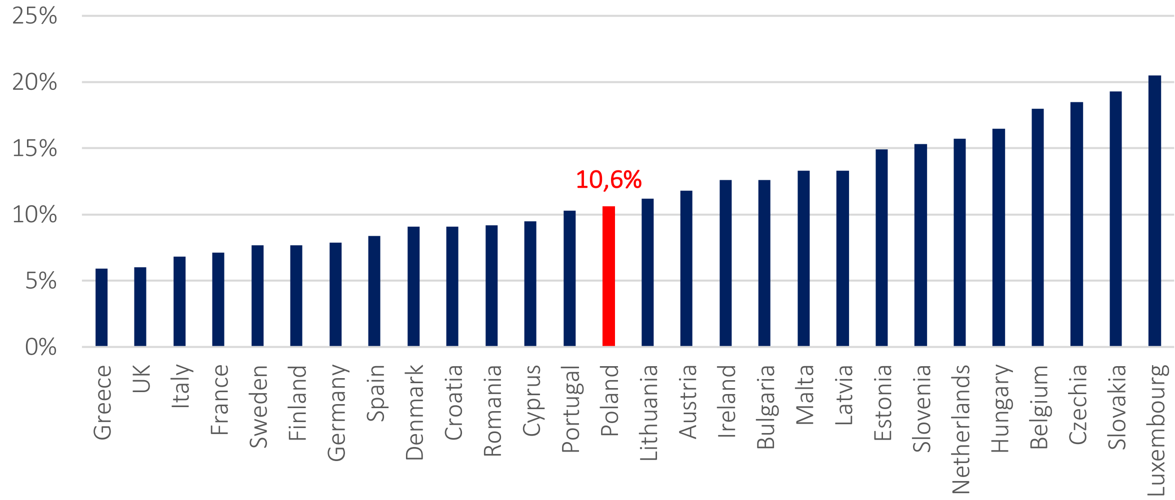
Source: Own elaboration of FOR based on Veld (2019), EC and MoF data

Poland's benefits from access to the European Single Market are at least five times greater than from EU funds. In Figure 1 we present net transfers received by Poland from the EU budget (based on data from the Ministry of Finance) and the benefits of the Single Market for goods and services according to estimates provided by Veld (2019)[1].

[1] Veld's estimates are based on the QUEST model, which is a DSGE class macroeconomic model used by the European Commission to evaluate public policies. Author estimates a counterfactual scenario in which there are customs and non-tariff barriers to intra-EU trade corresponding to the World Trade Organization rules. The change in the model takes place through internal trade channels and the intensity of market competition. In fact, the effects may be even greater because the model does not take into account the channel of innovation and the freedoms of movement of capital and people that make up the Single Market.

Poland's benefits from the EU Single Market are close to the average for all Member States. Smaller economies benefit more from access to the Single Market because they import and export relatively more than countries with a large internal market (Figure 2)

Figure 2: Benefits of access to the EU Single Market as % of GDP

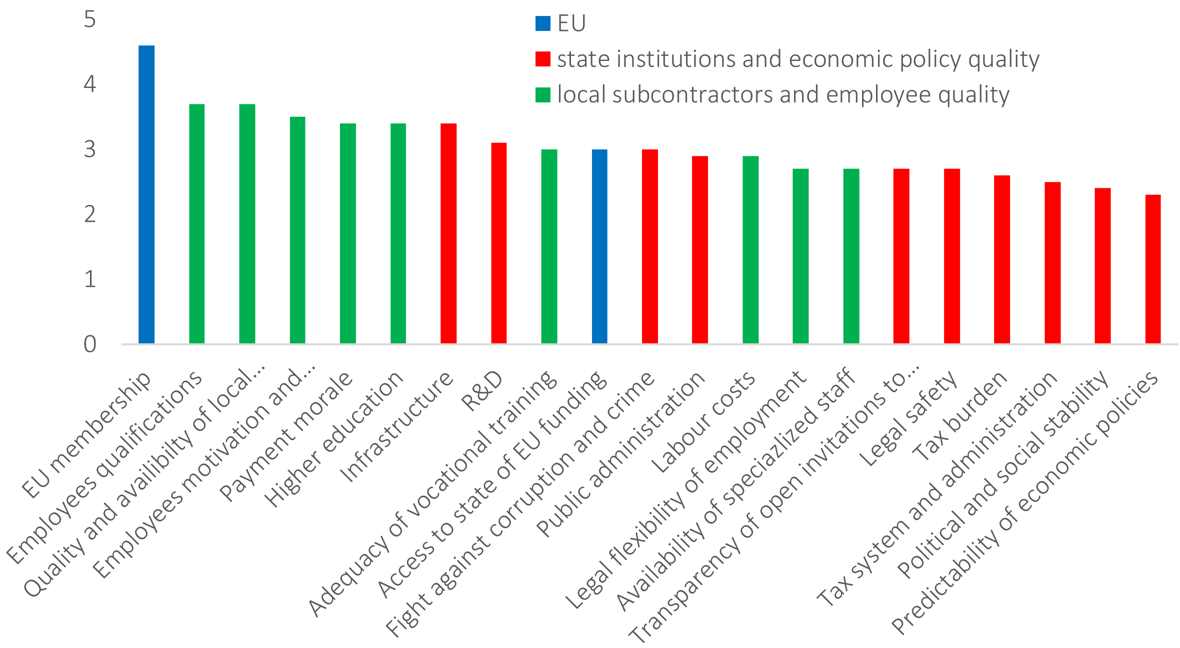


No estimates for Iceland, Liechtenstein, Norway and Switzerland, which participate in the Single Market with restrictions, but do not belong to the EU. The United Kingdom is participating in the Single Market on the same terms as before until end of 2020. Veld (2019) calibrates the QUEST model on WIOD data (2014).

Source: Own elaboration of FOR based on Veld (2019)

Poland's membership in the EU is crucial for foreign investors, and its importance will increase after the COVID-19 pandemic. The significant reduction in international transport during the COVID-19 pandemic has made many companies aware of the risks involved in moving their entire production far away from their markets. Poland, as a country with relatively low labour costs compared to the EU and at the same time located in the middle of Europe, may benefit from shortening supply chains (*nearshoring*). However, this requires the creation of appropriate conditions, including respect for EU rules governing the Single Market. In a recent survey conducted in cooperation with other chambers by the German Chamber of Commerce, investors present in Poland appreciated EU membership (probably after the pandemic the assessment of this factor will increase even more) and a thriving private sector (qualifications and productivity of employees, quality and number of local suppliers), while pointing to many problems in the public sector (Figure 3). Political and social stability, the unpredictability of economic policy and the tax system were particularly poorly assessed. It is in these areas in particular that we must strive to improve if we want to attract more foreign investors after the pandemic. At the same time, many similar problems are experienced by domestic companies, so the benefits will not be limited only to foreign entities.

Figure 3: Survey of factors influencing investment in Poland in 2019



Survey results among foreign investors present in Poland, with 5 being the best and 1 the worst.

Źródło: https://www.phig.pl/pl/article/514/2019/04/11/ankieta-koniunkturalna-2019/

Defending the rule of law is therefore primarily in the interest of Polish entrepreneurs. While foreign investors can count on the support of their governments in case of harmful actions of the Polish authorities, which was well seen in the example of American companies operating in Poland[2], for Polish companies the only protection against the government's arbitrariness remains the independence of courts. As a result, between 2015 and 2018, with the attack on the rule of law and the tightening of taxes by means of high penalties, investments by Polish companies dropped by 4% and investments by foreign companies increased by 22%.

Need for a broad coalition for further liberalization of the Single Market for services

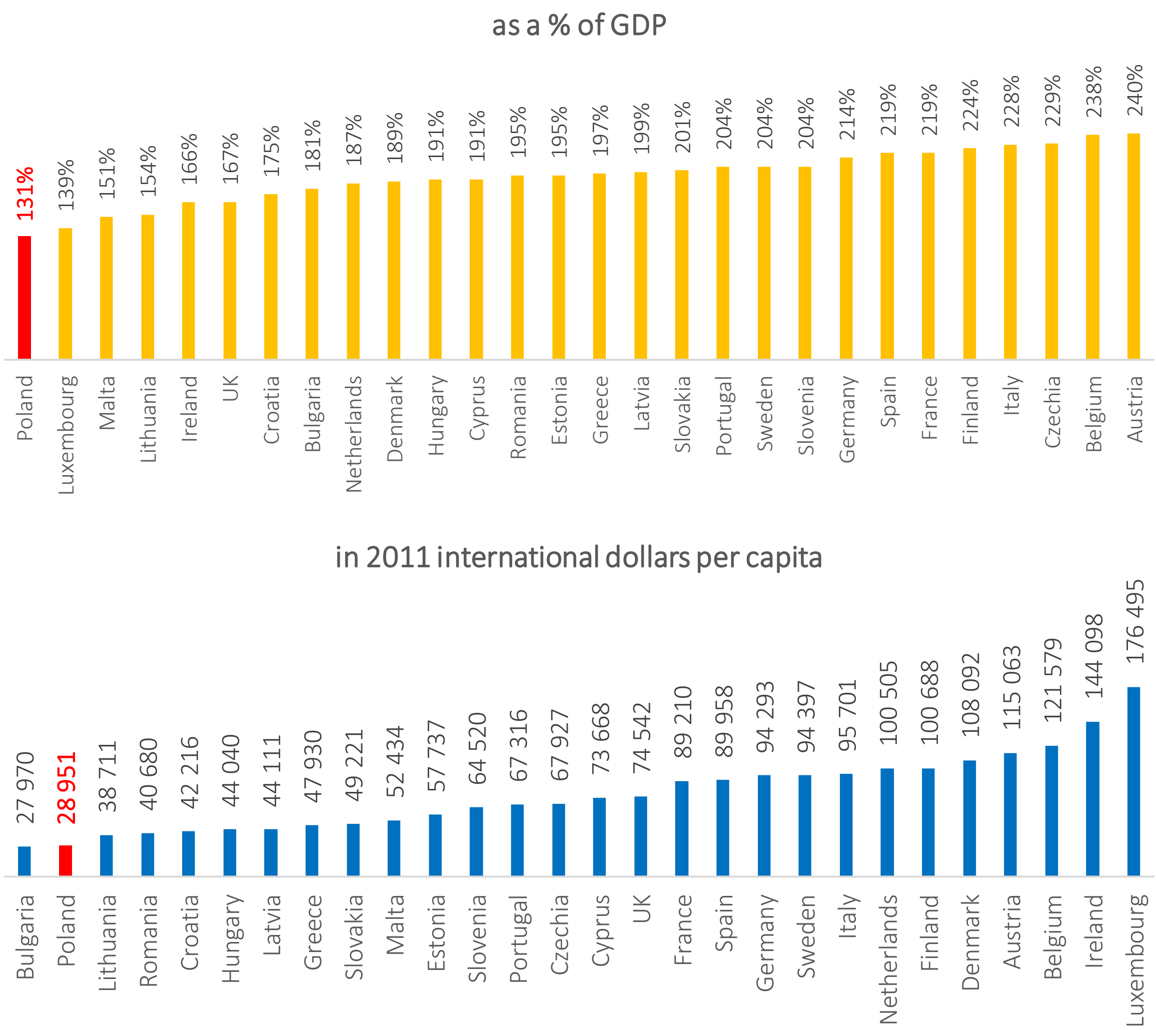
Economic integration in the trade of goods in Europe is already advanced, but the unfinished construction of the Single Market for services is still holding back Polish and European economy. Most start-ups with multi-billion dollar stock market capitalizations originate from the United States and China, not Europe. Thanks to large internal markets, technology companies from these countries can quickly achieve very large scale operations and access financing. Therefore, it is in Poland's interest to build as broad a coalition as possible for the liberalization of the services market.

The smallest in the EU private sector tangible capital stock and average human capital (in terms of workers' health and education) indicate that Poland's advantage lies in the provision of

[2] For example abandoning of the digital tax after visit of VP Mark Pence (https://polandin.com/44233209/poland-abandons-digital-service-tax-after-us-vp-visit), US Ambassador’s letter regarding transportation apps (https://polandin.com/40781592/another-letter-from-us-ambassador-leaks-out), and defence of US-owned tv station (https://notesfrompoland.com/2020/04/20/american-ambassador-defends-us-owned-station-attacked-as-fake-news-factory-by-polish-state-tv/)

services rather than goods. Tangible capital consists of machines, software, means of transport and buildings that increase employee productivity. Human capital is the productivity of an average worker resulting from his/her health and education. High labour productivity in industry requires significant expenditures of tangible capital, e.g. machines needed for car production, while in services, human capital often turns out to be more important, characterized by e.g. programmers and graphic designers creating video games. Also the IMF (2015), on the basis of the index of the revealed comparative advantage, concludes that Poland (like the Czech Republic, Romania and Hungary) has a comparative advantage over other EU Member States in the export of professional, scientific and technical services, for which there are still significant barriers in the Single Market.

Figure 4. Private (tangible) capital stock in 2017

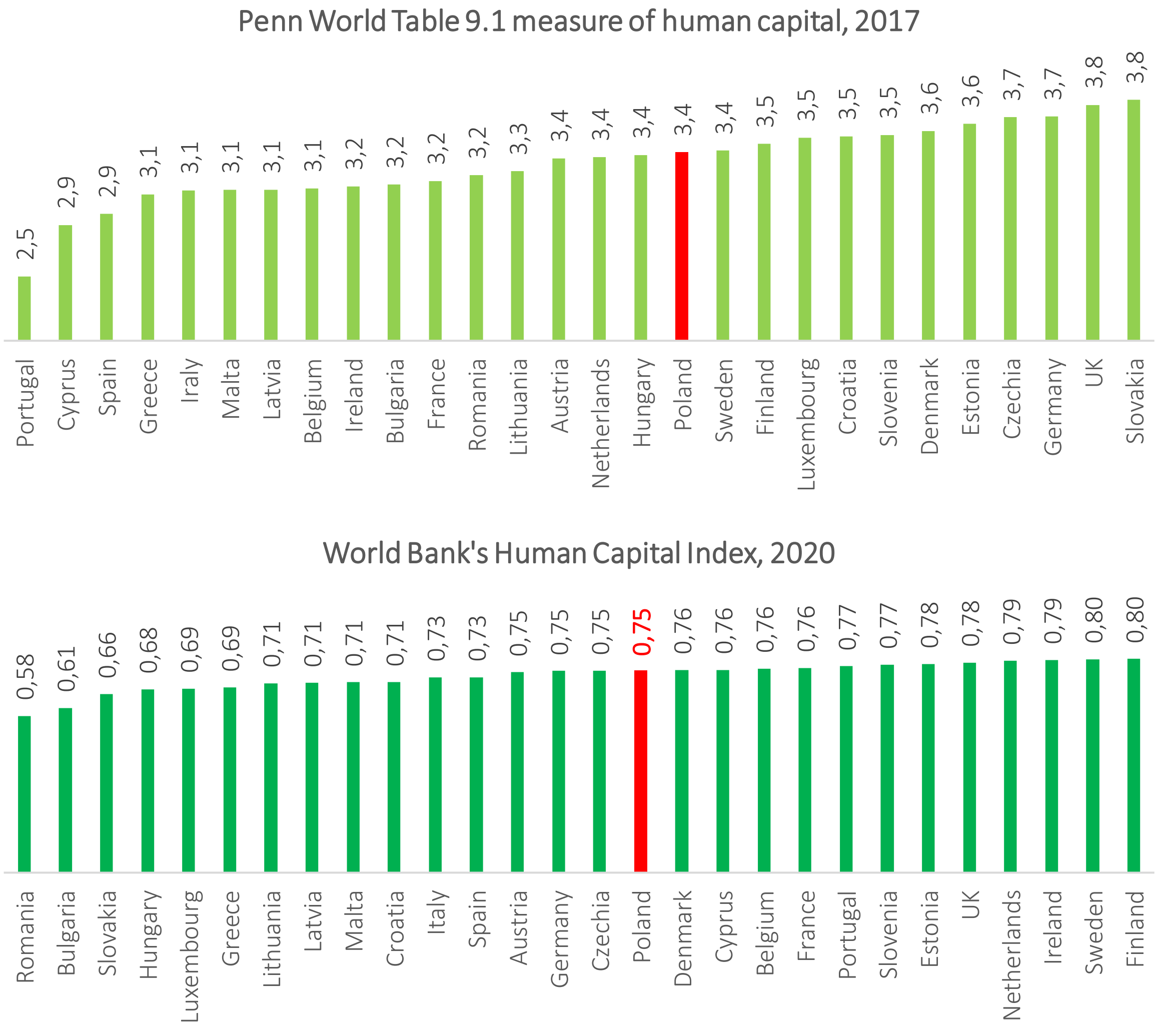


Source: Own elaboration of FOR based on IMF data (2020)

Poland is characterized by the smallest private sector tangible capital stock among all EU Member States. The IMF (2020) has estimated the global private sector's tangible capital for 2017. Among the EU economies, Poland had the lowest private tangible capital stock in relation to GDP and the second lowest (after Bulgaria) in international dollars per capita (Figure 4). Some service-specializing developed economies such as Luxembourg, Ireland and the United

Kingdom are characterized by low private capital in relation to GDP, but medium or high in international dollars per capita. In Poland it is low in both approaches and it is difficult to expect improvement, as stock of capital in most economies remains constant over many years and private investment in Poland remains low compared to both "old" and "new" Member States.

Figure 5: Human capital in Poland in comparison with EU-28



Source: Own elaboration of FORs based on Penn World Table 9.1 and World Bank data (2020)

Human capital, both on the basis of the years of education of today's employees and acquired by a newborn child under 18, on the basis of current health risks and educational opportunities, places Poland slightly above the EU average. Figure 5 shows the first of indices of the current economic potential of the Penn World Table 9.1 and the World Bank's Human Capital Index measuring how health and education shape the productivity of the next generation of workers, assuming that they will have the same educational opportunities and health risks as today's children. Further growth of human capital in Poland can be expected in the following years, as earlier generations (especially those brought up during the Polish People's Republic) had fewer educational opportunities and higher health risks than today's ones.

Summary

Respecting the rules governing the Single Market and completing its construction in the area of services, including digital and transport, are more important for the future development of Poland than the EU funds. Commitment to the rule of law is crucial for continuing to reap the benefits of the Single Market, which benefits Poland five-fold more than transfers from the EU budget. At the same time, a very low stock of private tangible capital makes it difficult for Poland to compete in the goods market, but a relatively larger human capital will increasingly build our competitiveness in the services market. The IMF also estimates significant benefits for Poland from the liberalization of trade in services, for which there are still significant barriers in the Single Market.

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AUTHOR:

Rafał Trzeciakowski
Economist
e-mail: rafal.trzeciakowski@for.org.pl

Civil Development Forum – FOR
Ignacego Krasickiego St. 9A · 02-628 Warsaw ·

Phone: +48 22 628 85 11, +48 726 621 240
e-mail: info@for.org.pl · www.for.org.pl/

/FundacjaFOR · @FundacjaFOR