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ROZWÓJ TURYSTYKI W POLSCE

Meeting Economic Policy Objectives and the Use of Investment Incentives for Tourism Development in Poland

WORKING PAPER

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Institutional Strengthening - Working Paper IV

Meeting Economic Policy Objectives and the Use of Investment Incentives for Tourism Development in Poland

by

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Contents

Introduction

In Institutional Strengthening Working Paper II the view was taken that government has to restrain itself in measuring out tasks, and that a division of labour with the private sector is desirable which leaves ample room for private initiative. In other words the decision-making process has to reflect to the highest possible degree the relative factor endowments and government has to abstain as much as possible from measures which distort the market mechanism of resource allocation (Theuns, 1993a).

In Institutional Strengthening Working Paper I, however, it had already been indicated that the market mechanism does not always produce optimal results and, with a focus on legal intervention, the rationale for government intervention in a market economy was outlined. Regulations to prevent monopoly positions, to protect consumers and the environment, and the pursuit of economic policy objectives, such as avoiding a chronic deficit on the balance of payments and income and employment generation, were given as reasons for government involvement in economic life (Theuns, 1993b). Providing guidance through indicative planning and the provision of social overhead capital (material and social infrastructure) for private sector development are generally accepted government tasks. Apart from such government activity in conformity with the market, however, circumstances may also arise which provide an argument for other government involvement in economic life.

The aim of this paper is to outline these circumstances and the conceivable government response to them.

Meeting Economic Policy Objectives

The government's pursuit of economic policy objectives derives from its responsibility for optimising national economic benefits from market operations in order to maximise national economic well-being. Common economic objectives are attaining a satisfactory level of economic growth, full employment, an acceptable degree of regional economic balance, a diversified economic structure, and an income distribution which is both socially acceptable and conducive to further economic growth. Orthodox instruments (intermediary objectives) applied to further the attainment of these (ultimate) objectives are the establishment of legal security, monetary stability, a fair and relatively stable system of taxation, and the provision of social overhead capital. The last mentioned intermediary objective, the provision of social overhead capital, is in Keynesian economics purposefully used to generate additional purchasing power. In order to alleviate widespread unemployment caused by recession then an anti-cyclical budget policy is applied to "pump-prime" the economy. This is the solution sought in Japan where the government has recently decided to invest heavily in infrastructure (airports, roads, bridges, tunnels, sewage, telecommunication) and research institutes of universities to boost the economy and counteract the recessionary contraction in demand. Contrary to most governments in other countries the Japanese government can afford this remedy because of its fiscal credibility: Japan has "room to reflate because it is the only big economy with a budget surplus and a tiny net public sector debt" (Anon, 1993a). This road is not open to countries with structural budget deficits and consequently a high domestic debt burden, often worsened by a high foreign debt burden. "The bigger the public debt, the greater the temptation for governments to erode the real burden of their debts by letting inflation rip. To cover that risk, investors demand higher interest payments, which cramp investment and growth. 'Expansionary' fiscal measures can be self defeating if their impact on demand is offset by higher interest rates" (Anon, 1993a). The Keynesian solution is not a feasible option for Poland because of: (1) the size of government debt - "Poland is 12.3 billion dollars in debt to commercial banks affiliated with the London Club" (Styczek, 1993a); (2) the burden of debt servicing - in 1991 Poland's foreign debts amounted to 281.4% of exports (Anon, 1993b) with an accordingly high debt service ratio; and (3) the recurrent deficit in the government budget which amounts to about 80 trillion zlotys annually or about 5% of the country's GDP (Styczek, 1993a). The question then arises whether it makes sense to apply some less far reaching and more specific solutions such as subsidies and/or tax facilities.

The Case for Wage-Subsidies

The more flexible a country's labour market, the more changes in demand and supply show up in relative wages rather than unemployment. Where countries have a high minimum wage, by contrast, this sets a floor for wages for the less skilled and so prevents the market from clearing. The result is higher unemployment. The lower the minimum wage the more flexible the labour market is. However, even in a situation in which no minimum wage exists still some notion about a socially acceptable minimum standard of living applies. Falling below this poverty line entails the risk of misery and starvation. Since this is socially, morally and politically unacceptable to any civilized society it has to be prevented, be it by a system of formal social welfare payments or by informal transfers among relatives and friends. Whether income transfers take the formal or informal form does not impact on the costs to society, although it may make quite a difference to those involved. Thus any measure which is capable of lowering these costs provides a relative gain to society.

Such a measure may consist of providing a wage subsidy to marginally unprofitable enterprises in order to prevent them from collapsing and causing a further rise in unemployment in a situation of already existing widespread unemployment at national or regional level. Already existing widespread unemployment is to be considered a precondition as providing a wage subsidy may reduce the company's efforts to become profitable in the short or medium run. It therefore also should be given only for a fixed time period. The granting of a wage subsidy is conditional upon it being a lower national economic cost than that which would be involved in the payment of transfer incomes to be made as a result of enterprise closure and consequent dismissal of personnel. This is what is implied in the statement by the Chairman of the Polish Economic Society that it is sometimes better to maintain production, even if it is not efficient, than to create unemployment (Sadowski, 1992).

In a country such as Poland which is in the process of transforming its former command economy into a market economy basic protection of the weaker social strata in the population is particularly called for as the starting positions in society and economy show strong inequalities. Those who were until recently at the lower end of the societal stratification not only lack the education and management experience but also the network of relations of the former nomenklatura. Without paying adequate attention to the inequality of opportunities the transition to a free market economy will not result in a socially acceptable income distribution and as a consequence a highly volatile political situation may emerge (Glombowski, 1993). Setting and respecting a welfare minimum, as announced by the new government (Styczek, 1993a), is a welcome step in a civilized society which wants to prevent civil strife and is on the way to realising "capitalism with a human face".

Investment climate

The investment climate consists of the dynamic business environment and the perceived inherent strengths, weaknesses, opportunities and threats connected with operating a business in that environment.

It has been pointed out before (Theuns, 1993a) that the special characteristics of tourism make it particularly susceptible to (changes in) the business environment. "In tourism, where visitor flows to a country might be diverted by reason of political, economic or national disaster, the investment risk might be higher than in other industries. It is this evaluation of risk which has led many international hotel companies to offer 'management only' service contracts (...) leaving the capital investment to be found by the host country" (Jenkins, 1982). Risk is a concomitant of change in the business environment (economic, political, social, cultural or physical, both national and international).

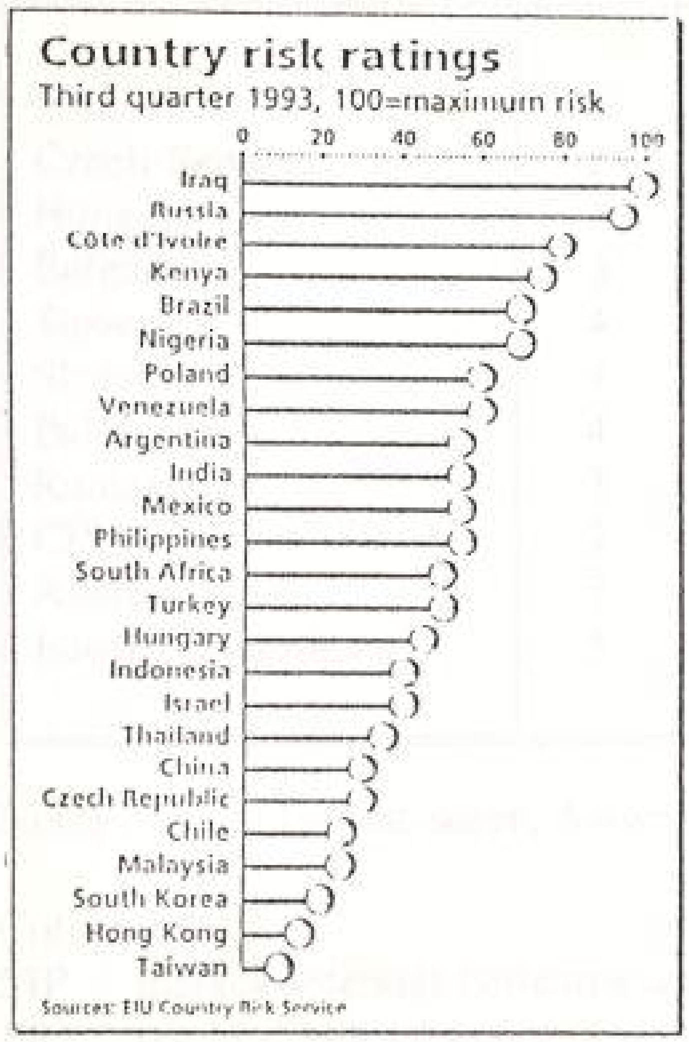
The interdependent system in which the enterprise functions has been outlined in previous papers. Based on the initial idea of Lorsch and Morse (1974), it can graphically be depicted by way of a number of concentric circles (Theuns, 1993c and d). It shows that enterprise viability is influenced by a three-layered system of dependencies consisting of the intra-sectoral, the wider domestic and the international environment. It is obvious that the viability of an individual enterprise can be judged appropriately only within the context both of the sector's inherent prospects based on the degree of attractiveness of the destination in comparison with competing destinations (intervening opportunities), and of the existing intra-sectoral relations, providing external effects (benefits and/or costs). Apart from this the prospects both of the sector and of the individual enterprises depend on the wider domestic and international context. Taken together these are referred to as the investment climate. The investment climate is dependent on a multitude of societal domains (politics, economy, physical environment, culture, and social structure and social relations) and how developments in these are perceived by potential investors.

Investing in tourism implies making an often substantial long-term financial commitment, therefore the investment climate and particularly the perceived risk of negative changes, such as political upheavels, an increased tax burden, or a degradation of the physical environment, is to be considered of crucial importance.

At present, according to the Economist Intelligence Unit's (EIU) data, the risk rating of

Poland is not conducive to large-scale long-term investment (Figure 1).

Figure 1.



Out of the 25 countries listed Poland is considered to have an above average riskiness. The riskiness assessed by the EIU is a weighted average of eleven factors including indebtedness, current account position, economic policy, and political stability. A rating of 100 indicates maximum risk. Poland is rated at 60, better than Russia but worse than Hungary and the Czech Republic. The result of the analysis depends on the basket of factors taken into consideration, the weights attached to these factors, and the perceptions of the analysts involved in the exercise. It therefore is not surprising to note that divergent views exist. The ABN-AMRO Business Supporter provides data based on the East European Country Profiles published quarterly by the London office of Ernst and Young according to which in Central and Eastern Europe Poland scores best. They apply no weights and limit the analysis to six broadly defined factors (Table 1).

Table 1. Risk Rating of Central and Eastern European Countries as of May 1993

	MP	PR	CR	DE	S	BJ	Total
Poland	1	2	2	3	2	2	12
Czech Republic	2	2	2	3	2	2	13
Hungary	3	2	2	3	2	2	14
Bulgaria	3	3	3	4	3	3	19
Slovenia	4	3	3	3	3	3	19
Slovakia	4	3	3	4	3	3	20
Baltic States	4	3	3	4	3	4	21
Rumania	3	4	4	4	4	3	22
CIS	2	4	4	4	4	4	22
Albania	5	4	4	5	4	4	26
Former Yugoslavia	5	5	5	5	5	5	30

Notes: 1=best score; 5=worst score

Columns:
MP market potential (structure and size) and attitude towards foreign investment
PR political risk (stability of government and market orientedness of policies)
CR credit rating stands for level of government debts and attitudes of international financial markets towards this
DE domestic economic situation and achievements
S stability, both economic and political
BJ business infrastructure (legal framework, professional services, telecommunication and distribution)

Source: ABN-AMRO, 1993

The picture provided in Table 1 of Poland's situation confirms as far as the investment climate is concerned, that provided by Wason, Touche Ross Management Consultants, Greene Belfield-Smith Division, at the November 1993 London Conference on Hotel Investment and Tourism Development in Central and Eastern Europe (Wason, 1993). In comparison with the other countries in the region Poland scores high. This does not imply, however, that there is no room for, sometimes substantial, improvement. Factors such as the risk of tyranny, turmoil, and war within the post-communist East, which is considered to be still large (Anon, 1993c) are clearly largely outside the policy scope of one country and have to be tackled at an international level. This also applies, although to a far lesser extent, to some environmental liabilities. Both the scope and importance of unilateral policies to upgrade the environmental situation should not be underestimated. "A survey of about 1,000 big North American and West European companies, conducted last year by the World Bank and the OECD (..), found that over half of those companies that got as far as evaluating sites in Eastern Europe rejected them at least partly on environmental grounds" (Anon, 1993d). Other factors having a bearing on the investment climate can be pointed out as being subject and responsive solely to national action in Poland and not needing inter-governmental co-operation.

A report on foreign investment in tourism in Central and Eastern Europe identifies a number of problem areas common to all countries in this region, including Poland (Hunt, 1993). The author mentions:

- uneven quality of services and accommodation;
- unstable currencies and rising prices;
- poor marketing of the range of products that are available and lack of proper qualitative controls (i.e. no licensing systems);
- uncertainty about demand beyond a hard core of business travellers to key cities;
- domestic political instability;
- disruptions caused by rapid changeover of governments;
- policy changes;
- bureaucratic delays, changing approval processes, and changes in personnel;
- land ownership issues;
- psychological barriers to foreign investment: fears of foreign economic domination and exploitation.

During recent Economic Seminars for Poland the following deterrents/problems areas were signalled (Styczek, 1993a; Pazio and Romaniuk, 1993):

- Poland's high debts to commercial banks affiliated with the London club;
- The recurrent deficit in the state budget;
- The bad debt burden of Polish banks;
- The unclear and inconsistent legal system;
- The enormous influence of trade unions (Cf. for instance Ministry of Privatization/Price Waterhouse, 1992; Falczyński, 1993);
- The poor infrastructure, including telecommunications and overland transportation;
- The still strong dependence of the economy on political decisions;

- Bureaucracy (decision makers' foot dragging and "red tape");
- The lack of good book keeping, which makes it difficult to value properties; and
- For investment banks, the absence of efficient mechanisms for recovering money loaned.

According to French corporate development specialist Lajoie (1993) perhaps the most often cited deterrent to private investment is to be found in "the frequent changes in government regulations which require constant double-checking, preventive measures or postponement of key decisions pending rule clarification". The head of the trade promotion section at the German Embassy in Warsaw, Hardieck, succinctly speaks of an "extremely frustrating instability in legal regulations" (Pazio and Romaniuk, 1993). This confirms that stability in the economic and legal system is of the utmost importance to investors. In fact it is incorporated in the two essential prerequisites for a properly functioning market economy, as formulated by Franck (1990), namely (1) political and economic stability and (2) guaranteed rights and social harmony. The basic nature of these is clear from the fact that for instance, without some guaranteed stability in taxation the whole effort of making a business plan (Cf. West, 1991) is jeopardised. In making investment decisions clarity is needed and therefore a guarantee that the tax burden will not be significantly increased within a reasonable period of years is more important than the actual level of taxation (as long as this is not excessive), or providing some temporary tax relief.

Investment Incentives

Investment incentives can be defined as government assistance to encourage firms to invest in physical assets in total, in particular industries, or in particular locations. They can be classified under three broad headings (Bodlender, 1982):

A. Measures to reduce the initial capital outlays, such as:
- capital grants;
- exemption of customs duties on imports during the construction phase;
- provision of project specific infrastructure (construction of access roads, utilities brought to site of structure);
- provision of land on concessional terms;
- equity participation.

B. Measures to reduce operating costs, such as:
- loans at concessional terms (interest rate subsidy, grace period);
- tax holidays;
- labour or training subsidies;
- exemption of customs duties on imports during the operational phase;
- special depreciation allowances.

C. Measures providing investment security, such as:
- guarantees against expropriation or nationalisation;
- guaranteed access to foreign exchange needed for imports;
- guaranteed right to repatriate invested capital, profits, dividends and interest;
- guaranteed provision of work permits for key personnel.

It goes without saying that investment security must be taken as essential. It is a *conditio sine qua non* to any investment and should be considered part and parcel of the investment climate. In fact it is not an incentive and does not conform to the definition given. As to the remaining two categories of incentives Wanhill (1986) has demonstrated that measures to reduce the initial capital outlays are superior to those aimed at reducing operating costs. Tourism projects are characterised by a high operating leverage, they have a high ratio of fixed to variable costs, and are therefore subject to greater profit variance and risk. Measures to reduce the initial capital outlays directly reduce the fixed costs and the risk inherent in the high level of these costs. Wanhill (1986) rightly concludes that "Given that variable costs are low, (...) a 'once-and-for-all' reduction in capital costs at the start of the project should be sufficient to ensure viability, and that incentives to reduce operating costs are largely unnecessary". Lump sum capital support (capital grants, equity participation, benefits - in - kind such as the provision of land or facilities) is, moreover, easier and less expensive to administer. If incentives are to be applied lump sum capital support should be the preferred means of "pump-priming" tourism investment. Using this instrument makes sense if widespread unemployment at national or regional level exists. As its use in this case is in employment creation the amount of support should be related to the amount of permanent employment to be created. It therefore should be based on an inter-sectoral comparison of investment costs per job. Further, investment incentives are to be considered as extras aimed at selectively increasing investment in specific sectors and/or regions. They have to be embedded in and be in line with formulated, adopted and implemented sectoral and regional development policies. Only then a careful evaluation of projects at the micro level within a macro and sectoral development framework is possible. Incentives are no substitute for the implementation of a sound sectoral development approach aiming at providing an optimal sectoral investment climate. As Jenkins (1982) notes: "It does not follow that an advantageous or even generous set of incentives will necessarily attract foreign investors - to a significant extent this will depend on the investor's perspective of the country".

Conclusion

In the present economic situation in Poland which is characterised by a depressed demand and high unemployment, particularly in some regions, it would make sense to provide a push to the economy by additional government investment in infrastructure, from which among other sectors also tourism would profit. The fragile state of the economy, however, makes this impossible. The government budget deficit leaves no room for large-scale across the board initiatives. Therefore less expensive more specific solutions such as subsidies and tax facilities have to be considered. For those regions with a substantial tourism development potential and excessive above national average unemployment it makes sense to grant wage-subsidies to marginally unprofitable tourism enterprises. Such wage-subsidies should be lower than the cost of living at the poverty line or the social welfare benefits to be paid by the state in case of additional unemployment. Since everything possible should be done to guarantee that such subsidies do not act as a disincentive for efforts to become profitable they should be given for a fixed period only and be gradually phased out during that period. If pegged to the level of unemployment benefits a revision will be needed after 12 months anyway.

Increasing investment and creating additional employment through tourism as in other sectors depends on the investment climate which is determined by a multitude of factors. It is important to note that improvement of some of these factors does not require large-scale capital outlays. In a situation of capital scarcity government efforts should focus on these factors. For tourism development this implies that attention should be focussed on such activities as introducing quality control of tourism services through licensing and grading (Cf Hueck, 1993), establishing an efficient and effective National Tourism Organisation, and devising and implementing a coherent tourism policy (Cf Theuns, 1993a). The latter is also a prerequisite for the application of investment incentives. These have to be embedded in and be in line with formulated, adopted and implemented sectoral and regional development policies. Due to the cost structure in tourism projects, which are characterised by a high operating leverage, the preferred financial incentive should be lump sum capital support. Given the strains on the government budget, however, in the present economic situation this will be hardly feasible.

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