REPUBLIC OF POLAND

Report on action taken by Poland in response to the Council recommendation of 10 December 2013 in order to bring an end to the situation of an excessive deficit

Warsaw, April 2015

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Introduction

In 2009 the Ecofin Council (i.e. economics and finance ministers of the European Union member states) decided that an excessive deficit existed in Poland and issued a recommendation to reduce the excessive deficit below 3% of GDP by 2012. In June 2013, the Ecofin Council, having positively assessed the effectiveness of actions taken by Poland towards the reduction of the deficit, due to the significant slowdown of the economic growth[1] and the associated failure of Poland to reach the recommended headline deficit target, established that Poland should put an end to the excessive deficit situation by 2014.[2] The new recommendations of the Ecofin Council of 10 December 2013, extended the deadline for this correction by one year, i.e. until 2015.[3]

In the latest recommendations, the budgetary targets for Poland in the period 2013-15 were defined as nominal deficit targets of: 4.8% of GDP, 3.9% of GDP and 2.8% of GDP, respectively (excluding the impact of the assets transfer). The Ecofin Council also stated that the achievement of those budgetary targets required an improvement in the structural balance by 1% of GDP in 2014 and by 1.2% of GDP in the following year. As compared to the European Commission's forecast in this period,[4] this meant the need for Poland to take additional structural measures amounting to 0.4% of GDP in 2014 and 1% of GDP in 2015.

In addition, the Ecofin Council recommended that Poland should:

- improve the quality of public finances, in particular through minimising cuts in growth-enhancing infrastructure investments, a careful review of social expenditures and their efficiency;
- improve tax compliance and increase the efficiency of tax administration;
- make the institutional framework of public finances more binding and transparent, including, through adjusting the definitions (methodology) used in the national budgetary system to the methodology used in the European System of National and Regional Accounts (ESA) and ensuring sufficiently broad coverage, improving the intra-annual monitoring of budget execution and ensuring an effective and timely monitoring of compliance with the permanent expenditure rule, based on reliable and independent analyses carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities.

Moreover, according to the Ecofin Council, the fiscal consolidation should be backed with comprehensive structural reforms, consistent with the recommendations of the Council issued within the European Semester.

The objective of the *Information*

The objective of this cyclical report is to present the state of implementation of the aforementioned recommendations related to public finances by Poland, including information and forecasts of economic and budgetary situation, which are to be specified in this year's update of the *Convergence Programme.* Based on the analogical information of 15 October 2014 concerning the progress in implementation of the aforementioned recommendations of the Ecofin Council[5], in autumn last year the European Commission held the excessive deficit procedure in abeyance and considered that no further steps towards Poland were needed[6].

The forecast of the European Commission published in February this year[7] indicates that Poland has reached its budgetary targets for 2013-14. The nominal deficit in 2013 (4.0% of GDP) was much lower than recommended by the Ecofin Council (4.8% of GDP), and in 2014 (3.6% GDP[8]) it was also better than recommended (3.9% of

[1] In 2012 the real GDP growth in Poland reached 2.0%, against 4.5% in 2011; in 2013 this rate decreased to 1.6%.
[2] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-07_council/2013-06-21_pl_126-7_council_en.pdf
[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0906:FIN:PL:HTML
[4] http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee7_en.pdf
[5] The report is available on the website of the Ministry of Finance at: Report on action taken by Poland in response to the Council recommendation of 10 December 2013 in order to bring an end to the situation of an excessive deficit.
[6] In relation to the assessment of June 2014, available on the website: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/other_documents/2014-06-02_pl_communication_from_the_commission_pl.pdf
[7] http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee1_en.pdf
[8] In accordance with ESA2010.

GDP). On the other hand, for 2015 the European Commission forecast the deficit of 2.9% of GDP, i.e. slightly above the recommended level (2.8% of GDP), however, below the reference value of 3% of GDP, i.e. at a level whose reaching would allow for timely abrogation of the procedure in relation to Poland. According to the European Commission, in 2016 the nominal deficit will decrease to 2.6% PKB, whereas the general government debt will remain below 50% of GDP over the forecast period.

In accordance with information and forecasts presented in this report, in 2014 the nominal general government deficit was reduced much more than recommended by the Council, to the level close to 3% of GDP. At the same time, Poland remains the country with the general government debt much below the reference value of 60% of GDP. In such a case, in accordance with the Stability and Growth Pact, the net cost of the pension reform should be taken into account in the assessment of the country's budgetary situation. Accordingly, following the adjustment by costs of the systemic pension reform (introduced in 1999), still incurred in 2014, at a level of 0.4% of GDP, the general government deficit in 2014 is estimated below 3% of GDP. Taking into account that the 2015 general government deficit is forecasted at a level of 2.7% of GDP, it can be stated that the excessive deficit in Poland has been sustainably corrected.

1. Budgetary situation in 2014

As a result of implemented consolidation measures as well as the economic growth structure which was more favourable for public finances (increase in the contribution of domestic demand by approximately 4.7 percentage points in 2014), and despite an increase in one-off and temporary expenditure (described below), the **nominal general government deficit in 2014** was reduced by 0.8 percentage points and **reached 3.2% of GDP, i.e. was much below the target of 3.9% of GDP recommended by the Ecofin Council in December 2013**. **Taking into account the costs of the systemic pension reform** (introduced in 1999), still incurred in 2014, at a level of 0.4% of GDP, **it is estimated that the adjusted deficit** (comparable with balances in countries which have not implemented the funded pension scheme) **reached 2.8% of GDP and, consequently, was reduced to below 3% of GDP** (cf. Box 1).

Box 1. Economic and statistical consequences of changes in the pension system in 2014 for the excessive deficit procedure

In the period until August 2014 the multi-pillar pension system in force in Poland was compliant with the conditions specified below, defined by Eurostat as prerequisites of eligibility of a pension reform to be recognised as a systemic pension reform for the needs of the excessive deficit procedure[9].

1. The system must be fully funded, mandatory, with a broad coverage in the population:

- the latest Eurostat assessment (of 2 December 2014) has not raised the issue of OFE (open pension funds) nature, consequently, **OFE, where the current contributions continue to be transferred, are still treated as a fully funded system**;
- in its latest assessment Eurostat directly refers to the issue of the mandatory transfer of contributions to the fully funded pillar: "[…] *the transfer of the pension contributions to the second pillar ceases to be mandatory*

[9] Article 2 item 7 of *Council Regulation (EC) no 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure,* as amended, stipulates special treatment of countries with the fully funded pension system reform in the excessive deficit procedure. The reason is that the net cost of the pension reform for the public fund should be taken into account, associated with the functioning of the pension system with the mandatory, fully-funded private pillar. This cost results from the fact that the contributions once classified as the general government revenue , are transferred to the fully funded pillar classified outside the general government. The EU institutions also take the cost of pension reform into account while considering the end of the excessive deficit procedure, if the excess over the reference value of 3% of GDP results exclusively from the reform cost.

and becomes voluntary". **The said contributions ceased to be transferred to the fully funded pillar on a mandatory basis only as of August 2014. Until that moment their transfer was mandatory**[10];

- **thus, until August 2014 the system was compliant with the requirements concerning the broad coverage in the population**.

2. The fully funded pillar has to be classified outside the general government (treated as private):

- the Eurostat assessment of 2 December 2014 does not refer to this aspect, which means **the lack of changes in the classification method of the fully funded pillar**.

3. Compliance with the aforementioned conditions **must be confirmed by Eurostat** (the position of Eurostat expressed on request of the Member State concerned):

- in accordance with the Eurostat assessment of 11 April 2013, the pension reform of 1999 has been recognised as the systemic pension reform[11];
- although in its recent assessment Eurostat does not indicate the explicit date as of which the Polish reform ceased to be systemic, it states that:

*Eurostat is of the view that, **after the amendments in 2013**, the Polish pension reform of 1999 is not eligible for a treatment as a systemic pension reform. **As a result of the changes incurred, the second-pillar ceases to be mandatory and will decrease its population coverage***;

- in accordance with applicable regulations related to ESA 2010,[12] Eurostat uses the economic concept instead of a legal one:

*Key concepts for measuring government deficit and debt ESA 2010 is a system for producing macro-economic statistics. As such, **it records the economic reality of transactions rather than their legal form**. Reporting the **economic reality where it is different from the legal form** is a fundamental accounting principle to give consistency and to make sure that transactions of a similar type will produce similar effects on the macroeconomic accounts, irrespectively of the legal arrangements.*

Summing up, in accordance with the current assessment of Eurostat, after the changes applied, the pension reform of 1999 is not eligible for a treatment as a systemic pension reform due to the fact that the participation in open pension funds is voluntary and a relatively limited number of the insured decided to save in OFE. **However, both above mentioned factors have materialised only as of August 2014, after the termination of the transfer window. Due to this fact, only then was the Social Insurance Institution (ZUS) able to estimate the number of the insured who had remained in OFE and, on that basis, Eurostat stated that:**

***According to the information available as of 14th of August 2014**, the number of people who made a statement to ZUS to continue paying part of their pension contributions to OFE, equals around 17-18% of those eligible to choose*.

The economic effect of introduced legislative changes for the general government balance actually occurred in August 2014 (with respect to contributions paid for July). On the other hand, the transfer of OFE assets to ZUS in February 2014 had an impact only on the reduction of the general government debt, and not on the general government balance. That transfer also did not affect the conditions of recognising the pension reform as a systemic reform.

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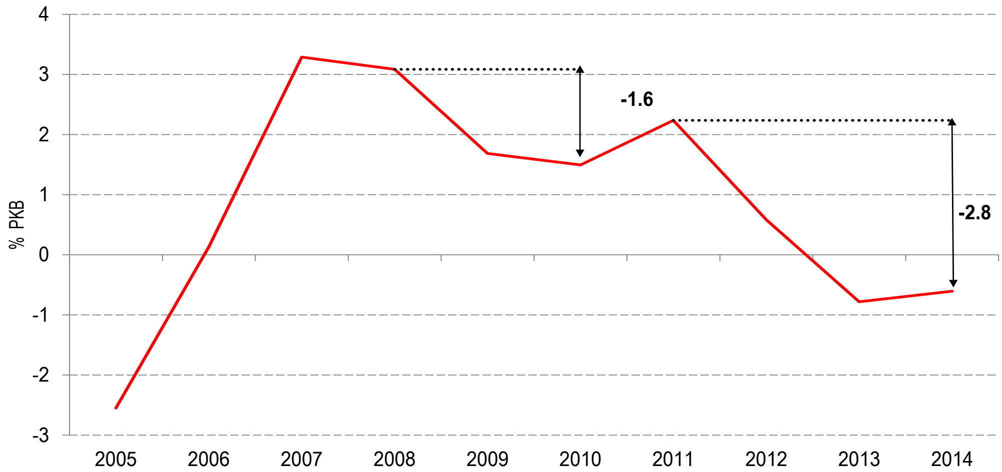
[10] From 1 April to 31 July 2014 (the so-called transfer window) persons who had entered the labour market prior to entry into force of the changes in the pension system (mandatory participation in OFE), had an option to decide whether their future contribution should be transferred to OFE or to Social Insurance Fund – FUS (the decision referred to only 2.92% of the basis for calculating pension contributions). Irrespective of the date of taking the aforementioned decision, the contribution paid for July 2014 was the first transferred to the entity they had selected (OFE or FUS). Only a marginal number of persons entering the labour market after 1 February 2014 made an effective choice already as of 1 February 2014.

[11] "(…) *In its letter of 11 of April 2013, Eurostat considered the Polish pension reform of 1999 as eligible for a treatment as a systemic pension reform. At that time, the reform fulfilled the above criteria.*(…)" The letter is available at: http://ec.europa.eu/eurostat/documents/1015035/2990403/PL-Reply-to-ex-ante-consultation-related-to-systemic-pension-reform-27-11-2014.pdf/86c08827-225f-4231-9f74-be6c2e7b9e1a

[12] *Regulation of the European Parliament and of the Council (EU) no 549/2013 of 21 May 2013 on the European system of national and regional accounts in the European Union*.

It is worth stressing that a stronger, than recommended by the Ecofin Council, fiscal consolidation was accompanied by a deterioration of the business cycle in Poland, almost two-fold higher in relation to the downturn observed in 2009-10, as measured by the change in the output gap in 2012-14 (cf. Chart 1). At the same time, **the structural balance improved by 0.9 percentage points**, i.e. by the value close to the Ecofin Council recommendation of December 2013 (1.0 percentage points). On the other hand, the **fiscal effort, adjusted** for the error in the forecast of the potential GDP nominal growth, the extraordinary changes in revenue and changes in the scope of the general government[13] in relation to the moment of issuance of the recommendation by the Council, **amounted to 1.0 percentage point, i.e. fulfilled the Council recommendations**.

Chart 1. Output gap 2005-14



Source: Ministry of Finance.

While calculating the structural balance for 2014, the following one-off and temporary measures have been taken into account:

— payments from the Bank Guarantee Fund (BFG) in connection with the restructuring of Credit Unions in the amount of PLN 3.1 billion;

— net effect of adjustment of the EU budget arising from the revision of VAT and gross national revenue in the amount of + PLN 1.5 billion;

— expenditure associated with the implementation of the Constitutional Tribunal ruling in connection with old age pensions from the Social Insurance Fund related to persons who acquired old age pension entitlement before 1 January 2011, without the need to terminate the contract of employment, in the amount of PLN 0.8 billion;

— expenditure associated with the implementation of the Constitutional Tribunal ruling resulting in payment of the overdue benefit for caretakers in the amount of PLN 0.3 billion.

The fiscal consolidation continued in 2014 comprised the limitation of expenditure as well as the growth of the general government revenues. The relation of domestic expenditure to GDP (after deducting the expenditure financed from the European Union funds, where the general government entities are the final beneficiaries) reached a level of 40.4%, i.e. by 0.4 percentage points lower than in 2013. At the same time, public investment expenditure which, in accordance with the Ecofin Council recommendations, should not be the area of consolidation, increased by 0.3% of GDP, i.e. by 11.9% y-o-y. It was mainly the result of a significant recovery in the local government sub-sector, where investment grew by 0.3% of GDP, i.e. by 18.6% y-o-y.

[13] Pursuant to the decision of February this year of the Team for General Government Statistics, established by the President of the Central Statistical Office, the PKP Polish Railway Lines company (PKP Polskie Linie Kolejowe S.A.) was included in the general government (central government sub-sector) as of 2014. At the same time, Eurostat decided to include BFG in the general government.

On the other hand, the relation of the domestic general government revenue to GDP increased by 0.5 percentage points in 2014. It was mainly the effect of including in the general government the PKP Polish Railway Lines company – PKP Polskie Linie Kolejowe S.A. (0.2% of GDP). The remaining part of the improvement in the aforementioned relation results from the government measures taken in order to strengthen the revenue side (i.a., the extension of application of the *reverse charge* mechanism, introduction of the joint liability of the purchaser for tax liabilities of the supplier of steel products and fuels in VAT, implementation of the action plan increasing tax compliance and improving the effectiveness of tax administration[14]), as well as from macroeconomic factors which generally had a positive impact on the revenue, even though the price developments of goods and services were below the forecast.

2. The underlying conditions of budgetary situation 2015-16

2.1. Macroeconomic outlook

According to current forecast, in 2015 GDP in Poland will increase by 3.4% in real terms, i.e. by the same value as in the previous year. Domestic demand will remain the key driver of economic growth as a result of further acceleration of private consumption growth and maintaining the growth of private and public investment at a high level[15]. The growth in real household disposable income will be fostered by positive tendencies observed in the labour market, decline in consumer prices, increased indexation of pensions and old age pensions as well as further increase of state aid for families with children. The positive impact of the private demand on the economic activity will be accompanied by maintaining of the positive - although lower than in 2014 - public sector contribution to the GDP growth. Contribution of net export to the GDP growth will remain negative and it will reach minus 0.6 percentage points (against minus 1.4 percentage points in the previous year). Maintaining good economic times will foster simultaneously the positive changes in the labour market. It is estimated that in 2015 the unemployment rate (BAEL) will drop to 8.2% against 9.0% recorded a year earlier. The decline in the unemployment rate will take place under the conditions of the growing occupational activity of Poles and the strong growth in labour demand. In the current year the number of employed is expected to increase by 1.1%. In 2016, parallel to the acceleration of the private domestic demand, further improvement of the economic situation in Poland is expected. The real GDP growth rate will speed up to 3.8% in real terms. Net export will be almost neutral for the economic growth, with the contribution at a level of minus 0.1 percentage points.

In connection with the expected maintaining of the real GDP growth rate at a level of 3.4% in 2015 and 3.8% in 2016, i.e. above the potential GDP growth in Poland, in 2015-16 the gradual closing of the output gap will take place. It is estimated that in 2015 the output gap in relation to potential GDP will decrease to -0.5% from -0.6% in the previous year, to be followed by further decline to the level of -0.2% in 2016. In the forecast period, the potential GDP growth rate will gradually increase from 3.2% in 2014 to, respectively, 3.3% in 2015 and 3.4% in 2016. It means the gradual improvement of the cyclical conditions for economic activity, however, excess of supply over demand will be still observed. The overall deterioration of the business cycle in Poland in 2012-14, measured by changes in the output gap, was almost two-fold higher in relation to the downturn observed in 2009-10. It will be reflected, inter alia, in the indicators describing the nominal sphere of economy.

For comparison, in the forecast of February 2015 presented by the European Commission, in connection with the expected moderate growth of real GDP at a level of 3.2% in 2015 and 3.4% in 2016, the gradual closing of the gap occurs, from the level of -0.8% in 2014 to -0.7% in 2015 and -0.4% in 2016. The forecast of the potential GDP growth rate in the analysed period 2014-16 assumes its gradual growth from 3.0% to 3.2%. While in the November 2013 forecast (which was the basis for the Ecofin Council recommendation of the structural effort, within the reduction of excessive deficit), the European Commission expected that the output gap will reach -2.0% in 2014 and -1.6% in 2015, together with the real GDP growth at 2.5% in 2014 and 2.9% in 2015.

The forecast of the developments in the real economy sphere is close to the projections which provided basis to the *Budget Act for 2015*. On the other hand, the inflation forecast has been revised downward significantly. The risk of lower inflation in 2015 measured by the CPI inflation, in relation to the forecast adopted in the *Budget Act*

[14] The material is available on the website of the Ministry of Finance at: [Measures increasing the level of tax compliance and improving the effectiveness of tax administration in the years 2014-2017.]

[15] It is foreseen that the share of total investment in GDP in Poland will increase from 19.5% in 2014 to 20.4% in 2016.

for 2015, emerged in the fourth quarter of the previous year and resulted mainly from the rapid decline in oil prices in the global markets and the consequent decrease of fuel prices in the domestic market, as well as from lower growth in food prices. The strong reduction of oil prices was mainly the effect of supply factors, i.a. the significant growth of the US supplies. From October 2014 to February 2015 the price of oil decreased by approximately 40%, from the level of USD 97 per barrel, in case of Brent oil, to USD 58. The impact of the strong slump of oil prices in the domestic market was partly mitigated by strong depreciation of zloty against dollar. Due to the strengthening of dollar in the global market, the Polish currency lost over 10% of its value against the American currency. Consequently, in this period, fuel prices in the domestic market decreased by approximately 17%, which directly affected the decline in the CPI inflation by 0.9 percentage points. Additionally, the indirect impact may be indicated, resulting from the decline of production costs and transport costs, thus contributing to the lower prices of goods purchased by households. The growth in food prices also remains very low, reaching 0.5% from October 2014 to February 2015, whereas in the corresponding period of the last 5 years, the average price growth in was at 3.4% (with the lowest growth amounting to 2.1%). The dynamics of food prices, lower by 2.9 percentage points, has an impact on the decrease of the CPI inflation by approximately 0.7 percentage points. The inflation pressure will be also limited by the continued negative output gap. Accordingly, the average decline in prices of consumer goods and services by 0.2% is forecast in 2015, and their growth by 1.7% in 2016. The acceleration of inflation in 2016 will be associated with the expiring of the direct impact of the decline in energy commodity prices on domestic prices, maintaining of the strong growth in the domestic demand as well as the gradual closing of the negative output gap.

The European Commission forecast for Poland of February this year[16] also indicates deflation in 2015 at a level of 0.2%, whereas in 2016 the expected growth in prices will reach 1.4%. At the same time, it is worth stressing that between November 2013 (the forecasts from this period provided basis for the Ecofin Council recommendations for Poland) and February this year the European Commission has clearly revised the inflation forecast down, both in relation to the whole EU and to Poland (cf. Chart 2). In case of the forecast for the whole EU, the expected growth of inflation in 2015 was reduced from 1.6%[17] to the current 0.2%. However, in case of Poland, the level of the adjustment is one of the highest among the EU member states (by 2.4 percentage points, from 2.2% to -0.2%), which means the necessity of relevant recognition of errors in inflation forecasts while calculating the corrected structural effort described in item 1 of this *Information*.

The negative dynamics of price growth makes a new condition for the implementation of the fiscal policy, which is associated both with the uncertainty related to behaviours of entities in new macroeconomic conditions, as well as with the existing nominal rigidities.

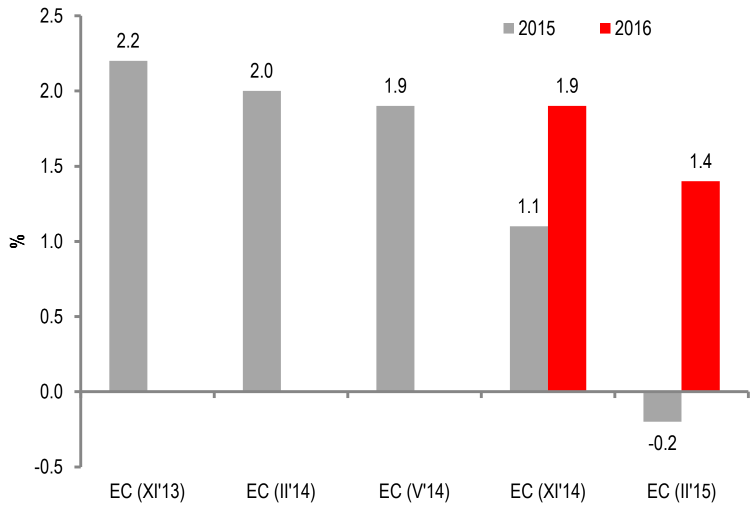
It is currently foreseen that the average wage in the national economy will increase by 3.5% in 2015 and 3.6% in 2016 in nominal terms. In the *Budget Act for 2015* the growth of this macroeconomic variable was forecast, respectively, by 4.3% and 4.8%, accompanied by the average annual CPI inflation at a level of, respectively, 1.2% and 2.3%.

Simultaneously, due to the nominal rigidities of the general government expenditure (the major part of expenditure is legally determined or dependant on macroeconomic indicators adopted in the Budget Act, instead of indicators really observed), the inflation significantly lower than originally projected will result in reduction of effects of the consolidation measures planned and implemented on the expenditure side. An example of such a measure is the nominal freezing of the wage fund in the central government sub-sector, with its effects measured by the relation of expenditure to nominal GDP dependent on the accomplished inflation level. It should be stressed that this mitigation of effects of deficit reducing measures results from factors remaining beyond the control of the government.

[16] *European Economic Forecast. Winter 2015,* http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee1_en.pdf

[17] *European Economic Forecast. Autumn 2013,* http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee7_en.pdf

Chart 2. Inflation forecast for Poland in the consecutive forecast of the European Commission



Source: Ministry of Finance.

The deflation processes also result in weakening of the revenue stream beyond the governmental control. The highest impact of the lower level of prices should be expected in the scope of VAT revenue. It arises from the fact that private consumption is the main element of the VAT base (including, inter alia, purchases of fuel, where the decline in prices was relatively high). On the other hand, low inflation also refers to food products whose contribution to the VAT inflows, due to the lower VAT rate, is much lower, therefore the effect of lower inflation on VAT inflows should be limited. The impact of the lower price level will have the least interference on revenue from excise duties, due to the fact that the tax rates are expressed in amounts (irrespective of the price, excluding excise duty on cars) and due to the negative price flexibility of some products subject to excise. The effects of lower inflation will also not translate proportionally to impacts of household income taxation.

Due to the nominal rigidities occurring in the general government, the reduction of effects of the planned and implemented consolidation measures on the expenditure side, as well as the weakening of the revenue stream beyond the governmental control, the negative inflation surprise causes that the effort required to achieve the comparable balance of the sector will be higher than planned by the government under the conditions of the earlier inflation forecasts.

The major risk factor for the 2015-16 forecast presented above is the continued conflict escalation and intensification of economic crisis in Ukraine which – also in the context of the sanctions in force against Russia and low oil prices affecting the economy of this country – poses the threat of continued slowdown in economic activity of the Commonwealth of Independent States and, as a consequence, the decline in the trade exchange dynamics of Poland with this region.

However, the exposure of Polish export to the markets of Ukraine and Russia remains moderate and in 2014, as a result of the decline in exchange, it has further decreased. The exposure to the Ukrainian market exclusively is minor, amounting only to 1.9%, and even including the share of Russia it reaches 6.2% (whereas it amounted to 8.1% a year ago). The negative consequences of the decline in demand from the eastern markets have been so far significantly mitigated by the improvement in the EU import dynamics and the positive impact of this factor should be also maintained in 2015-16. The potential escalation of the conflict might be, however, reflected in weaker results of our key trade partners, in particular, if the conflict resulted in the significant increase of turbulences in the global financial and commodity markets. It also cannot be excluded that restrictions in imports may be introduced by the Russian party for successive commodity groups.

The economic developments of the biggest trade partner of Poland, i.e. the European Union, are also important. In this scope, the above forecast is based on the scenario presented by the European Commission in the winter issue of forecasts published in February 2015, where, despite the identification of new positive factors in relation to the forecast for autumn 2014, the negative risks still prevailed.

Among the negative risk factors for its economic growth forecast, the European Commission mentions, among others:

- the possibility of further escalation of the conflict between Russia and Ukraine as well as in the Middle East and north Africa;
- increased volatility in financial markets in connection with the development of the situation in Greece, the potential impact of low nominal economic growth on the stability of public debt and the normalisation of monetary policy in the US;
- delays in the planned implementation of structural reforms in member states;
- intensification of deflation processes and consolidation of low inflation expectations of economic entities in the EU, leading to limiting of the aggregate demand and growth of real interest rates, which may consequently trigger the negative wage-price spiral;
- the continued so-called hysteresis effects in the labour market, resulting in extended period of unemployment rate recovery to lower levels and slower increase in productivity of means of production.

The European Commission recognises the following positive risk factors:

- higher positive impact of low oil prices on aggregate demand, as compared to the estimates;
- higher depreciation of the euro exchange rate than assumed, in connection with the quantitative easing policy conducted by the European Central Bank;
- positive effects of the European Investment Plan;
- successfully completed implementation of structural reforms in EU member states.

In the winter issue of European Commission forecast the balance of risk factors remained negative. However, it is worth highlighting that this forecast has not taken into account the additional information (strong growth in consumer confidence indicator, improvement in PMI, stronger euro depreciation than expected) which indicate that the spring update of European Commission forecast may result in raising of the real GDP growth forecasts in the EU.

2.2. Stabilising expenditure rule

The key factor determining the level of expenditures in Poland and, consequently, also the shape of the fiscal policy, is the stabilising expenditure rule introduced under the amendment to the *Public Finance Act*[18] of 2013. The stabilising expenditure rule was for the first time used on a binding basis during the works on the *Budget Act for 2015*. The functioning of the rule is based on determining the level of expenditure of almost the entire general government. Expenditure funded from the European Union budget and non-refundable funds from the aid granted by EFTA member states as well as expenses of entities with no capacity to generate high deficits are excluded from the scope of expenditure covered by the rule. The introduction of the rule imposed the change in the approach to the budgetary process from the bottom-up to the top-down method. Therefore, the budgetary process currently focuses on the method of distribution of expenditure, instead of on their level which is defined in advance, based on the algorithm.

The amount of expenditures for 2016, consistent with the stabilising expenditure rule, was estimated based on the amount of expenditures for 2015, at a level of PLN 696.7 billion, defined in Article 1 of *the Budget Act for 2015,* and the macroeconomic forecasts adopted for the development of the *Convergence Programme. Update 2015*, at the following levels:

- 1.0315 - indicator of medium-term real GDP growth rate,
- 1.017 - the CPI inflation forecasted for 2016, and

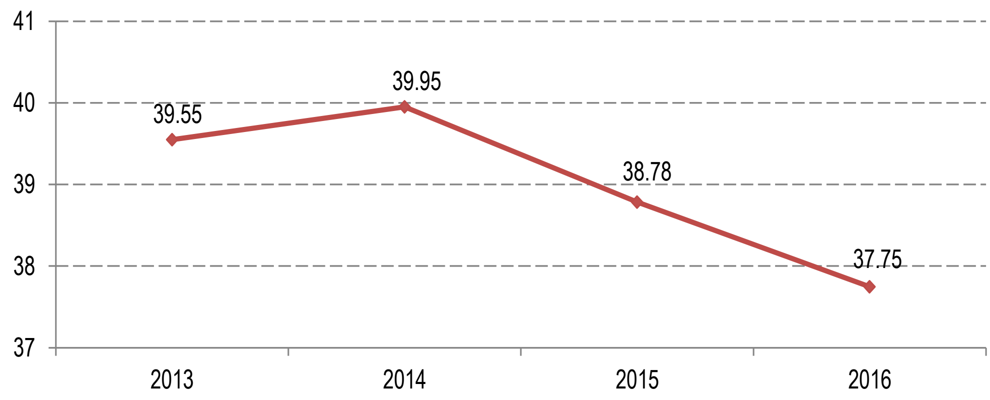
[18] *Act of 8 November 2013 on the amendment of the Act on public finance and certain other acts.*

— 0.9852 - the adjustment arising from the update of inflation rate estimates for 2014-15[19].

Additionally, the correction due to public finance imbalance amounting to -1.5 percentage points was taken into account as well as the overall value of significant discretionary measures forecast for 2016, amounting to PLN 3.2 billion, comprising the effects of introduction of the debtors' register, the anti-avoidance rule[20] and the effect of changes in VAT deduction on purchasing personal vehicles and incurring other expenses associated with such vehicles. As a result, the estimated expenditures for 2016 amount to PLN 712,819,988 thousand and they are higher by 2,31% than the amount of expenditures for 2015 defined in the *Budget Act for 2015*, which means the decline in the expenditure amount to GDP ratio by 1 percentage point against 2015.

The current estimate of the level of expenditure for 2016 is lower by 2.8% (PLN 20.4 billion) than the estimates obtained for the needs of the *Convergence Programme. Update 2014* (*2014 Programme*). It means the decline in the ratio of the level of expenditure by 0.3 percentage points in comparison with the level of expenditure to GDP ratio foreseen for 2016 in the *Programme* of 2014, due to the reduced GDP growth forecasts for 2015-16, the lower of inflation for 2014 and the lower inflation forecast for 2015-16, partly balanced by the lower correction due to the public finance imbalance for 2014, and the updated estimates of effects of significant discretionary measures.

Chart 3. The general government expenditure consistent with the rule (SER) to GDP



Source: Ministry of Finance

As a result, while defining of the binding limit of expenditure at the preliminary stage of the budgetary process changes in expenditure covered by the scope of the rule (increase or introduction of new categories of expenditure) are only possible under the condition that the appropriate adjustment of levels in other expenditure categories or significant discretionary measures in the area of taxes or contributions will be introduced. Consequently, any potential statutory changes generating new expenditures within entities covered by the rule (e.g. increase in defence expenses - the new MON (Ministry of National Defence) rule) are neutral for the level of expenditure covered by the scope of the rule. Moreover, owing to including the discretionary measures related to taxes and contributions in the rule, any potential discretionary measures affecting the income (e.g. child tax credit in the personal income tax) are also neutral for the general government balance. It changes the context of analysis of structural measures in the scope of taxes and contributions, currently automatically leading, by decreasing or increasing of the level of expenditure, to adjustments on the expenditure side, ensuring the sustainability of public finance.

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[19] The CPI inflation outcome amounted to 1.000 in 2014 and the current forecast of the rate for 2015 equals to 0.998 against the CPI inflation planned execution for 2014 at the level of 1.001 and the forecasted level of CPI inflation for 2015 amounting to 1.012 planned in the period of preparation of the *Budget Act for 2015* .

[20] The introduction of the clause on avoiding taxation was recommended to the member states by the European Commission (*Commission Recommendation of 6 December 2012 on aggressive tax planning* (C(2012) 8806 final)).

Thus, as a result of introduction of the rule, the approach to public expenditures changes, by focusing on their quality, effectiveness and structure, instead of their level which is defined by the rule. For this reason, in 2014 the department was established at the Ministry of Finance, responsible for conducting systematic assessments of public expenditure effectiveness in the form of expenditure reviews.

2.3. Other government measures

Moreover, the level of general government expenditures is still limited by the effects of reforms undertaken in the previous years. The most important reforms which should be mentioned include reduction of entitlements to earlier retirement and gradual increasing and equalising of the retirement age for women and men.

In addition, as a response to Ecofin Council recommendations concerning increasing of tax compliance and improving of tax administration effectiveness, the action plan announced by the Ministry of Finance in April last year is under implementation[21]. The expected total growth in the general government revenue, due to the implementation of all tasks envisaged in the aforementioned plan of the Ministry of Finance for 2015-16, amounts to PLN 5.7 billion. Further significant measures supporting the revenue side of the general government include:

- liquidation of partial VAT returns on housing expenditures, resulting in the growth of VAT revenues, mainly in 2015,
- maintaining the nominal freeze of tax thresholds and tax deductible costs in PIT,
- introduction of fuel reserve fee as of 2015 (in accordance with the *Act amending the act on stocks of crude oil, petroleum products and natural gas and on the procedures applicable in circumstances of a threat to the fuel security of the state and disruptions on the petroleum market and amending some other acts*),
- additional inflows from the so-called digital dividend (sale of reservation for selected frequencies through the electronic auction system).

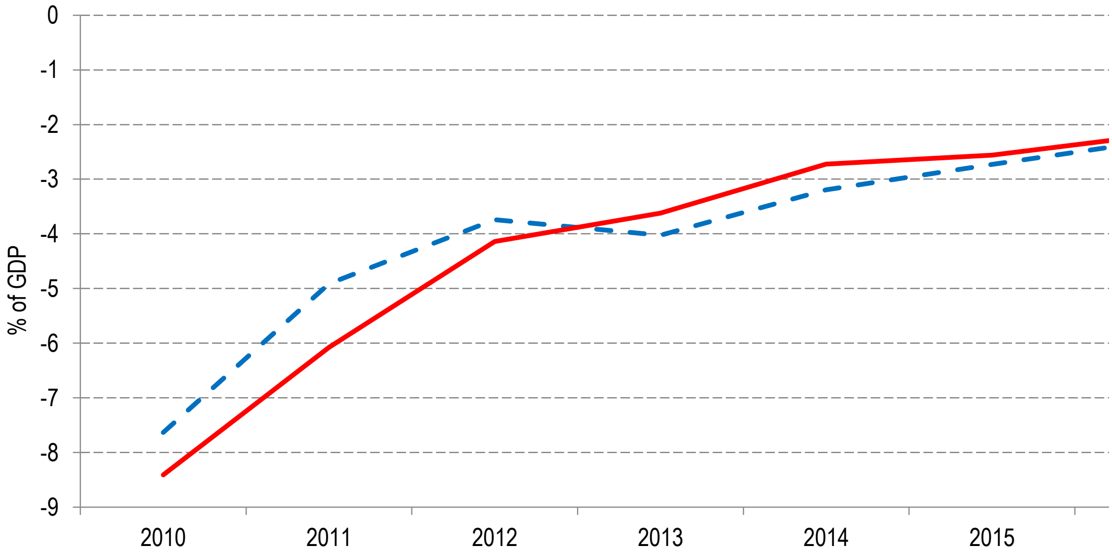
In addition, due to the poor situation in Credit Unions (Spółdzielcze Kasy Oszczędnościowo Kredytowe - SKOK), pursuant to the resolution of the Bank Guarantee Fund Council, the level of the prudential fee was raised which, as a result of BFG inclusion in the general government (decision of the Central Statistical Office of 2014) became the general government revenues.

3. General government balance in 2015-16

As a result of the aforementioned measures and conditions - mainly owing to the functioning of the stabilising expenditure rule – in 2015-16 the public finance consolidation is expected to be oriented towards the gradual achievement of the medium-term budgetary objective (MTO). As a consequence, the general government deficit will decrease, respectively, to 2.7% of GDP and 2.3% of GDP. At the same time, expenditures adjusted in accordance with the European Commission methodology (the so-called *expenditure benchmark*) will grow at a significantly slower pace than the medium-term potential GDP growth, and the structural balance will reach the level of -2.2% of GDP at the end of the analysed period. Consequently, **Poland will fulfil the requirements resulting from the adjustment path leading to the medium-term budgetary objective** at a level of -1% of GDP.

[21] Cf. footnote 15.

Chart 4. Nominal and structural general government balance in the years 2010-16



Source: Ministry of Finance

Summary

The government is committed to reducing the imbalance in public finances in the manner which would not pose any threat to the medium-term development perspectives of the country. In accordance with the information and forecasts presented in this *Information*, to be provided in more detail in the *Convergence Programme*, the nominal general government deficit , excluding the costs of the pension reform (introduced in 1999), still incurred in 2014, amounting to 0.4% of GDP, was reduced below 3.0% of GDP in 2014. In 2015 it will be reduced to 2.7% of GDP and in 2016 it will decrease to 2.3% of GDP. Consequently, the excessive deficit in Poland has been corrected.

In the subsequent years, the government will remain oriented towards achieving the medium-term budgetary objective, i.e. the structural deficit at a level of 1% of GDP. Achieving the MTO and maintaining the general government debt significantly below the reference value of 60% of GDP will, in particular, be ensured by compliance with the stabilising expenditure rule.

Table 1. Impact of the 2013–16 fiscal consolidation measures

% GDP	2013	2014	2015	2016
1. Real GDP growth(%)	1.7	3.8	3.4	3.4
General government balance – Ecofin Council recommendations	*-4.8*	*-3.9*	*-2.8*	
2. General government balance	**-4.0**	**-3.2***	**-2.7**	**-2.3**
3. Interest expenditure	2.5	2.0	1.8	1.5
4. One-off and other temporary measures		-0.2	0.1	
5. Potential GDP growth (%)	3.1	3.2	3.3	3.4
6. Output gap	-0,8	-0.6	-0.5	-0.2
7. Cyclical budgetary component	-0.4	-0.3	-0.3	-0.1
8. Cyclically-adjusted balance (2-7)	-3.6	-2.9	-2.5	-2.2
9. Cyclically-adjusted primary balance (8+3)	-1.1	-0.9	-0.7	-0.6
10. Structural balance (8-4)	**-3.6**	**-2.7**	**-2.6**	**-2.2**
Fiscal effort - Ecofin Council recommendations		*1.0*	*1.2*	
11. Fiscal effort	0.5	0.9	0.2	0.4
12. Fiscal effort corrected for changes in the definition of the general government	-0.3	1.0	0.6	

* **General government balance** corrected for the costs of the systemic pension reform (introduced in 1999) amounted to 2.8% of GDP.
Source: Ministry of Finance