REPUBLIC OF POLAND

THE CONVERGENCE PROGRAMME
UPDATE 2009

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INTRODUCTION

The Convergence Programme. Update 2009 was prepared in conditions of great uncertainty as regards the global economic situation. On one hand, under conditions of global recession, Poland remained the only EU country with positive GDP growth. On the other hand, Poland, like other countries, did not manage to avoid fiscal deterioration. As a result, on 7 July 2009 the Ecofin Council issued a decision on existence of an excessive deficit in Poland and a recommendation aimed at correcting it.

The Convergence Programme. Update 2009 contains a description of Poland's economic situation and key information about the condition of public finance. The *Programme* also contains answers to the Council's recommendations.

The forecasts indicate that the situation in the next few years should be more favourable for the Polish and global economy than recently. This will allow the implementation of reforms to be speeded up, while at the same time limiting their possible short-term negative effects on the real economy.

On 29 January 2010, the Prime Minister presented *the Plan for Development and Consolidation of Finances 2010-2011*, the activities of which, presented in chapter 3, are aimed at carrying out reforms allowing development risks related to the accrual of imbalances in public finance to be avoided and conditions for the construction of new competitive advantages in the Polish economy to be created.

The main objectives and directions of the government's economic policy stated in the *Update* have been retained from the *Convergence Programme. Update 2008.* One of the priorities of the government's medium-term strategy is to join the euro area and the steps being taken are aimed at meeting the criteria defined in the Maastricht Treaty.

The Convergence Programme. Update 2009 was adopted by the Council of Ministers on 8 February 2010. The document conforms to the *Guidelines on the format and content of Stability and Convergence Programmes* and will be discussed by Sejm and Senate committees.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

I.1. OVERALL FRAMEWORK

Since the elaboration of *The Convergence Programme. Update 2008*, the economic situation in Poland has changed significantly. The financial crisis, which has become global, has caused an aggravation of the main macroeconomic indicators. Anti-crisis packages implemented by particular countries have improved the situation of some economies, simultaneously increasing their long-term liabilities. Steps undertaken by the Polish government have allowed the positive pace of economic growth to be maintained, while the accumulation of deficit and national debt has been restrained.

In order to reduce the fiscal imbalance, accumulated due to neglect in the past, the government decided to prepare a package of reforms, the implementation of which will allow the growth rate to be increased while limiting adverse trends in public finance.

I.2. INTEGRATION WITH THE EURO AREA

The integration with the euro area remains one of the government's priorities. The change in the economic situation have postponed the prospects of adopting the common currency. However, steps taken by the Polish authorities are aimed at adopting the euro in Poland as soon as possible.

On 28 October 2008, the government adopted *Roadmap for Euro Adoption in Poland,* which scheduled the most important tasks in consecutive stages of preparation to full membership in the Economic and Monetary Union. However, turbulence on financial markets and a slowdown in economic growth in Poland, as well as in its main trading partners impeded the full realisation of the schedule adopted before the economic crisis intensified. For this reason, on 27 April 2009, *Prerequisites for Implementation of the Next Stages of the Road Map for Euro Adoption in Poland* was published. This document sets out the conditions for safe membership in ERM II. Firstly, the level of central parity should be consistent with the macroeconomic situation in the country. Secondly, the duration of ERM II membership should be as short as possible, which - by drawing nearer to the moment of adopting the common currency - will increase the credibility of the central parity as a reference point for the final conversion rate of the zloty to the euro. Thirdly, the fulfilment of all formal requirements for the participation in the euro area at the time of the assessment of Poland's readiness to adopt the common currency should be ensured. Only then it will be possible to adopt the common currency at a predetermined date. Fourthly, a political consensus over the necessary formal adjustments to adopt the common currency will be necessary.

The conditions set out have not been met so far, which makes it impossible to set a new credible target date for euro adoption in Poland. However, the Polish government intends to adopt the euro as soon and as safely as possible, which is reflected in the preparation work conducted by the Ministry of Finance. In January 2009, the *Government Plenipotentiary for Euro Adoption in Poland* was appointed by a government resolution. In March 2009, the *Bureau of Government Plenipotentiary* was set up in the Ministry of Finance, while in December 2009, the inter-institutional organisational structure was established, comprising the National Coordination Committee, the Coordination Council and 8 Working Committees. The work of the structure is chaired by the *Government Plenipotentiary for Euro Adoption in Poland* and co-chaired by the *Plenipotentiary for Euro Adoption of the National Bank of Poland's Management Board.* More than 30 institutions are involved in the work, in particular the Ministry of Finance and the National Bank of Poland.

In the near future, within this organisational structure, the *Strategic Guidelines for National Changeover Plan* will be agreed. This document will determine the scope of preparation necessary for a smooth changeover to the euro in Poland. In particular, it will set out the steps to be taken this year, a schedule for their performance and bodies responsible for their completion.

I.3. OBJECTIVES OF MACROECONOMIC POLICY

The main medium-term economic policy objectives are aimed at creating conditions for the economy's return towards quick and sustainable growth, while ensuring the optimum pace of consolidation of public finance and a high level of structural investment.

These plans will be achieved under difficult external conditions and factors for their success include developments in the global and in particular the European economy. Due to the economic crisis, since the last *Update,* the medium-term scenario of the macroeconomic situation in Poland has changed, as presented further in this document.

The most important governmental activities aimed at meeting the main objective of economic policy include:

1) Fiscal consolidation

In January 2010, the Prime Minister presented the *Plan for the Development and Consolidation of Finances 2010-2011.*

Chapter 3 of the *Plan* contains steps that will allow Poland to strengthen the foundations of long-term sustainable economic growth, while limiting fiscal imbalance.

2) Acceleration of privatisation and improvement of the management of State Treasury assets

The steps in this area are aimed at increasing the efficiency of the privatization process, finalizing the transformation of ownership in some branches and sectors and enhancing supervision over companies of key importance to the State Treasury. The efforts undertaken are to lead to an increase in economic effectiveness and thus are aimed at strengthening its competitive edge in the international stage.
The above-mentioned tasks will be carried out by way of implementing the updated *Privatisation Plan 2008-2011.*

3) Economic liberalisation

First of all, steps to abolish obstacles to the development of entrepreneurship will cover the reduction of red tape, simplification of regulations for starting and running a business (including simplification of the tax system and closing loopholes in it), improvement of the functioning of the judiciary system as well as a more effective allocation of public administration resources.

4) Growth in economic activity

Changes in the demographic structure of society and the pursuit to maintain balance in the social insurance system require, among others, an increase in economic activity among Polish people. A reform is planned of the uniformed services insurance system as well as a debate on methods to include farmers in the labour market with a simultaneous evolutionary reform of the pension and retirement system of this professional group, as well as to gradually increase and equalize the effective retirement age of women and men.

5) Increase in investment outlays and enhancing the efficiency of expenditure

To support the innovativeness of the economy, the increased level of funds for science and education, research and development as well as development of infrastructure will be of considerable importance. The implementation of infrastructure-related programmes, financed to a large extent from EU funds, will strengthen the economic potential of Poland.

In the long term, the changes that will be implemented will contribute to a change in the expenditure structure towards supporting innovation and ensuring the appropriate potential of infrastructure.

The implementation of tasks in chapter 3 of the *Plan for the Development and Consolidation of Finances* should have a positive influence on the efficiency of public spending. This will be fostered by an improvement in reporting quality and implementation of multi-year planning, which will provide greater opportunities for in-depth analysis of expenditure effectiveness and an evaluation whether planned objectives have been achieved.

I.4. IMPLEMENTATION OF THE COUNCIL RECOMMENDATION CONCERNING THE EXCESSIVE DEFICIT PROCEDURE

On 7 July 2009, the Ecofin Council issued a decision on existence of an excessive deficit in Poland and a recommendation aimed at correcting the excessive deficit. According to the Council recommendation under Art. 104.7 of the Treaty, Poland should:

- put an end to the present excessive deficit situation as rapidly as possible by 2012;
- bring the general government deficit below 3 % of GDP in a credible and sustainable manner by taking action in a medium-term framework;
- implement the fiscal stimulus measures in 2009 as planned, in particular the public investment plan, while structuring a supplementary budget in such a way that any further deterioration in public finance is avoided;
- ensure an average annual fiscal effort of at least 1¼% of GDP starting in 2010;
- spell out the detailed measures that are necessary to bring the deficit below the reference value by 2012, and reforms to contain primary current expenditure over the coming years.

In January 2009, i.e. six months before the Council issued its recommendation in accordance with Art. 104.7, the Polish government adopted a consolidation package consisting mainly of reductions in administrative expenditure. After the Council issued its recommendation for Poland, the supplementary budget for 2009 was adopted with new forecasts of tax revenues, increased non-tax budget revenues and additional cuts in expenditures. The funds for co-financing of projects financed from EU funds were, however, left unchanged, which - in combination with maintaining the initial level of expenditure for road infrastructure (although entirely shifted from the State's budget to the National Road Fund) - allowed the Ecofin Council recommendation in the area of fiscal stimulus to be fulfilled. The change in the economic situation caused a decrease in planned revenues by PLN 30.1 billion and expenditure by PLN 21.1 billion. As a result, the budget deficit increased to PLN 27.2 billion. Without the supplementary budget, the general government deficit would have been higher in 2009 by 1.8% of GDP.

The impact of the global economic crisis and uncertainty surrounding the world economic outlook have also affected the preparation of the 2010 budget. Macroeconomic assumptions for the 2010 budget were very conservative. Moreover, current expenditures were reduced by 10% and the wages in the budgetary sphere are to be constant in nominal terms. This means that the balance of risks for the execution of the state budget is definitely positive. At the same time, the Polish government implemented a fiscal impulse in the previous year, in particular in public investment, which helped the Polish economy to record positive economic growth in 2009.

The amended Public Finance Act, in force as of 1 January 2010, will contribute to balancing public finances. Its implementation will lead to an improvement in fiscal transparency and rationalization of public expenditures. It is the most important legislative change so far affecting the incurring of liabilities by public finance sector units.

With relation to the public debt the Act introduces the following changes:

• change of the scope and organisation of the public finance sector, which is aimed at increasing the effectiveness of the operation of the entire sector. In order to adapt the sector to the EU methodology, research and development units (RDU) and science institutes were excluded from its scope This means in particular that - similarly to the EU methodology - the debt of RDUs will not – constitute the public debt under the Polish methodology;

• amended prudential and recovery procedures while maintaining the thresholds of the public debt to GDP ratio. The major changes are the following:

- consequences for the State budget of exceeding the 55% and 60% thresholds concerning the public debt to GDP ratio
  - ➢ the draft budget for the next year adopted by the Council of Ministers must be at least balanced or the difference between state budget revenues and expenditure in this draft budget must ensure a decrease in the State Treasury debt-to-GDP ratio,
  - ➢ additional limits of the growth in expenditure (e.g. for wages in the public sector, indexation of retirements and pensions), and in granting new credits and loans from the State budget;
- exclusion of local government units (LGU) from limitations provided for in the prudential and recovery procedures at the first threshold concerning the public debt, i.e. 50% of GDP;

• implementation, as from 2011, of the rule of a balanced current budget of LGUs and, as from 2014, of a system of individual limits on incurring debt. The debt limits for particular units will reflect their abilities of its repayment;

• separation, within the State budget, of a European funds budget, the deficit of which will increase the borrowing needs of the State budget and the surplus could be used in the State debt management,

• extending the horizon of the debt management strategy from 3 to 4 years;

• adoption of the Multi-annual State Financial Plan (MYSFP), which will determine the upper limit of the deficit provided for in the budget act;

• preparing the performance based budget, which will allow for a more detailed analysis of incurred and results obtained.

Apart from the above, other measures are also taken, consistent with the Council recommendation. For instance, an amendment to the act on lump-sum income tax and to the amendment of the act on the protection of tenants' rights came in force on 1 of January 2010. The impact of the amendment should be positive for the budget, as relatively more favourable regulations concerning owners vs. tenants shall reduce the hidden economy on the rented property market, thus expand the tax base and lead to an increase in tax revenues. The amended act should also the liberalise the rental market, increase the owners' rights and their sense of security, and contribute to an increase in the labour mobility.

The government has decided to update the *Privatization plan,* and accelerate the pace of privatization. The actions undertaken from mid-2009 to mid-January 2010 brought receipts amounting to PLN 6.8 billion, which in turn decreased the growth rate of the public debt. Not only does the acceleration of the privatization programme support limiting public debt, but above all it leads to a change in the ownership structure from state-owned to more efficient private one.

Another important answer to the Council recommendation can be found in chapter 3 of the *Plan for the Development and Consolidation of Finances* presented by the Prime Minister in January 2010. Chapter 3 of this document provides for:

- reforming the social security system of uniformed services,

- broadening the tax base,

- ensuring the sustainability of public finances in the medium and long term by:

▪ attaining the structural deficit consistent with the medium-term budgetary objective (MTO),

▪ introducing in a special act on the stability of public finance: expenditure rules (one decreasing the deficit to the desired level, the other aimed at stabilizing the deficit at an appropriate level), other mechanisms and mechanisms related to the expenditure side of public finances, all aimed at an improvement of the balance, accountability and fiscal discipline in the macroeconomic sense;

- launching a debate on:

▪ methods of including farmers in the labour market while conducting an evolutionary reform of the pension and retirement insurance system of this professional group,

▪ gradual increase and equalization of the effective retirement age of women and men.

When assessing the current situation of public finance, one must stress that the fiscal imbalance is mainly due to structural reasons and abandonment of reforms during "good times" in previous years. The related rise in the government debt means that necessary reforms of public finances cannot be postponed anymore despite a still low economic growth. These reforms should lead in the first place to a reduction in fiscal imbalance and then create room for increasing effectiveness and improvement of the structure of public expenditure. The actions undertaken by the government will ensure the realization of these objectives. Their implementation will contribute to the strengthening of the long-term sustainability of public finances and to a decrease and later a stabilization in the debt to GDP ratio.

At the same time, it needs to be borne in mind that the reform of the pension system has contributed to the worsening of the fiscal situation. A part of implicit pension liabilities has become explicit, reflected in official) statistics of the general government deficit and debt, while in many other EU countries these liabilities remain implicit. As a result, the comparison of the fiscal situation in Poland with other countries would require an appropriate decrease in the Polish deficit and debt or "disclosure" of the long-term liabilities of the pension system in other countries.

II. ECONOMIC OUTLOOK

II.1. CYCLICAL DEVELOPMENTS AND CURRENT PROSPECTS

The escalation of the crisis in financial market and the deterioration in business and consumer confidence indicators resulted in a serious disruption to global economy activity at the turn of 2008 and 2009. In 2009, economic sentiment first stabilised then gradually recovered, mainly thanks to strong monetary and fiscal policy measures, the stabilization of the financial system and a building of inventories. After a further deterioration in trade flows in early 2009, the first increase in world imports for more than a year was recorded in Q3. The recovery in foreign trade, registered in both developed and emerging countries, supported faster growth in industrial production and GDP in the world's largest economies. What is the most important from Poland's perspective is that an improvement in the economic situation was noted in the euro area, particularly in Germany, where an increase in imports in Q3 2009 was the main contributor to the increase in Polish exports.

Despite a significant reduction in external demand, the Polish economy - as the only one in Europe - did not experience a contraction of GDP in 2009. We also avoided the technical recession, defined as two consecutive quarters of falling GDP. From the classic definition of the economic cycle, the Polish economy is still in an expansion phase, although the present crisis has resulted in a significant slowdown. The real GDP growth rate in 2009 decreased to 1.7% from 5.0% in 2008. At the same time, the positive output gap, which reached its peak (approx. 2.8% of potential GDP) in Q2 2008, was closing fast. By the end of 2009, the product gap finally closed and in 2010, GDP in Poland will be below its potential level. Despite positive dynamics of GDP, the deviation of current economic activity from the trend (the deviation cycle) indicates that the contraction in Poland has lasted for more than one year, similar to other EU countries.

Despite the strong slowdown, deterioration in the labour market and stagnant wage growth, consumption is estimated to increase by 2.3%. High pension and retirement benefit increases due to indexation (by 6.1%), and PIT reform (reduction of the tax burden by replacing rates 19%, 30% and 40% with 18% and 32%) supported households incomes during this period. The growth in individual consumption was accompanied by higher consumer credit, which increased by PLN 18 billion during the year. This increase was, however, much lower compared with the previous year.

Contraction in exports (denominated in euro), which had started in Q4 2008, resulted from an economic slowdown in Poland's main trading partners. However, the fall in imports was even higher. Apart from a depreciation of the zloty, which helped domestic manufacturers' price competitiveness, this was a result of high import intensity in export production and machinery and equipment investments – all of which were relatively strongly affected by the slowdown. Additionally, the demand in 2009 was based on consumption and infrastructure investments that mainly supported domestic production. As a result of these trends, the net export contribution to GDP growth was exceptionally high (approx. 2.7 % in 2009). A slight improvement of the balance of services has also helped to reduce the external balance. Throughout 2009, the current account deficit is estimated to fall to 1.6% of GDP, from 5.1% of GDP in 2008.

Declining exports and shrinking inventories triggered a significant contraction of industrial production, in particular in manufacturing. In the worst month - January 2009, the sold production of industry was lower by 12.9% when compared with the maximum reached in March 2008. The crisis had a particularly severe effect on the car industry, metal production as well as machinery and equipment manufacturing.

Shrinking production was also reflected in lower capacity utilisation, which triggered a drop in private sector investment. In the first three quarters of 2009, the investments of large and medium companies dropped by 9.4% year-to-year, with the largest drop being recorded in transport equipment investments. New investments were also hampered by stricter credit policy, even though most Polish companies rely on internal finance in this respect. Despite the adverse trends described above, investment in the whole economy in 2009 was only 0.3% lower than one year before. This was achieved thanks to high public sector fixed asset investment. A key role was played in this respect by infrastructure investment, which also fostered construction production.

A deterioration of economic activity also affected the labour market in 2009. In Poland, however, this effect was more muted compared with other EU countries. The average annual unemployment rate[1] increased in 2009 by 1.1 percentage point, to 8.2%, while the estimated growth in unemployment in EU-27 was twice that rate. At the same time, it must be stressed that the increase in unemployment in Poland was accompanied by a small increase but an increase nevertheless in the number of employed.[2] This reflected higher economic activity,

[1] Unemployment according to LFS (aged 15 years and older).
[2] Average number of employed (aged 15 years and older according to LFS).

resulting partially from phasing out early retirement schemes in 2009. With insufficient demand for work, higher economic activity in the short term leads to a statistical growth in the unemployment rate. In the longer perspective, however, it has a positive influence on the supply side of the economy, and therefore on its long-term growth.

Between August 2008 and March 2009, the zloty lost approx. 40%. Polish currency depreciation was an aftermath of the turbulence on global financial markets and the resulting high risk aversion. As global markets sentiment improved and investors regained their interest in the currencies of emerging markets, the zloty gradually strengthened during the last year. An especially strong appreciation of the Polish currency took place in July 2009. The temporary zloty exchange rate deviations from the appreciation trend that followed, were mainly caused by global factors, i.e. changes in investor sentiment reflecting the data readings from main world economies.

Throughout most of 2009, CPI inflation in Poland - despite an economic slowdown - remained close to the upper limit of permitted deviation from the inflation target of the Monetary Policy Council (i.e. 3.5%). As compared to other EU countries, inflation in Poland in 2009 remained at a relatively high level. The causes of this include a weakening of the zloty, a significant increase in food and fuel prices in the 1st half of 2009 and rises in the price of electricity. Additionally, consumer prices increased due to rises in excise tax rates on tobacco and alcohol products. In 2009, the average annual price index of consumer goods and services amounted to 3.5% (HICP 4.0%). The core inflation net of food and energy prices was 2.6% in December 2009.

The economic slowdown and the worsening situation on the labour market, which limited the growth in inflation pressure, were behind the continuation of a monetary easing cycle by the MPC in the 1st half of 2009. During this period, the basic interest rates were reduced by 1.5 p.p. As a result, by the end of June 2009, the main interest rate - the reference rate - was lowered to 3.5%. In the following months of 2009, signs of gradual improvement in economic activity and a relatively high rate of core inflation, including a marked rise in the growth rate of service prices were decisive factors in not lowering the interest rates and leaving them unchanged.

II.2. MEDIUM-TERM SCENARIO

In the following years, economic growth in Poland will mainly depend on the performance of its major trade partners and the pace of recovery in the labour market, which ensures an increase in household disposable income.

Current data about the global economy suggest that the most severe effects of the crisis have already taken place, and in coming periods, the trends will be more positive. An increase in global trade can be observed, while the forecasts of international institutions (e.g. the IMF January forecast) indicate a rate of global GDP growth higher than expected a few months ago. For the purposes of this forecast, it was assumed that in 2010, the global economy will grow at a rate of 3.8% and on average 4.1% in each of the years 2011-2012, while the growth in GDP in the EU in 2010 will be 1.2% and 2.2% in 2011-2012.

The expected world economic recovery will be reflected in the performance of the Polish economy. Growth in external demand will lead to a substantial growth in export production. An additional support for Polish exporters will be the exchange rate, which despite a forecast appreciation will remain weaker than in the period directly preceding the financial crisis. At the same time, experiences before the crisis showed that Polish exporters were able to increase their participation in foreign markets even with a relatively strong zloty.

Together with an increase in production, an improvement in the labour market is also expected, although in 2010, the positive effects for employment will be less noticeable. This will result from the fact that during the crisis, many Polish companies chose the strategy of "labour hoarding", adjusting labour costs to a lower demand by flexible forms of employment, and on a smaller scale, by laying off employees. Therefore, in the period in which demand rebuilds, Polish companies will be able to increase their production more easily and cheaply, by using spared labour factor, and not only by hiring new employees.

Despite an expected increase in employment, the unemployment rate in 2011-2012 will be only slightly lower than 10.0%. This is also related to the rising economic activity of Poles, due in part to the reduced ability to retire early and the enhanced share of the population aged 25-44 in the working age population. This also results from the effect of "labour hoarding".

It is expected that the improvement in the labour market will be accompanied by a limited growth in wages. Some acceleration will be seen in 2011-2012. However the growth rate will be lower than in 2006-2008. This will be due to a relatively high unemployment rate, which weakens the position of employees in the process of wage bargaining. The factor limiting growth in the national economy wage fund will be the planned freeze of the real wage funds in the public sector.

As a result, the growth in household disposable income in 2010 will not be high. According to forecasts, the household consumption will grow by 0.8% in real terms, which is less than in 2009. Such a low growth in consumption also results from the so-called base effects related to the impulse from fiscal policy, the additional effects of which for 2010 should be marginal. It is estimated that in the following years, with an increase in the wage fund in the economy, the growth in individual household consumption will increase to 3.0% in 2011 and 4.8% in 2012.

Public consumption will be determined by activities aimed at a reduction in the public sector deficit. A significant improvement in economic conditions will allow important activities to be undertaken aimed at limiting public expenditure, which will be fostered in part by the implementation of the expenditure rule. Under such conditions, short-term negative effects of fiscal consolidation will be compensated by faster economic growth, while the limitation of the participation of the state in the economy in the long term will contribute to a strengthening of the foundations over the long-term and faster economic growth. One of the activities aimed at the improvement of the general government will consist of the restructuring of employment in the public sector. This will allow the wage fund in the public sector to be frozen at constant prices, while increasing the efficiency of public services. The implementation of employment restructuring in conditions of positive trends in the labour market will allow the social costs of this action to be minimised. In combination with the limitation of operating expenses, it is expected that common consumption in 2011-2012 will remain at the real level of 2010.

Together with a cyclical upswing, business investment activity will also rise. In 2010, its growth in the private sector will be moderate, and in the following years, the rate of growth will accelerate to reach 13.9% in 2012. In 2011-2012, with the improvements on the labour market and a reduction in credit risk, production in housing construction sector will speed up. The expenditure of the general government will be an addition to the investment activity of the private sector. These assume an accumulation of expenditure for infrastructure projects co-financed by the EU in 2010-2011, so in the period when private sector investment will be just starting to expand. In 2012, when a substantial acceleration of private sector demand is expected, including its investment activity, the reduction of investment outlays of the public sector is forecasted. This is the natural consequence of the above-mentioned accumulation of investment outlays in this sector in 2010-2011. As a result, at the level of the whole economy, a moderate rate of growth in gross spending on fixed assets is forecasted at the level of 5.7% and 11.3% respectively in 2010-2011, and then - with relation to a significant reduction in public sector spending - the growth rate of investment will fall by 4.7% in 2012.

The increase in production will support the reconstruction of inventory levels in the economy. The contribution of this category in the growth in GDP will be especially large in 2010, due to a significant reduction of the level of inventories in the previous year. Within the horizon of the forecast, the contribution to GDP growth from the accrual of inventories will be significantly lower, although it will remain positive.

A recovery in final demand will be the basic determinant of import growth in Poland. The structure of final demand, with a relatively high contribution of import-intense export and investment, will result in a negative contribution of net exports to the GDP growth in 2010-2012.

The expectations concerning the GDP components indicate that economic growth in 2010 will significantly accelerate as compared to the rate noted in 2009 and will amount to 3.0% in real terms. In 2011-2012, the real rate of GDP growth will amount respectively to 4.5% and 4.2%, and the limitation of growth in the last year of the forecast will result mostly from the above-mentioned decrease in investment outlays of the public sector following their accumulation in the previous years.

With an acceleration in the economic growth rate, the deficit on the current account will increase. In 2010, due to a worsening of the balance of goods and revenues, it will amount to 2.4% of GDP and in the following years, it will be subject to a slight worsening to 2.8% of GDP in 2012. In the Update's horizon, it is expected that the current account deficit will be fully financed by the inflow of long-term capital, i.e. foreign direct investment and funds classified under the capital account (mainly European structural funds).

From early 2010, inflation in Poland should start decreasing. It will be mainly caused by continually moderate dynamics in economic growth and weaker wage pressure. Inflation pressure will be also limited by the forecasted appreciation trend of the Polish currency as well as a large supply of agricultural products related to good crops last year. Also statistical effects related to high prices in the 1st half of 2009 (negative base effects) will also act on lowering inflation. In the 2nd half of 2010, as demand continue to grow, a gradual increase in inflation is, however, expected. This will also be related to the expected acceleration of prices in the global economy, especially in 2011-2012. As a result, it is forecasted that the average annual rise in the prices of consumption goods and services will speed up to 3.2% in the last year of this *Update*.

The forecast inflation path indicates that the cycle of tightening by the Monetary Policy Council will start in the second half of 2010 and will be continued throughout the period under this Update. Additionally, in 2011-2012, the cost of central bank money will be conditioned by the prospect of the adoption of the euro and the related need for Poland to meet the inflation convergence criterion.

The stabilisation of the mood in global financial markets, the decrease in the risk aversion level, the improvement of the fiscal situation in Poland and an acceleration of the economic growth rate will be the factors supporting an appreciation of the zloty. The tightening of monetary policy and higher real percent rates will act in the same direction. It is expected that the appreciation trend of the zloty will be maintained throughout the horizon of the forecast.

II.3. KEY REFORM PLANS

National Development Strategy 2007-2015

Currently, work is being carried out on an update of the *National Development Strategy 2007-2015*, the horizon of which will be extended to 2020. According to the schedule of work on the document, the updated *Strategy* should be adopted by the Council of Ministers by the end of 2010, so that it can become effective from 2011.

There are ongoing works concerning the modernisation of the development management system. The document adopted by the Council of Ministers *Development strategy arrangement plan* aims to put some order in applicable documents of a strategic character, including multi-year programmes. It contains a concept concerning the optimisation of the number of applicable documents of this type, which will allow for a greater transparency of the strategic programming process, more efficient expenditure from the state budget, and in consequence, a more effective execution of Poland's development targets in the medium- and long-term. Moreover, a limitation on the number of development strategies was proposed, from the applicable 42 to 9 below:

- Innovation and economy efficiency strategy,
- Human resources development strategy,
- Transport development strategy,
- Energy security and the environment,
- Efficient state,
- Social capital development strategy,
- National regional development strategy 2010-2020. Regions-cities-rural areas.
- National Security of the Republic of Poland Strategy,
- Strategy for sustainable growth in rural areas and agriculture.

National Reform Programme for 2008-2011

In order to implement the *Lisbon Strategy*, the Polish Government prepared the *National Reform Programme for years 2008-2011 (NRP).* Henceforth, *NRP* reform will be implemented in three priority areas: *Active society*, *Innovative economy* and *Efficient institutions*.

The most important measures taken in the NRP programmes include: development of education in society and in a knowledge-based economy, implementation of a system of incentives encouraging people at risk of unemployment and social exclusion, development of an information society, providing transport, transmission and electronic communication infrastructure appropriate for the needs of a modern economy, using innovation in environmental protection.

Stability and Development Plan

On 30 November 2008, the Polish government presented the *Stability and Development Plan* aimed at reinforcement of the Polish economy amidst the world financial crisis and the stabilisation of the banking system. The document presents in detail the existing and planned anti-crisis measures for a total sum of PLN 91.3 billion.

The main measures supporting households included increasing warranties securing bank deposits of Poles up to EUR 50,000 and launching mortgage subsidies for individuals who following redundancy are unable to repay their mortgages.
On the other hand, in the case of businesses, the limit of warranties and sureties granted by the State Treasury was increased, which increased the availability of credits; Bank Gospodarstwa Krajowego was recapitalised, which contributed to a reinforcement of warranties, a higher rate of investment exemption was introduced for newly incorporated enterprises, and limits in obtaining prepayments were abolished, for instance for businesses applying for EU subsidies.
Moreover, savings in the state budget were made, which has contributed to the identification of an additional PLN 21.1 billion.

Package of anti-crisis measures

22 August 2009 saw the enforcement of the government *Package*, prepared in cooperation with trade unions and employers. The *Package* includes an extension of the settlement period up to 24 months, flexible working time and limitations in the application of definite time contracts were implemented. Also training and wage subsidies were introduced for employees of companies affected by the economic crisis.
The government decided to earmark for public aid for enterprises and employees a sum of over PLN 1.5 billion.

Poland 2030. Development challenges.

In June 2009, the Board of Strategic Advisors of the Prime Minister of Poland prepared the report *Poland 2030. Development Challenges,* which outlines potential routes for Poland over the next two decades. It is a Green Paper that establishes a framework for the long-term *Strategy for State Development.*

The document includes a diagnosis of Poland's situation after two decades of transition and a set of consistent recommendations which answer the challenges and strengthen the development factors. It presents a comprehensive approach covering many-sectors, which allows various tools to be combined to reach the selected goal.

The document lists 5 key factors for Poland's development:
1. Conditions for rapid investment growth.
2. Increase in professional activity and mobility of Polish citizens.
3. Productivity and innovation development.
4. Effective development diffusion in the regional and social dimensions.
5. Strengthening of social capital and state effectiveness.

The recommendations listed in the *Poland 2030 Report* for the ten development challenges identified can be presented in three dimensions, interrelated and mutually dependent:

- policies creating demographic, macroeconomic and institutional development foundations,
- policies to improve the economy's productivity, mobility and capacity to adapt,
- policies creating the social dimension of development and offering conditions for its diffusion.

Plan for the Development and Consolidation of Finances 2010-2011

On 29 January 2010, the Prime Minister presented the *Plan for the Development and Consolidation of Finances.* Particularly important is chapter 3 of the *Plan* concerning public finance. References to this part of the *Plan* are contained in particular chapters of the *Convergence Programme Update 2009.*

III. GENERAL GOVERNMENT BALANCE AND DEBT

III.1. POLICY STRATEGY AND MEDIUM-TERM BUDGETARY OBJECTIVE

Despite the fact that the prospect of adopting the common currency became more distant due to the significant worsening of the economic environment, integration with the euro area remains a priority to the government.

That is why one of the most important targets of government policy within the scope of this *Update* is the meeting of criteria determined in the Maastricht Treaty. In this context, the government's priority was to level the fiscal imbalance made visible by the crisis; its worsening is one of the more serious development risks. An excessive growth in the public sector deficit and public debt would limit the opportunities to create new competitive advantages for the Polish economy and would prevent Poland from quickly adopting the euro. That is why, in the coming years, it is necessary to implement a reliable fiscal consolidation, which will allow the foundations of long-term, sustainable economic growth to be strengthened.

Unfortunately, a fast, excessively strong consolidation creates the risk of adverse effects for economic recovery. This in turn means that the tightening of fiscal policy should be conducted through gradual but consistent implementation of reforms, which will allow a simultaneous limitation of the fiscal imbalance, while minimizing the possible adverse effects for the real economy.

In order to execute these tasks, the government will bring about in the near future a decrease in fiscal imbalance and will then implement mechanisms for improving the effectiveness and the structure of public expenditure. The new conditions will allow the economy to recover and return to the path of quick growth while ensuring a safe pace of reduction of the general government deficit as well as in the government debt. Specific measures in this scope have been presented by the Prime Minister in chapter 3 of the *Plan for the Development and Consolidation of Finances.*

The execution of the targets mentioned above will contribute to a strengthening of the foundations for Poland's long-term and sustainable development.

III.2. ACTUAL BALANCES AND IMPLICATIONS OF THE BUDGET FOR NEXT YEAR

In 2008, the general government deficit grew to 3.6% of GDP from 1.9% GDP in 2007. This mainly resulted from a decrease in revenues with relation to GDP (e.g. as a consequence of decreasing the pension contribution and weakening dynamics of GDP, mainly at the end of the year), with a simultaneous growth in the expenditure to GDP ratio, in particular expenditure on investment and costs related to employment. The greatest increase in the deficit was noted in the central subsector, and the state budget deficit on a cash basis increased from PLN 16.0 billion to PLN 24.3 billion.
On 13 May 2009, the European Commission prepared a report pursuant to then applicable article 104.3 of the EU Treaty concerning the initiation of the excessive deficit procedure against Poland. According to the recommendation of the Ecofin Council of 7 July 2009, Poland should correct the excessive deficit by 2012. In 2009, Poland's fiscal situation was determined mainly by a strong slow-down and an unfavourable structure of economic growth, which - in combination with structural reforms (*inter alia*, decreasing pension contributions in previous years, decreasing income tax rates from 2009 and changes in VAT favourable for tax payers) - had a significant effect on the decrease in the level of government revenues. A quick response by the government in form of a plan, prepared in January 2009, to reduce expenditure and amend the state budget made effective in July last year, allowed for a significant limitation in the increase in the state budget deficit. A consistent execution of the amended budget act resulted in smaller deficit than assumed being achieved (PLN 27.2 billion), at the level of PLN 23.8 billion.

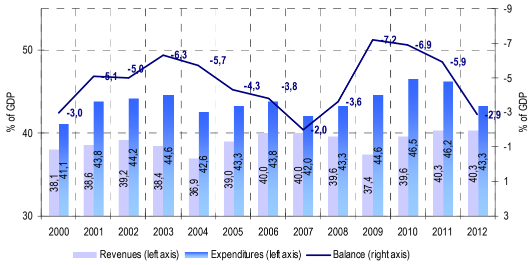
Although the measures taken have limited the increase in the fiscal imbalance, the latest estimates show that in 2009, the general government deficit amounts to approx. 7.2% of GDP, i.e. above the level forecast in the last *Update* December 2008.

The general government deficit in 2010 will be mainly affected by a higher state budget deficit. The budget act for 2010 assumes that the state budget deficit may not be higher than 52.2 billion PLN. Nevertheless, due to conservative macroeconomic assumptions made for the budget act, and taking into consideration the structure of growth, which is more advantageous than assumed in the Act, the execution of the state budget deficit at a lower level than assumed in the act is highly probable.

Under conditions of a gradual recovery of global economy, an too fast and too strong fiscal tightening, still in 2010, could have a strongly pro-cyclical character and bring about a slow-down of the economic recovery in Poland. As a result, it is expected that the deficit would reach 6.9% of GDP in 2010, and in the following years its reduction will be still more visible - to 5.9% of GDP in 2011 and 2.9% of

GDP in 2012. A further decline in the deficit is expected In the following years, which will allow to keep it permanently below 3% of GDP.

Graph 1 Revenues, expenditure and balance of general government



Source: 1999-2008 Eurostat, 2009-2012 Ministry of Finance

Tab. 1 General government balance and debt (EDP, % of GDP)

	ESA code	2008	2009	2010	2011	2012
General government balance	S.13	**-3.6**	**-7.2**	**-6.9**	**-5.9**	**-2.9**
Central government	S.1311	-3.9	-5.6	-5.7	-6.1	-3.6
Local government	S.1313	-0.2	-0.5	-0.5	-0.1	0.0
Social security funds	S.1314	0.4	-1.1	-0.7	0.4	0.7
General government debt	**S.13**	47.2	50.7	53.1	56.3	55.8

Source: 2008 r. – Central Statistical Office, 2009–2012 - Ministry of Finance

III.3. STRUCTURAL BALANCE

According to the latest data, in 2009, the structural deficit grew by 2.7 pp as compared to the previous year. This was contributed by changes in the tax system (change of the tax rate scale for incomes obtained by natural persons, shortening of the VAT tax reimbursement period and possibility to settle tax on goods import in certain simplified procedures in VAT tax declaration), as well as implementation of fiscal measures mainly in form of an increase in public investment. In 2010-2012, this unfavourable trend is expected to inverse and the structural deficit will gradually fall, respectively by 0.5 pp, 0.8 pp and 2.9 pp.

Tab. 2 Cyclical developments (% GDP)

	ESA code	2008	2009	2010	2011	2012
1. Real GDP growth		**5.0**	**1.7**	**3.0**	**4.5**	**4.2**
2. General government net lending/borrowing	EDP B.9	**-3.6**	**-7.2**	**-6.9**	**-5.9**	**-2.9**
3. Interest expenditure	EDP D.41	**2.2**	**2.4**	**2.7**	**2.8**	**2.7**
4. One-off and other temporary measures		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
5. Potential GDP growth		4.5	4.0	3.7	3.6	3.6
6. Output gap		2.0	-0.2	-0.9	-0.2	-0.2
7. Cyclical budgetary component		0.8	-0.1	-0.3	-0.1	-0.1
8. Cyclically-adjusted balance (2-7)		-4.4	-7.1	-6.6	-5.8	-2.9
9. Cyclically-adjusted primary balance (8+3)		-2.2	-4.6	-3.9	-3.0	-0.2

Source: Ministry of Finance

III.4. GENERAL GOVERNMENT DEBT

In the period covered by the *Convergence Programme Update 2009*, debt management will, as in previous years, focus on the achievement of the objective set out in the *Public Finance Sector Debt Management Strategy in 2010-2012,* i.e. the minimisation of long-term debt servicing costs subject to constraints on the level of risk.

Debt management will take place under conditions of significant public finance sector deficit, limited gradually in the following years and a significant uncertainty in financial markets during a global economy recovery from recession. Activities related to limitation of the general government deficit to under 3% by 2012 should have a considerable influence on the level and shape of the yield curve, therefore the debt servicing costs as well.

The changes in the debt to GDP ratio in 2010-2012 will result from, first of all, the state budget borrowing requirements (the State Treasury debt constitutes approximately 95% of the general government debt), expected GDP growth and the Polish zloty exchange rate in relation to other currencies, especially to the euro. An important condition will be the implementation of measures proposed in Chapter 3 of the *Plan for the Development and Consolidation of Finances*, including a limitation of state budget borrowing requirements related to privatisation, decreasing the amount of write-offs to target funds and utilisation of assets of public finance sector entities in managing the liquidity of the public finance sector.

In 2010-12 the volume of state budget borrowing requirements, apart from the budget deficit and European funds budget balance, will be under significant influence of the refund to the Social Insurance Fund (FUS) due to contributions transferred to Open Pension Funds (OFE), privatization proceeds, the balance of pre-financing tasks executed with participation of funds from the EU budget as well as loans granted from the state budget.

The expected changes in the debt of other general government entities will result mainly from the growth in the debt of the National Road Fund (with relation to the national roads and motorways building programme) and of local governments. The borrowing requirements of local governments will result to a large extent from infrastructural projects underway, co-financed from EU funds within the financial perspective of the years 2007-2013.

Within this *Update*'s horizon, the debt to GDP ratio will rise and ,according to the national methodology, it will not exceed the threshold of 55%, and according to the EU methodology, it will remain under the reference value of 60%.

Tab. 3 General government debt developments (end of year, % of GDP)

	ESA code	2008	2009	2010	2011	2012
1. Gross debt		47.2	50.7	53.1	56.3	55.8
2. Change in gross debt ratio		2.2	3.5	2.4	3.3	-0.5
Contributions to changes in gross debt						
3. Primary balance		1.4	4.8	4.2	3.1	0.2
4. Interest expenditure	EDP D.41	2.2	2.4	2.7	2.8	2.7
5. Stock-flow adjustment		**-1.4**	**-3.8**	**-4.5**	**-2.6**	**-3.5**
of which: differences between cash and accruals		-0.2	-0.6	-0.1	-0.2	0.1
Net accumulation of financial assets		-0.1	-0.5	-2.4	0.3	0.5
of which: privatisation proceeds		-0.1	0.0	-0.9	-0.3	-0.1
valuation effects and other		-1.1	-2.6	-2.0	-2.8	-4.2
p.m.: Implicit interest rate on debt (%)		**5.0**	**5.1**	**5.3**	**5.3**	**5.1**
Other relevant variables						
6. Liquid financial assets*		1.9	1.9	1.6	1.5	1.4
7. Net financial debt		45.3	48.7	**51.5**	**54.9**	**54.4**

Source: Ministry of Finance

III.5. BUDGETARY IMPLICATIONS OF MAJOR STRUCTURAL REFORMS

The execution of priorities indicated by the government is supposed to lead to a more efficient functioning of the state and to a decrease in the imbalance, followed by a stabilization of public finance at a safe level, while at the same time increasing the flexibility of labour resources and the efficiency of the use of investment funds. Some of the measures indicated constitute a continuation of the government's activities from the period preceding the preparation of *Update 2008.* At the same time, the change in the economic situation resulted in a need for the government to take on new obligations, which are reflected in the activities presented below.

1) Fiscal consolidation

As part of Chapter 3 of the *Plan for the Development and Consolidation of Finances,* a series of activities aimed at limiting the increment of the general government deficit and debt is provided for. They include activities influencing the revenue and expenditure sides.

The execution of Chapter 3 of the *Plan* will reinforce the institutional framework of fiscal policy, supporting its credibility and planned fiscal consolidation. One of the instruments to achieve the above-mentioned targets is the implementation of expenditure rules together with mechanisms to monitor and enforce them. Two rules have been proposed. The first rule is immediate with the objective to lower the structural deficit to the level of the medium term objective (MTO). This rule will strongly limit the growth in discretionary expenditure, i.e. not resulting from applicable acts regulating the public expenditure. Moreover, to further increase developmental expenditure, it will be necessary to continue the "untightening" of general government expenditure.

The second rule, of a target character, is in turn supposed to stabilize the structural deficit at the level compliant with Poland's obligations resulting from the Stability and Growth Pact (MTO for Poland is -1.0% of GDP). It should include a broad scope of public finance sector expenditure, thanks to which the level of freedom in shaping particular components of the entire aggregate will be kept. In order to ensure the anti-cyclicality of the above rule, it should be based in its real part on the economic growth in a multi-year reference period, and in its nominal part, on the inflation target of the Monetary Policy Council. Apart from that, there may be a need to implement an additional element which should gradually decrease the public expenditure to GDP rate to the level below 40%, which will allow a further decrease in fiscal burdens.

As part of Chapter 3 of the *Plan*, there is a plan to adopt the *act on stability of public finance.* It would reflect the above-mentioned expenditure rules as well as other mechanisms and principles leading to an improvement in fiscal discipline, the public finance sector balance as well as a transparency in fiscal policy.

This part of the *Plan* includes not only an element to reduce the imbalance and stabilise public finance, but also to increase the effectiveness of the management of resources. It is planned that the expenditure be linked with medium and long-term government priorities. The preparation of the state's budget and Multi-Year State's Financial Plan in a performance-oriented layout will significantly facilitate the execution of this target.

A significant change will be the release of frozen cash reserves, which will improve public sector liquidity management. Free funds of selected public finance sector units will be invested on accounts maintained by the Minister of Finance. This will allow the temporarily uninvolved assets of some units to be used in order to finance borrowing requirements of other entities. Such a measure will allow the level of public debt to be decreased by approx. 1.1 % GDP.

On the revenue side, it is proposed that the tax base be broadened by:

- limiting rights to the exemption from the obligation of using cash registers,
- limitation of VAT tax deductions when purchasing some fuels and vehicles categorized as trucks (with the so-called "grilles").

Further broadening of the tax base will also be a subject of the debate.

The above measures will not only increase the budget revenues, but will allow for a more complete taxation of incomes.

2) Acceleration of privatisation and improvement of State Treasury assets management

Main measures in this scope aim to change the ownership structure of the economy and restructuration of entities supervised by the State Treasury and under privatisation, which is supposed to ensure an increase in their value and competitiveness.

On 10 February 2009, the Council of Ministers adopted the update of the *Privatisation plan for the years 2008-2011*, taking into consideration the main companies commercialized after its adoption.

Moreover, on 11 August 2009, the Council of Ministers adopted a document called *Key companies for privatisation in 2009-2010*, which is a supplement to the *Privatisation plan.* This resulted from the need of current verification of privatisation activities and from the need to select the most efficient modes of privatisation, allowing an advantageous selling of stock or shares under worsening economic conditions. The economic slow-down on global markets resulted in the need to include in the process of sale the current market prices to a larger extent and more than once forced a change of schedules of the privatisation processes.

It is assumed that privatisation will be carried out using the stock exchange and publicly announced auctions.

From 22 April 2008 (date of adoption of the *Privatisation plan)* until 31 October 2009, 680 privatisation projects were started, which is 84.78% of all companies included in the applicable *Privatisation Plan.*

3) Liberalisation of the economy

The activities undertaken by the government are aimed at facilitating the operation of companies, by removing red tape and abolishing some requirements for businesses.

Changes in the general government administration and in cooperation between various administration entities aim to improve the operation and rationalisation of the division of competences between public administration entities.

It is planned to further improve the operation of the administration itself, by implementing a system of efficient allocation of central administration employees, rationalisation of employment in administration, optimisation of the model of operation and business processes carried out by government sector entities. These activities will allow for the outsourcing or centralisation of selected auxiliary areas, which will lead to a permanent reduction of expenditure. As part of the liberalisation of the economy, activities aimed at eliminating unnecessary administrative procedures, developing e-administration and improving the relations of citizens and business with administration will be carried out. Moreover, it is planned to implement a reform of the tax collection system, which will result in limiting the number of tax declarations submitted by implementing the e-tax Programme, as well as adopting the principle that the tax authorities do not require a confirmation from the tax payer for information they already have, and in situations which require access to information - adopting of the rule of exclusively electronic contact in the case of legal entrepreneurs and in the case of individual entrepreneurs - via e-mail or regular mail.

On 3 February 2009, the Council of Ministers adopted the document *Directions of development of loan and guarantee funds for small and medium companies in 2009-2013.* The measures it includes improve access to external sources of financing, in particular for micro and small enterprises.

Activities aimed at improving the operation of the common judiciary system are also being continued. Among other operations, the elimination of obstacles in entrepreneurship development thanks to improvements in economic court system and implementation of electronic reminder procedures should be highlighted.

The government also simplified the regulations such as the special road act, which replaced two decisions on starting construction work by just one.

4) Growth in economic activity

The most important actions undertaken by the government and promoting the growth in economic activity include the completion of the already initiated retirement reform (implementation of systemic solutions for some professional groups replacing the existing rights to earlier retirement).

Chapter 3 of the *Plan for the Development and Consolidation of Finances* proposes a reform of the social security system for uniformed services for officers and soldiers starting their service from 2012. The *Plan* also assumes that a debate on the gradual increase and equalisation of the retirement age of women and men, which would allow the retirement age to be adapted to ongoing demographic changes and increase the value of retirement benefits. Higher retirement benefits would also mean the lowering of required extra payments to minimum retirement benefits, which would lower state budget expenditure. The debate will concern the methods of including farmers in the labour market while conducting an evolutionary reform of the pension and retirement system of this professional group.

The activities to enhance economic activity are aimed at creating additional services and labour market instruments and an improvement of tools which support the operation of employment services.

Also the *Solidarity of Generations Programme. Actions for increasing economic activity of people aged 50+* is being carried out. Activities in this field relate to people aged 50+ and aim to improve working conditions, promote employment, improve competences and qualifications and increase the inclusion of people who are unemployed or threatened by unemployment in the labour market.

With relation to a difficult situation on the labour market, in August 2009, the *Anti-crisis Package* was implemented, elaborated in cooperation with trade unions and employers, in order to help companies affected by the crisis. The *Package* mitigates the effects of crisis for entrepreneurs and employees, by creating additional labour market instruments limiting unemployment, supporting human resources development and creating a mechanism of financial support for mortgage payers who lose their jobs.

5) Increase in investment outlays and enhancing the efficiency of expenditure

The government's activities aimed at increasing the rate of economic growth include enhancing efficiency of expenditure and increasing investment spending. This concerns above all spending on infrastructure, science, education, IT and health protection.

a) Infrastructure-related expenditure

Since the *Update 2008,* the extension of the network of national and local roads, modernisation of railway network, sea harbours and airports as well the development of sporting infrastructure related to the organisation of EURO 2012 remain priorities.

Activities under the *National Roads Construction Programme for the years 2008-2012* started in 2007 are being continued. The objective of these activities is the creation of a network of motorways and express roads, an increase in the load capacity of national roads up to 115 kN/axle, construction of ring roads and reconstruction of sections of national roads with respect to an improvement in traffic safety. These activities will additionally contribute to an improvement in traffic conditions for transit traffic, maintenance of traffic in metropolitan areas and large cities and improvement of maintenance of national roads.

The *National programme of reconstruction of local roads 2008-2011* (total cost is planned for PLN 3 billion from the state budget funds and PLN 3 billion from the budget of local governments). Includes the modernisation of key sections of roads at commune and poviat level, leading to an increase in traffic fluency and communication safety and to an increase in the availability of local economic centres.

The infrastructure-related projects financed from the Cohesion Fund are being carried out since 2000 and their completion is due in 2010 (settlement in 2011). The main objective of activities being undertaken is the comprehensive modernisation and improvement of railway, sea harbour and airport infrastructure.

As part of the preparation of Poland for the organisation of the European Football Championship UEFA EURO 2012, actions supporting sporting infrastructure are being carried out. Work is ongoing on the construction, extension and reconstruction of stadiums in Warsaw, Wrocław, Gdańsk, Poznań, Kraków, Chorzów (the estimated cost of these projects is approx. PLN 4.8 billion, financed from the state budget and local government). As part of the Orlik 2012 – My Football Pitch Programme, in each commune throughout Poland, publicly accessible, unpaid sporting complexes with changing rooms and social back-up facilities are being built (the estimated cost of project will be financed in PLN 1 billion from the state budget funds and PLN 2 billion from the local government budgets).

As part of these activities, the level of pro-development projects co-financed from the UE funds will be increased.

b) Expenditure on science, education, research and development

The main activities in this area relate to support of innovation and entrepreneurship by way of new technologies implementing projects. These shall be promoted by granting of technological credit, support of *know-how,* patents and the purchase of licenses, as well as application of tax credits for new technologies, support of research and development works, as well as stimulation of the creation of Research and Development Centres. A reform of the public research and development sector is being carried out in order to improve the quality of research conducted and increase the transfer of its results into the economy. A National Centre of Science is being created, while the National Research and Development Centre is undergoing a reform.

In education, activities aimed at lowering the school starting age to 6 years, modernisation of vocational and life-long education are being carried out. Moreover, it is planned to increase the effectiveness of the education financing model, implement a new model of higher education financing and ensure the universality of pre-school education.

c) Development of Digital Poland and an information society

The performance of tasks in this area are based on financing information technology projects with a public purpose, aimed at increasing the effectiveness of public entities and executing a policy of information society development by way of meeting objectives set in the *Strategy of Information Society Development in Poland by 2013.*

Moreover, activities aimed at increasing access to content and services via broadband networks throughout Poland will be carried out.

The creation of conditions ensuring the development of telecommunication infrastructure and access to telecommunication services will contribute to an elimination of digital exclusion, and to stimulate initiatives regarding the construction of broadband networks. The effects of the changes for the state budget and local government units will be largely compensated in the following years by additional tax revenues. Telecommunication investments will lead to a growth in production and employment.

d) Changes in the scope of health protection

Similarly to the *Update 2008*, changes in the scope of health protection aim to improve the operation of the system and its financing.

In the area of health protection financing, a significant role will be played by lists of guaranteed health protection benefits, determined in the form of Minister of Health resolutions. They shall contain catalogues of services financed from public funds, which will be subject to verification both with respect to costs and clinical approach.

As part of organisational changes in the health protection services, on 27 April 2009, the Council of Ministers adopted a Resolution on establishing the programme entitled *Support of local government units in activities stabilising the health protection system*, which will be executed until the end of 2011. Its aim is to create conditions which are favourable to the development and increase in competitiveness of regions by way of creating economically stable entities providing health services as part of the health protection system. Moreover, it contains solutions which provide financial support for founding authorities of facilities under transformation.

IV. Sensitivity analysis and comparison with previous Update

IV.1. Risk factors and sensitivity analysis

1. Key risk factors

Lower absorption of EU funds

The risk of incomplete utilisation of funds from the Polish allocation of structural funds and the Cohesion Fund results from an expected accumulation of payments in 2010-2011. The risk is related to the need to find public funds in order to ensure national co-financing for projects. Moreover, due to the speed of expenditure refunds from the European Commission, there is a risk of a necessity to "pre-finance" projects, which may mean a periodic increase in public debt.

An additional risk factor is the prolonged period of procedures for approval of the so-called major projects by the European Commission. In order to mitigate this risk, work aimed to simplify the system of preparation and approval of the above mentioned projects (among others, the limit above which the project is considered as "major") would be increased.
In addition, the following risk factors may be noted:
- problems related to imperfection of the public procurement law,
- problems related to limitations resulting from requirements of environment protection and NATURA 2000 areas,
- fixed tender criteria for obtaining funds and significant volumes of documents that are required from the beneficiary,
- long period of project execution, from the moment of signing the co-financing contract until the final project settlement.

No settlement of the restitution claims

The lack of sufficient settlement of the problem of financial benefits granted to certain people affected by nationalisation processes remains a source of risk. The estimated value of potential restitution claims amounts to over PLN 100 billion. The expected amount of payments due to these claims is, however, much lower and should not exceed PLN 20 billion. The assets of the Restitution Fund are planned to cover these payments.
Compensation from seizure of real estate located in Warsaw will be subject to separate statutory regulations.

Guarantees and other operations

The increase in contingent liabilities of the State Treasury arising from government guarantees is expected to rise in the coming years, from approx. 4% GDP forecasted at the end of 2009 to approx. 10% GDP in 2012. This increase is mainly caused by a significant increase in guarantees granted for infrastructure development. It is also expected to grant guarantees in relation to using EU funds and support of environment protection, creation of new workplaces, regional development, housing, small and medium companies, as well as supporting investments which stimulate the Polish economy. The forecast payments of guarantees should not exceed 1% GDP per annum, and so they will be contained within the limit of 1.4% of GDP indicated in the *Public Finance Sector Debt Management Strategy in 2010-2012.* With that, it is expected that the risk of the guarantee portfolio will not grow. While granting guarantees, the criterion is applied of not allowing the situation where the State Treasury would take over the debt of the entity to which the guarantee was granted.

Among other operations, which may result in increased risk of additional burdens to public finance, public and private partnership (PPP) transactions should be mentioned. In the budget act for 2010, the limit for the government administration to draw upon financial liabilities in relation to PPP contracts was set at 1 billion PLN.

2. Alternative scenario

The main risk for the public sector deficit path presented in the *Update* is onset of a more adverse scenario of economic growth. Lower GDP growth would limit the opportunities to reduce public expenditure with relation to the risk of excessive limitation of economic revival.

The scenario of lower growth in Poland's main trading partners would be one of the factors decreasing economic growth in the country. According to the alternative scenario it was assumed that the Polish export markets will grow in line with the path adopted by the EC in autumn 2009. This means that the global economy would grow at a rate of 3.1% in 2010 and 3.5% in 2011, with a growth in GDP in the EU at a level of 0.7 and 1.6% respectively.

The fulfilment of the above scenario would result in a lower rate of export growth, especially after 2010. In consequence, the expected improvement of the situation on the labour market would come later compared with the baseline scenario and at a lesser scale. This would cause a lower growth in household disposable income and as a result, a lower growth in consumption demand. Tighten conditions on the labour market would mean a lesser credit standing of households and a substantially slower recovery in the housing market, which in turn would limit the growth in private sector investments. A lower growth in investments in the enterprise sector would also hamper the investment activity.

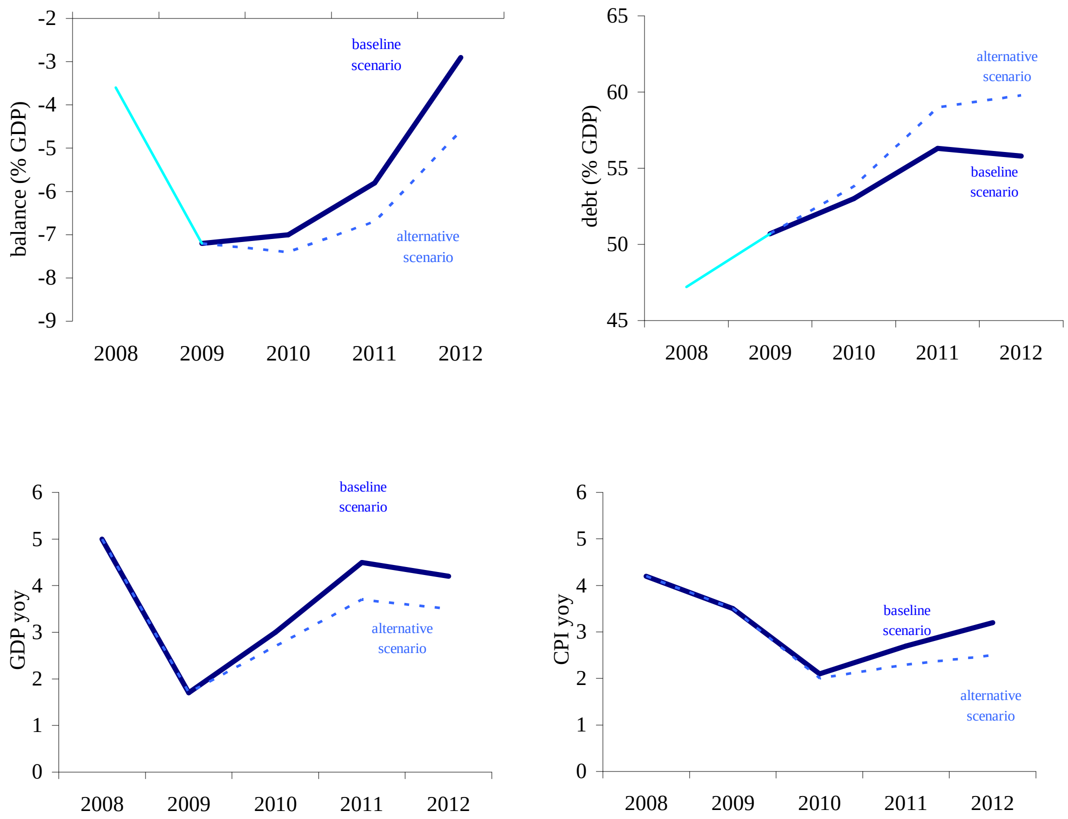
In the above scenario, the implementation of the reforms would be harder. Moreover, the alternative scenario assumes a lesser scale limitation of public sector expenditures than the baseline scenario. The full implementation of reform plans would be reflected in worsening situation on the labour market, contributing to a further decrease in GDP growth in Poland. A slower growth in private sector investments would be compensated only partially by a smaller scale of public investments limitation. In the light of that, the realisation of the alternative scenario would mean a slower reduction of deficit as compared to the baseline scenario.

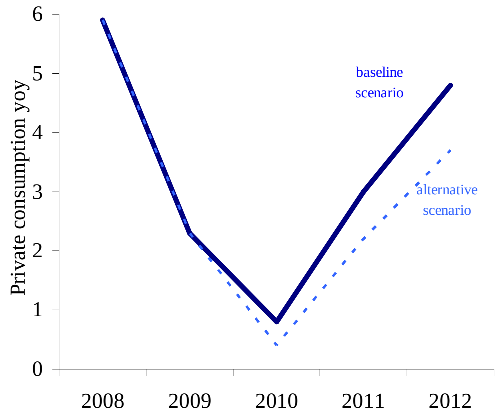
Apart from the fiscal policy, the factors mitigating the impact of a slower growth in export markets in the alternative scenario would be a weaker zloty exchange rate, improving in the short term the price competitiveness of export, as well as a lower inflation, which would limit the real decrease in households purchasing power.

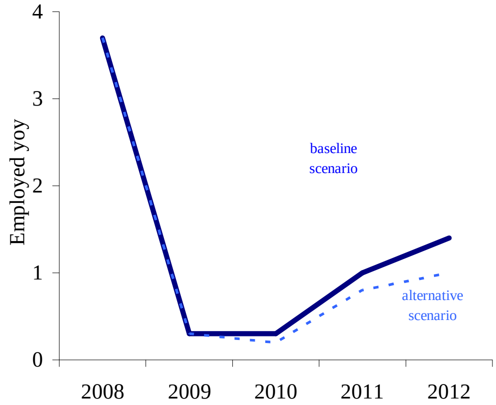
Taking into consideration the above effects of the alternative scenario, its realisation would mean for Poland in 2010-2013 an increase in GDP at a level of 2.7%, 3.7% and 3.5% respectively.

The details concerning the differences in selected macroeconomic and fiscal figures between baseline and pessimistic scenarios are presented on the graphs below.

Graph 2 Scenarios of development of macroeconomic situation, balance and debt of the general government







IV.2. COMPARISON WITH THE PREVIOUS UPDATE

Tab. 4 Divergence from previous *Update*

	ESA code	2008	2009	2010	2011	2012
Real GDP growth (%)						
Update 2008		5.1	3.7	4.0	4.5	
Current Update		**5.0**	**1.7**	**3.0**	**4.5**	**4.2**
Difference		-0.1	-2.0	-1.0	0.0	
General government net borrowing/lending (% of GDP)	EDP B.9					
Update 2008		-2.7	-2.5	-2.3	-1.9	
Current Update		**-3.6**	**-7.2**	**-6.9**	**-5.9**	**-2.9**
Difference		-0.9	-4.7	-4.6	-4.0	
General government debt (% of GDP)						
Update 2008		45.9	45.8	45.5	44.8	
Current Update		**47.2**	**50.7**	**53.1**	**56.3**	**55.8**
Difference		1.3	4.9	7.6	11.5	

Source: Ministry of Finance, Central Statistical Office

Compared to the previous Update from December 2008, the path of real GDP growth was corrected downwards in 2009-2010. The predicted rate of growth in both domestic demand and foreign demand turned out to be much slower, as in 2009 it amounted to -0.9% as compared to 3.0% forecast in the previous Update. This resulted from a limitation of consumption and investments. The positive contribution of foreign demand to GDP growth was in turn significantly higher than previously predicted.

In this Update, the rate of growth in GDP in 2010 is predicted to be lower, as compared to the previous document. However, the forecast of the rate of growth in GDP for 2011 is unchanged, although its structure changed. The predicted rate of growth in investments in 2011 is higher, while the pace of growth in private and common consumption is lower.

Changes of the predicted fiscal path result from the effects of the global economic crisis, which were hard to estimate in the previous *Update.* Some effects of the global recession were reflected in the global deepening of the fiscal imbalance, also in Poland.

Differences in the forecast government debt in 2009-2011, as compared to the previous *Update*, mainly result from:

- decrease in the predicted real GDP in particular years, due to the global financial crisis and related economic slow-down,
- changes in assumptions relating to the state budget borrowing requirements, which increased significantly,
- changes of assumptions concerning the shape of the currency exchange rate - after a significant weakening of the zloty in 2008 and return to the appreciation trend, the continuation of a moderate

strengthening, compared to the previous *Update* is predicted,

- increase in liabilities for infrastructure-related investments co-financed by the National Road Fund, among others,
- classification of investment outlays incurred by concessionaries as part of PPP in the scope of road infrastructure construction as a general government debt.

V. QUALITY OF PUBLIC FINANCE

V.1. POLICY STRATEGY

Many of the activities undertaken by the government in order to improve the effectiveness of operation of public finance are activities continued from the *Update 2008.* These mainly cover institutional changes, related to the implementation of new regulations and solutions as part of the public finance act and in the area of task-related budget (cf. chapter VII).

Tab. 5 Basic data concerning the general government (EDP).

	ESA code	2008 *PLN billion.*	2008 *GDP %*	2009 *GDP %*	2010 *GDP %*	2011 *GDP %*	2012 *GDP %*
Total revenues	TR	504.2	39.6	37.4	39.6	40.3	40.3
Total expenditure	TE	550.6	43.3	44.6	46.5	46.2	43.3
Balance	**S13**	**-46.4**	**-3.6**	**-7.2**	-6.9	-5.9	**-2.9**

Source: Ministry of Finance, Central Statistical Office

V.2. DEVELOPMENTS ON THE EXPENDITURE SIDE

The estimated general government expenditure to GDP ratio will be reduced from the predicted 44.6% in 2009 to 43.3% in 2012.

A significant influence on the level and structure of expenditure will be exerted by activities undertaken in order to rationalise expenditure, make it more flexible and increase the share of pro-development expenditure. The most important assumptions are:

• implementation of expenditure rules in order to achieve a permanent stability in public finance;

In particular, in the case of the expenditure rule aimed at decreasing the structural deficit, the necessary condition is the strong limitation of growth in discretionary expenditure, which does not result from existing acts governing public expenditure and a strong limitation on the creation of such new acts. The increase in this expenditure in the coming years should not exceed 1% in real terms.

• decrease and flexibility of public expenditure, by review of indexed and valorised expenditure and their rationalisation;

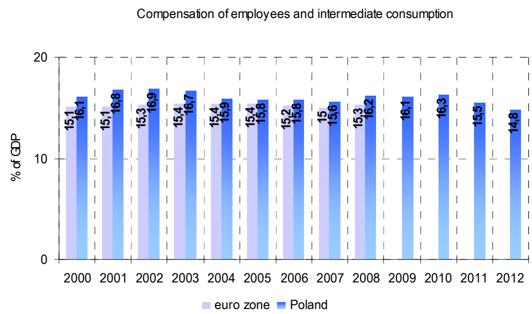
• within the scope of infrastructure-related expenditure: funds have been provided for the *National Road Construction Programme for years 2008-2012*, development of local roads under the *National Programme for local roads construction 2009-2011* and the investments related to preparations for EURO 2012;.

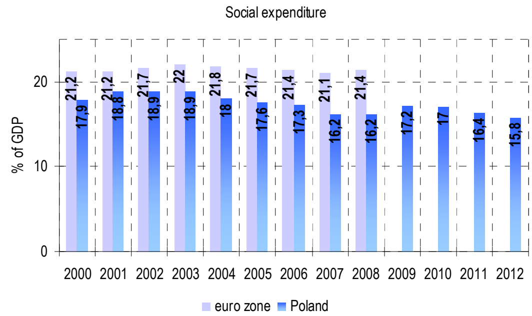
• securing of expenditure necessary for an efficient use of EU funds;

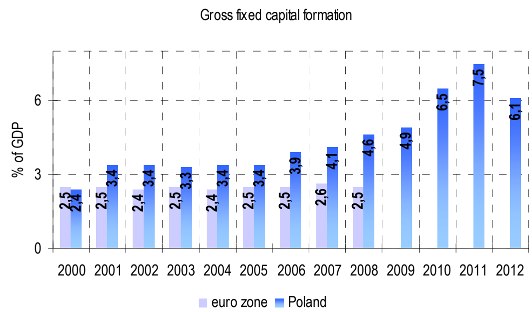
• annual indexation of pension and retirement benefits (according to the formula: CPI+20% of the real salary growth in the national economy);

• stability of the remuneration fund in real terms in budget sector units.

Graph 3 Selected categories of expenditures in Poland and euro area (% of GDP)







Tab. 6 General government expenditure by function (COFOG, % of GDP)

	COFOG code	2007	2012
1. General public services	1	5.6%	5.9%
2. Defence	2	1.4%	1.4%
3. Public order and safety	3	1.8%	1.8%
4. Economic affairs	4	4.7%	5.4%
5. Environmental protection	5	0.6%	0.7%
6. Housing and community amenities	6	1.1%	1.2%
7. Health	7	4.6%	4.7%
8. Recreation. culture and religion	8	1.1%	1.1%
9. Education	9	5.7%	5.8%
10. Social protection	10	15.6%	15.2%
Total expenditure		**42.2%**	**43.3%**

Source: Ministry of Finance, Central Statistical Office

Comparing 2007 with forecasts for 2012, an increase in expenditure to GDP ratio may be noticed (1.1 pp). The estimated growth results from, among others, an increase in the outlays from transport infrastructure (economic affairs), education and health in relation to GDP. These areas remain priorities of this government.

V.3. Developments on the revenue side

The general government revenue to GDP ratio reached 39.6% in 2008, in 2009 this ratio shall decrease to 37.4% and by 2012 and is expected to grow to 40.3%. The current forecast of the general government revenues for years 2010-12 takes into account the assumptions as to the macroeconomic developments and planned systemic changes. The most important changes in this area include:

- changes in VAT – increasing the subject based VAT exemption and changes regarding the deduction of VAT on company cars (liquidation of the possibility to deduct VAT from purchase and VAT on fuel in the case of cars with the so-called grid)

The change of subject based exemption is dictated by the need to support small companies. In 2010, the limit entitling to subject based exemption of VAT will increase from the current PLN 50,000 to PLN 100,000, while in 2011 it will be increased again to PLN 150,000.

The planned changes regarding the deduction of VAT on cars with the so-called grid aim to expand the tax base.

- in excise duty tax

The level of revenues from excise duty tax will be influenced by a growth in excise rate. As of the end of 2011, according to the provisions of the Council Directive 2003/96/EC, the period of exemption from excise duty tax on coal and coke for combustion purposes will expire.

- in income taxes, no significant systemic changes are expected

In 2011, it is also planned to change the payment date of the last advance payment of CIT. This change was proposed by companies. It aims to abolish the acceleration of advance payment for tax in December. The last advance payment in a year (in December) is currently paid in double, calculated on the basis of income obtained in November. As a result of this change, companies will have greater financial liquidity at the end of the year.

In order to expand the tax base and combat the black economy, from 2011, it is planned to introduce the obligation of using cash registers by lawyers, doctors and representatives of other professions who have not been subject to such an obligation so far, which is compliant with Chapter 3 of the *Plan for the Development and Consolidation of Finances.*

VI. SUSTAINABILITY OF PUBLIC FINANCE

The projections presented in table below for the long-term sustainability of public finances were prepared by the Economic Policy Committee (EPC) Ageing Working Group (AWG). The previous forecasts were drawn up in 2005.

The new retirement system introduced as of 1 January 1999 has led to a reduction of risk of long-term retirement system insolvency by adapting it to the demographic and social and economic changes. As a result, it is expected that the expenditure for retirement and pension benefits will maintain a decreasing tendency from 11.6% of GDP in 2007 to 8.8 % of GDP in 2060. The decrease in expenditure results above all from implementation of a new system for people born after 1948. A strong limitation of rights to take earlier retirement took place, as well as a tightening of the disability pension system, change of the formula of retirement benefit calculation etc. The above changes justify among others, the increase in the predicted effective retirement age. The decrease in expenditure is also a consequence of the methodology adopted by Eurostat, according to which the mandatory funded tier of the pension system, managed by private institutions, is not an element of the general government. Payments of retirement benefits do not increase public expenditure, as the related costs had been already incurred (by loss of contribution assigned to OFE).

According to the AWG projections, total expenditures of pension system drop from 11.6% of GDP in 2007 to 10.6% of GDP in 2060.

In the case of projected healthcare expenditure, it does not significantly differ from the forecast presented in the previous *Update.*

In turn, in relation to the previous projections concerning social security, new assumptions reflect the following legislation changes introduced after 2004:

1. Shifting the possibility for early retirement

According to the initial assumptions, the possibility for early retirement under the old system for people who meet the conditions for taking advantage of such retirement were expected to be maintained until the end of 2006. This deadline was finally extended until the end of 2008. It resulted in increased state budget expenditure until approx. 2013, in the following years, this effect will decrease.

2. Excluding miners from the new pension system

In 2005, the pension regulations relating to miners were changed. As a consequence, miners included in the employee pension system, obtained a right to early retirement and to calculate the amount of pensions based on the previous formula of defined benefit binding so far, which means that they were excluded from the new retirement system.

This change results in the increase in pension expenditure in view of the fact that miners' retirement benefits will be higher than the average retirement benefits and will be paid for a longer time.

3. Change of the benefit indexation principles.

In 2007, another change of an important parameter defining the operation of the system took place - the indexation rate. As a result of these changes, since 2008, annual indexation of old-age and disability benefits was restored. Moreover, the indexation of benefits was made dependant not only on the increase in the prices of consumption goods and services in the previous calendar year, but also completed by an element dependent on the real growth in average wage in the past year.

The change in indexation rules impacts on the increase in expenditure. In coming years, this effect will, however, decrease due to payment of benefits to subsequent years of insured people for whom the share of PAYG part will decrease for the benefit of the funded part of the system. Also a lower rate of wage growth was assumed.

4. Decrease in disability pension contribution.

A two-stage decrease in pension contributions was implemented (the first one since July 2007 and the second one since January 2008). This change caused a decrease in revenues from contributions and in consequence, an increase in the deficit of the Social Insurance Fund. These changes aimed at decreasing the taxation of labour.

5. Granting a right to early retirement to men until the end of 2008.

As a result of the Constitutional Tribunal verdict, it was necessary to introduce a possibility for men's early retirement into the old system regulations, on the identical terms and conditions as the ones binding for women. This privilege is available for men born in the years 1944-1948.

When analyzing data in the table *Long-term sustainability of public finances*, one has to remember that the old-age benefits from the new system have been paid out since 1 January 2009 to a small group of women. The first new retirement benefits for men will be paid out since 1 January 2014. In the first decades, the indexed initial capital, reflecting the retirement rights acquired until end of 1998, will play a significant role in the amounts of retirement benefits. In a few decades, when the time of paying contributions to the new system, including contributions paid to the open pension funds, has been long enough, the retirement benefits, including funded pensions, from the new system will begin to play an important role. Expenses for retirement benefits in Poland will continue to be a significant part of expenditure of the public finance sector.

The projections do not include legal changes enforced after 1 July 2008. This relates to the bridge pensions act (since January 2009) which - according to the intentions of the reform - are to be a transitional solution and will replace the existing early retirements, although only for a small group of entitled people. Introduction of this type of benefit will lead to an increase in state budget expenditures in the beginning, but with time, these expenditure are expected to decrease along with expiration of these rights. Bridge pensions will be financed from a separate fund.

Currently, retirement benefits are paid out to people from the so-called demographic boom. Therefore, it is planned to release funds accumulated on the Demographic Reserve Fund (DRF) in 2010. The budget act, the financial plan of the Social Insurance Fund (SIF) for 2010 provides for a shift of PLN 7.5 billion from the DRF as well as an increase in subsidy to the SIF from the state budget by PLN 7.5 billion.

The table below does not include changes concerning the Fund, as no resolution of the Council of Ministers allowing the use of these funds has been published yet.

Tab. 7 Long-term sustainability of public finances (% of GDP)

% of GDP	2000	2007	2015	2020	2030	2060
Total expenditure						
Of which age-related expenditure						
Pension expenditure	13.2	11.6	9.6	9.7	9.4	8.8
Social security pension	13.2	11.6	9.6	9.7	9.4	8.8
Old-age and early pension	10.3	9.8	8.4	8.7	8.4	7.9
Other pensions (disability. survivors)	2.9	1.7	1.2	1.0	1.0	0.9
Changes in inventories and net acquisition of valuables (% of GDP)						
Health care*		4.0	4.3	4.4	4.6	5.0
Long-term care*		0.4	0.4	0.5	0.6	1.1
Education expenditure		4.4	3.3	3.2	3.2	3.2
Other age-related expenditure						
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0
Total revenue						
Of which: property income						
Pension contributions	7.9	6.9	5.6	5.4	5.1	5.1
Demographic Reserve Fund	0.0	0.3	0.4	0.4	0.4	0.8
Retirement benefits reserves not included in the government assets						
Assumptions						
Labour productivity growth**		3.0	3.4	3.1	2.7	1.7
Real GDP growth		5.9	3.1	2.5	2.0	0.5
Participation rate males (aged 20-64)	79.3	77.4	76.8	76.9	78.6	77.1
Participation rate females (aged 20-64)	66.0	62.2	63.0	64.3	67.1	65.6
Total participation rate (aged 20-64)	72.5	69.7	69.8	70.5	72.8	71.4
Unemployment rate (aged 15-64)	16.1	9.8	5.9	5.9	5.9	5.9
Population aged 65+ over total population		13.4	15.3	18.2	23.0	36.2
Mandatory funded scheme						
Old-age expenditures	0.0	0.0	0.0	0.1	0.2	1.9
Contributions	1.2	1.3	1.7	1.8	1.8	1.9

** AWG reference scenario*
***per hour*

VII. INSTITUTIONAL FEATURES OF PUBLIC FINANCE

On 1 January 2010, the Act of 27 August 2009 on Public finance has came into force; it fulfils the intentions of the government aimed at balancing public finance, in particular aimed at meeting the macroeconomic challenges contained in the *National Reform Plan* and aiming for convergence as part of the European Union. The Public Finance Act contains a series of modern instruments of active management of public finance, which aim to improve the transparency of public finance, increase the control and supervision on financial management of the sector's units and rationalisation of public funds expenditure. The main changes aimed to achieve the above targets will consist in implementing:

1. new elements of the performance based budget.

In the new Public Finance Act, the term of "performance budget system" was defined and rules and the mode of creating the state budget in this structure were set. Thus, the structure of the performance budget system of the state budget was regulated on a statutory basis. Executive agencies, budget economy institutions, holders of state purpose funds and public legal people will also be obligated to create financial plans in the performance budget system for the given budgetary year and two following years. The legal framework for further work on implementing the performance based budget were created. Provisions regulating the issues of recording the execution of the budget in performance budget system were implemented. The Minister of Finance was authorised to determine the types, forms, dates and methods of creating reports on execution of the budget in performance budget system by state budget units, state purpose funds, executive agencies, budget economy institutions and public legal entities. The authorisation was given to the Minister of Finance to hold general control on the effectiveness and efficiency of the execution of the budget in performance budget system and execution by budget parts holders of the supervision and control on execution of the plans in performance budget system based on indicators related to the level of target fulfilment. A part of these solutions was included already in the justification to the Budget Act for 2010, in which the detailed description of expenditure was prepared in the performance budget system. The extended subject scope of the performance based budget included, apart from budget parts holders, other units of the public finance sector. State budget units, selected state purpose funds, all state agencies and selected other public legal entities prepared their financial plans in the performance budget system. Also lists of multi-annual investments and multi-annual programmes as well as a statement of planned expenditure for years 2011-2012 were prepared in performance budget system. The functional system of expenditure was extended by the so-called efficiency part, with targets and indicators allowing to assess the level of target achievement.

2. Multi-annual State Financial Plan (MSFP) and multiannual financial forecast in local authorities units.

The Public Finance Act implemented an instrument of modern public finance management - MSFP. This plan will be accepted by the Council of Ministers in the form of parliamentary resolution and will constitute a plan of revenues and expenditures as well as turnovers and expenses of the state budget prepared for the period of four budget years. It will be an instrument linking the strategic planning with annual decisions on the allocation of public funds at the stage of constructing the Budget Act for the following budget year. The level of state budget deficit assumed in the MSFP for the subsequent budget years will determine the level of deficit to be adopted for preparation of the Budget Act draft for a given budgetary year. A similar instrument at the local authority level will be the multi-annual financial forecasts, covering the period of a budget year and at least three following years. The minimum period of forecast preparation will be subject top mandatory extension for the period the execution of investments is planned for.

3. new solutions concerning the system of managerial control in public finance sector units.

The increase in effectiveness of public funds expenditure will also take place by way of implementing into the public finance sector the notion of managerial control, including in its scope all the aspects of the unit's operations. The unit manager will be responsible for implementation and monitoring of elements of the managerial control - reaching the set targets in a legal, effective, cost-efficient and timely manner. Plans and reports on operations should be consistent with the performance based budget methodology.

4. changes in safety thresholds concerning the public state debt to GDP ratio and strengthening of the prudential and recovery procedures in the state budget as well as budgets of local government units.

The new Public Finance Act maintains the three safety thresholds, while tightening the regulations on mechanisms aimed to limit the public state debt. The recovery procedure for the public debt breaching the threshold of 55% of GDP was strengthened . The implemented solutions allow a more flexible approach and allow the variant to be selected and adapted to the fiscal situation and meeting the basic objective of sanction.

5. changes in the scope of European funds management and other funds from foreign sources, not-returnable.

Since 2010, as part of the state budget, a "European funds budget" was separated and a change of making payments to the beneficiaries of projects and programmes was made. Its financing will be an additional borrowing requirement for the state budget. In turn, the turnovers from surplus of European funds may cover the state budget deficit and other borrowing requirements. The separation of the European funds budget will allow for a more flexible planning and use of these funds, and will make it possible to retain the liquidity of programmes execution in the following years of the National Strategic Reference Framework (NSRF).

ANNEX 1. TABLES

Tab. 8 Macroeconomic prospects

	ESA Code	2008 Level	2008 Rate of change	2009 Rate of change	2010 Rate of change	2011 Rate of change	2012 Rate of change
1. Real GDP (PLN billion)	B1*g	1 235.6	5.0	1.7	3.0	4.5	4.2
2. Nominal GDP (PLN billion)	B1*g	1 272.8	8.2	5.7	5.1	7.4	7.6
Components of real GDP							
3. Private consumption expenditure	P.3	753.9	5.9	2.3	0.8	3.0	4.8
4. Government consumption expenditure	P.3	226.9	7.5	1.1	3.8	0.0	0.0
5. Gross fixed capital formation	P.51	274.6	8.2	-0.3	5.7	11.3	4.7
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	21.4	1.6	-0.9	0.0	0.5	1.0
7. Exports of goods and services	P.6	513.4	7.1	-9.4	5.5	7.0	8.0
8. Import of goods and services	P.7	554.7	8.0	-14.4	6.1	7.6	8.5
Contributions to real GDP growth							
9. Final domestic demand		-	5.7	-1.0	3.4	4.8	4.5
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-1.1	-2.5	0.9	0.5	0.5
11. External balance of goods and services	B.11	-	-0.7	2.7	-0.3	-0.3	-0.4

Tab. 9 Price developments

	ESA Code	2008 Level	2008 Rate of change	2009 Rate of change	2010 Rate of change	2011 Rate of change	2012 Rate of change
1. GDP deflator		-	3.0	3.9	2.0	2.8	3.3
2. Private consumption deflator		-	4.2	3.0	2.1	2.7	3.2
3. HICP		-	4.2	4.0	2.1	2.7	3.2
4. Public consumption deflator		-	4.1	3.0	2.1	2.7	3.2
5. Investment deflator		-	2.3	2.0	3.3	3.3	3.5
6. Export price deflator (goods and services)		-	-0.9	13.8	-2.1	2.0	2.0
7. Import price deflator (goods and services)		-	0.9	10.0	-1.1	2.1	2.0

Tab. 10 Labour market developments

	ESA Code	2008 Level	2008 Rate of change	2009 Rate of change	2010 Rate of change	2011 Rate of change	2012 Rate of change
1. Employment (in thousand of people)*		15 800	3.7	0.3	0.3	1.0	1.4
2. Unemployment rate (%) **		7.1	7.1	8.2	9.2	9.3	8.9
3. Labour productivity (PLN thousand) ***		80.6	1.3	1.4	2.7	3.5	2.8
4. Compensation of employees (PLN billion)		472.5	13.0	3.7	3.4	6.7	8.5
5. Compensation per employee (PLN thousand)		38.8	8.2	3.9	3.5	5.4	6.8

* Average employee based on LFS (aged 15 and older).
** Harmonized unemployment rate definition, Eurostat; levels.
*** Real GDP per person employed.

Tab. 11 Sectoral balances (% of GDP)

	ESA Code	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world*)	B.9	4.0	0.1	1.1	0.0	0.8
of which: - Balance on goods and services		3.9	0.2	0.8	1.1	1.2
- Balance of primary incomes and transfers		1.1	1.4	1.6	1.5	1.6
- Capital account		-1.1	-1.5	-1.3	-2.6	-2.1
2. Net lending/borrowing of the private sector	B.9	0.8	4.4	5.8	5.9	2.1
3. Net lending/borrowing of general government	EDP B.9	-3.6	-7.2	-6.9	-5.9	-2.9
4. Statistical discrepancy **)		0.4	2.7	-	-	-

*) NBP, Payment balance data; „+" means a deficit of the determined balance

**) Difference resulting from the approach to foreign sector in national accounts (CSO) and payment balance data (NBP) in 2009, the differences were assumed on the basis of data from Q1-3.

Tab. 12 Basic assumptions

	2008	2009	2010	2011	2012
Short-term interest rate (annual average)*	5.7	3.8	3.7	4.8	5.6
Long-term interest rate (annual average)	6.1	6.1	6.2	6.3	6.4
Nominal effective exchange rate	-8.4	24.5	-9.4	-6.2	-3.3
Exchange rate vis-à-vis the € (annual average)	3.52	4.33	3.96	3.69	3.55
**World GDP growth ** **	3.0	-0.8	3.8	4.1	4.1
EU GDP growth	0.8	-4.0	1.2	2.2	2.2
Growth in relevant foreign markets	3.1	-13.3	4.1	6.3	6.3
World import volumes******	3.4	-12.3	5.6	6.8	6.8
Oil prices (Brent. USD/barrel)	97.7	61.9	76.0	80.0	80.0

* NBP reference rate (minimum profitability of 7-dat NBP bills)
** world GDP including EU GDP
*** Volume of import of goods and services from our main trading partners, weighted by the structure of our export. Weights on the basis of trade structure of 2008.
** world import including EU import

Tab. 13 General government

	ESA Code	2008 PLN billion.	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP	2012 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	**-46.4**	**-3.6**	**-7.2**	**-6.9**	**-5.9**	**-2.9**
2. Central government	S.1311	-49.4	-3.9	-5.6	-5.7	-6.1	-3.6
3. State sector	S.1312						
4. Local government	S.1313	-2.3	-0.2	-0.5	-0.5	-0.1	0.0
5. Social security funds	S.1314	5.2	0.4	-1.1	-0.7	0.4	0.7
General government							
6. Total revenue	TR	504.2	39.6	37.4	39.6	40.3	40.3
7. Total expenditure	TE	550.6	43.3	44.6	46.5	46.2	43.3
8. Net lending/borrowing	EDPB.9	-46.4	-3.6	-7.2	-6.9	-5.9	-2.9
9. Interest expenditure	EDP D.41	28.3	2.2	2.4	2.7	2.8	2.7
10. Primary balance		-18.1	-1.4	-4.8	-4.2	-3.1	-0.2
11. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes		290.3	22.8	20.5	21.7	21.8	22.4
12a. Taxes on production and imports	D.2	180.2	14.2	13.0	13.8	13.6	13.5
12b. Taxes on income. wealth	D.5	109.7	8.6	7.5	7.8	8.2	8.8
12c. Capital taxes	D.91	0.3	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	144.6	11.4	11.3	11.1	11.1	11.3
14. Property income	D.4	17.5	1.4	1.4	1.4	1.2	1.8
15. Other		51.8	4.1	4.2	5.5	6.2	5.0
16. Total revenue	TR	504.2	39.6	37.4	39.6	40.3	40.3
Tax burden		433.6	34.1	31.7	32.7	32.8	33.5
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D1+P2	206.0	16.2	16.1	16.3	15.5	14.8
17a. Compensation of employees	D.1	127.3	10.0	10.2	9.9	9.5	9.1
17b. Intermediate consumption	P.2	78.7	6.2	5.9	6.4	6.1	5.7
18. Social payments		205.8	16.2	17.2	17.0	16.4	15.8
18a. Social transfers in kind supplied via market producers	D.6311 D.63121 D.63131	26.6	2.1	2.4	2.4	2.3	2.4
18b. Social transfers other than in kind	D.62	179.1	14.1	14.8	14.7	14.0	13.4
19. Interest expenditure	EDP D.41	28.3	2.2	2.4	2.7	2.8	2.7
20. Subsidies	D.3	8.3	0.7	0.7	0.8	0.8	0.7
21. Gross fixed capital formation	P.51	58.5	4.6	4.9	6.4	7.5	6.1
22. Other		43.7	3.4	3.3	3.4	3.2	3.1
23. Total expenditure	TE	**550.6**	**43.3**	44.6	46.5	46.2	43.3
Government consumption (nominal)	P.3	236.3	18.6	18.8	19.0	18.2	17.4