REPUBLIC OF POLAND

CONVERGENCE PROGRAMME
2006 UPDATE

Warsaw, November 2006.

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INTRODUCTION

1. Poland's accession to the European Union in 2004 allowed for accelerating GDP growth dynamics thanks, inter alia, to opening of the EU market for Polish goods and services, a considerably increased access to EU funds, covering the country by the Common Agricultural Policy, and improvement of the country's trustworthiness among foreign investors. However, benefits effecting from the EU membership are accompanied by obligations. Participation in the coordination of economic policies has become one of Poland's tasks as the EU Member State. First of all, it envisages implementation of the so-called Broad Economic Policy Guidelines including general (for the entire Union and all its members) and detailed (for individual Member States) recommendations of the Ecofin Council referring to macroeconomic and structural policy. The way of implementing macroeconomic recommendations, including mostly the budgetary ones, is presented in detail in stability or convergence programmes submitted to the European Commission. The programmes and their annual updates are subject to opinion of the Ecofin Council.

2. The Ecofin Council stated in its opinion, issued on 14 March 2006, that the Convergence Programme – 2005 Update foresaw a certain progress in reducing excessive deficit, but it did not ensure its effective correction in 2007. The Ecofin Council adopted on 28 November 2006 a decision stating, pursuant to Article 104 (8) of TEC1, inadequate actions of Poland in response to the Council recommendation from 2004. On the other hand, one should remember that running budgetary policy in Poland is particularly difficult due to specific features of the social and economic situation of the country, the most important of which seem to be as follows:

- demographic situation – the turn of the century saw a soaring number of people from the population boom enter the labour market;
- level of economic activity – the early 90s (the period of political system transformations) resulting in a growing number of persons drawing retirement or disability benefits, along with a lowered regular age of retirement; all that resulted in a major increase of a share of economically inactive population in the working age population;
- trend to raise the GDP level mostly through a growing efficiency in industry and the construction sector, with lower stress on creating optimum conditions for development of services sector;
- pension reform – introduction of the reform in 1999 provided the basis for a major improvement in the long-term sustainability of public finances. However, it resulted in a significant rise of current burdens for the state budget.

Nevertheless, in this document we present the assessment of general government which, thanks to government actions and a good macroeconomic situation, allows to expect abrogation of the excessive deficit procedure as soon as statistical data will have confirmed this assessment. Reduction of the general government deficit will continue in the following years. This process will contribute to making the economy more flexible , first of all through significant cuts in non-wage labour costs. Achievement of that objective is however connected with a risk, in particular of political and macroeconomic character.

3. Poland prepared for many years to join the European Union, aware of obligations arising from the membership. Commitment to carry out the policy of sound public finances is also in our own interest. Year 2007 will be the subsequent year in implementing this objective.

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[1] TEC – Treaty establishing the European Community.

4. The present document was approved by the Council of Ministers on 29 November 2006,and it reflects the knowledge about the economy and government activities as on that day. The document will be discussed by committees at both houses of the Parliament.

I. FRAMEWORKS AND OBJECTIVES OF MACROECONOMIC POLICY

5. Macroeconomic policy objective is to solve key economic and social problems, being simultaneously cautious about the way of shaping public finances.

6. The most important challenge is to raise employment level considerably. It has to be high enough to allow for a simultaneous decrease of the unemployment and for absorbing of at least part of the economically inactive persons by the labour market. Striving for absorption of the economically inactive persons, it is important to impact both on a group of young people (in order to be the most effective in reducing social tensions related to a difficult start of youth in their professional life) and on older population, taking advantage of early retirement and disability benefits schemes. A clear improvement of the employment ratio is a prerequisite for essential changes leading to a reduction of tax wedge on labour and lowering income tax burden and also the improvement itself is a target of these changes.

7. It is especially important here to provide optimum conditions for the development of services sector that focuses on meeting both domestic customers needs (mostly households) and those of foreign customers. The development of services sector is the most important for employment growth, and moreover it can be achieved without any particularly high capital investments.

8. Equally essential is to level off divergences in per capita GDP between Poland and most developed EU countries. Improvement of productivity in particular economic sectors as well as increasing the production capacity is of a special significance here. It is also essential to find a relevant position for Poland in the globalising economy. A wider entering into services market and creating good conditions for global producers to place investments in Poland seems promising here. A growing well-being of households should allow for sustaining good economic conditions and domestic demand as far as consumer spending and corporate investments at their good level.

9. Tackling the above mentioned challenges fiscal prudence must be respected – including a compliance with rules related to the general government deficit. This is a challenge particularly difficult in a situation when public finances have to face a need of systematically growing co-financing of EU funds and the increasing costs of the pension reform.

10. Bearing in mind strong and positive dependencies between fiscal adjustment and economic growth, in particular in transition economies, the Government is committed to restructuring and consolidating public finances over the coming years. Another motivating factor is a need to achieve, pursuant to the requirements of the reformed Stability and Growth Pact, the so-called medium-term budgetary objective. Years covered by the present update should bring optimum shape of public finances, as far as macroeconomic stability, economic growth and also external obligations are concerned.

II. CURRENT ECONOMIC SITUATION AND OUTLOOK

II.1. WORLD ECONOMY

1. The global GDP growth dynamic occurred to be surprisingly strong in 1st half of 2006, regardless of high commodity prices (in particular crude oil and metals) and a less expansive monetary policy. The current data indicates that those positive trends have been continued in 2nd half of the year. Until the spring of 2006, the U.S. economy was a major driving force of the global economy, but since then its dynamics has declined in line with earlier expectations, which can mostly be assigned to the end of the real estate market boom and high oil prices. A slowdown of the U.S. GDP growth dynamics has to some extent been balanced with a faster economic expansion in the EU countries, and also with a continued impressive growth rates in Asian emerging markets, namely in China and India. The global GDP growth is estimated to be slightly above 5% in 2006, thus exceeding its earlier forecasts.

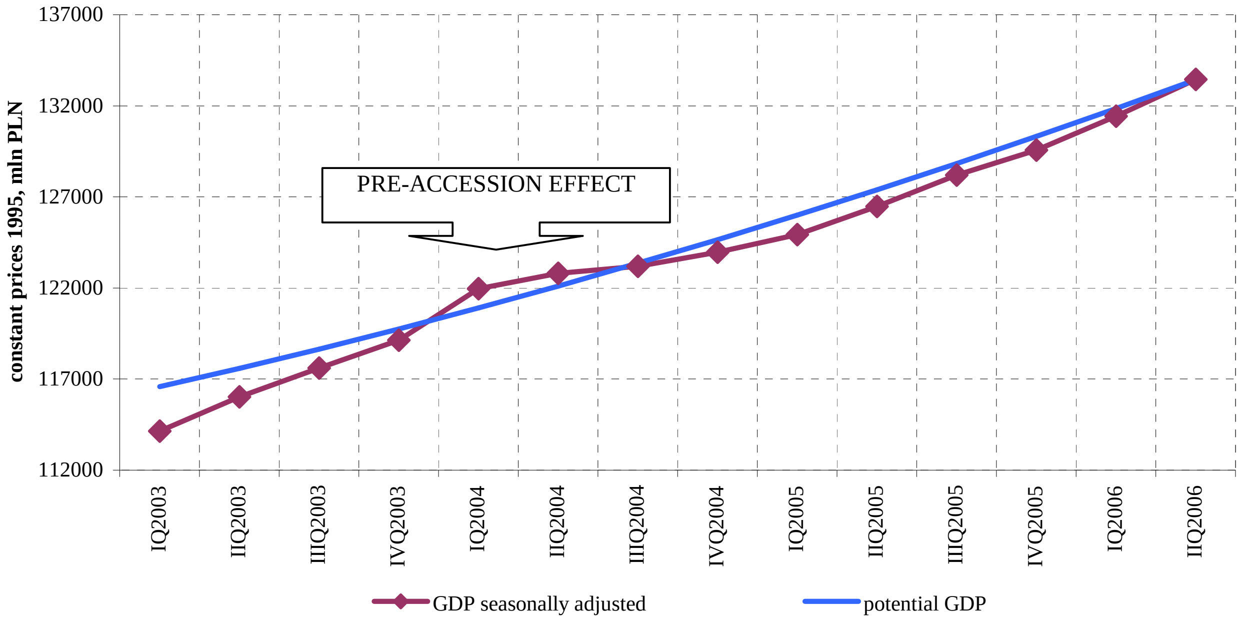
2. It is expected that the prospects of the world economy in the years 2007-2009 remain relatively favourable. Although the global GDP growth will decline to a level slightly above 4½%, it will however remain strong in its historical perspective. It needs to be stressed that the balance of risks related to the expected development of global economic situation is tilted to the downside. The main threat is a more abrupt slowdown of the U.S. economy as a result of a more rapid worsening of the U.S. housing market. There are still large global imbalances, which may be the reason for tightening of financial markets conditions. Some concerns exist that crude oil prices will grow again, bearing in mind a low level of refining and producing spare capacities. Another risk relates to the extent to which expansion in the euro zone and Japan will be sustained by increasing strength of domestic demand (in particular the consumer demand), thus reducing a too strong reliance on exports and exposure to a slowdown in the global economy.

3. It is assumed that the economic situation of our main trade partners in the forecast perspective will remain supportive of Poland's further exports expansion. However, Poland's external environment in a period of 2007-2009 is assessed to be less favourable than in 2006, e.g. due to a lower GDP growth dynamics in the EU. Average weighed import volume growth of Poland's trade partners is projected to reach ca. 7% on average in 2007-09, compared to more than 9% in the years 2004-2006.

II.2. CYCLICAL DEVELOPMENTS AND CURRENT PROSPECTS

4. Poland is now in the midst of strong economic expansion, sustaining a stable and low inflation rate, and maintaining a safe external position. In the 1st half of 2006, the real GDP growth reached 5.3% year-on-year, compared to a 2.7% growth in the corresponding period of previous year, and potential growth at ca. 4.8%. The sources of economic growth (recovery of investment demand, stable growth of consumption and fast growing exports) indicate that the currently observed economic trends are permanent.

Chart 1 Potential GDP



5. In 2005, the main source of economic growth was exports whose contribution in GDP growth was at 3.0 percentage points. Since the 4th quarter of 2005, domestic demand is becoming a driving force of economic development. In the 2nd quarter of 2006, the contribution of exports in GDP growth amounted to 4.9 percentage points compared to 4.8 percentage points of domestic demand. The revival of domestic demand is connected with a visible acceleration of consumer demand and the long-awaited investment boom.

6. According to the Central Statistical Office (CSO) data, in the 1st half of 2006, the total consumption rose in real terms by 4.6% which was an effect of 5.0% growth of households' individual consumption and 3.0% growth of collective consumption. As a result, contribution of total consumption in the GDP growth reached 3.9 percentage points (3.3 percentage points of individual consumption and 0.6 percentage points of collective consumption). For comparison, in the 1st half of 2005 total consumption increased by 2.0% in real terms, which effected in 1.7 percentage points contribution in the economic growth. A high growth of consumption is related to an evident improvement in the labour market. Starting from the 1st quarter of 2005, an increase of employment in Poland has been observed, which is accompanied by increase of wages connected with rising labour productivity. In the 1st half of 2006, the nominal wage fund in national economy increased by 6.7% with CPI reaching 0.7%, and 1.4% growth of unit labour costs. It should be stressed that the growth of the latter economic category resulted mostly from rising unit labour costs in the market services sector and the non-market services sector. Labour costs in industry sector dropped by 0.4% which, taking into consideration a large share of industrial products in the CPI basket, makes the wage related inflation pressure not so strong.

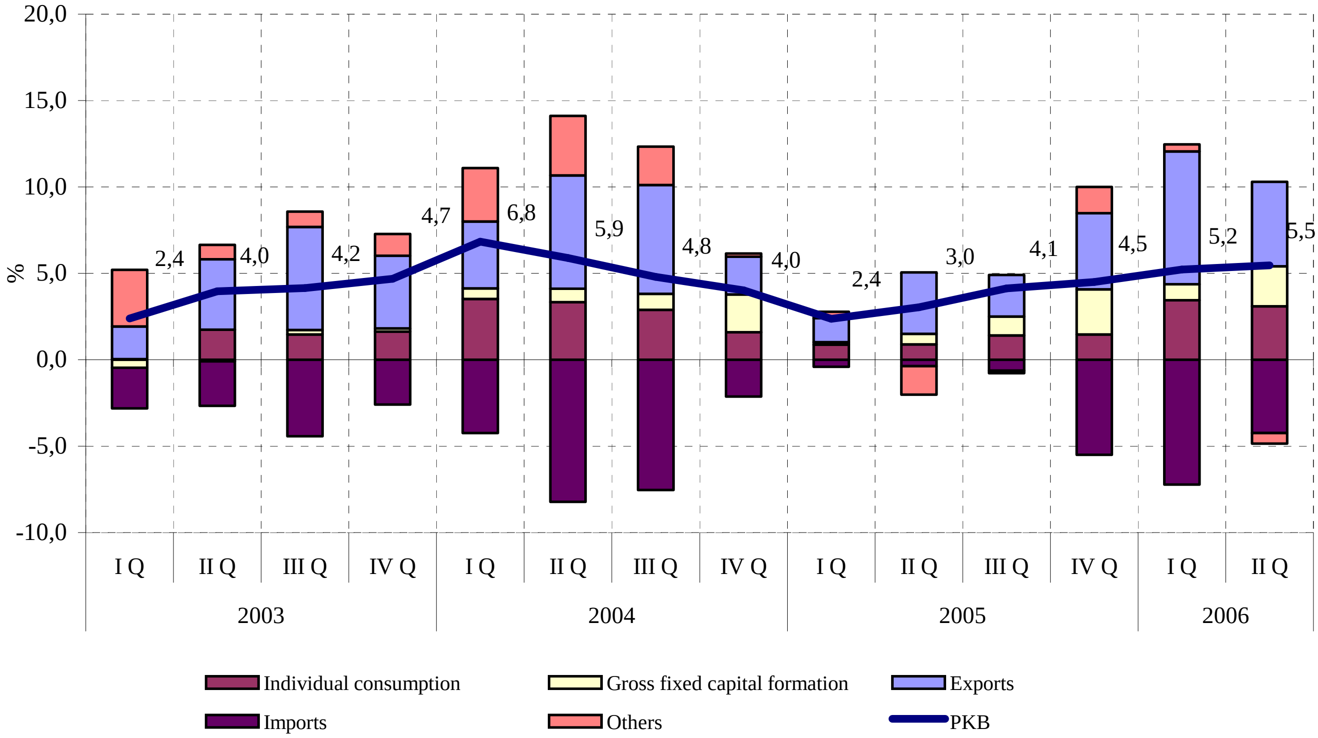
7. A visible upturn of investment activity indicates that the prospects of economic growth are optimistic. Following the CSO data, in 1st half of 2006, the gross fixed capital formation rose by 11.8% in real terms. The last time when Poland recorded a two-digit investment growth was in 2nd half of 1998. Investment acceleration is related to a few factors. The most important are as follows: an increasing absorption of the EU funds, very good financial results of companies, and improved assessment of future economic growth perspectives by entrepreneurs. The value of payments effected from the programme accounts under the

operational programmes as well as IW EQUAL and INTERREG IIIA (that is funds mostly allocated for co-financing investment projects) in January-June 2006, kept increasing on average by 1.5 percentage points per month[2]. For comparison, in September-December 2005 an average increase in payments amounted to 1.0 percentage points. It is worth adding that the increment of the payments clearly accelerates and it reached 2.6 percentage points in September 2006. In the first three quarters of 2006, enterprises, which employ over 49 persons, increased their revenues from total activity by 14% compared to the corresponding period of the previous year. At the same time the profitability rate of net turnover increased by 0.5 percentage points. The demand for credit by companies increased significantly mainly to finance fixed assets, inventories, and current assets (ca. 80% of enterprises mention such reasons). In the 2nd half of 2005, such motivation was mentioned only by ca. 50% of enterprises. The above trends allow to expect further acceleration of investments in the next quarters.

8. Exports also remain strong. In the 1st half of 2006, the real growth of this economic category was at 17.0%, which resulted in 6.3 percentage point contribution in the GDP growth. For comparison, in the 1st half of 2005, it was 6.7% and 2.5 percentage points, respectively. Good exports results are related to high competitiveness of Polish enterprises which is supported by a moderate (compared to other countries in the region) currency appreciation (till the end of 3rd quarter of 2006 zloty strengthened by 7.1% compared to year 2000, with average appreciation of the Czech, Hungarian, and Slovak currencies at the level of ca. 30%). Dynamic exports are accompanied by growing imports. In the 1st half of 2006 imports increased in real terms by 15.4%, compared to 1.0% growth of this economic category in the corresponding period of the previous year. As a result, the contribution of net exports in the GDP growth declined from 2.1 percentage points in the 1st half of 2005 down to 0.6 percentage points in the 1st half of this year.

[2] On the basis of "Information on the execution of operational programmes co-financed with EU structural funds in the period from 1st to 30th September 2006" - Ministry of Regional Development

Chart 2. Input in GDP growth



9. The strengthening of upward trends in the economy has been reflected in the improvement of the labor market situation. From the beginning of 2006 there has been steady growth of paid employment in enterprise sector, which indicates a continuation of trends that began in 2005. In October 2006 average paid employment growth in enterprise sector reached 3.6%, which is the highest employment growth from early 90s (2.8% in a period of I –X 2006). Data referring to average paid employment in the national economy concerning this year is also optimistic. In 1st half of 2006 high growth of average paid employment in the national economy[3] was recorded (the annual rate of average paid employment rose by 1.9%, i.e. by about 141 thousand of persons) and especially good results refer to a number of employees in the following sections: manufacturing as well as trade and repairs. The employment growth in these two sections makes up about 70% of total employment growth. Accelerated labor demand growth[4] was accompanied by considerable unemployment decline. From the beginning of the year the number of unemployed persons dropped by 471.4 thou. persons (i.e. by 17.0%), and the annual decline at the end of October 2006 amounted to 410.5 thou. persons (i.e. 15.1%). The unemployment rate reached 14.9% at the end of October 2006, i.e. 2.7 percentage points lower than at the end of 2005. It is estimated, that the number of registered unemployed persons will amount to ca. 2.37 million persons at the end of 2006 (i.e. 402 thou. persons and 14.5% less than at the end of 2005), with a simultaneous growth of

[3] Without small units, employees of budget entities conducting activity within the scope of national defense and public safety.
[4] Improved labor market situation has been also confirmed by LFS data. According to LFS the number of employed persons (15 years and more) reached 14.3 million persons in 1st half of 2006 and was about 3.7% higher than in corresponding period of previous year.

average employment by 2.2%[5], which will be reflected in a decline of unemployment rate to 15.2%[6] at the end of 2006, in comparison to 17.6% at the end of 2005.

10. Following the inflation growth reported in 2004 (effecting first of all from factors of transitional character, such as: impact of accession to the European Union, depreciation of PLN, a limited supply of agricultural produce in the first half of the year and a high jump of crude oil prices and other raw materials on global markets), the inflation dynamics clearly weakened in 2005, thus declining at the end of the year much below the bottom line of allowed fluctuation from inflation target that was set by the Monetary Policy Council (RPP) (the inflation target is 2.5% +/- 1 percentage point).

11. In 2006 inflation pressure remains under control, also as a result of a still high unemployment rate and thanks to a high work efficiency dynamics in industrial sector, and the annual consumer prices dynamics is still below or close to the bottom line of allowed fluctuation from the inflation target. The core inflation indicators also remain at their low level. At present, Poland belongs to the member states with the lowest inflation in the European Union, and since March 2006 the inflation in Poland is taken into consideration when calculating a reference value for the inflation criterion. The annual average growth of consumer prices is projected at 1.4% in 2006 (HICP).

12. In the first quarter of 2006, following a four-month break in the easing cycle, the Monetary Policy Council reduced the NBP's basic interest rates twice (in total by 0.5 percentage points). As a result of those decisions the reference rate dropped to its historical low of 4.0%. The rate cuts stemmed from a decline in current inflation and an increase in probability of inflation running in the first quarter of 2006 below the level forecast in the previous inflation projections. In the following months the Council – having considered inflation outlook and the strengthening of growth tendencies in the Polish economy – kept the NBP's interest rates on hold. The unchanged policy stance was also influenced by results of subsequent inflation projections indicating a faster than previously expected return of inflation to the target (2.5%).

13. In the period of January - October 2006, the volatility of Polish zloty exchange rate was similar to the one observed in the previous year. The zloty developments against the euro were mainly affected by swings in investors' sentiment towards the region connected with the shifts in expectations of Fed and ECB decisions on interest rates. Simultaneously, the zloty has been supported by strong Polish economy fundamentals. As a result, in the analyzed period, a nominal effective zloty appreciation was recorded (exchange rate weighted by geographical structure of Polish exports), the scale of which amounted to 2.7% on average, as compared to the similar period of the previous year.

II.3. MEDIUM-TERM SCENARIO

Real GDP growth

14. The potential growth of Polish economy is estimated now to be at the level of ca. 4.8%, and it is predicted to accelerate up to 5.1-5.2% by 2009. The acceleration is related to the expected improvement in the labour market and a projected rise of investments in the economy. The forecasts of GDP growth in 2007-09, which stand for 5.1%, 5.1%, and 5.6%, respectively, indicate that the output gap in Poland will be balanced in 2009. Until then, the

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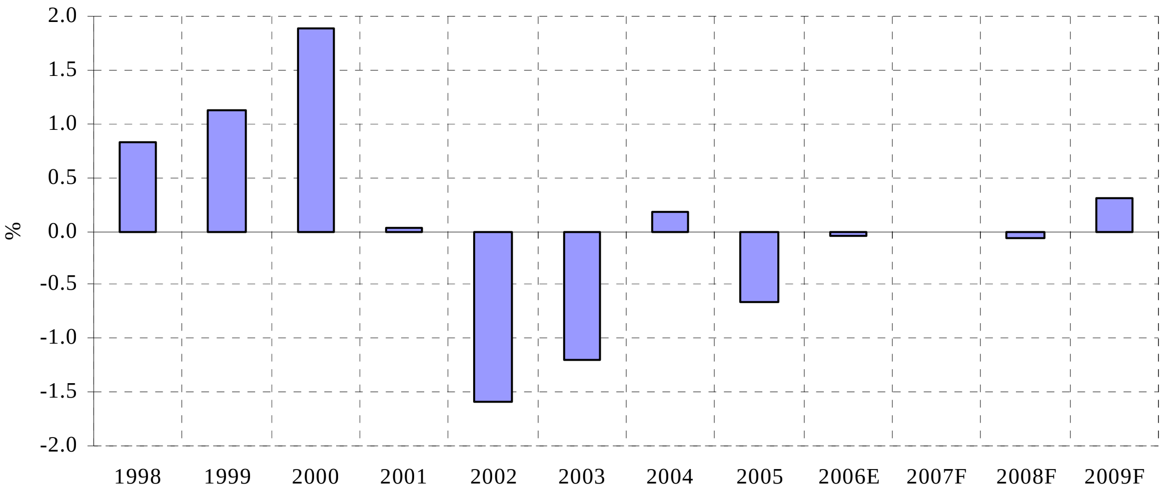
[5] Based on ESA'95; according to LFS (15 years and more) – 3.9%.
[6] According to LFS (15 years and more) average unemployment rate is estimated at 14.2% in 2006.

level of potential will be close to real production and one should not expect inflation pressure from the demand-supply imbalance.

Chart 3. Output gap in 1998-2009



Domestic demand

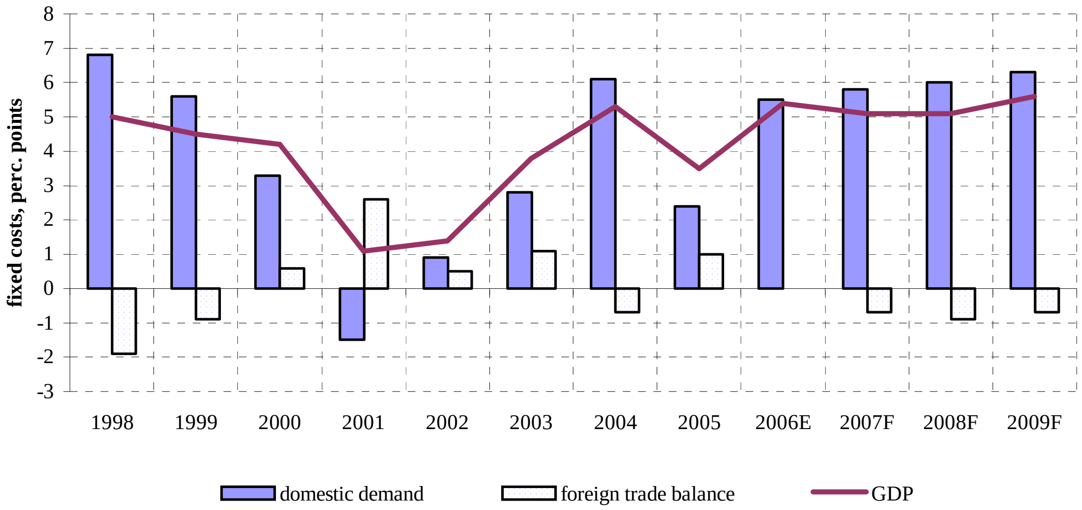
15. It is estimated that contribution of net exports to GDP growth will be neutral in 2006. Accelerating domestic demand is projected to be the main driving force of GDP growth in the coming years (2007-2009), rather consumer demand than investment demand, although the latter begins to play more and more important role along with rising absorption of the EU funds. Domestic demand is estimated to rise by 5.7% in real terms in 2007, as compared to the growth rate of 5.4% in 2006, and in the two consecutive years its growth will amount to 5.9% (2008) and 6.1% (2009).

16. Rising absorption of structural funds and the Cohesion Fund is expected to be the major factor supporting investments over the forecast horizon. The absorption of the EU funds in 2006 keeps improving systematically thanks to, among other things, the implementation of the restructuring Programme by the government aimed at increasing the absorption of structural funds under NPR 2004-06 (adopted by the Council of Ministers on 6th December 2005). Continuation of the above restructuring programme, together with introduction of simplifications in implementation of operating programs as well as an amended act on public orders law, will enable the absorption of the EU funds to improve further over the next years. Facilitation of project management and changes in the area of settlements shall allow participants of economic life access to capital of low leverage cost, which will make the implementation of larger package of investment projects easier and more realistic. Gross fixed capital formation real growth rate is estimated to be high over the forecast horizon and comparable to that estimated for 2006, amounting to ca. 11.7% on average in 2007- 2009. As a result, share of investments in GDP would increase in 2009 to 23.6% from 18.2% in 2005.

17. High households consumption expenditure growth rate is expected over the forecast horizon, that would reach 4.0%, 4.7%, 5.6% in 2007-09 respectively, in comparison to 4.8%, estimated for 2006. Significant household consumption expenditure growth rate in 2006 has resulted from increasing wage bill in national economy together with pensions indexation carried out this year, as well as substantial direct payments to individual farmers. Households' consumption expenditure growth in 2007-2009 is projected to be driven mainly by stable and high growth of wage and pension bill that is expected to rise in by ca. 4.1% in real terms on average throughout the period. Acceleration of households individual consumption

expenditure growth rate in 2008 and 2009 would stem from planned for these years 3-percentage points reduction in pension contribution rate. Moreover, government plans to cut further the tax burden by changes in personal income tax rates. Having the above in mind, real growth rate of households gross disposable income is expected to be high over the forecast horizon and would amount to 4.5% on average in 2007- 2009.

Chart 4. Real GDP growth, domestic demand and net exports contributions to GDP growth



External sector, exports and imports

18. Current account balance in 2007-2009 is forecast to move in line with the trade balance. Current economic upswing driven predominantly by strong domestic demand, including investments, is expected to lead to moderate deterioration of the trade balance due to surging imports (significant role of investment and intermediary imports for new projects, lesser role of imports for consumption). Following a temporary downturn expected in 2007 external conditions shall remain favourable during the reminder of the forecast period supporting respectable growth of exports and limiting the negative impact of high imports.

19. Foreign income deficit shall stabilise a notch below 9 bn EUR, and the non-residents income on foreign direct investment is forecast to determinate the outcome. Current transfers surplus is expected to grow further with both private and public current transfers inching up to circa 7 bn EUR in 2009. The increase in public current transfers will result from the inflow of the EU funds, whereas private transfers will rise due to remittances.

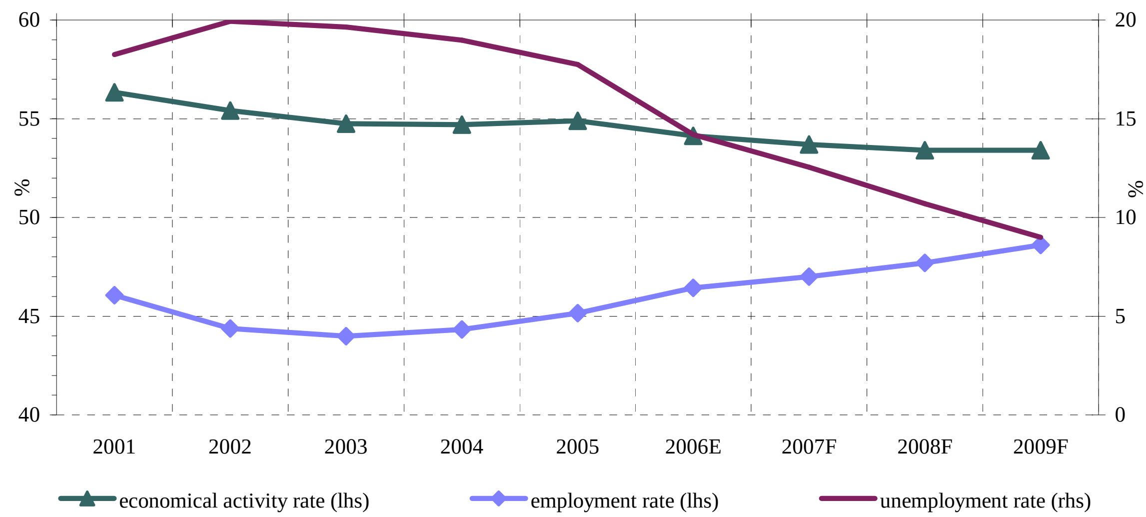
20. Widening of the current account imbalance will not jeopardise the external stability of the economy, as the inflow of capital in the form of FDI will be sufficient to finance almost entire deficit. Increase in portfolio investments will continue, and surplus of the balance of payments will result in a further rise of official reserve assets.

Labour market

21. A return of Polish economy to the path of fast economic growth will allow for continuation of upwards trend in employment. Pro-employment economic growth will be also supported by implementation of economic programmes, including the National Employment

Strategy for 2007-13. The planned reduction of tax wedge[7] (as a result of lowering pension contribution from 13% to 10% in 2008 and by further 3 percentage points to 7% in 2009, and effecting from having introduced two tax rates with a lower rate for the first income tax brackets – to 18%) will be an additional impulse stimulating a labour demand growth. Moreover, transfer of payments from the EU to Poland, addressed to a large extent to improvement of labour force mobility and labour market flexibility, should reduce structural mismatches between labour demand and supply, thus having a positive impact on the labour market. A significant rise in labour demand is forecasted to occur in the period of 2008-09, which will enable further unemployment drop. At the end of 2009, the registered unemployment rate will be at about 10.2%[8], and the employment rate will grow to ca. 54.0%[9].

Chart 5. Labour market based on LFS (15 years and more) in 2001-2009



Inflation, interest rates and exchange rate

22. In 2007 inflation pressure should still be limited, although the annual price dynamics may be slightly higher than that in 2006 because of the ongoing high dynamics of domestic demand and due to technical factors effecting in inflation growth at the end of 2006 (the annual ratio rose in the last two months of 2006 due to a low statistical base in the similar period of 2005). Stabilization of inflation at the low level will be facilitated by the exchange rate fluctuation (showing a slight trend towards appreciation) and Poland's share in the EU common market, which will soften any possible tensions on the agricultural produce market. The average growth in consumer goods and services prices is forecast at 2.1% in 2007.

23. The monetary policy over the next years will aim at inflation stability at the inflation target level set out by the Monetary Policy Council, i.e. 2.5%.

24. The projection of NBP's interest rates assumes that monetary policy will be accommodative in 2007-09. While making decisions on the cost of money the Monetary Policy Council will take into consideration the strengthening of growth tendencies in the

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[7] By 1.7 percentage points in 2008 and further 2.3 percentage points in 2009 (changes in tax wedge were calculated for average wage and salary in national economy).

[8] The average unemployment rate in 2009 according to LFS (15 years or more) is forecasted at 9.0%.

[9] Average employment rate in 2009 according to LFS (15- 64 years) is forecasted at 57.0%.

Polish economy accompanied by an increase in inflation pressure. As a result, the projected tightening of monetary policy in 2007 and 2008 should allow for keeping inflation within the tolerance range for deviations from the target in the horizon of monetary policy transmission.

25. The exchange rate projection assumes further strong zloty performance against the euro in the course of 2007-09 with a gradual reduction of its volatility. Strong Polish economy fundamentals and increasing foreign capital inflows will support the zloty in the aforementioned period.

II.4. COMPARISON BETWEEN THE EUROPEAN COMMISSION'S FORECAST AND NATIONAL FORECAST

26. The baseline macroeconomic scenario constituting a base for the projected trends in the area of public finance is generally consistent with the latest forecast[10] of the European Commission. The differences in the economic growth forecast are slight. Both Polish government and the European Commission expect domestic demand to contribute to GDP growth to a larger extent over the forecast horizon, and contribution of net exports, neutral to GDP growth in 2006, is projected to be negative from 2007 onwards. Both institutions project a considerable acceleration of investment growth rate. The Commission's forecast is more pessimistic however, probably due to not taking enough into consideration the activities performed by the Polish government focused on improvement of structural funds absorption. Actions taken by the government in this area (discussed in item 16) has resulted in resilient and accelerating quarter by quarter growth rate of gross fixed capital formation, as indicated by statistical data of 1st half of 2006. Moreover, it seems that the European Commission has underestimated the impact of a systematic improvement of the labour market situation, being expressed both in increasing wages and employment, on the consumer demand of Polish households. In the forecast prospects households consumer demand is projected to be stimulated also by foreign transfers, however to a lesser extent, what is unlike to have been considered under the Commission's forecasts. Having the above in mind, the private consumption growth forecast presented by the European Commission seems to be quite pessimistic.

Table 1. Comparison between forecasts of the European Commission and the Ministry of Finance for 2006-08[a)]

	2006		2007		2008	
	EC	MF	EC	MF	EC	MF
GDP	5.2	5.4	4.7	5.1	4.8	5.1
private consumption	4.6	4.8	3.9	4.0	3.6	4.6
gross fixed capital formation	10.4	12.0	10.8	12.0	10.8	12.0
exports	16.7	16.1	11.1	8.1	9.5	7.2
imports	16.6	15.4	12.0	9.6	10.5	9.0
Net exports [b)]	0.0	0.0	-0.5	-0.7	-0.6	-0.9
Unemployment rate [c)]	13.9	14.1	12.2	12.3	11.6	10.5
GDP deflator	1.0	0.5	1.9	1.7	2.5	2.2
HICP	1.4	1.4	2.5	2.1	2.8	2.5
Trade balance [d)]	-1.3	-1.1	-2.0	-2.1	-2.6	-3.1
Current account balance [d)]	-2.3	-1.9	-2.7	-2.5	-2.8	-3.1

Source: Ministry of Finance, forecasts as of 29 November 2006; The European Commission, forecasts as of 6 November 2006.

a) change in %, unless specified otherwise; Years 2006-09 – forecast

b) contribution in GDP change

c) As defined by Eurostat

d) GDP in %

[10] *European Commission Autumn 2006 Economic Forecasts*

II.5. GROWTH IMPLICATIONS OF "MAJOR STRUCTURAL REFORMS"

27. Government actions aiming at keeping a high economic growth and rising employment, in the horizon covered by the Programme update, will be focusing on public finance consolidation and improvement in public finance management, creation of proper conditions for an efficient absorption of the EU structural funds, stimulation of entrepreneurial initiative and innovation of enterprises, employment promotion, and support for measures aimed at limiting unemployment.

28. High economic growth shall facilitate the gradual elimination of development barriers resulting from negative structural aspects of the economy, and employment creation. Simultaneously, the government actions will focus on stimulating development trends and making them sustainable, and thus creating economic activity principles, which will decrease companies' operating costs and relieve economic operators of unnecessary bureaucratic and administrative burdens. These actions should strengthen the competitiveness of the economy.

29. *National Reforms Programme for 2005-2008* adopted by the Council of Ministers in December 2005 provides for measures, which the Polish Government wishes to take in order to achieve the main goals of the Lisbon Strategy. According to the National Reforms Programme, the main objective of the pursued socio-economic policy is to maintain high economic growth rate supporting employment creation, and in compliance with sustainable development principles. The implementation of six priorities presented in the document shall assure achievement of this objective. For the implementation of each of these priorities, institutional, organisational and legislative measures were proposed, aimed in particular at:

- public finance consolidation and public finance management i.e. – inter alia – rationalisation of public expenditure for administration and increasing the control over public resources, decentralisation of public expenditure, implementation of a multiannual budget planning system,
- entrepreneurship development, i.e. creating better conditions for setting-up new companies and a favourable institutional environment for economic activity and for efficient administration, as well as for facilitating entrepreneurs' access to capital,
- improvement of entrepreneurial innovation s, i.e. creating incentives for entrepreneurs to provide more funds for research and innovation, incentives to transfer technologies to companies, increasing research and development expenditure, especially in the private sector, support for R&D sector,
- development and modernisation of basic infrastructure (mainly road, rail, housing and energy infrastructure), by applying, *inter alia*, the Act on Public Private Partnership as an effective way of gaining private capital for the delivery of public tasks,
- creation and employment preservation and limitation of unemployment, i.e. lowering burdens imposed on employees with the lowest incomes, incentives for groups, which are in especially difficult situation at the labour market, vocational incentives for disabled persons,
- improvement of adaptation capacity on the labour market through investments in human capital, creating and popularising new flexible forms of employment and labour organisation.

27. The Council of Ministers adopted the *First National Progress Report* in October 2006. The report contains information on the way of implementing reforms under the *National Reforms Programme for 2005-2008*, along with a schedule for implementation and the expected effects of implementing particular actions (including either quantitative or qualitative indicators). The document identifies ministries and central authorities responsible for the implementation of particular actions, as well as financial resources necessary for the planned reforms to be implemented. It also describes monitoring and evaluation system developed for the purpose.

III. GENERAL GOVERNMENT BALANCE AND DEBT

III.1. POLICY STRATEGY

1. The priority of the government's economic policy is to achieve buoyant and sustainable economic development through employment development. A reduction in the general government deficit will facilitate attainment of this goal. Estimated balance of the general government in relation to GDP in the years 2006-09, calculated pursuant to the EU standards (with open pension funds – OPF classified in the general government) will reach: -1.9% -1.4%; -1.0%; -0.6%, respectively. This means a reduction in the deficit by 1.3 percentage points in the analysed period.

2. The objective of the government *Strategy for public finances debt management in 2007-2009* will be to minimise debt-servicing costs in long term under the assumed risk level limitations. The estimated debt of the general government in 2006-09 will be respectively at: 42.0%, 42.1%, 41.4%, 40.6% of GDP (OPF classified in the general government). Systematic reductions of the sector's deficit will allow for keeping the debt at the level much below the reference value.

III.2. MEDIUM-TERM BUDGETARY OBJECTIVE

3. The reference value of the medium-term budgetary objective for the structural balance has been defined for Poland at the level of -1% of GDP.

4. Based on estimates of the structural deficit and having included OPF into the general government, Poland meets its medium-term objective. The deficit is projected to decline from 2.3% of GDP in 2005 down to 1.0% in 2008 and 0.7% in 2009. Starting from the end of March 2007, based on Eurostat decision, OPF will be classified outside the general government. In this situation, due to ongoing implementation of key structural reforms (in particular the country's pension scheme reform envisaging an introduction of the pension scheme with three pillars of which two are capital), Poland, even with its serious effort in the area of public finances consolidation, will not be able to reach the level of the medium-term budgetary objective in the time span being covered by the current update of the *Programme*. Public finances consolidation will be however continued over the next years, which will allow for reducing the structural deficit down to the level of the medium-term objective following the year 2010.

5. Reforms that have been performed, being a considerable burden for public finances in the coming years, will have a very positive impact not only on medium-term but also on a long-term sustainability of public finances.

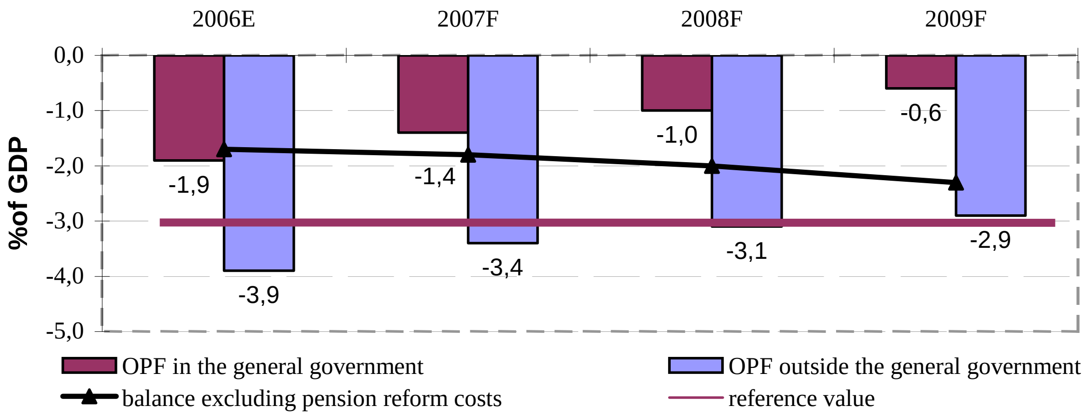
III.3. ACTUAL BALANCES AND IMPLICATIONS FOR NEXT YEAR BUDGET

6. On the basis of the spring fiscal notification data that was sent to the European Commission in 2004 and then confirmed under the *Convergence Programme* as of May 2004, the Ecofin Council found an excessive deficit in Poland and recommended that it should be limited as soon as possible, so that by 2007 it will have declined below 3% of GDP (Council Decision 2005/183/EC of 5 July 2004).

7. It is worthwhile stressing here that the Council's draft decision – pursuant to Art. 104.8 of TEC, which found Poland's activities ineffective in view of the Council's recommendations

as of 2004 that referred to the dynamics in cutting the level of general government deficit – was prepared and based on the former update of *Programme*, data included under the budget legislation for 2007 (prepared in September 2006), and based on the European Commission's own opinion. The most up-to-date illustration of the general government's situation is presented in the present update of the *Programme*. The general government deficit forecasts for 2006-09 indicate a systematic reduction in the deficit, even if OPF are classified outside the general government (from 3.9% in 2006, through 3.4%, 3.1% in the years 2007-08, and finally down to 2.9% of GDP in 2009). The hereto presented forecast shows that the general government deficit value in 2009 will have declined below the reference value. Moreover, the general government deficit estimated for 2007 will drop to the level low enough that it will become realistic to finalise this procedure thanks to the Stability and Growth Pact, which orders to include pension reform costs in the fiscal position assessment of the country that is covered by the excessive deficit procedure. Another fact should be underlined that estimates of macroeconomic figures and based on them fiscal forecasts are usually very cautious, and balances that were generated in the past occurred to be better than their forecasts.

Chart 6. General government balance



8. Table 2 presents data referring to the general government balance and debt in a period of 2002-2006.

Table 2. General government balance and debt (% of GDP)

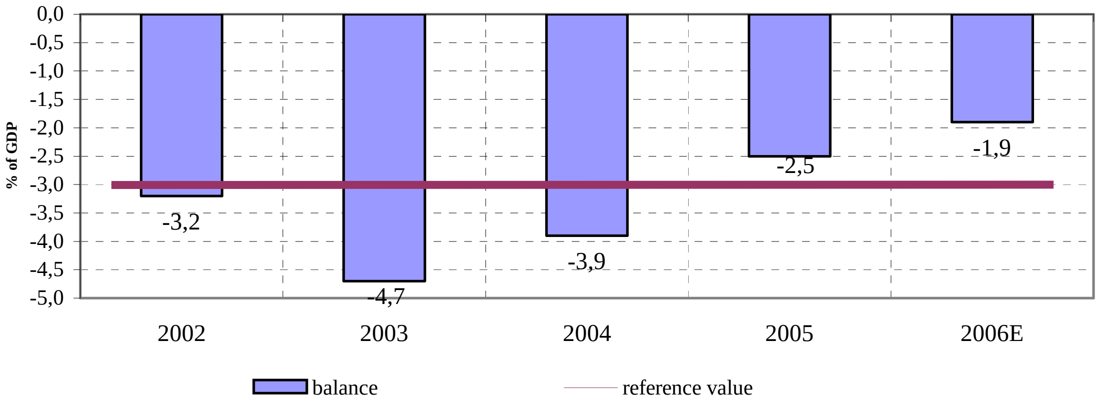
	ESA Code	2002	2003	2004	2005	2006E
General government balance (B9)	S13	-3.2	-4.7	-3.9	-2.5	-1.9
Central government	S1311	-4.3	-5.6	-5.4	-4.4	-4.4
Local government	S1313	-0.4	-0.4	0.0	-0.2	0.2
Social security funds	S1314	1.5	1.3	1.5	2.1	2.3
General government debt	S13	39.8	43.9	41.9	41.9	42.0

Source: for years 2002-05 nominal level of deficit and debt – fiscal notification, September 2006; the latest forecasts for 2006

9. In 2006, pursuant to estimations by the Ministry of Finance, the general government deficit will reach 1.9% of GDP (OPF classified in the general government). Revision of earlier forecasts results from the fact that the state budget deficit (on a cash basis) will be at least 10% lower in 2006 than planned under the State Budget Act for 2006, i.e. it will reach 90% of nominal budgetary anchor. In 2006, the general government deficit will be 0.7 percentage points lower compared to the previous update of the *Convergence Programme* due

to better than expected balances noted in all sub-sectors of the general government The central government balance has not improved in 2006, compared to 2005, mostly because of a transaction that was not made in 2005, namely a purchase of F16 jet fighters[11], and a worse balance of the National Road Fund which has more than doubled its road infrastructural investments.

Chart 7. General government balance in the years 2002-2006



Source: for years 2002-05 nominal level of deficit and debt – fiscal notification, September 2006; the latest forecasts for 2006

III.4. STRUCTURAL BALANCE

10. The structural balance, pursuant to Eurostat's derogation, has been calculated after including OPF in the general government.

11. The structural deficit forecast has been prepared having considered the output gap estimation performed on the basis of Hodrick-Prescott filter. Elasticities of the general government revenues to the cycle, based on OECD data (elasticities of indirect taxes and other revenues are 1; elasticity of CIT is 1.39; elasticity of social insurance contributions is 0.69), have been used when calculating a cyclical component of the general government deficit. It is estimated that the output gap, which the cyclical and structural component of the deficit depends on, will be closing in the period of 2006-08. This means that in the above period, the structural deficit will be very close to the general government deficit.

12. Structural deficit against GDP has been gradually declining in a period of 2005-09. In the above period, the structural deficit will fall the most in 2007, that is, by ca. 0.5 percentage points. In 2008-09, the structural deficit will be declining slightly slower, namely by about 0.4 and 0.3 percentage points per annum, respectively. This will be caused by a reduction of a disability pension contribution in 2008 and in 2009 and by a lower personal income tax burdens, in particular by introducing two tax rates 18% and 32% in 2009.

[11] The first four F16 jet fighters have flown into Poland in 2006. In line with ESA'95, expenditure for purchases of military equipment is included in the year of the equipment delivery.

Table 3. Cyclical developments (% of GDP)

	ESA Code	2005	2006E	2007F	2008F	2009F
1. **Real GDP growth**	B1g	3.5	5.4	5.1	5.1	5.6
2. **Net lending of general government**	B9	-2.5	-1.9	-1.4	-1.0	-0.6
3. **Interest payments (incl. FISIM)**	D41	2.6	2.4	2.4	2.4	2.4
4. Potential GDP growth		4.4	4.8	5.0	5.2	5.2
5. Output gap		-0.7	0.0	0.0	-0.1	0.3
6. Cyclical budgetary component		-0.2	0.0	0.0	0.0	0.1
7. Cyclically-adjusted balance (2-6)		-2.3	-1.9	-1.4	-1.0	-0.7
8. Cyclically-adjusted primary balance (7+3)		0.3	0.5	1.0	1.4	1.7

Source: Ministry of Finance

III.5. DEBT LEVELS AND DEVELOPMENTS

13. In the period covered by the hereto *Convergence Programme* update, debt management will aim at implementation of the objective of the *Public finance Sector Debt Management Strategy in the years 2007-2009*, namely the minimisation of debt servicing costs in the long term, taking into account limitations of given risks. .

Table 4. General government debt developments (% of GDP)

	2005	2006E	2007F	2008F	2009F
General government debt (OPF included)	41.9	42.0	42.1	41.4	40.6
Impact of nominal GDP growth	-2.5	-2.4	-2.7	-2.9	-3.1
Change in gross debt ratio	0.1	0.1	0.1	-0.7	-0.8
Contributions to change in gross debt					
Primary balance	0.1	0.5	1.0	1.4	1.7
Interest (including FISIM)	2.6	2.4	2.4	2.4	2.4
Other factors influencing debt-to-GDP ratio	0.1	0.6	1.4	1.2	1.6
of which: privatisation proceeds	-0.3	0.0	-0.2	-0.2	-0.1
Changes of foreign exchange rates	-0.3	-0.2	-0.1	-0.1	-0.2
p.m. implicit interest rate on debt	6.5	6.0	6.1	6.2	6.2
General government debt (OPF excluded)	47.3	48.9	50.0	50.3	50.2

Source: Ministry of Finance

14. Forecasted changes in debt-to-GDP ratio will result mostly from the developments of the State budget borrowing needs, estimated GDP growth rate and PLN exchange rate against other currencies, the euro in particular.

15. In years 2007-09, the level of state budget borrowing needs will be influenced mostly, along with the level of the deficit, by funds transferred from the State budget to FUS as a

result of its loss in contribution transferred to OPF and a balance of prefinancing of projects in execution of which the EU funds are involved.

16. Forecasted changes in debt of other general government entities will mostly result from the growing indebtedness of the National Road Fund (especially in 2007). The National Road Fund is assumed to issue mainly loans for the financing of investments in road infrastructure. A moderate rise in indebtedness of local government units is assumed as well as a significant reduction of debt of the social security subsector (mainly issued by the Social Security Institution and funds managed by it, as well as the Labour Fund).

17. In the timeframe of this update, the stabilisation of general government debt-to-GDP ratio is expected, followed by its later decline. The change of trend in the performance of debt-to-GDP ratio (from rising to declining) in the timeframe *of the Convergence Program Update* will significantly contribute to the improvement of Poland's fiscal position in the medium term.

18. Regardless of the classification of OPF, the debt-to-GDP ratio in the period will stay significantly below the reference figure of 60%.

III.6. BUDGETARY IMPLICATIONS OF "MAJOR STRUCTURAL REFORMS"

19. In 1999 Poland introduced the pension reform involving the establishment of a capital scheme (represented by open pension funds) beside the current pay-as-you-go scheme (with the Social Insurance Fund). This decision has had and will have over the coming years a significant impact on the general government deficit and debt. Disbursement of the first pensions from the new scheme will commence in 2009. At present, arrangements are being made to determine a unit to organise distribution of the pensions.

20. Implementation costs of the reform, aiming at a long-term stability of the general government, are a burden for the state budget in the medium term. The costs consist of the state budget transfers to Social Insurance Fund, effecting from a loss in contribution and limitation of its collection base down to 30-multiplication of the forecast average monthly salary in national economy, and debt servicing costs. The debt servicing costs result from an additional debt issue allocated for a transfer to Social Insurance Fund to finance a shortage that effected from having introduced the pension reform, as well as distribution of old-age pension and disability pensions from the pay-as-you-go scheme and from take-over by the State Treasury of the Social Insurance Institution's liabilities against OPF effecting from non-transferred contributions.

Table 5. Net costs of pension reform and the resulting debt (% of GDP)

	2006E	2007F	2008F	2009F
Net costs of the pension reform	2.7	2.7	2.8	3.0
Transfer from the State budget to SIF related to:	1.8	1.8	1.8	1.9
loss in contribution	1.3	1.3	1.3	1.4
multiplication by 30	0.5	0.5	0.5	0.5
Debt servicing costs	0.9	0.9	1.0	1.2
State Treasury debt resulting from the pension reform	15.0	17.2	19.1	20.8

Source: Ministry of Finance

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

IV.1. COMPARISON WITH THE FORMER CONVERGENCE PROGRAMME UPDATE

1. The projected economic growth rate over the forecast horizon is higher than in the previous update, mostly due to a higher domestic demand growth.

2. Higher GDP growth in 2005 than that assumed under the previous update of the *Convergence Programme* (3.5% against 3.3%) resulted, on the one hand, from a higher than expected contribution of the domestic demand (2.4 percentage points against earlier estimated 1.7 percentage points), but on the other hand, from a lower contribution of foreign trade balance (1.0 percentage points against earlier estimated 1.5 percentage points).

3. Faster than expected economic growth for 2006 (5.4% against 4.3% estimated in the previous update) is due to a more favourable developments in the economy in the first two quarters of 2006. Quarterly data indicate a strong domestic demand whose contribution in GDP growth reached 4.8 percentage points, compared to 5.3% GDP growth in real terms after the first half of 2006. The strong domestic demand has been forced both by high 5-percent real growth of households individual consumption and by almost a 12-percent real growth of gross fixed capital formation. Currently available information on the main indicators of economic activity in the third quarter of 2006 together with the strengthened domestic demand allow for expecting GDP real growth 5.4% year – on – year The estimate negative contribution of inventories to GDP growth in 2006 (–0.3 percentage points against 0.0 percentage points assumed under the previous update of the *Programme*) also results from a considerable adjustment of data both compared to 2005 and the first quarters of 2006.

4. Domestic demand will continue to be the main driving force of GDP growth in 2007 (5.1% in real terms). Both investment and private consumption growth are likely to stay strong over the projection period. Private consumption is expected to keep its high momentum as a result of the real wage fund growth and pensions fund estimated at ca. 4.1% in real terms as well as direct payments of UE grants to the farmers. In a period of 2008–09, the private consumption growth will be additionally encouraged by a reduction of disability pension rate by 3 percentage points, and moreover, starting from 2009, the government plans to reduce tax burdens related to changes in personal income tax rates. Investment growth will be supported by EU funds and by foreign direct investment. Poland will be able to use for two years (2007 2008) the funds from old financial perspective for 2004–2006 and at the same time funds from the new financial perspective period of 2007 – 2013 will already be available. A high economic growth is expected over the next years, which will reach 5.1% and 5.6%, respectively. Domestic demand will continue to be driving force of GDP growth in 2008-09, similarly to 2007, whereas net exports contribution in GDP growth will be negative.

Table 6. Divergence from previous update

	ESA Code	2005	2006	2007	2008	2009
Real GDP growth (%)						
2005 Update		3.3	4.3	4.6	5.0	-
2006 Update		3.5	5.4	5.1	5.1	5.6
Difference		+0.2	+1.1	+0.5	+0.1	-
General government net lending (% of GDP)	EDP B.9					
2005 Update		-2.9	-2.6	-2.2	-1.9	-
2006 Update		-2.5	-1.9	-1.4	-1.0	-0.6
Difference		+0.4	+0.7	+0.8	+0.9	-
General government gross debt (% of GDP)						
2005 Update		42.5	45.0	45.3	45.4	-
2006 Update		41.9	42.0	42.1	41.4	40.6
Difference		-0.6	-3.0	-3.2	-4.0	-
General government net lending (% of GDP)*	EDP B.9					
2005 Update		-4.7	-4.6	-4.1	-3.7	-
2006 Update		-4.3	-3.9	-3.4	-3.1	-2.9
Difference		+0.4	+0.7	+0.7	+0.6	-
General government gross debt (% of GDP)*						
2005 Update		47.9	51.2	52.1	52.6	-
2006 Update		47.3	48.9	50.0	50.3	50.2
Difference		-0.6	-2.3	-2.1	-2.3	-

* in case when OPF are classified outside the general government

Source: Ministry of Finance

5. Improvement in forecast balance of the sector results from favourable current and projected macroeconomic situation in Poland, in particular a growing employment level, higher consumption dynamics, better standing of corporate businesses, which will translate into higher revenues from tax and social insurance contributions.

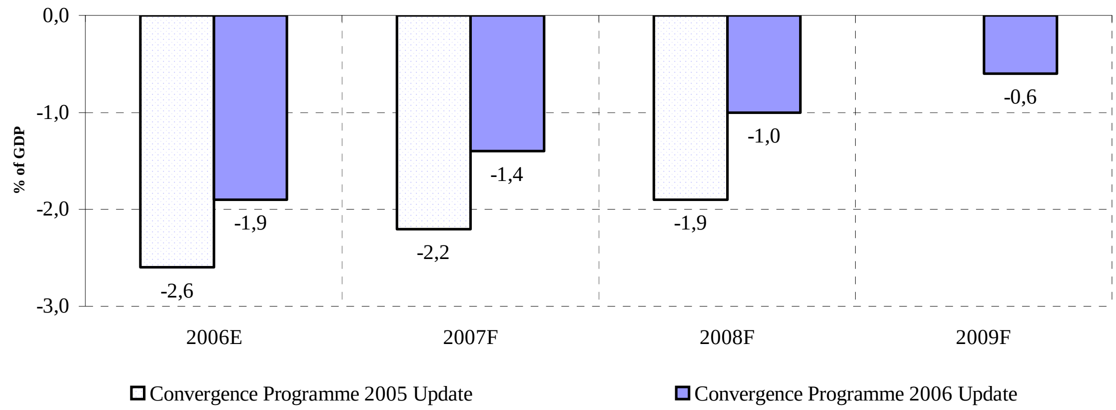
6. The deficit path of the general government for 2005-09 assumes reduction in the deficit from 2.5% of GDP in 2005 down to 0.6% of GDP in 2009, that is, by 1.9 percentage points. It is worthwhile to notice that deficits planned in consecutive years will be lower than those planned in the previous update of the *Convergence Programme*. Execution of the general government deficit in 2005 was lower by 0.4 percentage points, the planned for 2006 – by 0.7 percentage points, and that forecast for a period of 2007-08 – by 0.8 and 0.9 percentage points, respectively. In case of the state budget and local government units, expenditures that have been planned in the budget act or resolution stand pursuant to the public finances act for an upper limit, and in reality their execution seems to be much lower. With respect to other

general government units, information included in their financial plans presents a higher level of expenditures that as a rule are executed on a lower level.

7. The shape of the general government in the coming years will be affected by system changes on the revenue side leading to the lowering of non-wage labour costs (reduction of the tax wedge). On the expenditure side, the formation will further on be determined by the current demographical structure, meaning that there is still a need to bear high social expenditure (pension benefits, social disability pensions, allowances and pre-pension benefits), and a strong absorption of the EU funds. Public finances consolidation and limitation of employment-related costs will effect in a lower deficit.

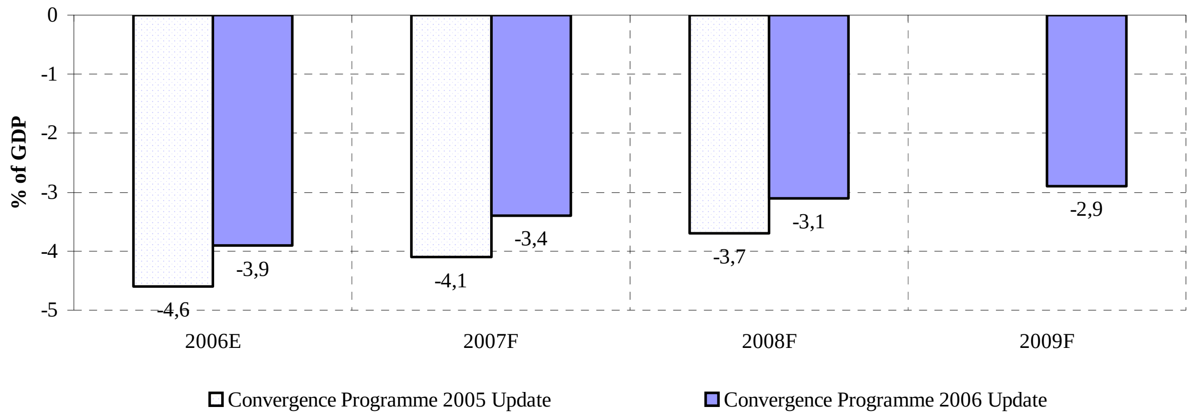
8. Differences in forecasts of debt-servicing costs result mostly from: changes in assumptions referring to borrowing needs, modifications in the financing structure that effects from revised assumptions of the budget and market situation, and changes in assumptions of interest rates level.

Chart 8. General government balance – comparison with the previous Convergence Programme Update (OPF in the general government)



9. Having excluded open pension funds, that generate a large surplus, from the general government the deficit grows by 2.0 up to 2.3 % of GDP in the years 2006-09.

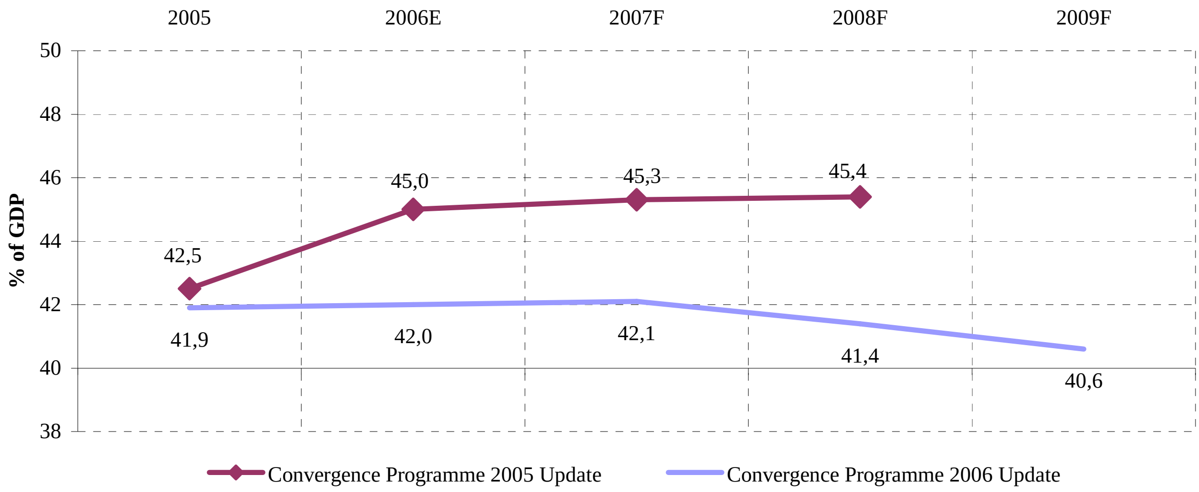
Chart 9. General government balance – comparison with the previous Convergence Programme Update (OPF outside the general government)



10. Differences between currently presented general government debt forecast for 2006-08 and the previous update of the *Programme* refer first of all to:

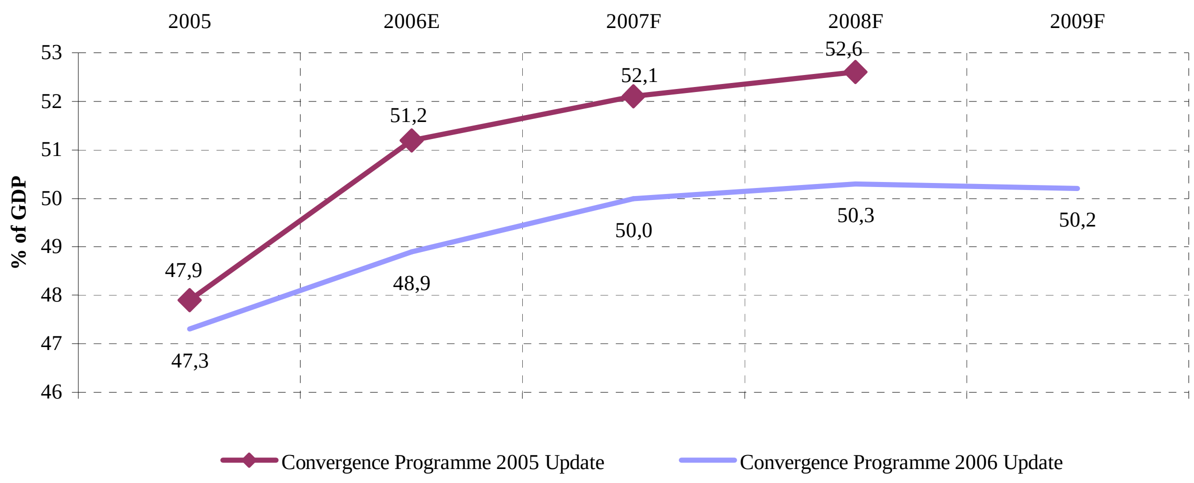
- revised assumptions referring to nominal GDP value, including the effect of GDP revaluation by the Central Statistical Office for the past years (2004 and 2005),
- modification of the assumptions as regards the state budget borrowing needs, in particular those referring to deficit, with a simultaneous change in assumptions of net privatisation receipts,
- modification of the assumptions regarding foreign exchange rate,

Chart 10. General government debt – comparison with the previous Convergence Programme Update (OPF in the general government)



11. The general government debt is increasing if OPF are excluded from the general government. This growth ranges from 5.3% of GDP in 2005 up to 9.6% of GDP in 2009. It effects from the fact that in its investment portfolio OPF holds securities issued by the general government units. If OPF are classified in the general government, the value of those securities is consolidated, as it constitutes a part of the government debt.

Chart 11. General government debt – comparison with the previous Convergence Programme Update (OPF outside the general government)



IV.2. RISK FACTORS

12. Risk factors that could have a negative impact on overall public finances include as follows:

1) macroeconomic risk, in particular:

   a) economic growth lower than projected,

   b) lower than expected absorption of EU funds (structural funds and Cohesion Fund),

   c) higher than expected inflation linked to a possibility of occurrence of negative shocks on food products market, due to a limited supply of some agricultural produce, effecting in a stronger than its previously assumed tightening of monetary policy,

   d) worsening of investment attitudes in countries of the region, in view of declining interest rates disparity compared to the developed economies,

   e) slower structural transformations of the economy towards services, effecting in a lower then expected improvement in the labour market.

2) political risk related to the lack of a support in the Parliament for amendments proposed by the government and pressure of various interest groups.

13. Here are special external risk factors for the macroeconomic scenario forecast:

   a) worsening of Poland's key trade partners' business outlook,

   b) possibility for raw materials prices to grow (especially of crude oil) due to limited supply capacity and a higher global demand, which would pose a threat on execution of the inflation forecast.

14. Situation of the general government results from i.e. external business environment of Poland, domestic economy standing, institutional conditions and adopted comprehensive solutions. The revenue and expenditure sides of the general government are determined by macroeconomic factors, such as: GDP growth, inflation, exchange rate, level of interest rates, and size of wages, or the employment level in the economy. Legislative solutions, binding in

Poland, which through their in-built indexation mechanisms and economic and legal conditions make a considerable part of expenditures directly dependent on the inflation level (old-age and disability pensions, some transfers), GDP (military defence expenditures), level of wages (some social expenditures, some transfers), or the interest rates level (debt-servicing costs).

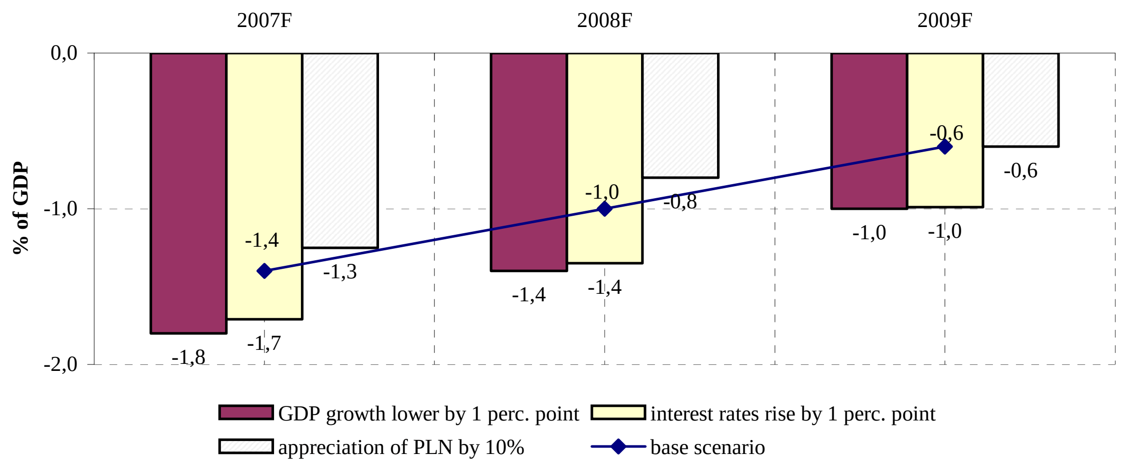
15. A size of revenues from contributions (being an important percentage of the sector's revenues) is strongly correlated with the remuneration fund in the economy. The volume of tax revenues is to a large extent affected by a size of nominal consumption and remuneration fund in the economy.

16. Worsening of the economic situation is accompanied by growing borrowing needs as a consequence of which debt level as well as debt-servicing costs over the next years increase.

17. Influence of macroeconomic factors such as: GDP performance, interest rates, and foreign exchange rates in *ceteris paribus* conditions have been presented in order to assess the impact of macroeconomic situation on the general government.

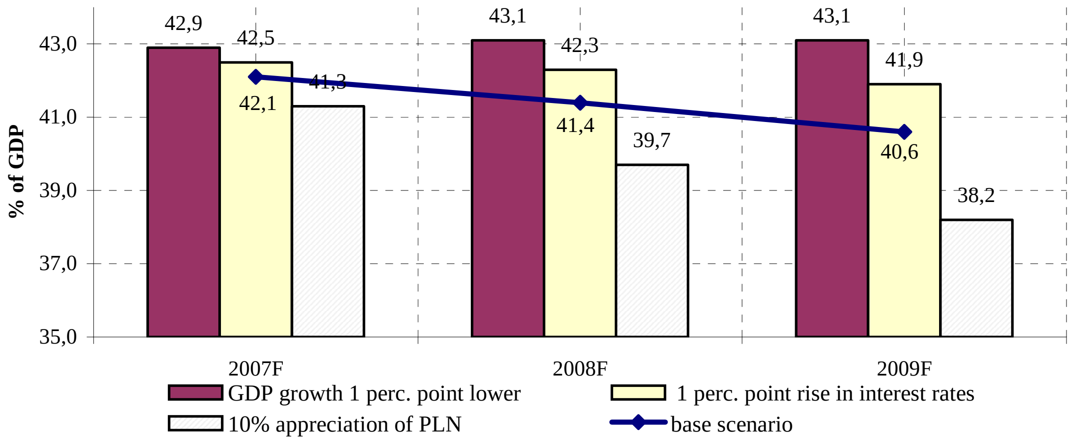
18. Debt servicing costs and the debt level are especially sensitive to interest rates fluctuations and foreign exchange rates. The volatility of debt servicing costs and the debt level depends on debt structure and duration. Due to a considerable share of fixed-rate instruments in debt and the current level of duration, a change of interest rates has a relatively weak influence on interest expenditure during the first year but increases with time.

Chart 12. Impact of fluctuations of GDP, interest rates, and foreign exchange rates on the general government net borrowing/net lending



19. The general government debt-to-GDP ratio depends both on macroeconomic and fiscal factors. The foreign exchange rate fluctuations (due to the debt structure) and changes in nominal GDP growth are the factors having the largest impact on the ratio.

Chart 13. Impact of fluctuations of GDP, interest rates, and foreign exchange rates on general government debt



20. Debt management is conducted under risk related in particular to macroeconomic and budgetary situation, market conditions, institutional and legal environment. The risk is mainly associated with both a threat of a negative impact of public debt on the economy, and the level of public debt and debt servicing costs.

21. A risk of the negative impact of public debt on the economy depends on the size of the debt level (the higher debt the higher risk). The general government debt level is lower in Poland than the average for the EU member states (63.2% at the end of 2005)[1]. On the other hand, Poland is the country with a lower creditworthiness than the EU average, therefore, the debt level considered as safe may be lower.

22. A risk related to the level of debt and its servicing costs as well as their fluctuation from expected values given the assumed level of borrowing needs, depends on adopted structure of financing and on operations performed on the debt. Risk management in the years 2007-09 will aim at the risk not to exceed the level considered as acceptable when executing the objective to minimise debt-servicing costs in long term.

23. Contingent liabilities resulting from different operations performed by the general government entities, e.g. securitisation, are an additional source of risk associated with public debt. Scale of their impact on public debt should be reduced over the next years.

Risk factors specific for Poland

24. To assure sound and sustainable public finances, in 1999 the government made a strong effort to reform the-then compulsory and inefficient pay-as-you-go pension scheme by establishing a capital scheme, namely the open pension funds. In case of such a large country as Poland, where participation in OPF is obligatory and contributions transferred to OPF are considerable, the reform poses a significant burden for the general government (costs of the reform). In view of adopted statistical solutions referring to classification of capital pension schemes outside the general government, there will be a rapid worsening of the general government balance in accounting terms starting from April 2007. The general government deficit calculated without taking into consideration results of the Eurostat decision on

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[1] *Eurostat Euro-indicators, News Release 139/2006* from October 23, 2006.

classification of capital pension funds is lower by ca. 1.8-2.3% of GDP when compared with the deficit presented when the decision is adopted, i.e. after March next year. To reduce the rapidly growing deficit calculated pursuant to the Eurostat decision, further intensive measures are required to be taken. It should be stressed that in log term the pension reform contributes to lowering the risk to which public finances are exposed as a result of the problem of population aging.

25. Public-private partnership operations of general government entities may also constitute an additional factor influencing situation of the general government in the next years. The legal framework for concluding such transactions was established by the Act of 28 July 2005 on public-private partnerships. However, the impact of public-private partnerships on the general government deficit and debt is expected to be limited, at least in the first years following the enforcement of the law. It should also be stressed that under the rules of performing public objectives within the public-private partnership framework the general government entities can construct an agreement with a private partner in a way ensuring that this type of projects should not result in rising public debt nor the general government deficit without limiting this kind of projects (pursuant to the Eurostat decision as of 11 February 2004 on deficit and debt). Moreover, on annual basis the budget act sets out a limit up to which the government administration bodies may issue financial obligations due to public-private partnership agreements. In 2006, the amount has reached PLN 3 billion, and PLN 5 billion has been planned for 2007.

26. Lack of legislative solutions in the area of restitution poses a certain threat on public finances. Solving of problems of restitution issues requires relevant legislative changes in the following areas:

- claims on real estates left outside Poland’s borders (the so-called claims for real property situated east of the Bug river),
- claims steaming from nationalisation of the industry and agricultural reform in years 1944-1962,
- claims on „Warsaw real estates,” effecting from the so-called Bierut’s decree.

27. As a result of the adopted in July 2005 parliamentary act on execution of a right to compensation for real estates left outside present borders of the Republic of Poland, the authorised persons are entitled to a compensation amounting to 20% of value of the left real property. Because of the still ongoing process of submitting applications, a final amount of those compensation payments remains unknown (value of claims in this area, understood as 100% value of the left real property, is estimated at PLN 11.5 billion, therefore, the projected compensation payments should not exceed PLN 2.5 billion).

28. On submitting a draft law to the parliament’s lower house, the Sejm, on compensations for real property and other property components taken over by the state, the value of reported claims in this area has been estimated at PLN 60 billion. The compensation payments are to be financed at 15% value of the nationalised components. The execution cost of the draft law has been estimated at PLN 12 billion.

29. Should the parliamentary act on „Warsaw real estates” be adopted, PLN 13.0 billion out of PLN 20.0 billion worth of total claims has been planned as compensation payments.

30. Total amount of restitution claims has been estimated at PLN 91.5 billion, and the one planned for disbursement at PLN 27.5 billion. Payments are to be executed from the established Restitution Fund, starting from 2009 and to continue over the next 4-5 years.

31. The level of potential liabilities of the State Treasury related to granted guarantees and sureties is forecast to grow from 3.2% of GDP at the end of 2005 to approximately 4.5% of GDP at the end of 2009. At the same time, the portfolio risk is expected to seriously decline from ca. 33% at the end of 2005 to approximately 28% at the end of 2009. This will result mostly from the adopted updated strategy for granting guarantees and sureties, which envisages providing support for development-oriented investments in infrastructure, environmental protection, and creation of new jobs, also utilising the European Union funds. The key parameter of the above-mentioned strategy is an assumption to maintain the ratio of total anticipated outgoing payments under guarantees and sureties (i.e. total potential risk-weighted liabilities) to GDP below 1.4% of its value. Simultaneously, the goal of the hereto strategy is not to allow for a situation in which the State Treasury would take over outstanding debt of the entity to which it had granted guarantee or surety.

32. Achievement of a late consensus on the new financial perspective and the following late finalisation of works on individual regulations package referring to cohesion policy instruments effects in delayed approvals of operating programmes for the EU member states, including Poland. Moreover, new legal acts for the programmes for years 2007-13 enforce some changes in the present implementation system. This creates a certain risk related to ability of the public administration units to develop a simple, clear, and beneficiaries-friendly system for managing the programmes. A risk factor that may affect expenditure volumes from the EU budget is a need to provide appropriate national public funding for co-financing of the operating programmes and projects under the EU current and the new financial perspective. In parallel to adoption of favourable solutions, referring to VAT and co-financing level, at the European Council summit in December 2005, further measures are planned to be taken to improve the national financing system, including continuation of works over application of budget planning to execute long-term operating programmes, introduction of a multi-annual budget planning and performance budgeting.

V. QUALITY OF PUBLIC FINANCES

V.1. STRATEGY

1. The scheduled reform of public finances envisages higher efficiency and effectiveness of the budgetary expenditures and a real consolidation of public finances by including financial plans of agencies, earmarked funds, and the National Health Fund under the budget act. The above goals will be achieved thanks to changes in the system of planning, execution, and assessment of the state budget performance.

2. There are plans to change the approach to expenditures from unit planning to target planning that includes the aspect of expenditures' purpose. Inter-ministerial functions will be established, covering various organisational units (ministries, agencies, and purpose funds) executing their common goal to enable control and rational use of funds. This will be facilitated by introduction of budgetary classification of expenditures by targets (objectives, programmes, functions), which will be linked with COFOG classification. It will replace the classification of expenditure that has been used so far. It is also planned to introduce accrual accounting methodology. Besides annual planning, a three-year planning of budgetary expenditures will be introduced in a breakdown for targets. Units in charge for budget programmes will have a freedom in reallocation of expenditures between individual task and expenditure categories, except for a possibility to increase personnel costs and exceed the employment limit. Effects of the implemented objectives will be measured using a system of indicators. A system for assessment of public expenditures will be established, thus allowing the preparation of reports that assess adequacy and cohesion of established budgetary goals with a strategy, efficiency and effectiveness of funds allocation, and efficiency of expenditures performance.

3. It is assumed that the second phase project of public finances organisation will be submitted for debate of the Parliament in the first half of 2007. Moreover, the solutions proposed under the project are projected to be gradually affecting public finances in the years 2008-09. In line with earlier announcements, effects of the ongoing changes (savings) will reach 0.8% of GDP within two years from the moment of their full implementation. Also a legal status of some general government units is planned to be changed (e.g. State Fund for Disabled Rehabilitation, National Environmental Protection Fund) and liquidation of the extra-budgetary economy.

4. Net transfers from the EU budget to Poland will grow significantly in years 2007-09, also as a result of meeting the deadlines related to execution of n+2 rule in the structural funds under allocation for years 2004-2006 and thanks to launched implementation of programmes under the new financial perspective. The level of direct subsidies for farmers will be gradually reaching that of subsidies in the EU-15, pursuant to the schedule defined under the Accession Treaty. Poland will also obtain access to a number of new programmes envisaged under the new financial perspective, including programmes related to increase of economy competitiveness, which is expressed also by Poland's willingness to join the works of the European Institute of Technology. In this period, contribution to the EU budget is the most likely to be growing in a degree close to the Gross National Income growth rate.

5. Along with rising volumes of transfers from the EU, a certain growth will commence of funds for co-financing of programmes and projects, including those originating from the state budget. However, the growth will have no rapid character because of lowering the compulsory domestic contribution and the increase of the EU contribution from 75% up to

85% of the maximum level of qualified expenditures of operating programmes co-financed from structural funds. It will be possible to include also private expenditures under the total amount of qualified expenditures of the operating programme. Moreover, an assumption is made that more effective absorption of the EU funds will result in increased revenues of the state budget from VAT.

6. Activities within priorities included under the *National Reform Programme for 2005–2008* are oriented to execution of the adopted strategy. The source of their financing, besides resources allocated from the state budget, will be first of all resources from structural funds and the Cohesion Fund. A detailed specification of objectives under the *National Reform Programme*, the implementation of which requires allocation of funds from general government units, is presented in Table 17.

7. Table 7 presents basic data on the general government.

Table 7. Basic data of general government units

	ESA Code	2005	2005	2006E	2007F	2008F	2009F
		PLN billion	*% of GDP*				
Total revenues	TR	401.0	40.9	41.8	42.4	41.6	40.0
Total expenditures	TE	425.1	43.3	43.7	43.8	42.6	40.6
Balance	S13	-24.1	-2.5	-1.9	-1.4	-1.0	-0.6

Source: 2005 – CSO, forecast for 2006-09 – Ministry of Finance

8. Until the end of March 2007, Poland can use a transitional period during which open pension funds are classified in the general government. The table below presents basic data if OPF have been classified outside the general government.

Table 8. Basic data of general government units if OPF are classified outside the general government

	ESA Code	2005	2005	2006E	2007F	2008F	2009F
		PLN billion	*% of GDP*				
Total revenues	TR	383.7	39.1	39.6	40.2	39.3	37.4
Total expenditure	TE	426.2	43.5	43.5	43.6	42.4	40.3
Balance	S13	-42.5	-4.3	-3.9	-3.4	-3.1	-2.9

Source: 2005 – CSO, forecast for 2006-09 – Ministry of Finance

V.2. DEVELOPMENTS ON THE EXPENDITURE SIDE

9. Table 16 illustrates the forecast changes in the main items of expenditure of the general government in a period of 2005-09.

10. Pursuant to the draft Act on public finances, the state budget expenditures that have been adopted in the budget law and expenditures adopted by resolutions of local government units stand for the upper limit. In practice, expenditures that have been executed by those units are lower than their original assumptions. Other entities that are included in the general government also plan the maximum level of expenditures in their financial plans, and they estimate their revenues with caution. Based on the performance of revenues during the year,

the entities adjust their expenditures amount. Therefore, the adopted mechanisms assure maintenance of discipline in expenditures.

11. The government actions will be aiming at rationalisation of expenditures and better control thereof with respect to:

a) administration (consolidation of some units of the general government, introduction of performance budgeting),

b) health care (effective use of resources, implementation of optimised basket of guaranteed services),

c) disability pension scheme (unification of the operating rules between the disability pension scheme and the pension scheme as regards determination of benefits size),

d) social insurance of farmers (diversification of contribution and disbursed benefits),

e) pension scheme (reduction of differences in size of pensions for men and women, lower subsidies to the social insurance system, promotion of professional activity).

12. The strategic goal, being a creation and maintenance of new jobs and reduction of unemployment, will be executed through projects aiming at reduction of burdens being imposed on employees with the lowest incomes and implementation of new organisational and financial solutions increasing the access of unemployed persons to the labour market.

Table 9. General government expenditure by function

% of GDP	COFOG Code	2004	2009
General public services	1	5.6	6.0
Defence	2	1.1	1.3
Public order and safety	3	1.6	1.9
Economic affairs	4	3.1	3.7
Environmental protection	5	0.6	0.7
Housing and communities amenities	6	1.4	1.1
Health	7	4.3	4.3
Recreation, culture and religion	8	0.9	0.9
Education	9	6.0	6.0
Social protection	10	18.0	14.7
Total expenditure		**42.6**	**40.6**

Source: 2004 – CSO, forecast for 2009, Ministry of Finance

13. By the end of December 2006, the Central Statistical Office will have sent table 11 “Expenditures of general government by functions” to Eurostat with data for 2005. Data that has been presented in table 9 and referring to 2009 is a forecast prepared by the Ministry of Finance.

14. The general government expenditures-to-GDP ratio in a period of 2006-07 is at a similar level of 43.7-43.8%, and in years 2008-09 its level will decline to 42.6% and 40.6%, respectively.

15. Nominal dynamics of social expenditures in a period of 2006-09 will reach ca. 4.0% annually. At the same time, the nominal GDP dynamics will be much higher ranging between

6% and 8% annually. Social expenditures, calculated as percentage of GDP, fall despite their nominal growth by 12.8% between year 2006 and 2009. A similar mechanism occurs in case of employment costs the ratio of which to GDP declines in a period of 2006-09, despite nominal growth by about 4.3% per annum in the above period (employment costs will grow by about 18% between year 2006 and 2009). Higher than in the previous years decline in collective consumption to GDP in 2009 effects from the fact of having finalised expenditures related to a purchase of a multi-task jet fighters for Polish armed forces in 2008. Expenditures related to the purchase of F-16 jet fighters are distributed over years 2006-08. Health care expenditures to GDP in 2009 will be kept at the same level as in 2004. However, their nominal dynamics in years 2004-09 will reach on average about 6.6% annually. Expenditures for education, calculated as percentage of GDP, are maintained in 2009 at their unchanged level compared to 2004 however, nominal dynamics of their growth is high and reaching 6.7% on average annually in the above period. A high growth of spending on education is in compliance with guidelines of the Lisbon Strategy. Pursuant to the assumptions under the strategy, there is a requirement to remodel education system in order to meet the needs of modern economies of the member states and enable development the knowledge-based economic model.

V.3. DEVELOPMENTS ON THE REVENUE SIDE

16. A high dynamics of the general government revenues has been recorded in the period of 2005-2006. Here are the key factors affecting the public finances situation in 2005 and 2006:

- good macroeconomic situation. As compared to original forecasts, the updated forecast for 2006 shows better macroeconomic indicators. With respect to 2006, a special attention should be paid to favourable, for the economy and revenues of the sector, consequences of improvement on the labour market. It is projected that the average salary in national economy will grow by 3.6% in real terms, the average employment rate will rise by 2.3%, a number of unemployed persons will decline by 14.5%, and the unemployment rate will reach 15.2% at the end of the period. It is worth pointing out to the fact that macroeconomic situation in 2005 was worse than its earlier forecast, in particular the real GDP growth dynamics was 1.6-percentage points lower than that originally planned under the budget law. Regardless of the above, the generated state budget revenues were by 2.9% higher than the budget forecast (tax revenues were by ca. 0.4 % higher).
- advantageous system changes, which combined with a serious modification and intensification of control actions effected in improved tax collection. Out of activities facilitating the improvement of work performed by tax and customs administration, the following should be mentioned:
  a) movement of a number of customs officers from the western to the eastern border where a threat of smuggling and other operations of a similar character is higher,
  b) implementation of a series of tools supporting the activities of tax and customs administration, e.g. IT systems, improvement and facilitation of customs services organisation and management processes in the following areas: human resources, investments, training, X-ray devices for screening containers and commercial vehicles (being used mostly by customs officers at the eastern border),
  c) breaking up of a number of criminal groups operating in the area of obtaining VAT under false pretences and excise tax offences,
  d) sealing the tax system and introduction of changes in legal regulations allowing for using a number of tools and instruments for fighting tax & customs crimes and other irregularities in this area.

Activities in the aforementioned areas result in improved effectiveness of tax revenue bodies in collection of due taxes, e.g. measured by a ratio of a share of delayed gross payments in payables and a high level of revenues. Continuation of such activities over the next years will aim at reduction of a grey economy and at improvement of effectiveness in collection of the public revenues.

17. The general government revenues forecasts for 2007-09 include assumptions referring to development of macroeconomic situation in national economy and a scenario of adopted system changes in the sector's tax and revenues system.

18. The following changes in tax system have a special impact on revenues forecasts of the general government in 2007:

- changes in PIT that envisage increasing amounts of taxation thresholds, tax-deductible costs, and so-called tax-free amount,

- high dynamics of employment (2.3%) and wages (3.6% - in real terms) in national economy; a growth in this part of the tax base has a special impact on the sector's revenues due to the fact that it is a basis for revenues for various components of the sector, in particular for social insurance contributions, contributions to the National Health Fund, and also the general government revenues.

19. Other changes referring to the general government revenues in 2007 are compliant with draft budget for 2007. The major changes planned for 2008-2009 in the tax system include as follows:

- changes in personal income tax PIT, leading to implementation of the „A Solidarity State" rules that envisage introducing a tax relief for families with children,
- reduction of labour costs, in order to promote employment and reduce unemployment, which is crucial for social and economic situation, but also for public finances. The employment growth, generated thanks to the lowering of labour costs, will in medium- and long-term allow for increasing revenues of the sector from social insurance contributions and PIT as well as for reducing the level of social expenditures. The above goal will be achieved, pursuant to the parliamentary act adopted already in 2006, thanks to introduction of two tax thresholds (18% and 32%) and gradual lowering of the tax wedge. Particularly in 2008 and 2009, disability pension contribution is planned to be lowered by 3 percentage points each year. The contribution being paid by an employee and an employer will be reduced in equal proportions. Changes with respect to labour costs burdens will positively affect income of households and corporate profits, which will increase the dynamics of private consumption, on the one hand and on the other increase corporate capacities for capital accumulation.
- other changes are as follows:
  a) to increase of excise tax on tobacco products until reaching the minimum required by the European Union regulations (starting from 2009),
  b) to increase of excise tax on engine fuels, LPG gas, heating oil in line with the CPI dynamics, that is, maintain the level of excise tax burdens on the same level in real terms,
  c) increase of VAT rates for catering services, agricultural foodstuffs, and food products presently taxed with a 3% rate;
  d) to introduce a new solution for cars taxation starting from 2008.

20. The changes in the tax system, planned for 2007-09, aim on the one hand at increased taxation effectiveness, allows to expect increased revenues of the general government units, and on the other hand, for making some order and improve legal regulations to facilitate performance of business activities by corporate enterprises (e.g. reduction of labour costs through the lowering of disability pension contribution, changes in depreciation rules). The planned changes will also positively influence the households sector thanks to reduction of tax burdens (e.g. in PIT: a tax relief for families with children, indexation of tax thresholds and tax-free amount, introduction of two lowered tax rates, reduction of disability pension contribution).

21. It should be stressed that any arising surplus of performed over the planned revenues is allocated for reduction of the general government deficit.

22. A share of total revenues of the general government in GDP over 2006-08 period will range from 41.8% in 2006, 42.4 % in 2007, and 41.6 % in 2008. However, in 2009 the

revenues are projected to seriously decline down to 40.0 % of GDP. There will be changes in revenues structure in the overall analysed period. The largest change refers to revenues generated from social insurance contributions. A decline from 13.4% of GDP in 2006 down to 11.7% of GDP in 2009 will result from a reduction of the „tax wedge”. It is worthwhile stressing that the planned government actions will effect in a considerable lowering of fiscal burdens from respectively 36.3% in 2007 down to 34.6% of GDP in 2009.

VI. Sustainability of public finances

1. Poland has prepared forecasts of long-term pension expenditure until 2050 within the work of the Economic Policy Committee (EPC). The forecast covers the following pension systems: employees, farmers and supply system for uniformed services. The forecasts are based on the commonly agreed macroeconomic assumptions and on the demographic forecasts prepared by Eurostat in cooperation with demographists from Member States. Preliminary forecasts results of the expenditure for health care, long-term care, are presented in Table 10. The forecasts of other expenditure – for health care, long–term care, education and expenditures related to labour market are currently prepared by the Commission on the basis of the assumptions and methodology agreed.

2. The following models have been used for the preparation of the old-age pension forecast: a model prepared in the Social Security Institution (common pension system), and a model prepared for the Ministry of Labour and Social Policy by the Research Institute for Market Economy on the basis of the "Social Policy Budget" model (social security system for farmers, supply systems and pre-retirement benefits system).

3. According to the forecast, the ratio of public expenditure for retirement pensions to GDP should gradually decrease from 13.7% in 2005 to the level of ca. 9.3% in 2050[12].The declining expenditure level is a consequence of the new pension scheme implemented since 1999. As a result, the pensions granted after 2009 will depend on the level of the contributions paid and on retirement age (including rights acquired before 1999 in the form of initial capital). This means that a higher effective retirement age has been assumed for the calculations; in 2004 it was only 58.7 for men and 56 for women.

[12] Calculations include disbursement of old-age pensions from the capital part of the scheme. The hereto presented data was based on a forecast, prepared last year and adopted by the Population Aging Working Group (pursuant to the *Code of Conduct* requirement). Therefore, they do not take into consideration the amendments enforced by 27 July 2005 Act on retirement and disability pensions from the Social Security Fund (concerning retirement pensions for miners, and extensions of early retirement period according to the current rules by the end of 2007).

Table 10. Long-term sustainability of public finances

	2005	2010F	2020F	2030F	2050F
Expenditure					
Age-related expenditure	18.6	15.2	12.8	12.4	12.4
Retirement and disability pensions	13.7	11.3	9.8	9.4	9.3
Retirement and disability pensions from social security	13.7	11.3	9.7	9.2	8.0
Retirement and early retirement pensions	11.1	9.4	8.4	7.9	6.6
Other pensions (disability, survivors)	2.6	2.0	1.3	1.3	1.4
Pension Schemes for Employees	-	-	-	-	-
Retirement pensions from the obligatory capital part of the system[a)]	0.0	0.0	0.1	0.3	1.3
Health care	4.1	4.3	4.7	5.0	5.4
Long term health care	0.1	0.1	0.1	0.1	0.2
Education expenditure	4.9	3.9	3.0	3.0	3.1
Other age-related expenditures	0.0	0.0	0.0	0.0	0.0
Interest expenditure	0.0	0.0	0.0	0.0	0.0
Revenues					
Property income					
Contributions	9.3	9.7	10.1	10.1	10.1
Retirement and disability pension contributions paid to SIF	7.8	8.0	8.1	7.9	7.9
Retirement insurance contributions in capital part of the system	1.4	1.7	2.0	2.1	2.1
Assets of Open Pension Funds[b)]	8.3	15.5	33.1	50.7	84.5
Assets of Demographic Reserve Fund [c)]	0.2	0.4	0.3	0.4	0.5
Labour productivity growth	4.2	3.6	3.1	2.7	1.7
Real GDP growth	3.3	5.0	3.2	2.2	0.4
Participation rate males (aged 20-64)	77.8	79.9	82.1	84.0	81.7
Participation rate females (aged 20-64)	65.1	67.0	71.3	74.4	70.3
Total participation rates (aged 20-64)	71.4	73.4	76.7	79.2	76.1
Unemployment rate (aged 15-64)	18.2	15.8	9.9	7.0	7.0
Population aged 65+ over total population	13.1	13.5	18.2	22.6	29.4

Source: Ministry of Labour and Social Policy, real GDP growth and unemployment rate in 2005 - Ministry of Finance estimates.

a) In Poland there are both voluntary pension schemes for employees and the obligatory capital system.

b) Demographic Reserve Fund and Open Pension Funds.

VII. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

VII.1. NATIONAL BUDGETARY RULES

1. Fiscal policy issues, being a significant part of economic policy of the State, are reflected in the Constitution of the Republic of Poland, various Acts, Laws, and other subordinate regulations e.g. ordinances.

2. The most important budgetary rules of legislative character include the competence rules and rules concerning the public debt related limits. The rules have not been changed compared to the previous update of the *Convergence Programme*.

3. Along with rules of legislative character there are also binding rules effecting from the strategy adopted by the government. The most important rule that has been introduced by the government is the so-called "budgetary anchor". The rule envisages that the State budget structure has to assure maintenance of the State budget deficit fixed at level of PLN 30 billion per year. Introduction of the rule provides a guarantee that in present economic conditions, the budget deficit-to-GDP ratio – calculated in compliance with the domestic methodology – will be systematically declining. The rule was applied for the first time in the State Budget Act for 2006.

VII.2. GENERAL GOVERNMENT STATISTICS

4. The inter-ministerial Team for general government statistics, appointed by the President of the Central Statistical Office, has already been operating for more than two years. It has been a period of very intensive works aiming at agreeing on a common methodology for three institutions: Central Statistical Office, Ministry of Finance, and the National Bank of Poland, for preparing general government data statistics.

5. During the meetings the Team members have solved many methodological problems. First of all:

- a method for registering social security contributions has been determined,
- an algorithm of transfer from the cash data to accrual data has been determined,
- works on defining the registration methods in statistics of transfers between Poland and the European Union have been continued,
- the analysis of primary sources of data, used for preparing quarterly and annual financial accounts of the general government, have been prepared,
- works aiming at assurance of conformity of financial accounts with non-financial accounts and with notifications of deficit and public debt have been launched.

6. Results of methodological works, carried out by the Team during their meetings, have already been used by CSO while preparing non-financial accounts of general government and notifications of deficit and public debt, as well as by the Ministry of Finance when preparing statistics for the International Monetary Fund and forecasts for the C*onvergence Programme*. Introduction of new methodological solutions has significantly improved the quality of data in the area of the public finance sector. Efforts of the working group to complete the priority objective, namely to determine methodology of the general government revenues and expenditure pursuant to ESA'95, have been continued. A few more key issues still require to

be solved, such as: capital injection operations, transfers between Poland and the European Union, and a scope of the sector. Then the Team will start working on methodology and definition of data sources used for preparing quarterly and annual financial accounts of the general government and notifications of deficit and public debt.

VII.3. OTHER INSTITUTIONAL DEVELOPMENTS IN RELATION TO PUBLIC FINANCES

7. The government decision to carry out a long-term reform of public finance, was accompanied by submission to the Parliament of a draft Act on *amending the Public Finance Act and some other acts* to the Parliament. The draft Act reflects the works performed to improve transparency, effectiveness, simplification, and consolidation of a number of public finance management procedures, and concerns for efficient and smooth implementation of the reforms. Execution of the objective that has been defined in this way is to be facilitated by a wide range of basic and possible for implementation - starting from early 2007 - actions, out of which a special attention should be turn on submission of draft budget plans of agencies and other state legal entities in a form of appendix to a draft budget act and inclusion of the EU funds under the State budget.

8. As a part of the planned reform and in order to increase effectiveness and efficiency of the State budget expenditure, the Polish government has decided to change the present budget system for performance budgeting. The reform that envisages implementing the Performance budgeting will have a crucial meaning for expenditure policy of the general government. Works over assumptions to the performance budgeting have been started at the central government level according to the *Cheap and Efficient State* programme. Implementing the performance budgeting will mean:

- implementation of a new budgetary procedure,
- implementation of a new management system for public finance sector entities, based on the concept of performance-oriented management,
- implementation of IT system supporting the management of public finance sector entities and allowing for monitoring the execution of objectives being carried out by those entities,
- full implementation of accrual accounting and costs account.

9. The Council of Ministers has adopted, in a form of resolution, guidelines of methodology for preparing budgets in their performance-oriented form and a work schedule for implementation of the performance budgeting. The work schedule for the performance-oriented budget implementation has been adjusted to the needs identified in progress of conceptual and pilot works. Methodological assumptions were prepared and the analysis of adopted foreign solutions was completed in October 2006. Further work phases will involve:

- implementation of the so-called pilot project (2007-2008), requiring participation of selected ministries and local government bodies. It will involve testing possibilities for applying theoretical and foreign solutions in Polish conditions. Results of pilot works referring to preparation of the budget for the Ministry of Science and Higher Education in performance-oriented layout have been presented in a justification to draft budget act for 2007. Budgets for Ministry of Labour and Social Policy, Ministry of Health, and Ministry of National Education will be prepared in their performance-oriented layout by the end of 2006. At the start of 2007, performance-oriented plans will be prepared for selected provincial government bodies. In 2007, the pilot implementation of the performance-oriented budget will cover further ministries at which evidence and reporting is also to be run in the performance-oriented layout;

- transitional phase in implementation of the performance-oriented budget (2009-2010) where the performance-oriented budget and the traditional one will function in parallel with respect to three types of bodies: ministries, provincial government bodies, and Local Boards of Appeal (LBA). This phase will enable introduction of required changes and further improvement of the new budgeting methodology;
- total resignation from a budget in its traditional (classical) form and transfer into only performance budgeting approach after year 2011;
- further dissemination of the system to cover other public finance units - preparation of performance-oriented budgets at all units of the government and social security sub-sector (2011-2012);
- implementation of performance budgeting in all local government units (starting from 2012).

STATISTICAL ANNEX

Table 11. Macroeconomic prospects

	ESA Code	2005	2005	2006E	2007F	2008F	2009F
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP (PLN billion)	B1*g	864.7	3.5	5.4	5.1	5.1	5.6
2. Nominal GDP (PLN billion)	B1*g	980.7	6.2	6.0	6.9	7.4	8.1
Components of real GDP							
3. Private consumption expenditure	P.3	544.3	1.9	4.8	4.0	4.6	5.6
4. Government consumption expenditure	P.3	154.7	5.3	1.9	3.4	3.0	1.5
5. Gross fixed capital formation	P.51	169.2	6.5	12.0	12.0	12.0	11.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	9.2	1.1	0.8	0.9	0.9	0.8
7. Exports of goods and services	P.6	306.7	8.0	16.1	8.1	7.2	6.9
8. Imports of goods and services	P.7	319.8	4.7	15.4	9.6	9.0	8.1
Contribution to real GDP growth							
9. Final domestic demand		-	2.4	5.5	5.8	6.0	6.3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-0.9	-0.3	0.2	0.0	0.0
11. External balance of goods and services	B.11	-	1.0	0.0	-0.7	-0.9	-0.7

Table 12. Labour market developments

	ESA Code	2005	2005	2006E	2007F	2008F	2009F
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment (thousands of persons)*		14 116	2.3	3.9**	1.4	1.8	2.0
2. Unemployment rate *(%)**		17.7	17.7	14.1	12.3	10.5	8.8
3. Labour productivity (thousands of persons)******		69.5	1.1	1.5	3.6	3.2	3.5
4. Compensation of employees (PLN million)	D.1	364.3	5.9	7.1	6.9	7.7	7.6

* Average number of employed persons according to LFS (15 years and more).
** Due to a new methodology, the level of employed persons in 2006 is incomparable to data for years back; rate of change – estimates of MF in comparable conditions.
*** Harmonised definition, Eurostat; levels.
**** Real GDP per person employed.

Table 13. Price developments

	ESA Code	2005	2005	2006E	2007F	2008F	2009F
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		-	2.6	0.5	1.7	2.2	2.4
2. Private consumption deflator		-	2.2	1.2	2.2	2.6	2.4
3. HICP		-	2.2	1.4	2.1	2.5	2.5
4. Public consumption deflator		-	3.8	1.1	2.1	2.5	2.5
5. Investment deflator		-	0.3	1.5	2.5	2.5	2.5
6. Export price deflator (goods and services)		-	-2.6	-0.5	1.0	1.5	1.5
7. Import price deflator (goods and services)		-	-3.7	1.3	2.0	2.0	1.5

Table 14. Sectoral balances

% of GDP	ESA Code	2005	2006E	2007F	2008F	2009F
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	1.4	1.6	1.8	2.2	2.7
of which: - Balance on goods and services		0.3	0.5	1.7	2.7	3.2
- Balance of primary incomes and transfers		1.5	1.4	0.9	0.6	0.5
- Capital account		-0.3	-0.3	-0.7	-1.1	-1.0
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	1.1	0.3	-0.4	-1.2	-2.1
3. Net lending/borrowing of general government	B.9	-2.5	-1.9	-1.4	-1.0	-0.6
4. Statistical discrepancy		-	-	-	-	-

Table 15. Basic assumptions

	2005	2006E	2007F	2008F	2009F
Short-term interest rate* (annual average)	5.3	4.1	4.6	5.2	5.3
Long-term interest rate (annual average)	5.2	5.3	5.3	5.4	5.4
Nominal effective exchange rate	-11.3	-3.1	-0.8	-1.0	-1.0
(for countries not in euro area nor in ERM II) exchange rate vis-à-vis the € (annual average)	4.03	3.91	3.90	3.86	3.82
World excluding EU, GDP growth	5.6	5.7	5.2	5.2	-
EU GDP growth	1.7	2.8	2.4	2.4	-
Growth of relevant foreign markets	7.5	10.8	7.9	7.4	-
World import volumes (excluding EU) **	7.3	8.8	8.2	7.7	-
Oil prices (Brent, USD/barrel)	54.1	65.6	66.3	68.0	-

* NBP reference rate (yield on 7-day NBP money market bills).
** Volume of world imports of goods and services

Table 16. General government budgetary prospects

	ESA Code	2005	2005	2006E	2007F	2008F	2009F
		PLN billion	*% of GDP*				
General government balance (B9)	**S13**	**-24.1**	**-2.5**	**-1.9**	**-1.4**	**-1.0**	**-0.6**
Central government	S1311	-43.0	-4.4	-4.4	-4.3	-3.9	-3.5
Local government	S1313	-1.7	-0.2	0.2	0.3	0.2	0.1
Social security funds	S1314	20.6	2.1	2.3	2.5	2.7	2.8
General government							
Total revenue		401.0	40.9	41.8	42.4	41.6	40.0
Total expenditure		425.1	43.3	43.7	43.8	42.6	40.6
Balance		-24.1	-2.5	-1.9	-1.4	-1.0	-0.6
Interest expenditure (including FISIM)		25.2	2.6	2.4	2.4	2.4	2.4
p.m.: FISIM		0.0	0.0	0.0	0.0	0.0	0.0
Primary balance		1.1	0.1	0.5	1.0	1.4	1.7
Revenue	**ESA**	**401.0**	**40.9**	**41.8**	**42.4**	**41.6**	**40.0**
Total taxes		202.3	20.6	22.0	22.5	22.9	22.6
Taxes on production and imports	D2	133.7	13.6	13.4	13.7	14.1	14.3
Current taxes on income, wealth, etc.	D5	68.4	7.0	8.6	8.8	8.8	8.3
Capital taxes	D91	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	D61	134.0	13.7	13.4	13.4	12.5	11.7
Property income	D4	18.9	1.9	1.6	1.8	1.8	1.7
Other		47.8	4.7	4.8	4.7	4.4	4.0
Fiscal burdens		332.8	33.9	35.9	36.3	35.9	34.6
Expenditure	**ESA**	**425.1**	**43.3**	**43.7**	**43.8**	**42.6**	**40.6**
Collective consumption	P32	78.4	8.0	7.8	7.8	7.5	7.0
Total social transfers		254.5	26.0	25.3	24.8	24.1	23.0
- Social transfers in kind	D63	100.6	10.3	10.0	10.0	9.6	9.1
- Social transfers other than in kind	D62	153.9	15.7	15.3	14.8	14.5	13.9
Interest expenditure (incl. FISIM)	D41 (FISIM)	25.1	2.6	2.4	2.4	2.4	2.4
Subsidies	D3	5.6	0.6	0.9	0.9	0.9	0.9
Gross fixed capital formation	P51	33.2	3.4	3.8	4.6	4.3	4.2
Other		28.3	2.7	3.5	3.3	3.4	3.1
Costs related to employment	D1	98.8	10.1	10.3	10.1	9.5	9.0

Source: 2005 – CSO, forecast for 2006-09 – Ministry of Finance

The data was calculated with an assumption that compulsory open pension funds are classified in the general government.

Table 17. Impact of the National Reform Programme on public finances

Priorities	No. of guideline	Activity	Implementation		Direct budgetary costs[1)]			
			Current status	Time frame	2006E	2007F	2008F	2009F
1. Consolidation of public finance and improving public finance management	1; 2	1.2. Improving farmers' social insurance system	planned	2006-08	0.00%	0.00%	0.00%	
	1; 2	1.4. Continuation of the healthcare organisation reform	partially executed	2006-08	0.00%	0.00%	0.00%	
	1; 2	1.9. IT development in public finance	partially executed	2005-08	0.00%	0.00%	0.00%	
	12; 13	1.11. Directing state aid towards horizontal goals	planned	2005-08	0.75%	0.70%	0.65%	
2. Development of entrepreneurship	14	2.2. Simplification of administrative procedures and lower costs of business activity	partially executed	2006-08	0.01%	0.01%	0.01%	0.00%
	14	2.3. Improved administration of justice in economic cases	in progress (ongoing work)	2006-09	0.00%	0.00%	0.00%	0.00%
	15	2.6. Financial strengthening of the loan, guarantee and capital funds	partially executed	Since 2005	0.03%	0.03%	0.03%	0.02%
3. Increased enterprise innovation	8; 9	3.1. Development of innovation market and institutional environment facilitating cooperation between R&D and the economy	partially executed	Since 2005	0.01%	0.01%	0.00%	0.00%
	7	3.2. Supporting of research and development area	partially executed	Since 2005	0.01%	0.01%	0.01%	0.01%
	8	3.3. Development of ICT in economy and administration	partially executed	Since 2005	0.01%	0.01%	0.01%	0.01%
	11	3.4. Facilitating of eco-technologies, supporting of energy efficiency and cogeneration	partially executed	Since 2005	0.02%	0.02%	0.02%	0.02%
4. Infrastructure development and upgrade and ensuring competitive environment in network sectors	16	4.1. Creating a modern transport network (roads, local public transport, railways, airports, seaports)	in progress (ongoing work)	Since 2005	0.38%	0.35%	0.33%	0.30%
	16	4.4. Support for the development of renewable energy sources (RES)	partially executed	Since 2006	0.00%	0.00%	0.00%	0.00%
	12; 13	4.8. Liberalisation of railway transport	partially executed	Since 2006	0.03%	0.02%	0.02%	0.00%
5. Creation and retention of new jobs and reducing of unemployment	17	5.2. Implementing new organisational and financial solutions in order to increase access to labour market services provided for the benefit of the unemployed, jobseekers, and employers	in progress (ongoing work)	Since 2006	0.02%	0.02%	0.02%	0.02%
	19; 20	5.5. Activating persons from groups particularly underprivileged in the labour market	partially executed	Since 2006	0.06%	0.06%	0.06%	0.06%
	19; 20	5.6. Professional activation of the disabled	partially executed	Since 2006	0.16%	0.16%	0.16%	0.16%
6. Improving the adaptability of staff and enterprises and investing in human capital	4	6.1. Increasing flexibility and diversification of employment forms and work organisation	in progress (ongoing work)	Since 2006	0.06%	0.06%	0.06%	0.06%
	23; 24	6.2. Investing in human capital	in progress (ongoing work)	Since 2006	0.10%	0.01%	0.00%	0.00%

1) The above data includes all the financial costs of priorities, that is, budgetary funds, money from loans, and financial resources from structural funds and the Cohesion Fund. Costs for years 2007 - 2009 do not cover operating programmes for 2007-2013, because as at the day of preparation of the Update they have not been adopted by the Council of Ministers yet (no financial statement available).

Source: Ministry of Economy, and Ministry of Labor and Social Policy