REPUBLIC OF POLAND

CONVERGENCE PROGRAMME

2011 UPDATE

Warsaw, April 2011

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Summary

Each Convergence Programme update presents medium-term forecasts for Poland's economy and public finances. The document has been prepared in accordance with the guidelines on the format and content of stability and convergence programmes of the EU Member States.

The main objectives and guidelines of the government's economic policy presented in the previous update have been maintained.

The *Convergence Programme. 2011 Update* shall be subject to discussion by Polish parliamentary committees.

I. Overall policy framework and objectives

I.1. Introduction

The *Convergence Programme* contains information on measures taken by the government in order to implement the Council recommendation for eliminating the excessive deficit situation (chapter III.2). It takes into account the European Council conclusions of 24-25 March 2011 on priorities in fiscal consolidation and structural reforms. Actions presented in the document and aimed at an institutional strengthening of public finances (chapter VII) shall also be implemented under the *Euro Plus Pact* which Poland joined at the above European Council meeting.

The government's activities in the area of macroeconomic policy address bottlenecks to sustainable growth which were identified by the European Commission[1]. With regard to the macroeconomic framework conditions, Poland accepts the findings of the Commission concerning the need to limit the high structural deficit as well as to ensure a reallocation of public expenditure towards growth-enhancement including infrastructure. The government's activities are also consistent with the *Broad Economic Policy Guidelines*, which constitute a part of the *Integrated Guidelines*[2] for all EU Member States. For Poland, the first of those guidelines – aimed at ensuring the quality and sustainability of public finances – is of paramount importance. The *National Reform Programme*, which Poland, under the *European Semester,* is bound to submit to the European Commission and the Economic and Financial Affairs Council (Ecofin) along with the Convergence Programme, will cover other guidelines and ways of addressing them.

The economic situation in Poland has improved since the *Convergence Programme. 2009 Update* and economic growth was significantly higher last year than in 2009. However, the better economic situation was accompanied by a widening general government deficit caused by a delayed negative response of tax revenues to the slowdown. In 2010, most of the EU Member States recorded a positive growth in GDP, but it is still uncertain how stable this recovery will be, due partially to the difficult condition of public finances of some of the euro area countries and the recent significant rise in commodity prices.

In order to decrease the fiscal imbalance the government has begun work on a reform package which will still allow a continuation of a relatively high economic growth. In February 2010, the European Commission stated that Poland had taken actions towards correcting the excessive deficit by 2012. In particular, the government adopted the budget for 2010 based on cautious macroeconomic assumptions and announced first elements of fiscal consolidation, as well as strengthened the fiscal framework and commenced work on the expenditure rule. In 2011, the Commission, referring to its high deficit forecast for Poland published in the autumn of 2010, sent a letter to the Polish authorities in which Poland was asked to outline measures ensuring the correction of the excessive deficit in accordance with the Council recommendation. Subsequently the Commission and the Ecofin Council took note of information submitted by Poland in March that described measures taken to correct the excessive deficit within the deadline set by the Council.

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[1] European Commission, *Macro structural bottlenecks to growth in EU Member States, European Economy. Occasional Papers. 65. July 2010*; http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp65_en.pdf

[2] The recommendation of the Council of 13 July 2010 on broad guidelines for the economic policies of the Member States and of the Union (2010/410/EU) and the decision of the Council of 21 October 2010 on guidelines for the employment policies of the Member States (2010/707/EU), which jointly comprise of the integrated guidelines regarding the "Europe 2020" strategy.

I.2. Integration with the euro area

Integration with the euro area remains one of the government's priorities. However, changes in the economic situation – throughout the world and, as a consequence in Poland – have made the prospect of introducing the common currency more distant.

Turbulence in the financial markets, a slowdown of economic growth in Poland as well as in it's main trade partners have resulted in a necessity to determine the *Prerequisites for Implementation of the Next Stages of the Roadmap for Euro Adoption in Poland*, which were adopted on 27 April 2009 by the Council of Ministers. This document indicates the conditions for safe membership in ERM II, which precedes euro area membership. The conditions indicated have not so far been met, which makes it impossible to set a new, credible target date for the adoption of the common currency in Poland.

What is also important for Poland's membership of the euro area, apart from the economic and legislative criteria enumerated in the *Prerequisites*.... which our country is obliged to fulfil, is an institutional strengthening of the monetary union. This is aimed at reducing the risk of macroeconomic and financial imbalances emerging in the euro area. Prior to Poland adopting the common currency, the proposals concerning the coordination of economic policies of the Member States (in particular euro area countries), as well as the crisis mechanism intended to safeguard the financial stability of the euro area (*European Stability Mechanism*), which are currently in the last stages of preparation, will be in force. The final design of these solutions should ensure a higher stability of the euro area, thus improving the reliability of the conditions of future participation in the monetary union.

The Polish government intends to adopt the euro as soon as possible, but at the same time is aware of the necessary security conditions. This is reflected in the preparatory work currently being undertaken. In January 2009, the Government Plenipotentiary for Euro Adoption in Poland was appointed by government resolution. In March 2009, the Bureau of the Government Plenipotentiary was set up within the Ministry of Finance, while in December 2009, an inter-institutional organisational structure was established, which comprised the National Euro Coordination Committee, the Coordinating Council and 8 Working Committees, and is chaired by the Government Plenipotentiary for Euro Adoption in Poland and co-chaired by the Plenipotentiary for Euro Adoption of the National Bank of Poland's Management Board. More than 30 institutions are involved, including the Ministry of Finance and the National Bank of Poland. On 26 October 2010 the government adopted the *Strategic Guidelines for the National Euro Changeover Plan*. This document elaborates on the formal conditions indicated in the *Prerequisites...* as well as presented possible scenarios for fulfilling the exchange rate stability criteria by Poland. Moreover, it contains a schedule of the preparatory work for the full integration of Poland with the euro area. Continuing these preparations while there is uncertainty as to the final date for the adoption of the common currency in Poland is aimed at ensuring readiness for monetary integration in terms of organisation, when the requirements of safe membership in ERM II and the euro area are met. Stabilisation of the economic situation in the euro area, which is also significant for Poland's roadmap to the euro, should be supported by the above new principles for economic policy coordination as well as establishment of the crisis mechanism.

The timetable for the next months is aimed in particular at identifying the scope of preparations required for euro adoption and to determine their timing. The results of this preparatory stage will define the activities for later stages of the currency integration process. A detailed schedule of these actions will be published as a more detailed update of the *Strategic Guidelines...*, prepared – as in other EU Member States – in the form of the National Euro Changeover Plan (NECP), which will be prepared by the inter-institutional organisational structure in 2011. The NECP shall be updated as needed.

I.3. Economic policy objectives

The main medium-term economic policy objective is the creation of conditions for fast and sustainable growth, while ensuring the optimum pace of consolidation of public finances. This section presents the most important measures designed at achieving this objective. Measures in the Polish economic policy framework are consistent with the priorities of the *Europe 2020* strategy, reflected in the *National Reform Programme for the implementation of the "Europe 2020" strategy*. In this context, the government recognises the importance of ensuring adequate expenditure, in particular on research and development.

1) Fiscal consolidation

The government's objective is to reduce the general government excessive deficit in 2012 and to ensure the long-term sustainability of public finances. Achievement of this goal requires inter alia strengthening of the institutional framework for fiscal policy. Some essential provisions, including the setting of a ceiling on new expenditure by general government units, have already been introduced through an amendment of *the Public Finance Act* in December 2010. The key change, in comparison with the current fiscal framework, is that greater emphasis will be put on the structural general government balance through the introduction of a permanent expenditure rule. There is ongoing work on the draft of such a rule as well as on proposals for measures aimed at improving the budgetary process and monitoring, which are essential for an efficient implementation of the permanent expenditure rule.

2) Privatisation and improvement of State Treasury assets management

Measures in this area are aimed at streamlining and increasing efficiency of the privatisation procedures, completing ownership transformations in some industries and sectors as well as enhancing ownership supervision of the State Treasury. The efforts undertaken will lead to faster growth and modernisation of enterprises and will contribute to the enhancement of the competitiveness of the Polish economy. These tasks will be carried out inter alia by conducting privatisation in accordance with the *Privatisation Plan for the years 2008-2011*.

3) Improving conditions for business activity

Measures aimed at further removal of barriers to business activity will include in particular, the reduction of the administrative burden and duration of administrative procedures, as well as improvements to the legal-institutional system (e.g. through review and simplification of commercial law and enhancement of the law-making process). Wider application of modern information and communication technologies will increase the quality of services provided by the administration as well as its communication with citizens and business. These measures will constitute the basis for implementing the new policy of innovation, which covers promotion of creativity and cooperation as well as promotion of innovation in the industrial, educational, scientific and administrative sectors, and support for putting this into effect.

4) Increasing economic activity of population

Changes in the demographic structure of the population and the objective of maintaining balance in the social insurance system require an increase in economic activity by the Polish people. Making work pay by rationalising the social allowance and benefit system as well as facilitating the reconciliation of professional and family life will contribute to an increase in the level of employment.

II. Economic outlook

II.1. Cyclical developments and current prospects

In the first half of 2010 the world economy improved relatively fast on the back of improving global trade volumes and industrial production. In the second half of last year, although the pace of the recovery was slower, overall global GDP recovered strongly, largely due to the performance of emerging and developing economies. In this context, the recovery of the economic situation in the euro area and - as a result - in the EU, (which is the destination for almost 80% of Polish exports), is comparatively weak. GDP in the EU, despite a strong recession in 2009 (a drop by 4.2%) increased by only 1.8% in 2010, which was below the long-term average from the period before the crisis. EU import, which is the main component of the wider indicator of demand for Polish goods and services, grew by 9.0%, which is more than the average before the crisis, but it still has not made up the losses suffered in 2009. The strong increase in trade volumes in Germany, which is Poland's main trade partner, was particularly important for Polish exporters.

Relatively good results for the Polish economy – real GDP growth rate increased in 2010 to 3.8% - allowed for a gradual reduction of the output gap, defined as the deviation of current economic activity from the long-term trend. From the second quarter of 2010, Poland has been in the growth phase of the economic cycle, however the output gap is still negative. The global economic crisis reduced the potential growth of the Polish economy from about 4.7% at it's highest level to less than 4.0% in 2010.

2010 saw an important change in the quarterly, seasonally adjusted GDP growth profiles. The weakest first quarter was negatively affected by unfavourable weather conditions, which delayed construction investments. As a result growth rate slowed to 0.6% q/q. Part of the investment slack was recovered in the second quarter, when GDP growth increased by 1.1% q/q. This growth rate was also maintained in the third quarter (1.2% q/q.), slowing slightly in the fourth quarter (0.8% q/q). This reflected, to a large extent, the growth rate of private consumption (1.1% q/q in the third quarter and 0.7% q/q in the fourth quarter of 2010).

Economic growth in 2010 was mainly fuelled by the restocking of inventories and private consumption. After the largest drop in history (11.3 billion PLN in 2009), in 2010 companies rebuilt their inventories which by the end of the year had reached historically high levels. The inventories increased by 13.8 billion PLN, which contributed 1.9 percentage points to the GDP growth rate. Apart from inventories, the other key factor was individual consumption, which increased in 2010 by 3.2% (2% in 2009), contributing another 2.0 percentage points to GDP growth. Relatively high consumption growth was possible due to an increase in employment and remuneration.

In 2010 investment activity was still subdued with the gross fixed capital formation 2% lower than in 2009. This was related to a low investment demand by the private sector, despite a considerable improvement of the economic situation and very good financial results of non-financial enterprises. In 2010, investments by large and medium enterprises fell by 3.2% y/y, with the steepest drop being recorded for investment outlay for machines, technical equipment and tools (by 8.6%). On the other hand a significant improvement was recorded in transport equipment investment (increase of 29.4%). Total investments in 2010 were supported by the public sector, where a key role was played by infrastructure projects, which also fostered the growth in construction and assembly production.

Economic recovery by Poland's major trade partners contributed to the export recovery, which in 2010 reached roughly 146.4 billion EUR, exceeding the previous record level from 2008. However, compared to 2009, the contribution of net exports to GDP growth in 2010 was negative at -0.3 percentage points. The high import intensity of exports and the rebuilding of (relatively import-intense) inventories commenced in the first quarter of last year, resulting in a slightly faster growth of imports. At the same time, compared to 2009, the appreciation of the Polish zloty lowered the price competitiveness of domestic producers. The increase in the scale of external imbalance was also influenced by the drop in the current transfer surplus, caused mainly by lower private transfer inflow. The improving financial results of direct investment enterprises was reflected in the on-going high income deficit. As a result, in 2010, the estimated current account deficit grew to 3.3% GDP from 2.1% GDP in 2009. 90% of this deficit was indirectly financed by an inflow of long-term capital, that is foreign direct investments and EU funds, most of which are classified on the capital account.

The recovery in external demand was the main cause for the growth of industrial production, especially in manufacturing. In 2010 industrial production grew by 9.8% in real terms, against a drop by 4.5% in 2009. In December 2010 the level of sales by industry (seasonally adjusted) was 19.4% higher than at the start of the recovery stage, which began in January 2009. The highest growth was recorded in industries supplying mainly foreign markets, i.e. automotive, electric, electronics and metal working. Some of these industries experienced a substantial reduction in production during the crisis, thus the high speed of recovery can partially be attributed to a low initial base. The food industry which is an important section of manufacturing, also maintained a growth trend, as it is highly dependent on domestic demand, and did not experience any drop in production during 2009.

Improving economic activity in 2010 positively influenced labour demand. Employment[3] increased by 0.6% mainly due to strong labour demand in services (by 3.0%), which exceeded a corresponding drop in industry and agriculture. In 2010, both the number of self-employed and employees grew. Similarly to most of the EU-27 Member States, Poland saw growth in the number of temporary jobs, while the number of permanent jobs fell. Despite the growth of labour demand, unemployment increased in 2010. The unemployment rate[4] grew by 1.5

[3] Average number of employed (aged 15 years and over according to LFS).
[4] Unemployment according to LFS (aged 15 years and over).

percentage points to 9.6%, which was also the average level in the EU-27. Due to significant growth in the participation rate and despite the increase in labour demand, the employment rate[5] remained at the level of the previous year (50.4%).

The improvement in the labour market observed in 2010 was mainly due to the increase of employment, accompanied by limited wage pressure. A relatively slow growth of remuneration was the result of relatively high unemployment, which limits employees' bargaining positions in salary negotiations.

The average annual increase in the prices of consumer goods and services in 2010 reached 2.6%, even though inflation was above the target (2.5%) only in the first and fourth quarters of last year. The main reasons for the inflation rise in the last quarter of 2010 were the commodity price surge on global markets and increased risk aversion on global financial markets, resulting in the weakening of the Polish zloty, and the corresponding rise of import prices. The increase of the current inflation indicator was not accompanied by higher demand pressure: the core inflation, net of food and energy prices, remained at a low level and at the end of 2010 it reached 1.6%. The supply side factors, together with one-off events (e.g. increase in rental prices, increased energy tariffs, changes to the VAT rates), also contributed to the acceleration of the inflation rate in the first months of 2011.

The stable economic growth accompanied by limited remuneration and inflationary pressure with the risk of weaker global economic growth, prompted the Monetary Policy Council to continue with a moderate approach to monetary policy. This resulted in the NBP keeping interest rates at the same level throughout 2010, including the main interest rate - the reference rate - at a record low of 3.5%. In January 2011, in the face of increasing inflationary pressure as well as a possible projected rise in inflation, the MPC started to tighten monetary policy, increasing interest rates by 0.25 percentage points. In April NBP interest rates were increased again by 0.25 percentage points, including the reference rate, to a level of 4.0%

The PLN/EUR exchange rate was very volatile in 2010, with the causes of these variations being mostly of a global nature. Until April last year the Polish zloty steadily gained in value. The strengthening of the Polish currency at this time was influenced by the drop in risk aversion on the global financial markets and the positive assessment of the fundamentals of the Polish economy by foreign investors, reflected in publication of positive macroeconomic data. The sudden worsening of sentiments on the financial markets which was caused by fiscal problems in Greece resulted in the drop in the value of the Polish zloty during the second quarter of 2010. Later that year, with a decline of global risk aversion and rising interest from foreign investors in the Polish debt market, the national currency market became stable. A volatile period on financial markets triggered by fiscal problems in Ireland and increasing concerns about other peripheral members of the euro area, however resulted in a further drop of the Polish zloty's value at the end of November 2010.

II.2. Medium-term scenario

Among the major factors which will determine the path of economic growth in Poland over the next few years are the development of the economic situation of Poland's main trading partners, that is the other EU Member States, the scale and structure of the required fiscal consolidation and demographic trends, particularly a significant decrease in the population of working age. All these factors will have a key influence on the GDP growth rate, its structure, inflationary developments as well as developments in the labour market.

Current projections regarding the state of the global economy indicate that 2011 will be a period of slower growth of global GDP compared to the very good results of the preceding year. For the Polish economy, the key factor determining external demand will be the situation of the export markets. For the forecast horizon it was assumed that the key indicator will be import growth in the EU. Based on the available forecasts of GDP growth, published by international institutions (IMF, EC) it was assumed that import growth in the EU in 2011 would slow down to about 6.0% as compared to the 9.0% growth in 2010. It is expected that in the years 2012-2014 EU import growth will stabilize at a similar level. The above assumptions were made without factoring in the effects on world trade of the earthquake and tsunami in Japan, as these are difficult to estimate.

The expected growth of external demand is reflected in the Polish export forecast. In the forecast horizon, the pace of growth of this economic category will slowly decrease, yet it will still be higher than the growth of the export markets. As a result, the trend of increasing share of Polish production imported by our biggest

[5] LFS (aged 15 years and over).

commercial partners, observed since 2000, should be maintained. This stems from the higher productivity growth rate and the GDP potential of Poland as compared with those countries. In the past, Polish exporters were able to increase their participation in foreign markets even when the Polish currency was strong but with reduced price competitiveness by Polish producers. Along with the progress in real convergence, the significance of the above factors will lessen while the participation of Polish exports in response to foreign demand will gradually stabilize.

Very good financial results of enterprises in 2010 and business confidence indicators point at the growing level of capacity utilization and decreasing percentage of companies reporting problems with insufficient domestic and external demand, permit - in the current year, and after two years of declines – an expectation of a positive growth in private investments. It is estimated though that investment growth will not be significant and will not exceed 5.0%. A significant speed-up should be expected in the next year, which will be caused mainly by the predicted stabilization of the global economic situation and resulting reduction of uncertainty in economic activity. During the timespan covered by the forecast, the share of private investments in GDP will gradually return to the levels of 2007-2008. Meanwhile, the level of public investments will depend on the limitations caused by the consolidation measures, and on the use of EU funds for the infrastructure, whose influence on the general government deficit is neutral. It is assumed that the highest rise of investment from EU funds will be in the current year and will allow for a record high (about 6.6%) share of public sector investments in GDP. In consecutive years, the share of public investments in GDP will decrease to reach about 4.6% at the end of the forecast horizon, which is still slightly above the average for the years 2001-2006 (3.5% of GDP) and about 2 percentage points over the average for the EU.

Improvement of the economic situation, including growing investment demand, will positively influence labour demand. An important supply constraint will be the unfavourable demographic trend. Taking into account the predicted reduction of the working age population, the labour supply is expected to decrease. The consequences of these adverse trends will be partially offset by the predicted increase of the active population, caused by improvements of salaries, further growth in the working population in the 25-44 age bracket as well as a significant decrease of entitlements for earlier retirement. However, a significant drop in the population of working age, despite the rising employment rate, will be a major barrier to an increase in employment and in the next years, it is predicted that the growth rate in this economic category will gradually slow down. Taking into account the expected growth of employment together with a decrease in the population of working age, it is estimated that the unemployment rate will reach about 9.3% in 2011. In subsequent years it will gradually decrease to slightly over 8% in 2014.

Together with the expected improvement on the labour market, it is predicted that the rate of growth of wages will accelerate, which will be influenced by the lower supply of labour. Despite the assumed strengthening of the employees' position in wage negotiations, the expected rise in wages should not exceed the levels of the boom years 2006-2008. The rate of wage growth for the whole economy will be dependent on labour productivity growth and the freezing of the wage fund (in nominal terms) for most of the units in general government for 2011 and 2012. In the next years, it is planned that the wage fund for these units will rise in value by 1% in real terms.

The situation on the labour market and the predicted growth in wages will allow for a some increase of household disposable income in 2011, but due to inflation, the real growth will not exceed 3.0%. Assuming a slight decrease of the savings rate, the predicted real increase of household consumption in 2011 will be 3.2%. In 2012, the pace of the real growth of household consumption demand should increase, partially due to EURO2012 - the estimated influence of this event's organisation on private consumption may be up to 0.5 percentage points. In the next years, the pace of private consumption growth should stabilize at a level of about 3.8%.

A decrease in the dynamics of public consumption will be caused by the process of reducing excessive deficit. In 2011 the contribution of public consumption to GDP growth will be about 1/5 lower than in 2010. In 2012 it will be close to zero, and in subsequent years the share of this macro-economic category in GDP will decrease, generating a marginally positive contribution to GDP growth.

In addition, changes to inventories will have a significantly lower contribution to GDP growth than in 2010. The record contribution last year was caused by a significant speed-up in final demand compared with that in 2009: stock inventories in the economy were adapted proportionally to demand growth. It is predicted that in the following years growth of the final demand will be relatively constant, and the share of inventories in this economic category will gradually stabilise. As a consequence, in 2011 the contribution to GDP growth from the change of inventories will only amount to 0.2 percentage point, plateauing by the end of the prognosis period.

A recovery in final demand will be the basic determinant of import growth in Poland. The structure of final demand, with a relatively high contribution from import-intense exports and investments, will result in a negative contribution of net exports to GDP growth in 2011-2012. In subsequent years, together with the gradual stabilisation of particular demand components to GDP, the contribution to economic growth of net export should be neutral.

In summary, the expectations for the development of GDP components indicate that economic growth in Poland in 2011 will be about 0.2 percentage points higher than in 2010. In the next year, despite a significant limitation of the contribution from public demand, the expected speed-up of private demand should contribute to maintaining the real GDP growth rate at the level of 2011. In 2013, it is expected that real GDP growth will temporarily slow down to about 3.7%. In the next forecast year, with the expected stabilisation of household consumption demand growth and the gradual stabilisation of the share of private investment in GDP, the economic growth rate will approach the long-term average and will be about 3.9%.

With an acceleration in domestic demand growth rate, the deficit on the current account will increase. The scale of the increase of external imbalance will remain moderate, as the increase of the trade deficit should be partially compensated by the increase of the surplus of current transfers, which will mainly be due to the larger inflow of funds from the EU budget. The negative income balance should be maintained at a high level, determined largely by revenues from foreign direct investors. It is predicted that the current account deficit will rise to 3.4% of GDP in 2011 and 3.6% of GDP in 2012. In the next two years (together with the drop in the trade deficit) it is predicted that it will become stable at a level of 3.4% of GDP. At the end of the forecast period, the deficit on the current account will be financed in its majority by the inflow of long-term capital, that is foreign direct investments and funds classified on the capital account (mainly European structural funds).

In accordance with the forecast, the temporary growth of inflation to 3.5% in 2011 will be mainly a result of a high rise in commodity prices on the global markets. The inflation pressure may be also strengthened by the expectation of rising remuneration. In the next years, due to the stabilisation of raw materials prices, a gradual appreciation of the national currency and the monetary policy tightening which commenced in 2011, inflation should gradually decrease. As a result, the predicted inflation for 2014 is consistent with the NBP's inflation target (2.5%).

A forecast of higher inflation indicates that in the years 2011-2012 the MPC will continue the process of monetary policy tightening. The pace and scale of the NBP interest rates rises will be determined by the progress of the economic recovery, the consolidation of public finances, improvement in the labour market, the exchange rate and inflation predictions. The most important external factors will be the decisions made by the main central banks in the world on their monetary policies. In subsequent years the reference NBP interest rate should stabilize at a level of about 4.5%.

Throughout the forecast period it is expected that the appreciation trend for the Polish zloty will be maintained. The gradual strengthening of the Polish currency will be supported by the strong foundations of the Polish economy, including the relatively stable current account deficit, the inflow of foreign investments and a reduction in the risk premium which is relevant to limiting the imbalance of public finances. An important risk factor for the Polish zloty exchange rate is the uncertainty on the global financial markets, in particular a potential sudden growth of risk aversion.

III. General government balance and debt

III.1. Policy strategy and medium-term objectives

The present fiscal imbalance is one of the major threats to Poland's development, as it limits the possibilities of creating new competitive advantages for our economy. Reducing the excessive deficit, limiting debt growth, decreasing and subsequently stabilising the structural deficit at the level of medium-term budgetary objective, are the government's most important challenges. Their successful implementation will increase the sustainability of Polish public finances. Both the deadline for the reduction of the excessive deficit (2012) and the scale of the required actions place Poland among the leaders in budgetary consolidation.

Achieving those objectives requires a further strengthening of the institutional framework for fiscal policy. Some essential provisions which address expenditure limits for public finance sector units have already been enacted by an amendment to the Public Finance Act of December 2010. The basic difference compared to the current fiscal framework is more emphasis on the general government structural balance via new rules for the local government sub-sector and a new, permanent expenditure rule ensuring stabilisation of public finances. In order to establish conditions for efficient implementation of this rule, actions to facilitate the budget creation process and monitoring are being prepared.

III.2. Measures taken to reduce the excessive deficit

The Council recommended that Poland should put an end to the excessive deficit situation in a credible and sustainable manner by 2012. In February 2010, the European Commission stated that Poland had taken actions towards correcting the excessive deficit by 2012. In particular, the government adopted the budget for 2010 based on cautious macroeconomic assumptions and announced first elements of fiscal consolidation, as well as strengthened the fiscal framework and commenced work on the expenditure rule. In 2011, the Commission, referring to its high deficit forecast for Poland published in the autumn of 2010, sent a letter to the Polish authorities in which Poland was asked to outline measures ensuring the correction of the excessive deficit in accordance with the Council recommendation. Subsequently, the Commission and the Ecofin Council took note of information submitted by Poland in March that described measures taken to correct the excessive deficit within the deadline set by the Council.

The structure of fiscal consolidation has a profound impact on achieving the desired adjustment results. Analysing the experiences of other countries[6] one may conclude that the most beneficial scenario is a consolidation focused on the expenditure side. The impact of consolidation measures in Poland in the years 2011-2012 is estimated at 4.6% of GDP, of which only 0.8 percentage points will be due to increases in tax rates, more limited use of tax relief, and other taxation changes. One of the most important elements of fiscal consolidation in Poland is the introduction of the temporary expenditure rule and extending its coverage beyond the state budget, i.e. to other units of general government under the direct control of the government.

The following measures were adopted by Poland in 2010 and implemented in 2011 in order to reduce the excessive deficit.

1) As of 1 January this year, some of the amendments introduced by the ***Public Finance Act*** of 2009 and its amendment adopted at the end of 2010 came into force. These changes introduce:

- the temporary expenditure rule limiting the growth rate of discretionary expenditure and new legally mandated expenditure, which shall also cover current legally mandated expenditure, if the legal act determining it is modified; any draft act resulting in the increase of such an expenditure, must be included in the general pool of discretionary expenditure and new fixed expenditure, which may not grow by more than 1% in real terms annually; the temporary expenditure rule shall remain in force until the Ecofin Council adopts a decision abrogating the excessive deficit procedure for Poland,
- new principles affecting revenues and expenditure of the general government as long as Poland remains subject to the excessive deficit procedure. In accordance with the aforementioned, during that time the Council of Ministers cannot adopt any draft acts which may result in:
  - decrease in revenues of the general government units in relation to their level under the current binding regulations,
  - increases in some categories of expenditure of general government units in relation to their level under the current provisions of law. This provision applies to the following categories of expenditure not covered by the temporary rule: servicing of public debt, own resource contributions to the European Union budget, obligatory contributions paid to international organisations, implementation of programmes co-financed with EU funds, payment and service of family benefits, payments from the alimony fund and financing of retirement and pension contributions for persons receiving care allowance, social insurance contributions for persons on maternity and childcare leave and for the disabled,

[6] E.g. European Commission, *Public finances in EMU – 2010, European Economy* 4/2010.

expenditure connected with disbursement of retirement pay and pension benefits guaranteed by the state;

- medium-term planning, also in local governments,
- a strengthened system of state treasury liquidity management which obliges public finance sector units to deposit disposable funds in an account of the Ministry of Finance. This measure, will have an influence on reducing public debt and the borrowing requirement by more efficient management of public finance sector assets,
- as of 2011 – the principle of a balanced current budget for local governments which will support an improvement in the balance of the local government sub-sector. Regarding this sub-sector, the new Public Finance Act obliges local authorities to balance the current part of their budgets starting from 2011, and by 2014 a system of individual debt limits will come into force. These limits will depend on the debt repayment capacity of particular local governments and will be calculated on the average current surplus (increased by the revenues from property sales) over the previous 3 years;
- the obligation to determine annual limits on new expenditure on a cash basis, based on the draft acts adopted by the Council of Ministers that will remain current for 10 years after the acts come into force. This requirement shall remain even when Poland is no longer subject to the excessive deficit procedure,
- an additional mechanism for protecting public finances through the introduction of conditional VAT rate rises. Should the ratio of the state public debt (calculated according to Polish methodology) to GDP exceed 55% in 2011, two VAT rate rises of one percentage point each will take place, the first from July 2012, and the next from July 2013. Should the ratio of state public debt to GDP exceed 55% in 2012, then the first of these two rises would come into effect from July 2013, and next from July 2014. In each case, the higher VAT rate would be binding for no longer than 3 years. However, over the forecast span the state public debt with relation to GDP is not expected to exceed the 55 % threshold, which means that there will be no necessity to raise VAT after 2011.

2) Instruments amending certain legislation relating to the execution of the 2011 budget:

- standard VAT rate was increased to 23% (from 22%) and the lower rate to 8% (from 7%).
- the wage fund was frozen in nominal terms for most general government units;
- expenditure on some less effective labour market programmes was reduced;
- funeral benefit was reduced (from March of this year).

The increased tax rates will be binding for three years, as part of the plan aimed at reducing the excessive deficit. Some other steps have also been undertaken, aimed at strengthening the revenue side of the state budget - the excise duty on cigarettes was increased (with a further increase envisaged for 2012) and relief on bio-components added to motor fuels was withdrawn.

3) Act amending some acts relating to the functioning of the social insurance system

Another important measure which reduces general government expenditure is associated with recent changes to the pension system. From 1 May 2011, the pension contribution transferred by the Social Insurance Institution (ZUS) to the Open Pension Funds (OFE) will be reduced from the current 7.3%, initially to 2.3%, and from 2017 - to 3.5% of the pension contribution base. The remaining part of the contribution will be kept by ZUS in special, individual sub-accounts and shall be transferred to a separate fund managed by ZUS in order to finance current payments.

Reduction of the contribution transferred to the Open Pension Funds (OFE) will contribute to an improvement of the general government balance by about 0.6% GDP in 2011 and by another 0.5% (that is in total 1.1% GDP) in 2012[7]. The reform of the retirement system is described in section III.6 of this update.

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[7] Taking into consideration savings resulting from lowered costs of debt servicing, the general government balance will improve in the years 2011-2012 by 0.7% GDP and 1.2% GDP, respectively.

The measures implemented in 2011 and planned for 2012 in order to reduce the excessive deficit are presented below.

Table 1. Government measures reducing the general government deficit

	ESA code	2011 % of GDP	2012 % of GDP
Impact of adjustment measures on selected components of general government revenues			
Taxes in total		0.65	0.18
Taxes on production and imports, of which:	D.2	**0.56**	**0.05**
- increase of VAT rates by 1p.p. and accompanying measures		0.41	
- abolition of VAT reimbursement for company cars and fuel		0.08	
- abolition of reduced excise duty on bio-fuels		0.06	0.04
- increase in excise duty on tobacco		0.02	0.02
Current taxes on income and wealth, of which:	D.5	**0.09**	**0.12**
- a freeze of PIT thresholds		0.09	0.10
- introduction of tax on profits from overnight deposits			0.02
Social contributions, of which:	D.61	**0.64**	**0.53**
- changes to the funded pension scheme (lower contribution to OFE)		0.64	0.53
Total impact on revenues		**1.29**	**0.71**
Impact of adjustment measures on selected components of general government expenditure			
Compensation of employees + intermediate consumption + current transfers, of which:	D1+P2+D7	**-0.46**	**-0.60**
- temporary expenditure rule (including a freeze of the nominal wage fund) and the effect of setting a ceiling on discretionary and new legally mandated spending		-0.46	-0.60
Social transfers, of which:		**-0.70**	**-0.40**
- implemented abolition of early retirement scheme (as a result of implementation of bridge pensions)		-0.36	-0.39
- lower spending of the Labour Fund		-0.28	
- reduction in funeral benefits		-0.06	-0.01
Interest expenditure, of which:	EDP D.41	**-0.02**	**-0.04**
- reduction in debt-servicing cost due to changes in the funded pension scheme		-0.02	-0.04
Additional, new deficit rule for local governments			**-0.40**
Total impact on expenditure		**-1.18**	**-1.44**
Total		4.62	

Source*:* Ministry of Finance.

4) Other changes to the taxation system

As a result of the *resolution of the Minister of Finance of 26 July 2010 on the exemptions from using cash registers*, an obligation to have a cash register was imposed on lawyers and medical doctors who run their own practices. This change is consistent with implementing the principle of the widest possible registration of economic turnover (to limit the grey economy).

Moreover, following the *act of 16 December 2010 on the change in the goods and services tax act and the road transportation act,* the right to VAT deduction from the purchase of passenger cars with classification as goods vehicles and deduction of VAT from the fuel consumed by them has been abolished from 2011. The aim of this change was to prevent the deduction of VAT from the purchase of cars which do not differ from private passenger models. These allowances are planned to be reintroduced in 2013. In the years 2012-2014 further changes to the tax system are planned. Excise duty on tobacco products will be raised once again in 2012. In 2014 the higher tax rates of VAT introduced in 2011 will expire and will mean the return of the 22% rate (previously 23%) and 7% (previously 8%).

As regards PIT, from 2012 there will be a change in the rules for rounding the tax base and tax due on interest income from bank accounts (excluding the interest income from funds in bank accounts connected with business activity), which will result in the necessity to pay the tax, regardless of the amount of income earned. At the moment the tax on interest income from a deposit at certain levels, with daily capitalization, is not chargeable.

Some of the measures undertaken to reduce the deficit are temporary. Most of these measures have already been implemented and the government is determined to implement the remainder. The government is convinced that these measures will be sufficient to reduce the excessive deficit by the deadline set by the Council, that is by 2012. Should the need arise, the government is ready to undertake additional measures in order to implement the Council recommendation.

III.3. Actual balances and implications of the budget for next year

In 2010, the general government deficit reached 7.9% GDP compared with 7.3% GDP in 2009. The widening imbalance in public finances resulted first of all from a fall in revenue from income and property taxes (about 1.8% y/y) and a low growth rate of social insurance contributions (by 3.3% y/y). The state budget deficit increased on a cash basis to 44.6 billion PLN compared to 23.8 billion PLN in 2009, which resulted in a rise of the deficit of the sub-central sector (an element of general government). The state budget deficit in 2010 was, however, 7.6 billion PLN lower (about 0.5% GDP) than the level predicted in the budget act. This result was achieved despite one-off expenditures of about 3 billion PLN spent on mitigating the consequences of the two floods last year.

Poland remains a net beneficiary of EU funds, which has helped to soften the negative effects of the global crisis on the Polish economy. Absorption of structural funds requires co-financing from the state and local government budgets. This, in turn, together with lower tax revenues, is the reason why the deficit of the local government sub-sector was higher in 2010 than in 2009.

1) Factors determining the income of general government

Despite the fact that the Polish economy has not felt the recession, slower GDP growth rate in the years 2009-2010 had a negative impact on taxation revenues. The effects of the economic slowdown were mainly observed in the dynamics of income tax revenues, in particular - CIT, which due to its nature is very sensitive to sudden changes in the economic situation. The nominal decrease of CIT recorded in the years 2009-2010 meant *de facto* a negative elasticity of CIT revenues in relation to GDP, which was growing at that time. This effect was especially noticeable in 2009. Despite the significantly better financial condition of enterprises in 2010, a decrease in CIT revenues was still observed. It was caused by the negative effect of the annual balance (for 2009) for the public finance sector and by companies deducting losses incurred during the economic slowdown from their current profits. Due to the relatively short period of the slowdown we may reasonably expect that any losses incurred have already been deducted and that in subsequent years they will not significantly reduce tax revenues. Moreover, from 2011, we may assume a significant improvement in the positive annual CIT balance for the general government.

For similar reasons PIT revenue growth slowed down in the last year, caused mainly by lower tax revenues from persons conducting business activity and paying a 19% flat rate. Another factor was a significant decrease of tax revenues from capital profit (stock exchange tax). It is expected that from 2011 PIT revenue dynamics will accelerate caused by the rise in company income tax revenues and the effect of freezing the taxation threshold and tax relief limits. The PIT reliefs are mainly limited in value and as they are not indexed, in the course of the next few years their impact on tax revenue will decrease. This effect will be strengthened by the shrinking (due to demographic reasons) population of children with an entitlement to childcare relief (constituting over 80% of all current tax deductions). From 2013 the act reforming the current retirement system which allows relief on voluntary savings to an individual retirement protection account, will work in the opposite direction. Another source of increased revenue in the next years will be a significant rise in capital gains tax. The predicted improvement on the labour market in 2011 will also have a positive influence on PIT revenues through expanding the tax base.

The economic slowdown in the past 2 years has also had a negative influence on VAT revenues, which are the biggest source of revenue for the state budget. During the slowdown, the elasticity of VAT revenues against the tax base decreased. Starting from 2011, we predict a rise in the elasticity of VAT to the average level of the past few years, that is close to 1. The rise in VAT revenues in 2011 will also be supplemented by a favourable economic growth structure, driven by dynamic growth of those economic categories, which constitute the main components of the VAT tax base: private consumption and public investments. A particularly rapid increase in public investments will stem from preparations for, and the organisation of the European Football Championships (EURO 2012), the construction of road infrastructure and the predicted highest ever absorption of European funds. Over the next years, the participation of public investments in GDP will decrease, to reach about 4.6% in 2014, still slightly above the average from the years 2001-2006 (3.5% GDP) and by about 2 percentage points above the EU average . The planned changes to tax rates are a reduction of VAT rates in 2014 from 23% to 22% and from 8% to 7%.

A new element increasing the revenues of the state budget will be revenues from selling entitlements to greenhouse gas emissions from 2012.

2) Factors determining the expenditure of the general government

The major factors influencing the level and the structure of expenditure within the forecast horizon will be implemented (description in section III.2) as well as planned systemic changes, and infrastructure expenditure. The amount of infrastructural expenditure will be determined by: realization of the *National road construction programme for the years 2011-2015*, development of local roads within the *National programme for local roads construction 2009-2011*, investments associated with preparations for EURO 2012, and effective use of EU funds within the operational programme *Infrastructure and Environment*.

The most important structural factor limiting expenditure of the general government will be the application, over the next years, of the temporary rule for that part of the general government which is under direct control of the government. In turn, the local governments will be obliged to adhere to the binding fiscal regulations in the Public Finance Act, and from 2012 - also to the new regulations, which are currently being worked on. In particular, in the forecast for the local government sub-sector it has been assumed that the maximum ratio of deficit to revenues of local governments shall be determined for subsequent years.

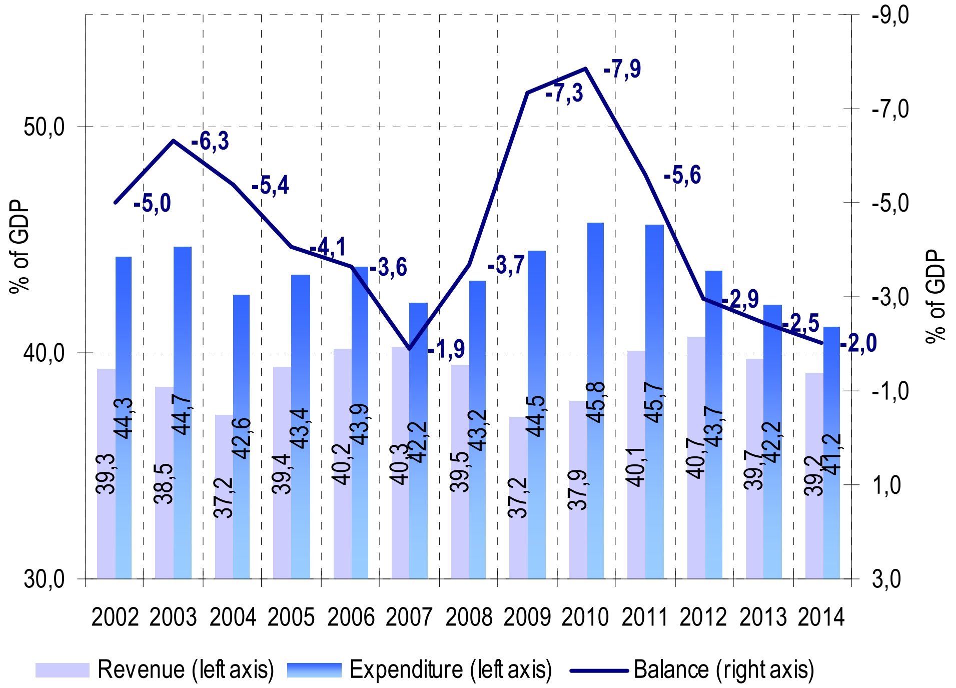
The expected nominal freeze of the wage fund in the budgetary sphere will be a strengthening factor, as in the following years the growth of this fund should not exceed 1% in real terms. A planned reduction of employment in public administration will be conducive to limiting the growth of wages in general government.

Moreover, the improvement in the condition of public finances within the forecast horizon will be influenced by the decrease in the number of retired persons, i.e. by limiting the possibilities of earlier retirement, which will translate into a decrease in pension payments from social insurance. In addition the expenditure on funeral benefits will decrease. Moreover, improvements to the situation on the labour market will allow for reduced expenditure of public funds on counteracting unemployment.

In the course of reducing expenditure in the central sub-sector one must remember that the expenditure from the budget presented in the *Multi-annual State Financial Plan* (MYSFP) for the years 2011-2014 reflects the assumption that the deficit level of the state budget will be realized in this period to its full extent. In practice, the actual state budget deficit is usually lower than the limit indicated in the budget act. Analysis of the budget implementation compared to original plans for the years 2002-2009 shows that the expenditure reached on average 97.4% of the plan (in 2010 - about 97.9%). The actual state budget outcome in 2002-2009 was on average almost 5 billion PLN better than planned. Taking into consideration the above trends, the state budget deficit forecast in this update is lower than the maximum allowed limit in the MYSFP.

As a result of the consolidation measures and taking into account further planned actions as well as the predicted macro-economic conditions, it is predicted that the general government deficit in 2011 will be about 5.6% GDP and in subsequent years will decrease to about 2.9% in 2012, about 2.5% in 2013 and about 2.0% in 2014. Having reduced the excessive deficit, the government in accordance with the Council recommendation of 2009, will continue fiscal consolidation until the medium-term budgetary objective is achieved, that is a structural deficit of 1% of GDP.

Chart 1. Revenue, expenditure and balance of general government



Source: 2002-2009 – Eurostat, 2010-2014 – Ministry of Finance

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

	ESA Code	2010	2011	2012	2013	2014
General government balance	S.13	**-7.9**	**-5.6**	**-2.9**	**-2.5**	**-2.0**
Central government	S.1311	-5.9	-4.4	-2.7	-2.5	-2.2
Local government	S.1313	-1.1	-0.8	-0.4	-0.3	-0.2
Social security funds	S.1314	-0.8	-0.4	0.2	0.3	0.4
General government debt	**S.13**	55.1	54.9	54.1	52.4	50.8

Source: 2010 – Central Statistical Office, 2011-2014 - Ministry of Finance

III.4. Structural balance

A significant increase in the general government deficit in 2010 was largely caused by the worsening of tax revenue dynamics, i.e. as a result of the deduction of losses suffered by enterprises during the economic slowdown. The method of structural deficit calculation presented here does not take into account the short-term pro-cyclical effects of tax elasticity. The methodological weakness of the common European methodology of calculating the structural deficit is that it is based on fixed tax elasticity with respect to GDP. Taking into account the real tax elasticity (instead of the fixed one estimated by OECD), the structural balance in 2010 would be much more favourable than presented in table 3. The general government balance, also in structural terms, is forecast to keep improving from 2011.

Table 3. Cyclical developments

% of GDP	ESA Code	2010	2011	2012	2013	2014
1. Real GDP growth (%)		3.8	4.0	4.0	3.7	3.9
2. Net lending of general government	EDP B.9	-7.9	-5.6	-2.9	-2.5	-2.0
3. Interest expenditure	EDP D.41	2.7	2.8	2.8	2.7	2.6
4. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		3.9	3.8	3.8	3.9	3.9
6. Output gap		-0.4	-0.2	-0.1	-0.2	-0.2
7. Cyclical budgetary component		-0.2	-0.1	0.0	-0.1	0.0
8. Cyclically-adjusted balance (2 - 7)		-7.7	-5.5	-2.9	-2.4	-2.0
9. Cyclically-adjusted primary balance (8 + 3)		-5.0	-2.7	-0.1	0.3	0.6

Source: Ministry of Finance.

III.5. Debt levels and developments

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

Debt management will occur in conditions of the gradual limiting of the general government deficit as well as insecurity on the financial markets caused by growing inflationary pressure and the threat of debt crises in some of the euro area countries. Actions aimed at limiting the general government deficit to under 3% should have a significant influence on the level and shape of the yield curve, and as a consequence on State Treasury debt servicing costs.

The changes in the debt to GDP ratio in 2011-2014 will result from, first of all, the state budget borrowing requirements (the State Treasury debt constitutes approximately 88% of the general government debt), GDP growth and the Polish zloty exchange rate in relation to other currencies, especially to the euro. A significant factor limiting the borrowing needs of the state budget will be the decrease compared to 2010 of the state budget deficit, a surplus, from 2013 on, of EU funds budget, the decrease, from May 2011, of pension contributions transferred to the Open Pension Funds, and proceeds from privatisation.

The decrease of borrowing requirements in 2011 will be significantly influenced by a systemic change which introduces an obligation to deposit liquid funds of the indicated units of general government at the central level to the account of the Ministry of Finance. It will allow the use of general government liquid financial assets to decrease the borrowing needs of the state budget, thus decreasing the difference between the gross and net public debt in the next years by about 15-20 billion PLN. It is also known that the NBP profit payable this year to the state budget (for 2010) will be about 4.5 billion PLN higher than predicted in the budget (1.7 billion PLN), which will be reflected in a relevant decrease of borrowing needs.

The changes in the debt of other general government entities will mainly be the result of growth in the debt of the National Road Fund (national roads and motorways building programme) and of local governments. The borrowing requirements of local governments will also result from infrastructure projects which are underway, co-financed with EU funds within the financial perspective 2007-2013. After a dynamic increase of debt in local governments in the years 2009-2010, a slowdown of the increase is predicted, due to, among others, the introduction of new fiscal rules for local governments.

In the timeframe of this update, the ratio of debt to GDP will fall below 51% using the EU methodology and below the 50% threshold using the national methodology.

Table 4. General government debt developments (end of the year, % of GDP)

	ESA Code	2010	2011	2012	2013	2014
1. Gross debt		55.1	54.9	54.1	52.4	50.8
2. Change in gross debt ratio		4.2	-0.2	-0.8	-1.7	-1.6
Contributions to changes in gross debt						
3. Primary balance		5.2	2.8	0.2	-0.3	-0.6
4. Interest expenditure	EDP D.41	2.7	2.8	2.8	2.7	2.6
5. Stock-flow adjustment		-3.7	-5.8	-3.8	-4.2	-3.6
of which: Differences between cash and accruals		-0.3	-0.2	0.2	0.2	0.0
Net accumulation of financial assets		-1.3	-1.5	0.3	-0.8	-0.4
of which: privatisation proceeds		-0.6	-0.5	-0.3	-0.1	-0.1
valuation effects and other		-2.1	-4.1	-4.3	-3.6	-3.3
p.m.: Implicit interest rate on debt		4.9	5.1	5.1	5.2	5.1
Other relevant variables						
6. Liquid financial assets		3.3	1.7	1.8	1.9	2.0
7. Net financial debt		51.8	53.2	52.3	50.5	48.8

Source*:* Ministry of Finance

The accumulation of net financial assets is a result of various factors, the major ones including: making use of liquid funds of general government units within the consolidation of liquidity management (in 2011), proceeds from privatisation (significant in the years 2011-2012) and the cash balance of European funds budget (negative in 2011-2012 and positive in 2013-2014).

III.6. Budgetary implications of "major structural reforms"

In April 2011 the President of the Republic of Poland signed an act amending the current retirement system. The basic objective of the act is to limit the growth rate of public debt without negative effects on the value of future pensions.

Starting from 1 May 2011, the pension contribution transferred from the Social Insurance Institution (ZUS) to the Open Pension Funds (OFE) will be reduced from the current 7.3%, initially to 2.3%, and from 2017 - to 3.5% of the pension contribution base. The remaining part of the contribution will be transferred to a separate fund managed by ZUS and used to provide financing for current pensions. The contributions will be registered in individual retirement accounts, indexed annually with a moving average based on the 5-year nominal GDP growth indicator. Upon reaching retirement age, the accumulated value of this account, divided by remaining life expectancy will be used to increase the person's individual pension. Individual accounts are inheritable in the same way as existing OFE accounts.

Reimbursement of the contribution transferred to OFE will decrease in 2011 by 0.6% GDP and by an additional 0.5% of GDP in 2012 (that is in total - 1.1% GDP). Including the savings from the lower cost of debt refinancing, the general government balance will improve in 2011 by 0.7% GDP and in 2012 by 1.2% GDP. The impact of this modification in the pension system will be limited in 2013-2014 by the tax relief introduced as part of these changes. Taking into account the deductions that will affect the budget revenues from 2013, the general government balance will improve in the years 2013-2014 by 1.1% GDP. As a result of these changes, the net borrowing needs of the State Treasury will decrease accordingly.

Concluding the pension reform, including the review of the II pillar pension's efficiency, was one of the measures included in the *Plan for the Development and Consolidation of Public Finance 2010-2011,* dated January 2010 and presented in the previous programme update. Within the forecast horizon of the present update other actions outlined in the *Plan* will also be realized, with a positive impact on the general government. This includes a gradual reform of the retirement-pension insurance system for farmers. Currently, the health insurance contributions are financed from the state budget, regardless of the income level of the farmers. The Constitutional Tribunal, in its ruling of October 2010, decided that the provisions concerning health insurance contributions by farmers are unconstitutional and as a consequence should be changed within one year.

Moreover, the government is working on social security reforms for the uniformed services. The *Plan* also announced a significant speed-up of privatisation of companies owned by the State Treasury. In 2010 the proceeds from the privatisation of State Treasury assets exceeded 22 billion PLN. This will continue in subsequent years and substantially reduce the net borrowing needs of the State Treasury. Further reduction in the borrowing needs will be possible thanks to other measures indicated in the *Plan*, which improve the efficiency of liquidity management within the public finance sector.

IV. Sensitivity analysis and comparison with previous update

IV.1. Risk factors

1) Lower absorption of EU funds and other risk factors

The risk of incomplete utilisation of funds from the Polish allocation of structural funds and the Cohesion Fund as well as from the *Rural Development Programme* (RDP) results from an expected accumulation of payments from the current EU multiannual financial framework (2007-2013) in 2011-2013. It is connected with the possibility that the Budget Authorities will not accept the EU budgets for 2012 and 2013 or that they will adopt the annual EU budget at a level, that will be insufficient for implementing the cohesion policy and RDP in Poland (accumulating and prolonging of expenditure pre-financing from the state budget and local government budgets). Another source of this risk is the necessity to ensure availability of public funds for national co- and pre-financing of projects.

Moreover, attention should be paid to the risk (until 2015) associated with the negotiations for another multiannual financial perspective (2014-2020), that may continue until 2013. Determining payment limits which are too low, in particular in the first 2-3 years of next financial period, may call into question the possibility of timely refunds of expenditures from the EU budget according to the principle n+2/n+3, within the current financial framework (refinanced from the state budget and local government budgets).

In addition, the following risk factors may be noted:

- limitations resulting from the requirements of environment protection and NATURA 2000 areas,
- fixed tender criteria for obtaining funds and the significant volumes of documents that are required from the beneficiary,
- long period from the moment of signing the co-financing contract until the final project settlement.

2) Guarantees and other operations

In the next years a concentration of sureties and guarantees granted by the State Treasury on investments facilitating development in road and rail infrastructure, environment protection, workplace creation and regional development is anticipated. Sureties and guarantees will mainly be granted for investments utilizing EU funds (loans and bonds underwritten or guaranteed by the State Treasury should enable the obtaining of EU funds), as well as for other investment tasks arising from potential new support programmes for which sureties and guarantees may be granted according to EU regulations.

The value of new sureties and guarantees granted by the State Treasury in a given year is limited by the budget act. The limit for 2011 was determined at 60 billion PLN. As of the end of 2010, the sum of potential obligations of the State Treasury for sureties and guarantees already granted was about 5% of GDP. For the years 2011-2012 further growth of this sum is predicted, however it should not exceed 10% of GDP.

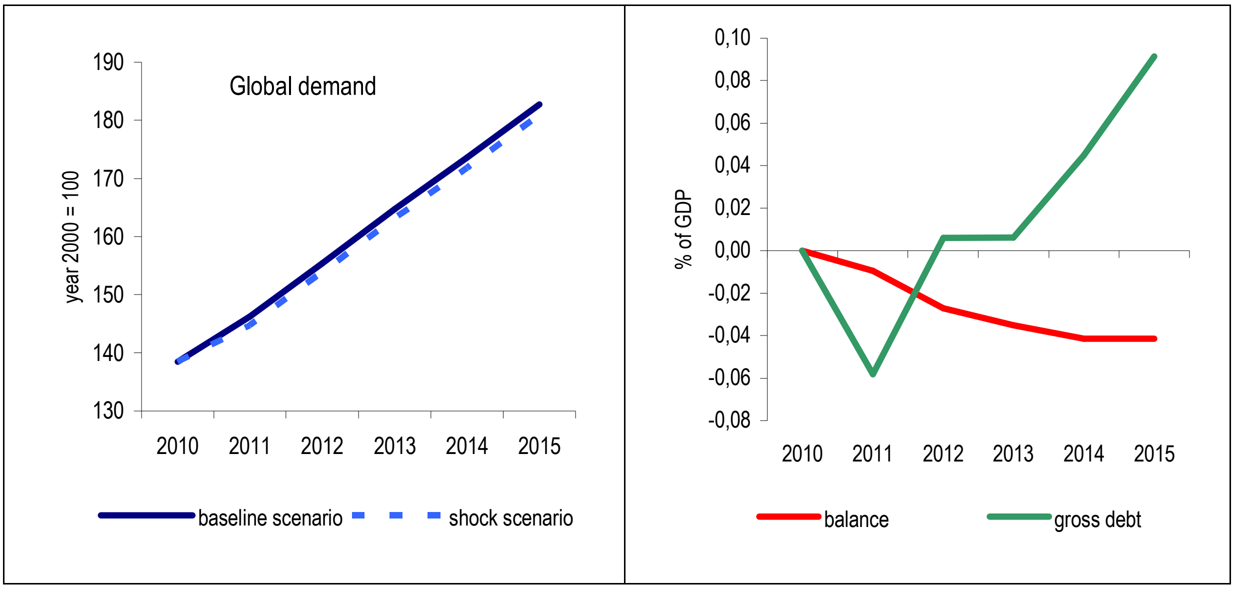
It is predicted that the estimated payments for the sureties and guarantees granted by the State Treasury (that is total potential risk-weighed obligations) shall not exceed 1% of GDP in the next years. Thus, they will be lower than the 1.4% GDP threshold indicated in the *Public Finance Sector Debt Management Strategy in 2011-2014*. The expected risk of the sureties and guarantees portfolio should not increase.

Among other operations which can increase the risk to public finance are public - private partnerships (PPP). In the budget act for 2011, a limit for government administration to draw upon financial liabilities in relation to PPP contracts was set at 1 billion PLN.

3) Sensitivity analysis

The sensitivity of the general government balance and debt in the years 2011-2014 to the decrease in global demand, lower public investments, depreciation of the Polish zloty exchange rate and the increase in the domestic interest rate is presented below. The analysis was made on the basis of the econometric Model of Public Finances (eMPF) developed by the Ministry of Finance. The simulations were conducted assuming no reaction from economic policy, both fiscal and monetary, that is with the monetary rule disabled. Thus the real short-term interest rate does not change against the baseline scenario (except the scenario, where the interest rate impulse is itself analysed).

Chart 2. Global demand (left chart) and its impact on general government balance and gross debt (right chart)



Source*:* Ministry of Finance

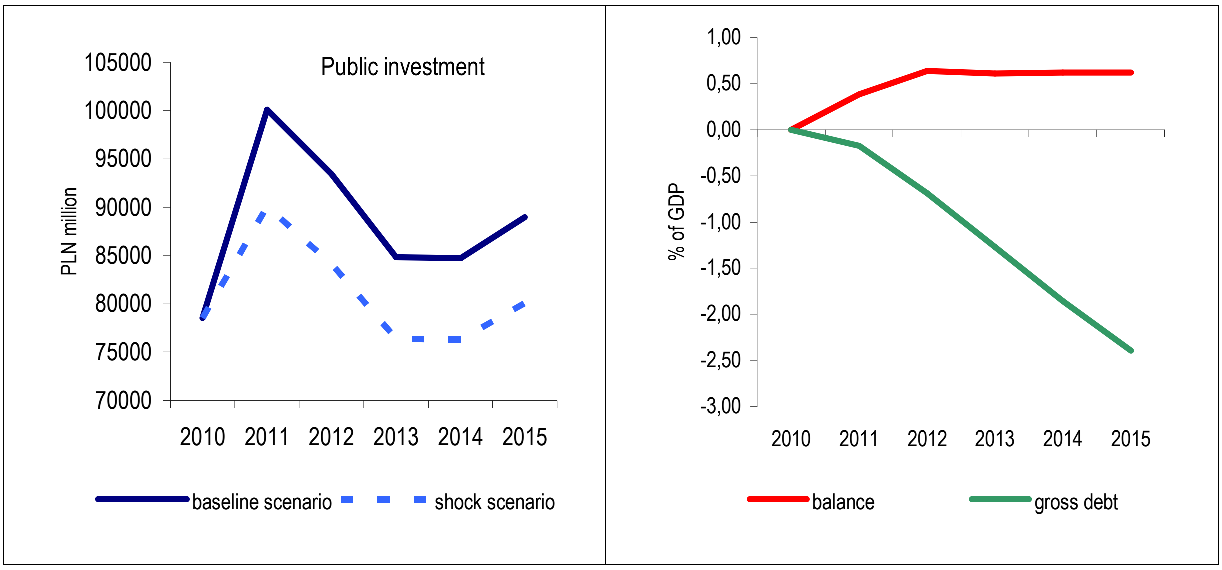
The impulse of the slowdown in global demand has been defined as a permanent 1% decrease in the global demand indicator as compared to the baseline scenario. A direct effect of disturbances in the external environment for the national economy is a reduction in foreign trade. In the short term, the volume of exports drops in the shock scenario by 1.9% against the baseline scenario, and in the longer timeframe it remains permanently lower by about 1.2%. Due to the high import intensity of exports, the drop in the export volume is accompanied by a decline in imports. Immediately after the disturbance, imports decrease by 1.2% and in the long term they remain lower by about 1.0%. The balance of goods and services worsens. Decrease of global demand also translates into the limiting of investment activities of enterprises. Private sector investments, after the temporary decrease of 1.2%, remain lower by 0.2% in the long term against the baseline scenario. Household disposable income also goes down, which limits private consumption - after the temporary decrease of 0.5%, household consumption remains lower by 0.2% in the long term, in comparison to the non-shock scenario. Due to the present labour market rigidity (a fall in production is not followed by a decrease in employment), labour efficiency falls in the initial period after the shock, which translates into a temporary decrease in wages, prices and interest rates.

As a result of these disruptions, GDP decreases in the short term by 0.6% and by the end of the forecast period it stays about 0.2% lower than in the baseline scenario. The annual growth rate of GDP decreases in the short term by 0.7 percentage points, and after ca. 3 years it returns to the previous path, consistent with the baseline scenario.

Lower economic growth negatively affects the country's fiscal position. The general government deficit, after a rise of 0.1% of GDP in the shock-year, returns to the base path in the next year (due to lower interest rates and debt servicing costs), but in the long term remains permanently higher by about 0.1% of GDP. After 4 years, public debt rises by about 0.3% of GDP as compared to the baseline scenario.

No progress in reducing global imbalances remains a significant risk for subsequent perturbations on the global markets. Due to the complexity of the potential shock connected with the above, the scenario presents only the potential outcomes arising from the eventual decrease of demand on the Polish export markets.

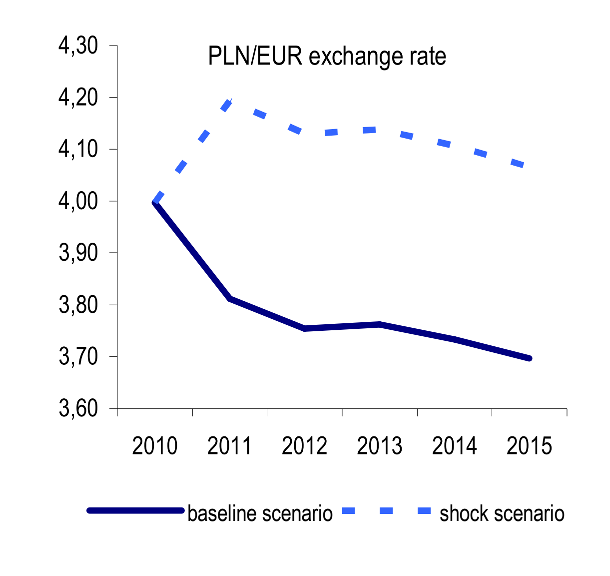
Chart 3. Public investment (left chart) and its impact on general government balance and gross debt (right chart)

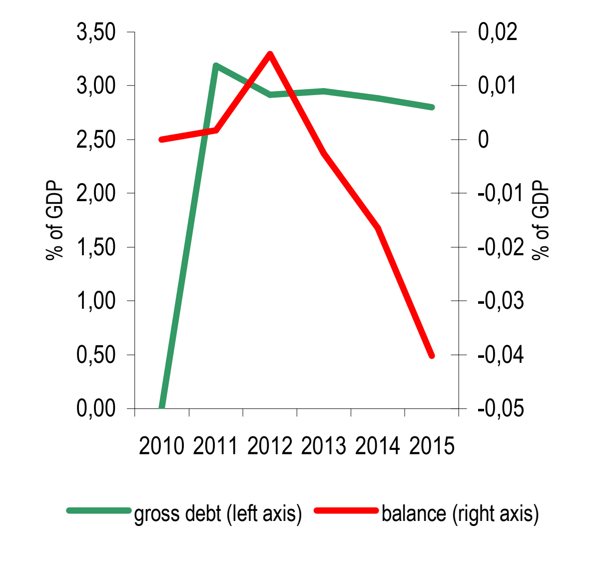


Source: Ministry of Finance

The fiscal impulse has been defined as a permanent reduction in general government investments of 10% as compared to the baseline scenario. The direct effect of a decrease in public expenditures is a reduction of the deficit. Lower expenditures also imply a drop in domestic demand and a slight decrease in imports As a result, the introduced shock leads to a persistent decrease in GDP of ca. 0.4%. The largest decline in the annual GDP growth rate, amounting to 0.4 percentage points, is observed after 4 quarters. In the longer term, the GDP dynamics return to the base path. The general government balance improves in a sustainable way by 0.4% of GDP, which contributes to a decline in general government debt. Due to the short horizon of the shock, the above simulation does not reveal the negative effects of limiting public investment in the form of lower potential GDP.

Chart 4. PLN/EUR exchange rate (left chart) and its impact on general government balance and gross debt (right chart)

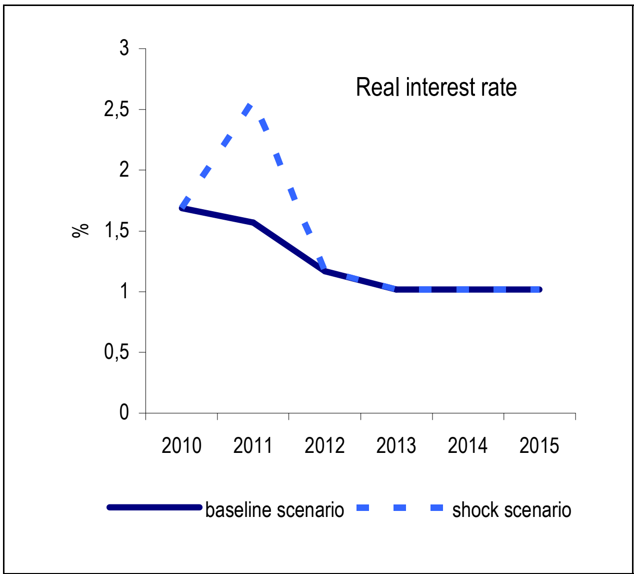


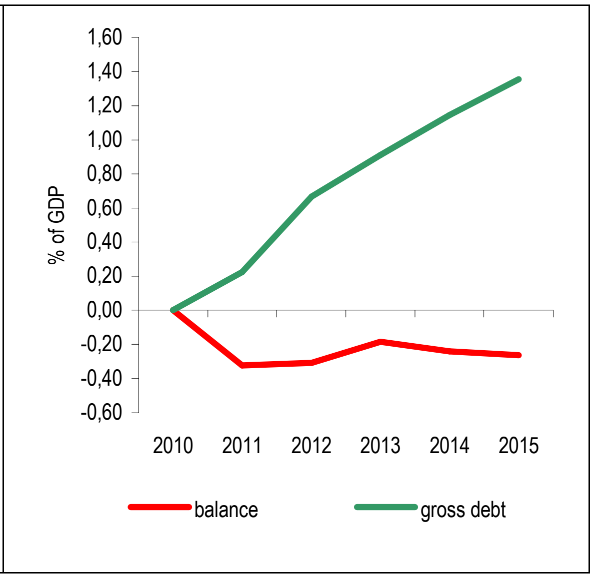


Source: Ministry of Finance

The exchange rate impulse has been introduced as a sustained 15% depreciation of the PLN/EUR exchange rate. The weakening of the Polish zloty improves the price competitiveness of domestic producers, which results in a persistent increase in exports of about 2.5% (immediately after the shock the exports grows temporarily by about 6%), and a decline in imports of about 1.8% compared with the baseline scenario. The strongest influence on increasing the annual growth rate of GDP is observed after 4 quarters; subsequently the dynamics of economic growth return to the base path, with the GDP level higher by about 3.7%. The situation in the labour market also improves, which permanently increases household consumption by about 3.5% in comparison with the baseline scenario. Higher economic growth supports the growth of general government revenue, but conversely the depreciation of the Polish zloty increases debt denominated in foreign currencies. As a consequence, the effect of the exchange rate shock on the deficit in the first quarters remains ambiguous. Still, an accumulation of positive factors results in a permanent improvement of the general government balance 2 years after the shock. Within the simulation horizon, the general government debt decreases by almost 1.4% GDP.

Chart 5. Real interest rate (left chart) and its impact on general government balance and gross debt (right chart)





Source*:* Ministry of Finance

The interest rate impulse has been defined as a transitory increase in the real short-term interest rate of 1 percentage point for a period of four quarters. A rise in short-term interest rates results in an increase in long-term interest rates and consequently leads to a higher cost of obtaining capital and lower investments (private investments decrease permanently by 2% against the baseline scenario) and higher debt financing costs. Due to a shift in consumption over time under the inter-temporal substitution, private consumption is also slightly lower. Higher domestic interest rates support the strengthening of the Polish zloty, which - contrary to the previously described effects of the Polish zloty's depreciation - leads to a decrease in GDP due to a drop in price competitiveness of domestic producers. As a result, the monetary impulse leads to a permanent decrease in GDP volume of about 0.6%. 5 quarters later, the annual GDP growth rate is lower by about 0.3 percentage points against the baseline scenario and then returns to the original path. As for the general government balance, after a temporary worsening of about 0.5% of GDP, in the long term it remains lower by ca. 0.2% of GDP (higher deficit) than in the baseline scenario. The permanently higher deficit leads to an increase in the general government debt.

IV.2. Comparison with previous update

Compared with the previous Convergence programme update, the predicted path of real GDP growth has been lowered. The causes of this change include: better than expected GDP growth in 2010 in Poland as well as among our main trading partners, which has an influence on a relative worsening of the GDP growth rate in 2011 (statistical base effect). The composition of economic growth in Poland last year also indicates that recovery of private investments will take place later than was expected in the previous update. The changes to the economic growth prognosis were also influenced by the changes to the fiscal consolidation path and the size of this tightening in specific years.

Changes to the predicted fiscal path arise mostly from actions that have already been taken and others planned by the government (in particular regarding expenditure) to limit the structural general government deficit. The deficit decrease will also be supported by an acceleration of economic growth and the termination of negative effects of the financial crisis, especially revenues from income tax and social insurance contributions.

The differences in the forecast government debt in 2011-12, as compared with the forecast from the previous update, arise mostly from a significant deficit reduction in 2011. The changed fiscal path associated with the implementation of measures described in chapter III.2 will result in a lower debt-to-GDP ratio as early as from 2011. A lower forecast nominal GDP growth than in the previous update, as well as a lesser appreciation trend of the Polish zloty are factors limiting the size of the debt ratio reduction.

Table 5. Divergence from previous update

	ESA Code	2010	2011	2012	2013	2014
Real GDP growth (%)						
Previous update		3.0	4.5	4.2	-	-
Current update		**3.8**	**4.0**	**4.0**	**3.7**	**3.9**
Difference		0.8	-0.5	-0.2	-	-
General government balance (% of GDP)	EDP B.9					
Previous update		-6.9	-5.9	-2.9	-	-
Current update		**-7.9**	**-5.6**	**-2.9**	**-2.5**	**-2.0**
Difference		-1.0	0.3	0.0	-	-
General government gross debt (% of GDP)						
Previous update		53.1	56.3	55.8	-	-
Current update		**55.1**	**54.9**	**54.1**	**52.4**	**50.8**
Difference		2.0	-1.4	-1.7	-	-

Source*:* Ministry of Finance, Central Statistical Office

V. Long-term sustainability of public finances

The projections presented in table No. 6 for the long-term sustainability of public finances were prepared by the Economic Policy Committee (EPC) Ageing Working Group (AWG). The results of the AWG projections to the year 2060 were published by the European Commission in 2009 in the report on the effects of population ageing .

The projections were based on the demographic assumptions prepared by Eurostat in 2008 and the extrapolation of historic trends as well as the technical assumptions on the convergence of basic economic growth factors, that is labour, capital and work efficiency. The calculations take into account the legal situation as of July 2008, and include the effects of the reform which is most significant to the sustainability of public finances, that is the reform of the pension system, which was introduced on 1 January 1999. The main component of this reform was the replacement of the defined benefit system by a defined contribution one, which led to a reduction of the risk of long-term pension system insolvency by adapting it to demographic and social-economic changes.

Changes introduced subsequently are listed below.

1) Introduction of bridging arrangements

Bridging arrangements are intended to be a transitional solution and to replace early retirement.

Bridging pensions are financed from a separate fund and are associated with additional contributions paid by the employers. Introduction of this type of benefits will lead to an initial increase in expenditures, but over time, these are expected to decrease along with expiration of these rights. Apart from direct savings for retirement expenditure, another important outcome of this reform is that the significant reduction of entitlements to early retirement should contribute to increased economic activity, in particular for older persons. This in turn, by increasing labour supply should have positive long term impact on economic growth. As a result, the significant reductions of entitlements to early retirements should - through increasing long-term economic growth - influence the long-term condition of public finances.

2) Introduction of compensation allowance for teachers

The compensation allowance replaces early retirement benefits for teachers and is financed from the State budget. As with bridging pensions, these allowances are a temporary solution and have no significant impact on the long-term sustainability of public finances.

3) Launch of the Demographic Reserve Fund

Polish society is systematically ageing. This is indicated by the increasing share of the population in the 60+/65+ age group. Currently, pensions are being paid to the so-called baby boomers. For demographic reasons and given the need to ensure payments of benefits from the pension fund, the Council of Ministers may order by decree, the launch of the Demographic Reserve Fund (DRF) to supplement the pension fund. Moreover, as a consequence of the ruling of the Constitutional Tribunal, it became necessary to equalize retirement ages of men to that of women. This privilege was applied to men born between 1944 -1948 and as a consequence led to a significant increase in the number of persons retiring in 2008[8].

In line with Art.112 of the Act on the social insurance system, the launch of the Demographic Reserve Fund could take place no earlier than 2009, but in in fact it was launched in 2010. Resources which were transferred to the Social Insurance Fund (SIF) amounted to PLN 7.5 billion, i.e. about 0.53% of GDP. In the State Budget Act for 2011 the amount transferred from the Demographic Reserve Fund is planned to be at a level of PLN 4 billion, which represents 0.27% of GDP. This means that in 2010 and 2011 there was a deficit in DRF resources. On the other hand, in 2009 the rules governing supply of the DRF with funds from privatisation were also changed. In line with the Act on the social insurance system, 40% of the revenues from the total gross amount of funds transferred from privatisation of State Treasury property, less the amounts of compulsory contributions to the special fund,

[8] According to data from the Social Security Fund (ZUS), in 2008, early retirement pensions (i.e. prior to reaching 65 years - the statutory retirement age) were granted to 176 thousand men, while in 2007 this was 51 thousand men. In 2009 early retirement pensions were granted to 88 thousand men.

referred to in art 56, paragraph 1, item 1 of the Act on Commercialization and Privatisation is allocated to DRF. As a result of these changes the DRF assets actually increased.

4) Modifications to the retirement system

In April 2011 the President of the Republic of Poland signed an act amending the current retirement system. The change will limit the transition costs of the retirement reform without deterioration of the long-term sustainability of public finances. Taking a long-term perspective and compared with the no-policy-change scenario (estimated in the FUS09 model[9] with updated macroeconomic assumptions[10]), annual revenues of the pension fund by 2060 will be higher by about 0.9% GDP. Due to the defined contribution formula, this will also increase pension expenditure: initially only marginally, but by 2060 - by about 0.7% GDP. As a result, by 2060 these changes will have permanently improved the pension fund balance.

To reflect this change it is necessary to update measures of long-term sustainability of public finances provided in table 6. This concerns the macroeconomic and demographic assumptions, as well as the estimates in the specific expenditure categories. In the new estimate, current macroeconomic trends and the influence of the structural reforms on long-term expenditure and economic growth must be taken into account.

The current data indicates that the influence of a significant reduction of early retirement benefits on the participation rate had been severely underestimated. In the assumptions of the AWG projection it was assumed that in 2008-2010 the participation rate for the population, aged 55-64 will increase by only 0.9 percentage points, whereas in reality it grew by as much as 4.6 percentage points. Faster growth of the participation rate will result, over the span of the prognosis, in higher contributions of the labour factor to the growth of potential GDP than in the baseline AWG scenario.

Moreover, taking into account the objectives adopted in government documents regarding the trend of the employment rate up to 2030[11], an even more favourable situation on the labour market for the long-term sustainability of public finances can be expected than that which arises from assumptions prepared by AWG.

Table 6. Long-term sustainability of public finances (% of GDP)

% of GDP	2000	2007	2015	2020	2030	2060
Total expenditure						
Of which: age-related expenditures		20.5	19.1	17.6	17.8	18.1
Pension expenditure	13.2	11.6	9.6	9.7	9.4	8.8
Social security pension	13.2	11.6	9.6	9.7	9.4	8.8
Old-age and early pensions	10.3	9.8	8.4	8.7	8.4	7.9
Other pensions (disability, survivors)	2.9	1.7	1.2	1.0	1.0	0.9
Changes in inventories and net acquisition of valuables (% of GDP)						
Health care*		4.0	4.3	4.4	4.6	5.0
Long-term care*		0.4	0.4	0.5	0.6	1.1
Education expenditure		4.4	3.3	3.2	3.2	3.2
Other age-related expenditures						
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0
Total revenue						
Of which: property income						
Pension contributions	7.9	6.9	5.6	5.4	5.1	5.1
Demographic Reserve Fund	0.0	0.3	0.4	0.4	0.4	0.8
Retirement benefits reserves not included in the						

[9] FUS model - actuary model used by ZUS and used i.e. in AWG projections at the EU Economic Policy Commission.
[10] Macroeconomic assumptions adopted in this scenario differ from the assumptions used in the AWG prognosis.
[11] *National Reform Programme* for the implementation of the *Europe 2020 strategy*; *Poland 2030. Development challenge*.

% of GDP	2000	2007	2015	2020	2030	2060
government assets						
Assumptions						
Labour productivity growth**		3.0	3.4	3.1	2.7	1.7
Real GDP growth		5.9	3.1	2.5	2.0	0.5
Participation rate males (aged 20-64)	79.3	77.4	76.8	76.9	78.6	77.1
Participation rates females (aged 20-64)	66.0	62.2	63.0	64.3	67.1	65.6
Total participation rates (aged 20-64)	72.5	69.7	69.8	70.5	72.8	71.4
Unemployment rate (aged 15-64)	16.1	9.8	5.9	5.9	5.9	5.9
Population aged 65+ over total population		13.4	15.3	18.2	23.0	36.2
Mandatory funded scheme						
Old-age expenditure	0.0	0.0	0.0	0.1	0.2	1.9
Contributions	1.2	1.3	1.7	1.8	1.8	1.9

** AWG reference scenario.*

**per hour

VI. Quality of public finance

VI.1. Strategy

Many actions taken by the government to improve the fiscal framework within which fiscal policy is conducted are inter-related with the introduction of new regulations and solutions under the Public Finance Act, as well as with other planned activities, including the institutional changes described in chapter VII.

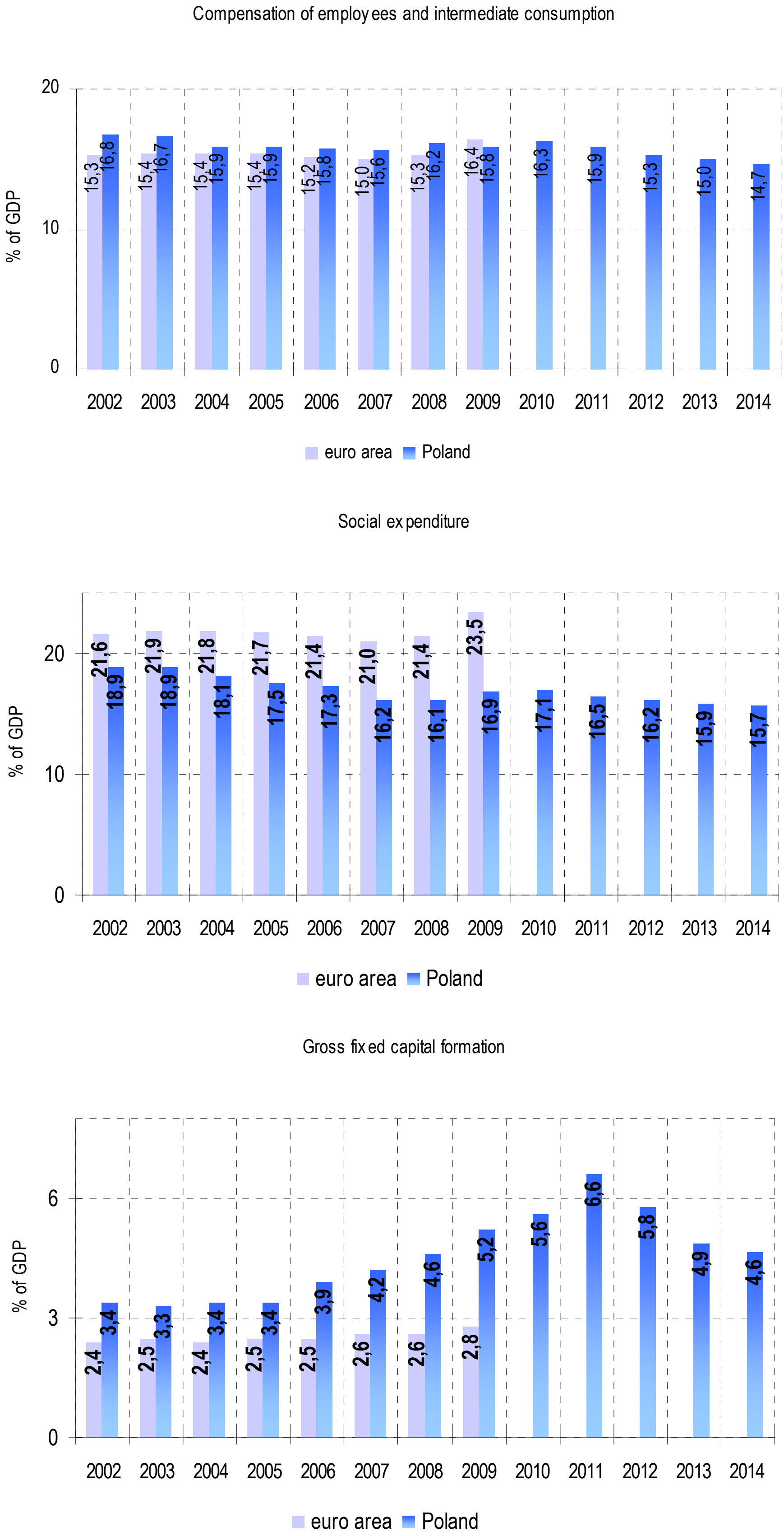
VI.2. Composition, efficiency and effectiveness of expenditure

It is estimated that the general government expenditure to GDP ratio will decrease from 45.8% in 2010 to 41.2% in 2014. Actions to consolidate, rationalise and increase flexibility of expenditure, as well as the size of infrastructure expenditure will all affect the level and the structure of expenditure. The government has been working on proposals for rationalising the expenditure of general government units, i.a. expenditure reviews. Its conclusions will contribute to an increase in efficiency and improvement of the legitimacy of spending budgetary funds, and the process itself is unprecedented in the history of Polish public finances as an example of an internal audit conducted on such a large scale.

Decrease of public expenditure to GDP ratio and the changes to the structure of such expenditure will also be an outcome of the temporary expenditure rule, distinguishing between discretionary expenditure and the new, legally mandated (fixed) expenditure. Reduction of expenditure will also be enhanced by the obligation for certain sector units to locate their free funds as a deposit at the Ministry of Finance, which will significantly decrease the costs of management of current liquidity of the sector and will decrease the borrowing needs of the State Treasury.

A planned reduction of employment in public administration will be conducive to limiting the growth of wages in general government. Rationalisation of employment should contribute to an increase in efficiency and effectiveness of public administration as well as providing a better quality of public service.

Chart 6. Selected categories of expenditure in Poland and the euro area (% of GDP)



Source: Eurostat, Ministry of Finance

Table 7. General government expenditure by function (COFOG, % of GDP)

	COFOG Code	2009	2014
1. General public services	1	5.8	5.2
2. Defence	2	1.1	1.0
3. Public order and safety	3	2.0	1.8
4. Economic affairs	4	5.3	4.8
5. Environmental protection	5	0.7	0.6
6. Housing and community amenities	6	1.2	1.1
7. Health	7	5.1	4.9
8. Recreation, culture and religion	8	1.3	1.2
9. Education	9	5.6	5.3
10. Social protection	10	16.5	15.3
Total expenditure		**44.5**	**41.2**

Source*:* Ministry of Finance, Central Statistical Office

The forecast expenditure-to-GDP ratio in 2014 is 3.3 percentage points lower than in 2009. The largest decrease of expenditure by function is expected to be in social protection (over 1 percentage point). It arises from i.a. a significant reduction of privileges which entitle earlier retirement, which results in limiting expenditure for this purpose, decreasing expenditure on some less effective forms of counteracting unemployment and the reduction of funeral benefits. In comparison with the 2009-2011 period, which saw an unprecedented increase in public expenditure on fixed assets as a result of inflow of EU funds and the preparations for EURO 2012, a decrease in public investments is expected in 2012-2014. This in turn will lead to a considerable decrease in expenditure by functions with a large share of investment, e.g. in economic affairs (0.5 percentage points).

VI.3. Structure and efficiency of revenue systems

The revenues of general government reached a level of 37.9% GDP in 2010, and it is predicted that this ratio will rise to 40.1% GDP in 2011 and 40.7% in 2012. In subsequent years this ratio should decrease gradually to achieve a level of 39.2% GDP in 2014.

Next to the changes in the taxation system described in section III.2., other changes were introduced, which have a lesser influence on general government revenues, yet are still significant in terms of the quality of the revenue system.

For the goods and services tax in 2011, the annual turnover limit allowing VAT relief for tax payers was increased from 100 thousand to 150 thousand PLN. The aim of this change is to facilitate running business activity for lower turnover tax payers, as it significantly reduces their administrative burden. There are changes to the calculation and settlement system for goods and services tax in the turnover of renewable resources such as scrap metal and entitlements for greenhouse gase emissions. The proposed mechanism of reverse charging for these industries, requires the tax to be settled by the purchaser not by the supplier, which will reduce the scope for abuse. Lawyers and doctors running their own practice are now obliged to use cash registers. This change is consistent with the principle of limiting the grey zone by increased registration of economic turnover .

In 2013, legal regulations enabling the use of simplified invoices for goods and services tax will be implemented. These regulations shall take into account the changes to the Council directive on a common system of the value added tax as regards the rules on invoicing.

By the Act of 24 September 2010 on amending the Tax Statute and the Act on recording and identification principles of taxpayers changes to *the Tax Statute Act* were introduced, aimed at:

- simplifying the "pre-measure" security procedure and an increase in efficiency of security institutions,

- maintaining the relevant ratio between the turnover loans and delayed payment interest rates for overdue tax. This will be be done by increasing the delayed payment interest rate, which should encourage taxpayers to pay public receivables when due. The delayed payment interest rate determined according to the new principles will be 200% of the basic lombard interest rate plus 2%, but may not be lower than 8%,
- increasing the frequency of submission to the Minister of Finance of information about opened and closed bank accounts connected with business activities, by banks and cooperative savings societies & loan funds. This will allow for more efficient use of information by taxation bodies and will improve tax collection.

The majority of the changes were introduced on 09 November 2010, while the remainder will be introduced on August 1, 2011.

To further consolidate public finances rationalization though efficiency analysis of various taxation solutions is necessary. In 2010, the Ministry of Finance published a report on preferential taxation in Poland[12]. The objective of this undertaking was to identify and to present the value of the reliefs and deductions functioning in the taxation system. 473 areas of preferential taxation were identified within the tax area investigated. The global value of these was estimated to be 65.9 billion PLN, that is 4.9 % GDP. Detailed results will be used during the budget debate over the allocation of public resources and thus contribute to their better use.

The main activities of taxation policy will be focused on improving efficiency, simplifying and increasing transparency of the taxation system and making it more tight, including by counteracting international tax evasion. The changes to the taxation system planned for 2011-2014 will in particular address issues regulated in the Tax Statute Act, and will facilitate the realization of tax obligations through:

- development of electronic forms of contact with the taxation administration,
- issuing individual and general interpretations of tax law provisions - introduction of changes, which will describe in detail and clarify the mode of issuing such interpretations, is planned.

VII. Institutional features of public finances

VII.1. Introduction

A domestic fiscal framework (DFF) can be defined as a country-specific institutional environment, shaping fiscal policy making at national level. The DFF comprises in particular (numerical) fiscal rules and the budget process (procedures governing the preparation, approval and implementation of budget plans), including the medium-term budgetary framework.

DFF should ensure that the main objectives of a well-functioning public finance management system are met, in particular it should ensure long-term sustainability of public finances and be conducive to macroeconomic stability, also in the short term[13]. DFF should also promote compliance with the obligations arising from the provisions of the *Treaty on the functioning of the EU* and *the Stability and Growth Pact*.

VII.2. Fiscal rules

The basic objective of (numerical) fiscal rules is to ensure fiscal and macroeconomic stability, as well as maintaining the size of the general government at a given level. The domestic fiscal framework in Poland is based on certain rules. The most important of these is the debt rule, included in two legal acts - *Constitution of the Republic of Poland* and *the Public Finance Act,* whose main objective is to constrain state public debt (calculated according to the Polish methodology) to certain defined limits.

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[12] The *Taxation preferential treatment in Poland* report is available on the Ministry of Finance website: http://www.mf.gov.pl/_files_/podatki/system podatkowy/raport/raport_nt_preferencji podatkowych_w_polsce_wersja_polska.pdf

[13] Other, equally important objectives cover: strengthening allocation of public resources (budgetary resources), improving the efficiency of public expenditure, ensuring optimum management of financial flow within public finances, ensuring a suitable level of budget transparency.

Rules limiting the financial policy of local governments are similar and are also included in the Public Finance Act. They set an upper limit to the debt level (in relation to revenues) and an upper limit to debt servicing in the year, but shall cease to be binding in 2014. An additional rule imposed on local governments is the obligation to balance the current budget, and as of 2014 individual limits for incurring debt for local governments shall be implemented. Currently, work is being finalized on regulations which will define the relation of local governments' deficit to revenues .

The new rule, binding as of 2011, is the temporary expenditure rule. It limits the growth rate of discretionary and new legally mandated expenditure, which shall also cover current legally mandated expenditure, if the act defining them is modified. Any draft act resulting in a rise of this expenditure will require the inclusion of the total amount of discretionary expenditure and the new legally mandated expenditure, and which may not rise by more than 1% annually in real terms. The temporary expenditure rule shall be binding until the Ecofin Council abrogates the excessive deficit procedure for Poland.

Despite their many advantages, the two main Polish fiscal rules also have some disadvantages. In particular, even though the debt limits encourage improvements in budgetary discipline, they may have an adverse effect on the stabilisation function of fiscal policy. Reduction of the budget deficit to prevent exceeding debt limits may occur in a situation of sudden worsening of economic conditions, which means that it will have a pro-cyclical character, additionally strengthening the negative economic trends. However, the most serious disadvantage of the temporary expenditure rule is that it has limited scope of application to general government entities subject to this rule, which means that it may only partially mitigate the problem of excessive growth of expenditure "in good times", which is the main reason for the growth of imbalances of public finance in most countries.

Despite those limitations, Polish fiscal rules are ranked relatively high in the EU countries, which is reflected in the fiscal rule indices published by the European Commission (chart 7)[14]. The "quality" verifying factor for the rules is the final budgetary outcome, measured by the balance and the debt level (comparing the index of rules and outcomes of the general government throughout 2008 - see the chart below). Since the mid-90s of the twentieth century, the general government deficit in Poland was, on average, maintained at a level of 4.5% GDP, and its temporary limitation was the result of good economic situations and more rarely of consolidation measures. Even at the time of the biggest economic boom, the balance of general government was not restored, meaning that the structural deficit in the period analysed remained distinctly higher than the medium-term budgetary objective (MTO), which is -1.0% GDP for Poland. The relatively high value of the fiscal rule index for Poland did not translate as a consequence into a good budgetary outcome.

Due to the prior weaknesses of the domestic fiscal framework, the government introduced new regulations, including the temporary expenditure rule (see section III.2). What is even more important, introduction of additional solutions is planned, in particular the new permanent fiscal rule, which shall be binding also at the time, when Poland shall not be subject to the excessive deficit procedure. This rule is to ensure, after the previous deficit reduction, that the general government balance is on average stable at the MTO level over the cycle. Simultaneously, through creating an appropriate fiscal space, it will allow the mitigation of cyclical variations in the economy. At the operational level, this will take the form of an expenditure rule, imposing relevant limitations on the growth of public expenditure, ensuring in particular that the participation of expenditure in GDP will not keep growing. Currently, work is underway on determining a stabilizing formula for the expenditure rule. Its final form will guarantee compliance with the obligations arising from the provisions of *the Treaty on the functioning* of the EU and *the Stability and Growth Pact*.

In order to ensure the credibility of the permanent expenditure rule, it must be backed by strong legal instruments, i.e. an Act of Law. This rule should cover the general government to the greatest possible extent. The local government sub-sector and grants from EU funds may be exempt from this rule. Prior to determining the final parameters of the rule, it would be desirable to provide the local government sub-sector with separate regulations, which will work to stabilize the balance of this sub-sector in relation to GDP at a suitably low level.

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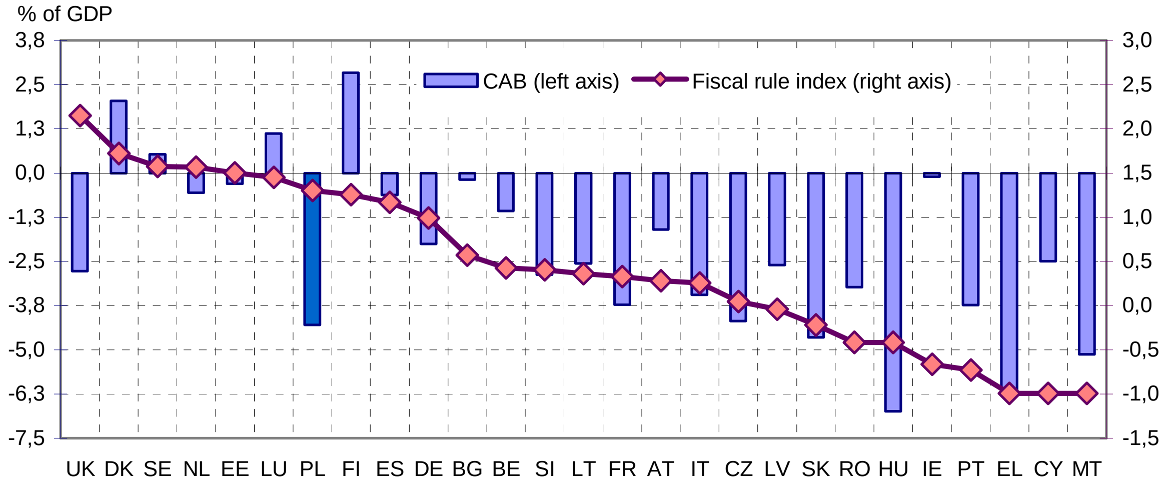
[14] The fiscal rule indices are based on information covering the period to 2008. In the case of Poland, this index does not contain information about the local governments' rules and the temporary expenditure rule, which has only been in force as of 2011.

Chart 7. Fiscal rule index and the level of the cyclically-adjusted general government balance (average for 2000-2008)



Source: AMECO, European Commission, and Ministry of Finances' own calculations.

VII.3. Budgetary procedure

For the efficient implementation of the permanent expenditure rule, aimed at ensuring the long-term sustainability of public finances, a key factor is the quality of DFF, including the budgetary and reporting process. Among the planned changes to the budgetary process, one should highlight:

- increasing the role of *top-down budgeting*,
- concluding the process of limiting the legal-organisational forms of the general government units,
- preparing the new (or at least modifying the current) budgetary classification (towards increasing its economic capacity),
- making reporting uniform within the sector,
- defining (for the purpose of the expenditure rule) the scope of the sector in a way, which is in line with the EU ESA classification,
- improvements in the medium-term budgetary framework.

Implementation of the new solution by accepting the obligation to issue MYSFP is a step in right direction for improving the medium-term budgetary framework. MYSFP is a four year plan for revenues and expenditures as well as usage and resources of the state budget. At the same time, further actions in this area are required, in particular through a stronger focus of MYSFP on the situation of the whole sector, not only concentrating on the state budget.

An important element of the planned changes is the implementation of an annual spending review, initially limited to state budget expenditure, later to be extended to other general government units. The enhancements in budgetary discipline will also be supported by actions aimed at verifying the legitimacy and objectives of the spending requirements at the budget planning stage as well as their conformity with the relevant law on public finance management. In addition, the intention of the current initiatives is to improve the efficiency of management and expenditure of public funds as well as to increase the credibility and transparency of public finance.

Annex

Table 8. Macroeconomic prospects

	ESA Code	2010 Level	2010 rate of change	2011 rate of change	2012 rate of change	2013 rate of change	2014 rate of change
1. Real GDP* (PLN billion)	B1*g	1 237.4	3.8	4.0	4.0	3.7	3.9
2. Nominal GDP (PLN billion)	B1*g	1 412.8	5.1	7.4	6.7	6.2	6.4
Components of real GDP*							
3. Private consumption expenditure	P.3	764.4	3.2	3.2	3.9	3.6	3.8
4. Government consumption expenditure	P.3	221.6	3.5	2.2	0.2	1.8	1.9
5. Gross fixed capital formation	P.51	257.2	-2.0	9.9	7.1	4.5	5.1
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	12.1	1.0	1.1	1.2	1.2	1.2
7. Exports of goods and services	P.6	501.6	10.2	8.5	8.5	8.0	7.1
8. Imports of goods and services	P.7	519.6	10.7	9.5	8.5	7.4	6.7
Contributions to real GDP growth							
9. Final domestic demand		-	4.0	4.6	4.1	3.6	3.8
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	1.9	0.2	0.1	0.0	0.0
11. External balance of goods and services	B.11	-	-0.3	-0.6	-0.2	0.1	0.0

* In 2005 prices.

Table 9. Price developments

	ESA Code	2010 Level	2010 rate of change	2011 rate of change	2012 rate of change	2013 rate of change	2014 rate of change
1. GDP deflator		-	1.3	3.3	2.6	2.5	2.5
2. Private consumption deflator		-	2.7	3.5	2.8	2.5	2.5
3. HICP		-	2.7	3.5	2.8	2.5	2.5
4 Public consumption deflator		-	3.0	3.5	2.8	2.5	2.5
5.Investment deflator		-	-1.2	3.0	2.5	2.4	2.4
6. Export price deflator (goods and services		-	0.4	2.4	2.0	2.0	2.0
7. Import price deflator (goods and services		-	2.1	2.6	2.1	2.0	2.0

Table 10. Labour market developments

	ESA Code	2010 Level	2010 rate of change	2011 rate of change	2012 rate of change	2013 rate of change	2014 rate of change
1. Employment (in thousands of persons)*		15 961	0.6	1.6	1.2	0.7	0.4
2. Unemployment rate (%)**		9.7	9.7	9.4	8.8	8.5	8.4
3. Labour productivity (PLN thousand)***		88.5	3.2	2.3	2.8	3.0	3.4
4. Compensation of employees (PLN billion)	D.1	523.6	6.2	8.5	7.1	6.5	6.6
5. Compensation per employee (PLN thousand)		42.5	5.6	6.8	5.8	5.7	6.1

* Average employment based on LFS (aged 15 and older).

** Harmonised definition, Eurostat; levels.

*** Real GDP per person employed.

Table 11. Sectoral balances (% PKB)

	ESA Code	2010	2011	2012	2013	2014
1. Net lending / borrowing vis-à-vis the rest of the world *	B.9	1.4	1.3	1.1	1.4	1.8
of which: - Balance on goods and services		0.9	1.3	1.5	1.2	1.0
- Balance of primary incomes and transfers		2.4	2.1	2.2	2.2	2.4
- Capital account		-1.9	-2.1	-2.5	-2.0	-1.7
2. Net lending/borrowing of the private sector	B.9	6.5	4.3	1.8	1.1	0.2
3. Net lending/borrowing of general government	EDP B.9	-7.9	-5.6	-2.9	-2.5	-2.0
4. Statistical discrepancy		-	-	-	-	-

* NBP, Balance of payments data; „+” denotes negative balance.

Table 12. Basic assumptions

	2010	2011	2012	2013	2014
Short-term interest rate (annual average)*	3.5	4.0	4.7	4.6	4.5
Long-term interest rate (annual average)	5.8	6.3	6.4	6.3	6.2
Nominal effective exchange rate	-6.6	-3.7	-4.0	-3.5	-2.1
Exchange rate vis-à-vis the € (annual average)	3.99	3.87	3.69	3.55	3.47
World GDP growth**	5.6	4.6	4.7	–	–
EU GDP growth	1.8	1.8	2.1	2.1	2.1
Growth of relevant foreign markets ***	9.0	6.1	6.3	6.3	5.7
World import volumes**	13.0	8.3	7.9	–	–
Oil prices (Brent, USD/barrel) **	80.2	112.8	112.0	–	–

* NBP reference rate.

** Source: EC, *Common external assumptions*, April 2011. World GDP and world import excluding EU.

*** EU imports taken as foreign markets indicator.

Table 13. General government

	ESA Code	2010 PLN billion	2010 % of GDP	2011 % of GDP	2012 % of GDP	2013 % of GDP	2014 % of GDP
Net lending (EDP B9) by sub-sector							
1. General government	S.13	**-111.2**	**-7.9**	**-5.6**	**-2.9**	**-2.5**	**-2.0**
2. Central government	S.1311	-83.9	-5.9	-4.4	-2.7	-2.5	-2.2
3. State government	S.1312						
4. Local government	S.1313	-16.1	-1.1	-0.8	-0.4	-0.3	-0.2
5. Social security funds	S.1314	-11.2	-0.8	-0.4	0.2	0.3	0.4
General government							
6. Total revenue	TR	535.7	37.9	40.1	40.7	39.7	39.2
7. Total expenditure	TE	646.9	45.8	45.7	43.7	42.2	41.2
8. Net lending/borrowing	EDPB.9	-111.2	-7.9	-5.6	-2.9	-2.5	-2.0
9. Interest expenditure	EDP D.41	38.0	2.7	2.8	2.8	2.7	2.6
10. Primary balance		-73.1	-5.2	-2.8	-0.2	0.3	0.6
11. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes		289.6	20.5	21.2	21.7	21.9	21.7
12a. Taxes on production and imports	D.2	191.1	13.5	13.9	14.1	13.9	13.4
12b. Current taxes on income, wealth, etc	D.5	98.2	7.0	7.3	7.6	8.0	8.3
12c. Capital taxes	D.91	0.3	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	157.5	11.1	11.9	12.5	12.5	12.5
14. Property income	D.4	15.0	1.1	0.9	0.9	0.8	0.7
15. Other		73.6	5.2	6.2	5.7	4.5	4.2
16. Total revenue	TR	535.7	37.9	40.1	40.7	39.7	39.2
Tax burden		445.7	31.5	33.0	34.1	34.3	34.1
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D1+P2	229.7	16.3	15.9	15.3	15.0	14.7
17a. Compensation of employees	D.1	142.3	10.1	9.8	9.4	9.2	9.0
17b. Intermediate consumption	P.2	87.4	6.2	6.1	5.9	5.8	5.7
18. Social payments		241.2	17.1	16.5	16.2	15.9	15.7
18a. Social transfers in kind supplied via market producers	D.6311 D.63121 D.63131	30.9	2.2	2.2	2.2	2.2	2.2
18b. Social transfers other than in kind	D.62	210.2	14.9	14.3	13.9	13.7	13.5
19. Interest expenditure	EDP D.41	38.0	2.7	2.8	2.8	2.7	2.6
20. Subsidies	D.3	7.1	0.5	0.5	0.5	0.5	0.5
21. Gross fixed capital formation	P.51	78.8	5.6	6.6	5.8	4.9	4.6
22. Other		52.1	3.7	3.4	3.2	3.2	3.1
23. Total expenditure	TE	646.9	45.8	45.7	43.7	42.2	41.2
Government consumption (nominal)	P.3	266.2	18.8	18.5	17.9	17.6	17.3