



REPUBLIC OF POLAND

CONVERGENCE PROGRAMME
2004 UPDATE

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INTRODUCTION

1. As a new Member State of the European Union Poland submitted in May 2004 its Convergence Programme, which presents a three-year perspective of economic development aiming at real convergence with the European Union. The programme was examined by the Ecofin Council which recommended the Polish authorities to correct the excessive deficit in accordance with the path presented in the Convergence Programme.
2. The update and the Convergence Programme cover the same period, i.e. the years 2004-07.
3. Main differences between macroeconomic forecast presented in the Convergence Programme and its update are the outcome of faster than projected development of the Polish economy in 2004. It entailed a slight revision of macroeconomic forecast for the oncoming years. However, average GDP growth in the update period remains unchanged and amounts to 5.3%.
4. The quality of data on revenues and expenditure of the general government was significantly improved as compared with the Convergence Programme. It was an outcome of activities of the Interinstitutional Group for the Statistics of the General Government, established in June by the Central Statistical Office responsible for interpretation of ESA 95. The group comprises representatives of the Central Statistical Office, the Ministry of Finance and the National Bank of Poland. As a result of continued activities of the group, the quality of presented data is expected to be further improved. It means that currently presented data may be subject to small revisions.
5. The biggest discrepancies between May data and the present one relate to total revenues and expenditure of the general government and result from the full consolidation of some transfers within the sector (the changes had no impact on the general government balance).
6. A forecast path of the general government deficit changed marginally. The main difference between the May forecast and the present one refers to the year 2007. It is namely expected that precautionary procedures contained in the Public Finance Act (which come into force should public debt – according to the Polish methodology - exceed 55% of GDP) will not need to be applied in 2007 due to a more favourable relation of public debt to GDP.
7. The change in the fiscal path as compared with the May 2004 forecast results also from more favourable economic development in 2004, which entails a better execution of the state budget, and an update of macroeconomic scenario for the subsequent years. The main objective, which is to decrease the growth rate of the government debt and to reduce the general government deficit below 3% of GDP in 2007, remains unchanged.

I. FRAMEWORKS AND OBJECTIVES OF MACROECONOMIC POLICY

1. The main objective of economic policy in Poland is to achieve a high long-term economic growth rate – a prerequisite for real convergence with the 15 Member States of the European Union (EU-15)¹. A high rate of economic growth should be reached while maintaining macroeconomic stability, i.e. at such inflation level and current account balance that facilitate preserving a stable exchange rate and fulfilling the Maastricht criteria so as to enter the euro area.
2. A decrease in fiscal imbalance and public finance reform build a base for long-term macroeconomic sustainability. Ongoing implementation of the Government's *Programme for Rationalisation and Reduction of Public Expenditure* should lead to a lower rate of the debt growth and a reduction in the general government deficit to the level below 3% of GDP in 2007.
3. Buoyant economic growth is also dependent on structural changes in the labour market allowing a sustainable increase in competitiveness of Polish companies and a decline in unemployment. At the same time competitiveness and innovation should be bolstered by changes in the tax system and a reduction of the administrative burden. Structural reforms have been covered inter alia in programmes of infrastructure development, environmental protection as well as in sectoral restructuring programmes of the hard-coal mining, energy industry, steel industry and the Polish State Railways. Transformation of the regional and sectoral structure of the Polish economy will be conducted within the framework of the *National Development Plan* with the use of structural funds and the Cohesion Fund.

¹ EU-15 means 15 Member States on April 30, 2004.

II. ECONOMIC DEVELOPMENTS IN POLAND

II.1. CURRENT ECONOMIC SITUATION AND DEVELOPMENT PROSPECTS UNTIL 2007

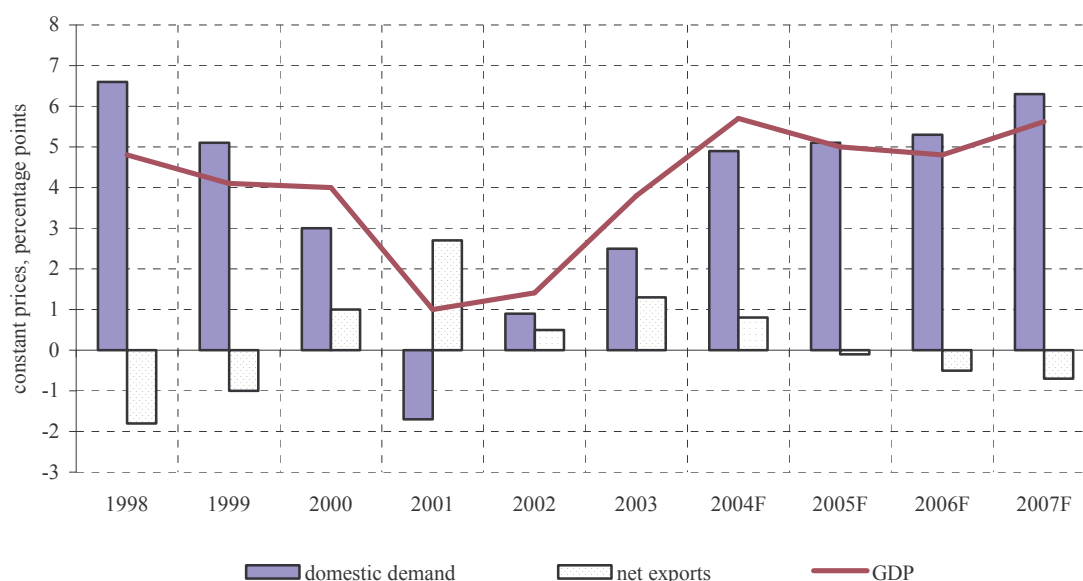
1. A marked improvement in Poland's economic situation has been noticed in 2004. After a two and a half year period of slowdown in economic activity, Poland has been on the path of fast economic growth beginning from the 2nd half of 2003. Gross domestic product rose by 4.3% year-over-year in the 2nd half of 2003, with the GDP growth in 2003 at the level of 3.8%. The growth accelerated further in the 1st half of 2004. It stood at 6.9% in real terms in the 1st quarter of 2004 and at 6.1% in the 2nd quarter.

2. Significant recovery observed since 2003 has been driven to a large extent by dynamic exports. This, in turn, mainly reflects improved competitiveness of Polish enterprises which, until recently, has also been supported by the favourable exchange rate. Net exports contribution to the GDP growth in the 1st and 2nd quarter of 2004 amounted to 1.1 and 0.9 percentage points, respectively. Exports contributed to the GDP growth at the level of 3.5 percentage points in the 1st quarter of 2004 and were the main factor driving the growth. However, a gradual recovery of domestic demand should also be noted. Contribution of gross fixed capital formation to the GDP growth reached 0.5 percentage point in the 1st half of 2004, while it was negative from the 2nd quarter of 2001 until the 1st half of 2003; in the 2nd half of 2003 it was neutral.

3. A high growth rate of private consumer demand exceeding 3.5% has been maintained since the 2nd quarter of 2003. In the 1st half of 2004 contribution of private consumption to the GDP growth amounted to 2.6 percentage points. Growth rates of the main indicators of economic activity in the first months of the 2nd half of 2004 (sold industrial production, construction and assembly production, retail sales) allow to expect that the rate of economic growth will be high in the oncoming quarters of 2004, reaching about 5.0%. Domestic demand, especially investment demand, is forecast to gain in importance. GDP growth in 2004 is projected to equal 5.7%.

4. Taking into account earlier than expected closing of the output gap as well as a sharp inflation rise in the 1st half of 2004 (caused mainly by temporary factors), between June and July 2004 the Monetary Policy Council raised the policy rates in total by 1.25 percentage points. These actions were oriented towards avoiding second-round effects, and they enhance foundations of a higher and sustainable economic growth. However, in the short term they can induce a slower economic growth which is forecast in the years 2005-06 at 5.0% and 4.8%, respectively. A slightly lower GDP growth projected for 2006 will also result, to some extent, from the public finance consolidation. It will be accompanied by the projected stabilisation of the GDP growth in other EU countries. The rate of economic growth, fostered by a pick-up in private consumption and investment, is expected to accelerate again in 2007 and reach 5.6%.

Chart 1. Real GDP growth, domestic demand and net exports contributions to GDP growth



External sector, exports and imports

5. Poland's current account deficit is expected to shrink to 1.9% of GDP in 2004 from 2.2% recorded in 2003. The improvement of external position of the economy is to be achieved mainly as a result of narrowing trade deficit and higher surplus on current transfers account.

6. Restructuring pursued by exporting companies that were hit by two consecutive external shocks (the Russian crisis and economic slowdown in the EU) combined with improved price competitiveness created a solid base for outstanding exports performance observed recently. Given the revival of economic activity in the EU that accounts for some 80% of Poland's exports, recent appreciation of domestic currency is expected to have limited impact on exports prospects.

7. At the same time strong domestic demand combined with improving price competitiveness of foreign goods is estimated to boost imports in 2005 and the following years. Consequently, trade balance is expected to widen gradually up to over 11 bn euros in 2007 (4.2% of GDP).

8. Since Poland is to remain a net beneficiary of EU funds in the oncoming years, moderate deterioration of trade deficit is forecast to be largely offset by a higher surplus on the current transfers account. Income deficit is estimated to increase in the subsequent years driven by higher dividend payments on FDI.

9. Current account deficit is forecast to stabilise at a relatively low level reaching 3.6% in 2007. There is no particular risk to external stability in the medium term, especially considering that the current account deficit is financed mainly by the inflow of long-term capital. FDI inflow alone is estimated to finance more than 90% of the current account deficit in 2004 and the overall balance is projected to remain in surplus throughout most of the projection period.

Table 1. Balance of payments in 2003-07

<i>Billions of euro</i>	2003	2004 forecast	2005 forecast	2006 forecast	2007 forecast
A: Current account	-4.1	-3.8	-5.1	-7.1	-9.4
Balance on goods	-5.1	-5.0	-6.6	-8.4	-11.0
Exports (f.o.b.)	53.8	64.6	71.8	81.9	92.9
<i>% change</i>	<i>9.1</i>	<i>19.9</i>	<i>11.3</i>	<i>14.1</i>	<i>13.4</i>
Imports (f.o.b.)	58.9	69.5	78.5	90.3	103.9
<i>% change</i>	<i>3.3</i>	<i>18.0</i>	<i>12.9</i>	<i>15.1</i>	<i>15.1</i>
Balance of services	0.4	0.7	0.6	0.6	0.8
Balance on income	-3.2	-3.8	-4.5	-5.1	-5.3
Balance on current transfers	3.7	4.2	5.5	5.8	6.1
B: Capital account	0.0	0.5	0.6	0.7	0.7
C: Financial account	7.8	5.5	4.8	6.5	8.5
Foreign direct investment: net	3.5	3.5	3.5	4.5	4.9
Portfolio investment: net	2.2	6.7	3.3	3.6	4.0
<i>FDI/CA</i>	<i>84.9</i>	<i>91.0</i>	<i>69.1</i>	<i>63.0</i>	<i>52.2</i>
D: Official reserve assets	-1.1	-1.7	-0.3	0.0	0.2
<i>Trade balance / GDP</i>	<i>-2.7</i>	<i>-2.6</i>	<i>-3.0</i>	<i>-3.5</i>	<i>-4.2</i>
<i>Current account / GDP</i>	<i>-2.2</i>	<i>-1.9</i>	<i>-2.3</i>	<i>-3.0</i>	<i>-3.6</i>

Source: 2003 - NBP, 2004-07 – Ministry of Finance forecast.

10. The year 2004 is expected to be the last year of positive contribution of net exports to GDP growth. Since 2000 external demand has been an important force driving growth of Poland's economy but in 2005-07 domestic demand and especially investment demand is to become the main source of growth in aggregate demand.

Domestic demand

11. It is forecast that in 2004 consumer demand will increase by 3.4% in real terms, and in 2005-07 its average growth will amount to 3.5%. It is expected that the wages and salaries fund will increase by 4.2% in nominal terms in 2004, and in 2005-07 by 6.1%, 6.5% and 6.8%, respectively. Private consumption is projected to increase by 3.8% in real terms in 2004 (compared to 3.1% in 2003). Its growth in 2005-07 will amount to 3.7%, 4.1% and 4.8%, respectively. The growth of public consumption will be affected by cuts in public expenditure resulting from the implementation of the public finance reform. Real growth of public consumption will amount to 2.0% in 2004, 1.5% in 2005, 0.8% in 2006 and 2007.

12. In the 2nd half of 2003 a long-term downward trend in gross fixed capital formation was reversed. Its growth was marginal (0.2%) but it can be considered the most desired factor stimulating sustainable economic revival. In the 1st half of 2004 the growth of gross fixed capital formation amounted to 3.4%. According to statistical reports of entities employing more than 49 persons, total investment outlays increased by 8.7% in real terms in the 1st half of 2004, of which outlays on buildings and structures rose by 12.7%, on machinery and equipment by 1.4%, and on means of transport by 32.2%. Business surveys carried out by the National Bank of Poland point at a high level of capacity utilisation, amounting to more than 80%. It is also expected that due to the inflow of EU structural funds and improving balance

sheets of Polish enterprises (partly because of lower CIT rate and higher depreciation rates of capital), a significant increase in corporate deposits in the banking sector (noted recently) will be used for investment expenditure leading to a rise in output capacity and higher labour productivity. It is forecast that the gross fixed capital formation will increase in 2004 by about 7% in real terms (compared to its decrease by 0.5% in 2003 and 5.8% in 2002), and in 2005-07 its growth will considerably exceed 10%. As a result, the share of investments in GDP will increase from 18.9% in 2003 to 24.1% in 2004 approaching the level recorded in 1999-2000.

13. The projected increase in investment and consumption demand suggests that the growth of domestic demand (recorded since 2002) will continue. Domestic demand is expected to increase by 4.8% in real terms in 2004 compared to 2.5% in 2003. In 2005-07 the growth of domestic demand will amount to 5.0%, 5.2% and 6.2%, respectively.

Labour market

14. The data for the 1st quarter of 2004 indicate the beginning of revival on the labour market. In the 1st half of 2004 the annual rate of decrease in employment was significantly lower than in the previous years (1.0% vs. 2.9% a year before and 4.0% in 2002). Moreover, in the 2nd quarter of 2004 employment rose by 0.4% compared to the previous quarter. The data on registered unemployment show that the unfavourable tendency was reversed and unemployment began to fall slowly. At the end of August 2004 unemployment was lower by 5.4% than at the end of 2003 and by 3.0% than in August 2003. It is estimated to decrease to ca. 3.05 million persons by the end of 2004, and the average number of employed persons will decline by ca. 0.5% in comparison with the previous year. The number of employed is expected to begin to increase gradually in the years 2005-07, in 2007 it will be higher by more than 4.0% in comparison with 2004. As a result of a steady growth in labour demand the unemployment rate will fall to 15.8% at the end of 2007. In spite of a strong GDP growth, in the years 2005-07 high raises in real wages and salaries will not be possible in consequence of still significant unemployment (ca. 2.5 million persons at the end of 2007). The growth in real wages and salaries is estimated to amount to 2.0% in the years 2005-06 and to increase further up to 2.4% in 2007.

15. The improvement in the situation on the labour market will remain one of the main priorities of the Polish economic policy in the oncoming years. The most important actions taken by the government concerning labour market regulations and counteracting unemployment comprise: changes in the labour law, institutional transformation, new legal regulations for the public employment services as well as attempts to directly influence labour market by active and passive policies. The most essential among the latter include: restrictiveness of granting pre-retirement benefits as of August 1, 2004 as well as the reduction of these benefits, and *Programme 50+* aiming at the activation of persons aged over 50. The future tasks of the state connected with the employment policy are presented in the *National Action Plan for Employment for 2005*. Execution of this plan should enable the introduction of the European employment guidelines in Poland.

Chart 2. Labour market in 2000-07 (end of period)



* without budgetary units operating in the national defence and public safety and without hidden economy. CSO data on the number of employed as of 2002 include the results of the *National Population and Housing Census* of 2002 and are not comparable to data for the previous years. Hence, the number of employed in 2000-01 was estimated by the Ministry of Finance.

Potential GDP

16. Given the revision of GDP growth forecast for 2004-07, the estimation of potential GDP and hence the output gap were also revised. Due to higher than previously expected growth of real GDP in 2004, output gap is forecast to close in 2005. As a result of forecast acceleration in investment growth, potential growth of GDP is estimated to reach some 5.0% in 2006-07. Temporary deceleration of economic growth to 4.8% in 2006 leads to re-emergence of negative output gap estimated at 0.2%. In 2007 real growth of GDP is likely to be significantly higher than potential.

Table 2. Growth rates of real and potential GDP and the output gap (%)

	2000	2001	2002	2003	2004	2005	2006	2007
Real GDP growth	4.0	1.0	1.4	3.8	5.7	5.0	4.8	5.6
Potential GDP growth	3.3	3.0	3.1	3.6	4.2	4.7	5.0	5.1
Output gap	1.8	-0.1	-1.7	-1.6	-0.2	0.0	-0.2	0.2

Source: Ministry of Finance.

Inflation, interest rates and exchange rate

17. Inflation dropped substantially in the years 2001–03, and the average consumer price index declined to 0.8% in 2003. The absence of inflationary pressures in this period corresponded with the estimates of a negative output gap. Due to efficient measures aiming at disinflation Poland fulfilled the inflation convergence criterion in the period of August 2002 – July 2004 .

18. In 2004 inflation accelerated reaching 4.6% year-over-year in July and August. The inflation level was mainly influenced by: raise in food prices (resulting from limited supply of agricultural products and high increase in foreign demand), high commodity prices (especially

crude oil prices) and accession-related price and tax adjustments (inter alia raises in some VAT rates). In 2004 the average CPI is estimated to increase to 3.4%. In 2005 the average inflation should decline to ca. 3.0% as a result of monetary and fiscal policy tightening, the zloty appreciation and higher crop harvest of agricultural products.

19. In the oncoming years the monetary policy target is to stabilise the inflation at the level close to the permanent inflation target set at 2.5% (with a tolerance range for deviations of ± 1 percentage point), and to create the opportunity to fulfil the inflation convergence criterion and to enter the euro zone. The average CPI is forecast to increase in the years 2006-07 to 2.7% and 2.5%, respectively.

20. As a result of strong price shocks that appeared in spring of 2004, the Monetary Policy Council adopted in April 2004 the tightening bias and after that increased the policy rates as many as three times: in total by 1.25 percentage points. Taking into account the expected price developments and the Monetary Policy Council's position presented in the *Monetary Policy Guidelines for the Year 2005*, a further tightening of monetary conditions aiming at bringing the inflation down to the target cannot be excluded in 2005, so as to bring the inflation down to the target at the turnover of 2005-06. However, it is expected that the reduction of the monetary policy restrictiveness will be possible in the years 2006-07.

21. In the period of 1st quarter 2003 – 3rd quarter 2004 the zloty depreciated strongly and its nominal effective depreciation (the exchange rate weighted by geographic structure of Polish exports) amounted to 14.3% in comparison with 2002 (the zloty depreciated most significantly against the euro – by 16.6%). However, steady zloty appreciation vis-à-vis the main currencies used in Polish foreign trade transactions has been recorded since May 2004. It has resulted from improvement in the macroeconomic fundamentals of the Polish economy and the stabilisation of the political situation in Poland. The exchange rate projection assumes that the zloty will remain strong vis-à-vis the euro in the years 2005-07 and that the volatility of PLN/EUR exchange rate will gradually decrease.

II.2. COMPARISON BETWEEN THE EUROPEAN COMMISSION'S FORECAST AND NATIONAL FORECAST

22. The baseline macroeconomic scenario underlying public finance sector forecasts is broadly consistent with the latest projection of the European Commission². The Ministry of Finance and the European Commission similarly assume that after a significant increase in the economic growth, approximating 6% in 2004, its deceleration will follow in the next two years, but to the level still above that noted in 2003. Both institutions forecast a growing role of domestic demand in the GDP growth in the projected period while net exports contribution will be negative as of 2005. The two projections rest on the assumption of a marked pick-up in investment activity in the 2nd half of 2004 and in the years 2005-06. The investment recovery will be helped by improved corporate profitability, an increase in capacity utilisation and accession-related improvement of the investment climate.

² *European Commission Autumn 2004 Economic Forecasts.*

Table 3. Comparison between forecasts of the European Commission and the Ministry of Finance for the years 2004-06^{a)}

	2003		2004		2005		2006	
	EC	MF	EC	MF	EC	MF	EC	MF
GDP	3.8	3.8	5.8	5.7	4.9	5.0	4.5	4.8
private consumption ^{b)}	3.1	3.1	4.0	3.8	4.2	3.7	4.4	4.1
gross fixed capital formation	-0.9	-0.5	6.5	7.4	10.0	12.9	12.0	12.6
exports	14.7	14.7	13.3	14.2	11.9	12.0	10.4	11.1
imports	9.3	9.3	11.6	11.1	12.6	12.0	12.6	12.1
Net exports ^{c)}	1.8	1.3	0.8	0.8	-0.1	-0.1	-0.7	-0.5
Unemployment rate ^{d)}	19.2	20.0	19.0	19.3	18.7	18.2	18.1	17.4
GDP deflator	0.5	0.5	2.8	2.7	2.9	2.7	3.3	2.5
HICP	0.7	0.7	3.5	3.5	3.3	3.0	3.0	2.7
Trade balance ^{e)}	-2.7	-2.7	-2.6	-2.6	-3.1	-3.0	-3.5	-3.5
Current account balance ^{e)}	-2.2	-2.2	-2.6	-1.9	-3.1	-2.3	-3.3	-3.0

a) In %, unless otherwise indicated. Shaded area – forecast.

b) Ministry of Finance – individual consumption of households, European Commission – individual consumption of households and non-commercial institutions.

c) Contribution to GDP growth.

d) Ministry of Finance – registered unemployment rate at the end of period, European Commission – unemployment rate average in period.

e) In % of GDP.

23. Both scenarios assume similar tendencies of inflation developments, especially as concerns the harmonised index of consumer prices. The forecasts of the GDP deflator are different – the European Commission expects a gradual increase in the GDP deflator while the Ministry of Finance predicts a slightly lower growth of the deflator.

24. The European Commission as well as the Ministry of Finance project but a slight improvement in the labour market in the years 2004-06 in spite of a relatively dynamic economic development in this period. This should be ascribed to structural features of unemployment in Poland that limit possibilities of unemployment reduction in the short term.

25. The European Commission and the Ministry of Finance similarly assess foreign trade developments in the years 2004-06 as a result of close forecasts of exports' and imports' growth rates. However, the European Commission is more pessimistic in the evaluation of the external imbalance of the Polish economy measured by the current account deficit, especially in the years 2004-05.

III. GENERAL GOVERNMENT BALANCE AND DEBT

III.1. STRATEGY

1. The objective of the Polish fiscal policy is to reduce the ratio of the general government deficit to GDP below 3% in the shortest possible time and in a manner favouring simultaneous progress towards real convergence. Like in the May 2004 Convergence Programme, it is still anticipated that objective may be achieved in 2007. The debt level is also assumed to remain below the reference level of 60% of GDP for the entire period. Measures aimed at containing the public debt growth rate will be continued, while minimizing the costs of its servicing. This will be implemented through selection of an optimum structure of new issues of debt instruments and simultaneous striving towards lengthening the average maturity, as well as improving efficiency of the Treasury securities market and adjusting the principles of its functioning to the standards followed by other EU countries.

2. The primary instrument to be used in order to gradually reduce fiscal deficit will be the implementation of measures laid down in the *Programme for Rationalisation and Reduction of Public Expenditure* (hereinafter referred to as the *Programme*) adopted by the government at the beginning of this year.

III.2. ACTUAL BALANCES AND IMPLICATIONS OF THE FORTHCOMING BUDGET

3. The general government deficit has been high for several years, posing one of the main problems of the Polish economy. A fast increase in the deficit was due to the sluggish economic growth in 2001-02 and the necessity to finance structural reforms initiated in 1999. The decline in budgetary revenues came also from system changes in direct taxes, more intensive utilisation of tax relief, ambiguity and inconsistency of legal regulations, as well as from a shift of businesses to the hidden economy. On the other hand, increase in total expenditure of the sector was largely due to a considerable share of legally determined expenditure.

Table 4. General government balance and debt (% of GDP)

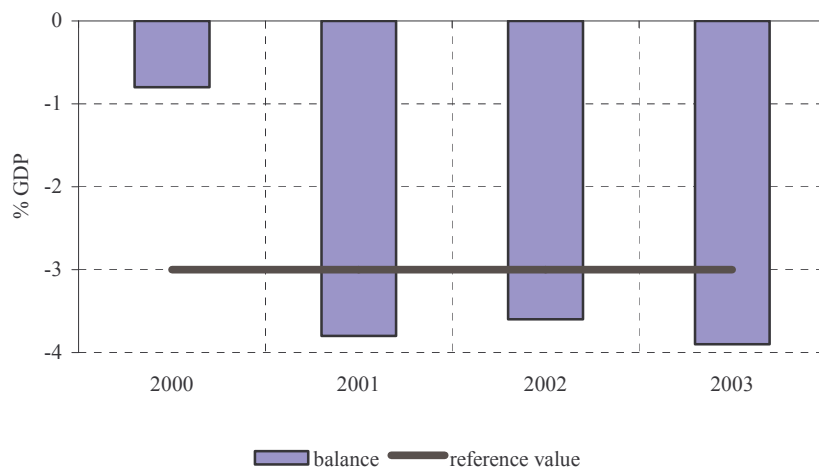
	ESA Code	2000	2001	2002	2003
General government balance (B9)	S13	-0.7	-3.8	-3.6	-3.9
Central government	S1311	-0.9	-4.5	-4.6	-5.3
Local government	S1313	-0.5	-0.3	-0.3	-0.2
Social security funds	S1314	0.6	1.0	1.3	1.6
General government debt		36.8	36.7	41.1	45.4

Source: Central Statistical Office, fiscal notification, August 2004.

4. In July 2004 the Ecofin Council found Poland's deficit to be excessive, i.e. above the reference level of 3% of GDP. The excess of the general government deficit over the reference value did not result from an unusual event outside the control of the Polish authorities, nor was it the result of a severe economic downturn. Pursuant to Article 104.7 of the Treaty, the Council recommended the Polish authorities to put an end to the present excessive deficit situation as rapidly as possible and to take action in a medium-term framework in order to achieve the objective of bringing the deficit below 3% of GDP in 2007

in a credible and sustainable manner. Moreover, the Council recommended the Polish authorities to implement with vigour the measures envisaged in the Convergence Programme, and to take effective action by November 5, 2004 regarding the measures envisaged to achieve the 2005 deficit target. Furthermore, the Council invited the government to allocate possible extra revenues to decrease the general government deficit and to ensure the rise in the debt ratio was brought to a halt.

Chart 3. General government balance in 2000-03



5. The draft budget for 2005 as well as the solutions, already approved or considered by the Parliament, relating to the package of measures contained in the *Programme* indicate that public finance consolidation in Poland is heading in the right direction. Implementation of the *Programme* is aimed at a gradual reduction of the general government deficit and the debt growth rate, as well as altering the unfavourable public expenditure structure by reducing the share of legally determined expenditure in favour of more flexible ones. The reduction of fiscal imbalance shall support maintaining long-term macroeconomic stability, whereas rationalisation of public expenditure will allow to target a larger share of central and local government resources towards co-financing of projects implemented with the assistance of structural funds and the Cohesion Fund. This will raise absorption capacities of EU funds.

6. The draft budget for 2005 adopted by the Council of Ministers assumes a considerable reduction in the state budget deficit from 4.9% of GDP in 2004³ (expected execution) to 3.7% of GDP in 2005. Simultaneous improvement in the balance of majority of other general government units should reverse the present upward trend in the general government deficit. The position of the general government will be determined by its relation to both the EU budget, and the *Programme* adopted by the government at the beginning of 2004. The adoption of new indexation principles of retirement and disability pensions as well as suggested increase in social security contributions that will limit subsidies of the state budget to social security funds will further cause a reduction in so-called fixed expenditure. In addition, administrative expenditure will be limited and liquidation of special resources is planned (some of them will be included in the state budget, while others will be transformed into 13 new earmarked funds). The balance of financial transfers between Poland and the EU is expected to be definitely positive for the Polish economy, though it will remain negative as far as the general government is concerned. The strong economic activity in the projected

³ Figures calculated in accordance with the Public Finance Act (cash basis).

period will support the deficit reduction. As a result, the general government deficit should go down in 2005 to the level of 3.9% of GDP, i.e. by ca. 1.5 percentage points over 2004.

III.3. MEDIUM-TERM OBJECTIVES FOR THE GENERAL GOVERNMENT

7. Medium-term objectives with respect to the general government are determined by the requirements arising for the Polish economy from the accession to the EU, including the necessity of ensuring institutional and financial capacities in order to optimise the use of structural funds and the Cohesion Fund.

8. Specific tasks aimed at meeting the fiscal criteria will be implemented inter alia under measures adopted by the government in the *Programme*.

III.4. BALANCES BY SUB-SECTORS OF THE GENERAL GOVERNMENT

9. Macroeconomic and structural trends in the Polish economy (strong economic growth, signs of modernisation of the economic structure, tightening links between Polish and foreign companies operating within the enlarging Single Market) offer a special opportunity for reducing the general government deficit and the debt growth rate.

10. Assumed economic growth and continuation of the reforms initiated by the government in 2004 allows to forecast a decrease in the general government deficit from 5.4% of GDP in 2004 to 3.9%, 3.2% and 2.2% of GDP respectively in 2005-07.

11. A gradual reduction in the central government deficit will come from revenues growth and cuts in social and administrative expenditure. Decreasing debt growth rate should be accompanied by a decline in debt servicing costs. In 2003, the central government deficit amounted to 5.3% of GDP, and is expected to reach 6.0% of GDP in 2004, 5.2% of GDP in 2005, 4.7% of GDP in 2006, and 3.8% of GDP in 2007.

12. The local government deficit will continue to represent an insignificant part of the general government deficit. In the forthcoming years, local government units will have to find additional resources for co-financing EU projects and related outlays needed to ensure an efficient absorption mechanism. Planned commencement of numerous new investment projects will be reflected in a slight increase in the deficit level over the 2003 figure. The local government deficit amounted to 0.2% of GDP in 2003, and is expected to reach 0.4% of GDP in 2004, 0.4% of GDP in 2005, 0.4% of GDP in 2006, and 0.3% of GDP in 2007.

13. Successive improvement in the labour market and a declining unemployment rate, as well as the social security reforms implemented by the government will result in an improved balance of social security funds, in particular of the Labour Fund and the Social Security Fund (FUS). In 2003, the surplus of social security funds accounted for 1.6% of GDP, in 2004 the surplus will amount to 1.0% of GDP. It is expected to reach 1.7% of GDP in 2005, 1.9% of GDP in 2006, and 1.9% of GDP in 2007. A significant surplus in 2003 compared with 2004 comes from the cancellation of a state budget loan granted to FUS of approx. PLN 8 bn (capital and interest). The surplus growth expected in 2005-07 shall be due primarily to the fact that the ongoing fiscal reforms are largely focused on the social area.

III.5. STRUCTURAL BUDGET

14. Similarly to the May 2004 Convergence Programme, in order to estimate the structural deficit, the output gap was estimated with the use of the Hodrick-Prescott filter, whereas elasticities were adopted in two options⁴. In the 1st option, elasticities of revenues items in relation to GDP were adopted on the basis of OECD data. In the 2nd option, own calculations of elasticities were applied. The results are almost identical in both cases.

15. Considering the large scale of changes on the expenditure and revenues sides of the general government in Poland in recent years and potential objections as regards the method used for estimating potential GDP, the presented figures should be treated with utmost caution. Buoyant economic growth may also result in changing elasticities used for estimating the figures in Table 5.

16. Estimates indicate the output gap will be closed in 2005. This means that in 2005 the structural deficit will be almost the same as the general government deficit.

Table 5. Cyclical developments (% of GDP)

	ESA Code	2003	2004	2005	2006	2007
1. GDP growth at constant prices	B1g	3.8	5.7	5.0	4.8	5.6
2. Actual balance of GG sector	B9	-3.9	-5.4	-3.9	-3.2	-2.2
3. Interest payments	D41	3.1	2.8	2.6	2.7	2.6
4. Potential GDP growth		3.6	4.2	4.7	5.0	5.1
5. Output gap		-1.6	-0.2	0.0	-0.2	0.2
6. Cyclical budgetary component		-0.5	-0.1	0.0	-0.1	0.1
7. Cyclically-adjusted balance (2-6)		-3.4	-5.3	-3.9	-3.1	-2.3
8. Cyclically-adjusted primary balance (7+3)		-0.3	-2.5	-1.3	-0.4	0.3

Source: Ministry of Finance.

III.6. GENERAL GOVERNMENT DEBT

17. Current forecasts provide for a gradual deceleration in the pace of increase in the debt ratio. Stabilisation of the debt-to-GDP ratio in 2006 and its decline in 2007 will stem from a high GDP growth and a simultaneous gradual reduction in the borrowing requirements. In 2006, the planned nominal GDP growth will be similar to the debt growth, and in 2007 it should exceed it.

⁴ Due to limitations resulting from the length of time series and quality of statistics there is a lack of structural deficit estimates consistent with the methodology applied in the EU-15 countries. The results presented in Table 5 may not be comparable with results for other EU Member States, obtained by application of a single methodology.

Table 6. General government debt (% of GDP)

	ESA Code	2003	2004	2005	2006	2007
Gross debt level		45.4	45.9	47.6	48.0	47.3
of which: due repayment		13.6	12.8	11.0	13.8	11.5
Change in GDP/gross debt ratio		4.3	0.5	1.7	0.4	-0.7
Contributions to change in debt/GDP ratio						
Primary balance		0.8	2.6	1.3	0.5	-0.4
Interest payments	D41	3.1	2.8	2.6	2.7	2.6
Nominal GDP growth	B1g	-1.7	-3.6	-3.3	-3.3	-3.6
Other factors influencing debt/GDP ratio, of which:		2.1	-1.3	1.1	0.5	0.7
Exchange rate		1.4	-1.3	0.1	0.0	0.0
Privatisation receipts		-0.4	-0.8	-0.5	-0.4	-0.4
p.m. implicit interest rate on debt (%)		6.9	6.1	5.5	5.7	5.5

Source: Ministry of Finance.

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH THE CONVERGENCE PROGRAMME

IV.1. RISK FACTORS AND VARIOUS SCENARIOS FOR THE GENERAL GOVERNMENT

1. The general government deficit and debt path presented in the update of the Convergence Programme results from the adopted macroeconomic assumptions and system changes affecting the sector. There is, however, a group of risk factors, which could significantly impede or prevent implementation of the adopted scenario. Such risks may include:

- economic risk (for instance a slowdown in economic growth, significant weakening of the zloty, inflation growth and tightening of the monetary policy),
- political risk (which may lead to a postponed implementation of the *Programme* or elimination of its components),
- other risks (including unfavourable ultimate decision on the classification of open pension funds, threats resulting from guarantees and sureties granted by the State Treasury, and uncertainty regarding the ultimate shape of regulations concerning privatisation).

2. Unlike in the 2004 Convergence Programme, the analyses presented herein assume a permanent character of the risk factors (cumulative effect).

Economic risk

3. The risk factors for the macroeconomic scenario forecast are as follows:

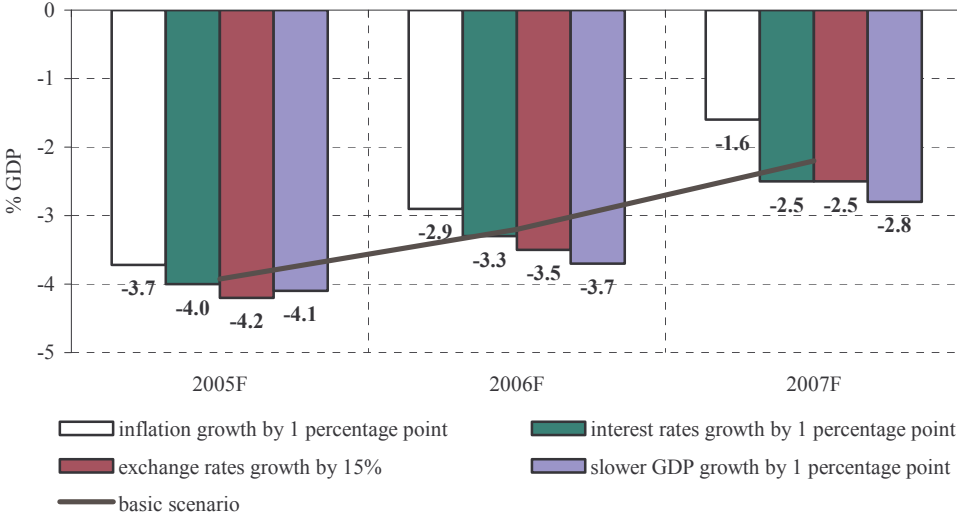
- worsening economic conditions of Poland's main trade partners,
- further increase in oil prices which would translate into a slowdown of the world GDP growth and inflation rise,
- greater than expected increase of domestic prices, followed by tightening of the monetary policy,
- intensified fluctuations of exchange rates in the new Member States of the EU, owing to the convergence play of foreign investors,
- depreciation of the zloty because of a greater political risk and possible problems with implementation of the public finance reform,
- lower than projected price increase resulting from a stronger than assumed appreciation of the zloty or a significant drop in commodity prices on world markets,
- lack of institutional capacities to achieve anticipated absorption of EU funds.

4. The GDP growth impacts the condition of public finance by affecting the level of revenues (mainly tax revenues and social security contribution, i.e. revenues related with the wage fund in the economy), and some expenditure (primarily social transfers, including in particular unemployment benefits).

5. Revenues and expenditure of the general government are dependent on inflation – both directly and indirectly. The so-called inflationary premium has a strong effect on the revenues of the social security funds, the central government and local government units. In addition, certain expenditure groups, including in particular social expenditure (retirement and disability pensions), wages and salaries have strong links with the inflation level through indexation mechanisms.

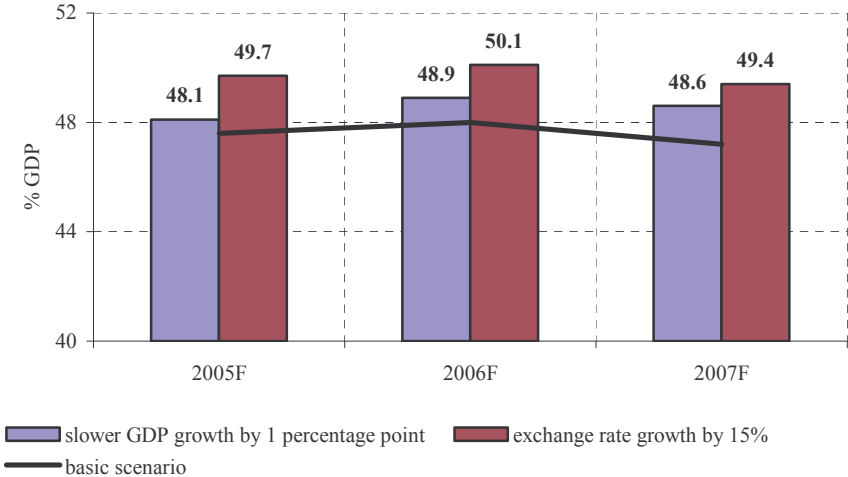
6. Debt servicing costs are characterised by the strongest sensitivity to changes in interest and exchange rates. Owing to a large share of fixed interest liabilities, changes in interest rates have relatively insignificant short-term consequences, though they have a much larger impact on deferred costs. Impact of exchange rates fluctuations on the debt servicing costs level is limited by a relatively small share of external debt in total debt and low average interest rates on foreign liabilities.

Chart 4. Sensitivity of the general government balance to changes in GDP, inflation, interest rates and the exchange rate



7. Factors that exert the largest impact on altering the debt-to-GDP ratio include changes in exchange rate and in the nominal GDP growth.

Chart 5. Sensitivity of the government debt to exchange rate and GDP changes



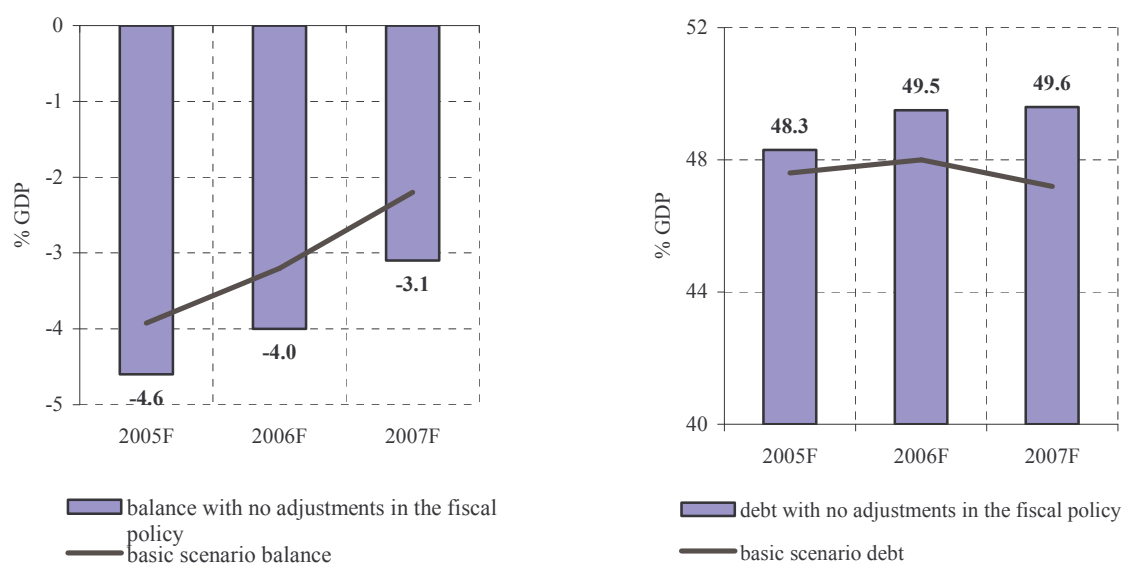
8. In the short run, a rise in interest rates affects the nominal debt level through the channel of new issues of discounted instruments (primarily treasury bills and zero-coupon bonds). Financing the same level of gross borrowing requirements means a positive correlation between a rise in interest rates and nominal debt. In the long run, an additional factor appears: increase in interest rates pushes up debt servicing costs and the deficit simultaneously. The period of full adjustment to the new level of interest rates depends on the debt structure.

Duration of the domestic market debt, which reflects adjustment time to the new level of interest rates, is slightly more than 2 years.

Political risk

9. Elections to the Sejm and Senate in Poland will be held in 2005. The new government will have to make a decision on the method and pace for continuing the public finance reform. Continuation of reforms may be impeded by possible absence of a stable parliamentary majority or the need to make trade-offs between future coalition partners. However, judging from the position publicly voiced by the major opposition party it may be presumed that if it were to win the elections it would strive at continuing the reform process.

Chart 6. Hypothetical general government balance and debt, assuming lack of adjustment actions in the fiscal policy



Other risk factors

10. A very important risk factor, which may significantly change the adopted fiscal adjustment path, is unfavourable ultimate decision on the classification of open pension funds (OPF). A decision to exclude OPF from the general government statistics would result in an upward adjustment of the deficit figures by ca. 1.7% of GDP annually in 2005-07. The debt-to-GDP ratio would increase by 5.4%, 6.2%, 6.8%, respectively. In such a situation, and given the lack of other opportunities to consider short-term costs of the pension system reform in the excessive deficit procedure and in the evaluation of fulfilment of fiscal convergence criteria, it would be almost impossible for Poland to meet these criteria by 2007, as currently planned. This would also delay the date of entering the euro zone.

11. The present activity of the State Treasury in granting guarantees and sureties does not pose any major threats to public finance. To contain risks associated with granting guarantees and sureties by the State Treasury, as well as to retain advantages of application of such an instrument of economic policy, the government intends to:

- focus the granting of sureties and guarantees on supporting development-oriented investment, in particular in infrastructure, and implementation of environmental protection projects; projects implemented with the assistance of EU funds will be given priority,

— continue to follow the principle whereby the ratio of anticipated payments under the guarantees and sureties of the State Treasury to GDP does not exceed 2% (in 2005-07 expected payments under guarantees and sureties will amount to not more than 1.5% of GDP each year).

12. Another risk to the public finance sustainability is represented by issues relating to reprivatization and claims concerning real property situated east of the Bug river (Bug river claims)⁵. Altogether, payments by virtue of restitution of property could amount to ca. PLN 55.0-58.5 bn (6.2-6.6% of GDP), of which ca. PLN 13.5 bn for Bug river claims. The issue of compensations for the property taken over by the State Treasury in 1944-62 has not been legislatively settled yet. *The Programme of Privatisation of the State Treasury Property until 2006*, adopted by the government in 2003, assumes such a way of satisfying restitution claims which presents the least possible burden for public finance. Compensation payments were to be based on offering shares in state-owned companies, receipts from the sale of real estate owned by local government units and from the sale of property managed by the state agencies. Considering the public finance sustainability, such a solution appears the most appropriate.

IV.2. COMPARISON WITH THE MAY 2004 CONVERGENCE PROGRAMME

13. Modification of data concerning real GDP growth in 2003 (3.8% as compared with 3.7%) is a result of an adjustment of earlier estimates made by the Central Statistical Office. A higher growth forecast for 2004 (5.7% vs. 5.0%) is based on preliminary results from the 1st half of the year (GDP grew by 6.5%) and estimates of activity in the 2nd half of 2004. In the 1st half of 2004, a slightly higher than expected in the May 2004 Convergence Programme contribution of gross fixed capital formation to GDP growth was noted. Growth rates of main indicators of economic activity in the first months of the 2nd half of 2004 allow to expect that the GDP growth will be high in the oncoming quarters of 2004, reaching about 5.0%. The estimate of the contribution of changes in inventories and net acquisition of valuables to GDP growth in 2004 has been significantly raised (from 0.0 percentage point to 0.7 percentage point) as a result of a surprisingly large contribution of that factor to GDP growth in the 1st half of the year (2.1 percentage points vs. 1.2 percentage points in the 1st half of 2003 and minus 0.2 percentage point in the 1st half of 2002). Earlier than expected closing of the output gap, increased inflationary pressure and tightening of the monetary policy indicate that the GDP growth may decelerate to 5.0% in 2005, and 4.8% in 2006. The projected further slight slowdown of GDP growth in 2006 will be inter alia a result of anticipated negative contribution of net exports to the GDP growth (minus 0.5 percentage point as compared with plus 0.1 percentage point in 2005). A slightly lower GDP growth will also result, to some extent, from the public finance consolidation. The rate of economic growth, fostered by a pick-up in private consumption and investment, is expected to accelerate again in 2007 and reach 5.6%.

14. Adjusted estimates of the government debt and its relation to GDP are largely an effect of different exchange rate levels adopted for calculations. Forecast continued appreciation of the

⁵ These claims concern indemnity (compensation) for property left behind by Polish citizens in the areas, which after World War II were not incorporated in the present territory of Poland. This property is currently located on the territory of Belarus, Ukraine and Lithuania. International agreements (so-called republican agreements) concluded between Poland and the Belarusian, Ukrainian and Lithuanian Soviet Socialist Republics stipulated that compensation for the property left behind in the east would be paid by the Polish government.

zloty will contribute to the significant lowering of the PLN amount of the debt denominated in foreign currencies. In 2004, changes in exchange rates account for almost 60% of the total decline in the debt level as compared with earlier forecast. The biggest changes in debt estimates refer to the central government and, apart from exchange rate differences, reflect altered borrowing requirements of the state budget (primarily resulting from changes in the state budget deficit, scale of prefinancing and privatisation receipts), a change in assumptions concerning the value of Treasury securities held in the OPF portfolio, and changed estimates concerning the takeover and conversion of FUS debt to OPF. The changed 2006-07 forecasts reflect also the reduction of anticipated debt of FUS and Labour Fund. It should be noted that changes in the debt level in 2005–07 are caused also by the so-called base effect (lower than previously assumed debt level in 2004). A large impact has been exerted on the forecasts of the debt-to-GDP ratio by a change in the GDP level at current prices, which in accordance with the present forecast will be by 1.6 to 2.3 percentage points higher than previously expected.

15. As compared with the May 2004 Convergence Programme, significant changes in the general government deficit forecast concern the years 2004, 2005 and 2007. The currently expected lower deficit in 2004 results from a better performance of state budget revenues and expenditure, and a new estimate of VAT revenues. The new estimate takes fully into account the change in VAT payment scheme after the accession to the EU. The payments are due within longer period of time what leads to the delay in revenues on cash basis but on a memorial basis those revenues are now attributed to 2004.

16. The projected improvement in the general government balance in 2005 reflects a lower state budget deficit as adopted in the draft budget for 2005 (difference by 0.4 percentage point of GDP in comparison with May). The largest difference between the Convergence Programme and the update concerns 2007 (0.7 percentage point). The forecast of the general government deficit in 2007 presented in the Convergence Programme was developed inter alia on the assumption of implementation of the *Programme*. Moreover, adoption of additional radical adjustment measures in 2007 was assumed so as to lower the public debt-to-GDP ratio (according to the Polish methodology). Under the Public Finance Act, an obligation to adopt such measures arises should the public debt, increased by anticipated payments under guarantees and sureties, exceed the threshold of 55% of GDP. Earlier forecasts indicated that the threshold would be exceeded in 2005. Currently, this is not expected to happen in 2005. This in turn has helped to present a more credible adjustment path. Additionally, the government intends to put forward amendments to the Public Finance Act, adjusting the definition of the public debt to the principles specified in ESA 95 and other EU regulations. If the amendments pass the Parliament, the forecast debt-to-GDP ratio will not exceed the first prudential threshold of 50% of GDP in the future. Hence, it would not be necessary to implement precautionary procedures provided for in the Act. Therefore, the government could continue to determine the pace and mechanisms of the deficit reduction in such a manner which would not pose any special threats to the sustainable economic growth. The currently presented adjustment path allows a better absorption of structural funds and the Cohesion Fund, and therefore better use of opportunities related to Poland's membership in the EU.

Table 7. Divergence from the Convergence Programme (% of GDP)

	ESA Code	2003	2004	2005	2006	2007
GDP growth	B1g					
Convergence Programme		3.7	5.0	5.0	5.6	5.6
Update		3.8	5.7	5.0	4.8	5.6
Difference		0.1	0.7	0.0	-0.8	0.0
General government balance	B9					
Convergence Programme		-4.1	-5.7	-4.2	-3.3	-1.5
Update		-3.9	-5.4	-3.9	-3.2	-2.2
Difference		0.2	0.3	0.3	0.1	-0.7
Debt level						
Convergence Programme		45.3	49.0	51.9	52.7	52.3
Update		45.4	45.9	47.6	48.0	47.2
Difference		0.1	-3.1	-4.3	-4.7	-5.1

V. QUALITY OF PUBLIC FINANCE

V.1. STRATEGY

1. Upon its accession to the EU Poland began to participate in the 3rd stage of the Economic and Monetary Union as a Member State with the derogation status. One of the main objectives of the Polish fiscal policy is to meet the fiscal criteria constituting a precondition for Poland's joining the euro zone as soon as possible. This should, however, be carried out in the way that would guarantee stability of the improvement of fiscal situation and be conducive to simultaneous progress in the real convergence.

2. The objective is to be mainly attained by continuation of actions specified in the *Programme* adopted by the government at the beginning of 2004. Vigorous implementation of the *Programme* should lead to a radical reduction in the general government deficit and halt the process of the government debt increase. The forecast reduction of the deficit is dependent on the effects of measures which do not require decisions of the Parliament, as well as the consequences of legislative amendments already adopted or scheduled for implementation. It cannot be taken for granted that all solutions proposed by the government would be ultimately adopted by the Parliament. Hence, possible deviations from implementation of the *Programme* due to political reasons were referred to as a risk surrounding the achievement of the assumed path of the deficit reduction. In case of a rejection or substantial modification of some *Programme* proposals, the government shall be making attempts to find other possibilities to reduce expenditure or increase revenues so as to maintain the path of the deficit reduction close to that planned at present.

3. Not only is Poland's accession to the EU connected with a wider access to EU funds, but also with a necessity to contribute to the EU budget. Poland's contribution to the EU budget in 2005-07 is estimated at the equivalent of 1.1% of GDP per annum. This additional burden shall not be fully covered by the lump sum cash flow facility to be received by the state budget from the EU. Moreover, in 2006 the lump sum cash flow facility will be reduced, and in 2007 totally eliminated. The balance of financial transfers between the Polish general government and the EU budget will be negative in 2005-07, amounting to 0.7%, 0.8%, 1.1% of GDP, respectively. The state budget will continue to cover costs of co-financing projects implemented with the assistance of EU funds, and topping-up direct subsidies to farmers.

4. Table 8 presents the situation of the general government by 2007. The projections reflect the adopted macroeconomic scenario and basic assumptions concerning the future fiscal policy of the government.

Table 8. Revenues and expenditure of the general government (% of GDP)*

	ESA Code	2003	2004	2005	2006	2007
General government balance (B9)	S13	-3.9	-5.4	-3.9	-3.2	-2.2
Central government	S1311	-5.3	-6.0	-5.2	-4.7	-3.8
Local government	S1313	-0.2	-0.4	-0.4	-0.4	-0.3
Social security funds	S1314	1.6	1.0	1.7	1.9	1.9
General government (S13)						
Total revenues	ESA	43.7	43.2	44.5	44.8	44.0
Total expenditure	ESA	47.6	48.6	48.4	48.0	46.2
Budget balance	B9	-3.9	-5.4	-3.9	-3.2	-2.2
Net interest payments	D41	3.1	2.8	2.6	2.7	2.6
Primary balance		-0.8	-2.6	-1.3	-0.5	0.4
Components of revenues						
Taxes	D2+D5	22.3	22.1	22.3	22.5	22.5
Social contributions	D61	13.5	13.0	13.2	13.1	13.0
Interest income	D41	0.6	1.0	1.1	0.9	0.9
Other		7.3	7.1	7.9	8.3	7.6
Total revenues	ESA	43.7	43.2	44.5	44.8	44.0
Components of expenditure						
Collective consumption	P32	9.1	9.3	9.4	9.1	8.8
Social transfers in kind	D63	8.5	8.0	8.1	8.0	8.1
Social transfers other than in kind	D62	17.6	16.1	15.2	15.1	14.4
Interest payments	D41	3.1	2.8	2.6	2.7	2.6
Subsidies	D3	0.4	0.7	0.9	0.9	0.9
Gross fixed capital formation	P51	3.4	4.1	4.2	4.3	4.0
Other		5.5	7.6	8.0	7.9	7.4
Total expenditure	ESA	47.6	48.6	48.4	48.0	46.2

Source: 2003 - CSO, 2004-07 – Ministry of Finance forecast.

* Data have been calculated on the assumption that obligatory open pension funds are classified as the general government.

Note: presented reporting and forecast data should be treated as preliminary due to the work undertaken by the Interinstitutional Group for the Statistics of the General Government, set up at the Central Statistical Office. One of the goals of the group is harmonisation of the data presented in accordance with the ESA 95 rules, and currently presented data may be subject to small revisions. It should be emphasised, however, that in comparison to the May 2004 Convergence Programme, the data presented now indicate already a substantial improvement in the general government statistics developed by the Central Statistical Office.

V.2. GENERAL GOVERNMENT EXPENDITURE

5. The reform of public finance based mainly on the *Programme* implementation provides for substantial savings in the general government expenditure. The most important savings shall result from changes in defining the level and in indexation of retirement and disability pensions. Considerable savings may also follow from changes in the rules of financing national defence requirements and granting pre-retirement allowances as well as from reducing different administrative costs and new incentives to activate disabled persons.

6. The total effect of all measures aimed at restricting expenditure is expected to bring about savings estimated at about 0.8% of GDP, 0.6% of GDP and 0.9% of GDP in 2005-07,

respectively (as compared with the situation of non-implementation of the reforms). The lower projected level of savings in 2006 stems from the assumed indexation of retirement and disability pensions in that year. According to the newly adopted principles, indexation is carried out when the cumulative growth of inflation exceeds the threshold of 5%. According to the latest forecast this threshold will be exceeded in 2006.

Table 9. Performance of the Programme - the general government expenditure (% of GDP)

	2004	2005	2006	2007
Savings in total expenditure	0.06	0.79	0.62	0.93
1. not requiring legislative changes (reduction in administrative costs)	0.01	0.05	0.07	0.07
2. requiring legislative changes:	0.05	0.74	0.55	0.87
a) approved by the Parliament	0.00	0.60	0.39	0.67
<i>changes in defining the level and in indexation of retirement and disability pensions</i>	0.00	0.42	0.12	0.33
<i>changes in the rules of financing national defence requirements</i>	0.00	0.14	0.15	0.16
<i>change in the rules of granting pre-retirement benefits</i>	0.00	0.05	0.12	0.18
b) in the legislative process	0.04	0.14	0.16	0.20
<i>changes in the system supporting employment of the disabled</i>	0.04	0.05	0.03	0.02
<i>other</i>	0.00	0.08	0.14	0.17

Source: Ministry of Finance on the basis of data obtained from the Ministry of Economy and Labour and the Ministry of Social Policy.

7. The above mentioned measures aimed at restricting expenditure will result in a steady decrease of total general government expenditure in relation to GDP. In 2004, the general government expenditure is expected to reach 48.6% of GDP, while in 2007 it should be brought down to 46.2% of GDP, i.e. by 2.4 percentage points.

8. The reduction of the expenditure-to-GDP ratio will come mainly from a decline in social transfers (D62+D63) by 1.6 percentage points (24.1% in 2004 vs. 22.5% in 2007). The share of social expenditure in the total expenditure of the general government will diminish on a similar scale, i.e. from nearly a half (49.6%) in 2004 to about 47-48% in 2005-07.

9. Investment expenditure will continue a positive upward trend in the structure of planned expenditure. The level of investment outlays financed with public resources is assumed to increase from 3.4% of GDP in 2003 to about 4.1–4.3% of GDP in 2004-06. The increase is related to the expected substantial growth of financial transfers from the EU (Cohesion Fund and structural funds) in that period and the necessity to save up suitable own resources to co-finance the EU projects. A drop in investment expenditure assumed in 2007 (by 0.3 percentage point of GDP) is mainly related to the beginning of a new financial perspective of the EU in that year. This may result in a temporary decline in absorption of EU funds as at the commencement of the perspective it becomes necessary to submit individual projects anew to the European Commission. The amount of funds available for Poland will depend on whether and when these projects will be approved.

10. Fixed expenditure play a considerable role in the structure of the general government expenditure. It should be stressed, however, that the division of total expenditure into determined and flexible ones is a matter of convention. Legally determined expenditure (stemming from legal provisions or international agreements, inter alia: retirement and

disability pensions, unemployment benefits, housing allowances, contribution to the EU budget, debt servicing costs) is the major part of fixed expenditure. Flexible expenditure includes mainly remunerations, expenditures on purchases of goods and services, subsidies to business entities, transfers to entities outside the general government. Proportions between fixed and flexible expenditure in 2004-07 are presented in Table 10.

Table 10. Structure of the general government expenditure

	2003	2004	2005	2006	2007
Total	100.0	100.0	100.0	100.0	100.0
Fixed	42.5	40.7	40.7	39.1	39.3
Flexible	57.5	59.3	59.3	60.9	60.7

Source: Ministry of Finance.

V.3. GENERAL GOVERNMENT REVENUES

11. Within the ongoing reform of public finance, measures on the revenues side have also been envisaged. The most important of them concern broadening of the tax base, elimination of irregularities and shrinking of the hidden economy, changes in the social security system for farmers (including modifications in contribution payments), and restructuring the Polish State Railways and the coal mining sector. The government has also proposed changes in the rules of social insurance contribution payments by persons running economic activity, but these proposals have not been accepted by the Parliament. However, the government is planning to adopt additional measures, which would bring about the total financial effect of ca. 0.2% of GDP per annum, beginning from 2005.

12. It is expected that as a result of measures under the public finance reform it will be possible to obtain additional revenues representing ca. 0.7%, 0.8% and 0.8% of GDP in 2005-07, respectively (as compared with the situation of non-implementation of the reform).

13. Recently introduced changes in the tax system have been mainly aimed at supporting entrepreneurship and helping to curb unemployment, maintaining at the same time the appropriate level of the general government revenues. The most important changes include reduction in the corporate income tax to 19% in 2004 and introduction of the so-called tax option. The tax option enables persons running economic activity to apply also the 19% rate provided that they give up their right to most of the tax relief previously available.

Table 11. Performance of the Programme - the general government revenues (% of GDP)

	2004	2005	2006	2007
Total additional revenues	0.07	0.71	0.76	0.75
1. not requiring legislative changes:	0.00	0.40	0.39	0.38
a) restructuring of the Polish State Railways	0.00	0.04	0.04	0.04
b) broadening of the tax base	0.00	0.35	0.35	0.34
2. requiring legislative changes:	0.07	0.31	0.37	0.36
a) approved by the Parliament	0.07	0.04	0.04	0.04
<i>restructuring of hard coal mining</i>	0.07	0.04	0.04	0.04
b) in the legislative process	0.00	0.27	0.33	0.33
<i>additional actions</i>	0.00	0.17	0.17	0.17
<i>changes in the pension system for farmers including, inter alia, modified rules of social contribution payments by farmers</i>	0.00	0.10	0.10	0.10
<i>other</i>	0.00	0.00	0.06	0.05

Source: Ministry of Finance on the basis of data obtained from the Ministry of Economy and Labour and the Ministry of Social Policy.

14. In 2004, several changes were also introduced to the tax system with a view of adjusting to the EU requirements. They concerned mainly indirect taxes (VAT and excise tax). Major changes in the tax policy are not provided in the draft budget for 2005. After the relatively essential changes introduced in the previous period, certain stabilisation of the tax system has been deemed necessary. Stability and predictability of the system should lower risk to economic activity and thus be conducive to the economic growth.

15. The expected increase in the general government nominal revenues in 2004-07 will result from the steps taken to reduce the fiscal deficit and the forecast favourable economic development. The highest level of revenues-to-GDP ratio is envisaged for 2006: 44.8%. It represents an increase by 1.6 percentage points as compared with 2004, when the ratio shall reach 43.2%.

16. Tax revenues (D2+D5) and social security contributions (D61) will be prevailing items in the structure of the general government revenues, accounting in 2004-07 for ca. 50-51% and 30% of the total, respectively. The combined share of these items constituting the main fiscal burden will amount to ca. 80-81% in the projected period.

17. Increase in the "other revenues" item will have the largest impact on the growth of general government revenues. In 2004-06, it will amount to 1.2 percentage points of GDP and originate mainly from the inflow of EU funds. In 2007, the relation of these revenues to GDP will decrease again (by 0.7 percentage point).

VI. SUSTAINABILITY OF PUBLIC FINANCE

1. Poland participates in the preparatory work for the new round of forecasts of expenditure related to ageing populations in the Member States. The forecasts will be focused on expenditure of the social security system as well as health care, education and labour market related expenditure. According to the schedule of the EPC Working Group on Ageing Populations, Poland and other Member States should present the results of their work by the end of March 2005.

2. Table 12 presents a preliminary forecast of expenditure of the pension system and projection of health care expenditure, prepared within the framework of the *National Development Plan 2007-13*.

Table 12. Pension system and health care expenditure in 2002-20 (% of GDP)

	2002	2005	2010	2015	2020
Retirement pensions	7.9	7.9	6.6	4.9	4.5
Health care	4.6	4.6	4.2	3.8	3.5
OPF assets	4.2	8.2	15.6	23.4	31.1
Assumptions:					
labour productivity growth	1.7	2.9	5.0	4.6	4.8
real GDP growth	1.4	5.0	6.1	5.0	5.1
participation rate - men (15-64)	67.5	67.5	66.5	67.9	70.6
participation rate - women (15-64)	57.7	57.7	57.1	59.0	62.6
total participation rate (15-64)	62.6	62.6	61.8	63.4	66.6
unemployment rate	20.3	18.5	14.2	12.7	11.3

Source: Ministry of Economy and Labour, Ministry of Social Policy.

3. The forecast has been prepared on the basis of the model *Social Policy Budget*. It takes into account public expenditure of all pension systems, inter alia the employee pension system (ZUS – Social Insurance Institution), pension system for farmers (KRUS – Agricultural Social Insurance Fund) as well as other special pension systems. The health care projection does not take into account expenditure on care for the elderly.

VII. HORIZONTAL ISSUES AFFECTING PUBLIC FINANCE

1. The *Programme* adopted by the government at the beginning of 2004, and aimed inter alia at diminishing the imbalance of the public finance and reducing the government debt growth, has been subject to various modifications and supplements in the process of its implementation. The present shape of the *Programme* is thus to a certain degree different from its original version. The most significant changes include:

- combining the modified indexation of retirement and disability pensions with elimination of the so-called “old portfolio”,
- abandoned equalisation of the retirement age for women and men,
- abandoned new regulations on verification of the pension entitlement (verification will be carried out on the basis of existing legal provisions),
- abandoned equalisation of the age qualifying for family benefits with the retirement age,
- modified proposal on drawing retirement and disability pensions combined with work,
- abandoned termination of granting pre-retirement benefits after 2006.

2. Pursuant to the government plans, implementation of solutions envisaged in the *Programme* has already been started. Implementation of some measures provided for in the *Programme* does not require amending the law, while putting other measures into practice necessitates adoption of changes in legal regulations by the Parliament. Some of the bills submitted by the government have already been passed and several other legislative initiatives are being now analysed and developed by the Parliament.

3. The most important actions implemented in 2004 contain:

- modified indexation of retirement and disability pensions combined with elimination of the “old portfolio”,
- change in the rules of financing national defence requirements,
- increased revenues as a result of hard coal mining restructuring,
- reduction in administrative costs without legislative changes (inter alia reduction in operational costs of public administration).

4. The above mentioned measures are estimated to bring about total savings of ca. 0.7% of GDP in 2005 and in 2006-07 ca. 0.5% of GDP and ca. 0.8% of GDP, respectively (as compared with the situation of non-implementation of the reform).

5. The government and the Parliament are continuing with their works on bills and on assumptions for other undertakings that could yield further savings for the general government. The savings in this range may equal about 0.8% of GDP per annum in 2005-07.

6. The most important measures still under preparation relate to:

- broadening of the tax base,
- changes in the social security system for farmers,
- changes in the employment support system for the disabled.

7. Within the framework of implementation of the *Programme* the government has proposed changes in the rules of social insurance contribution payments by persons running economic

activity. Additional revenues from this source had been estimated at about 0.2% of GDP annually, but the proposal was not accepted by the Parliament. Under these circumstances the government is planning to take up other actions that would yield a similar financial effect.

Decentralisation of public finance

8. The local government plays a very important role in effective utilisation of EU funds. It is thus necessary to adopt such solutions with regard to financing of those units which would be conducive to absorption of EU funds through an increase in resources available for co-financing.

9. As of January 1, 2004 a new system of financing local government units has been in force. The new solutions are oriented towards:

- continued decentralisation of tasks and public resources and thereby an increased share of local government units in the allocation of public resources,
- increased economic accountability of local government units through an increase in the share of own resources in total revenues of these units,
- stronger links between financial situation of the local government and changes in the overall economic situation of the country,
- developing possibilities for absorption of EU funds through their increased transfer and greater flexibility of the principles of financial management of local government units,
- creating instruments supporting entrepreneurship.

10. A qualitative change has taken place in the structure of revenues of local government units and, as a result, own revenues and general subsidy have become the main source of financing, with earmarked subsidies playing supplementary role.

11. New solutions provided for the percentage increase in the share of local government units in personal and corporate income tax revenues. As of 1 January 2004, a new revenues source of all local government units has been a 5% share in revenues obtained from implementation of tasks related to government administration and other tasks stipulated for implementation by the law in force. The share of the local government in the following revenues has been raised from 5% to 25%: sales, charges on permanent management, usufruct, perpetual usufruct, rent and lease payments on the State Treasury property administered by counties performing tasks related to government administration.

Table 13. Participation of local government units in PIT and CIT revenues (in %)

	2003	2004
Total participation in PIT	30.10	45.74
municipal administrations (<i>gminy</i>)	27.60	35.72
counties (<i>powiaty</i>)	1.00	8.42
voivodships (<i>województwa</i>)	1.50	1.60
Total participation in CIT	5.50	24.01
municipal administrations (<i>gminy</i>)	5.00	6.71
counties (<i>powiaty</i>)	-	1.40
voivodships (<i>województwa</i>)	0.50	15.90

Source: Bill on revenues of local government units from November 13, 2003.

12. Under the new financing system for local government units a new structure of the general subsidy has been introduced. Not only does it take considerable differentiation in revenues of local governments into account, but also specific expenditure needs of the units related to their social and economic situation. A more objective subsidy mechanism is related to macroeconomic indicators (GDP, unemployment rate), and other variables such as population density and road area per capita.

13. Changes regarding the scope of tasks and the methods of their financing by individual levels of local government units exert a significant influence on financial management of the local government. Some of the tasks were performed until the end of 2003 as tasks related to government administration and as own tasks, and were financed with earmarked subsidies from the state budget. Since 2004, these tasks have been financed with own revenues of local government units as their own tasks. In this respect, the most important changes include:

- financing the lighting of public roads not administered by municipal administrations as well as financing the lighting of county, voivodship and national roads in towns with a county status,
- disbursement of housing allowances,
- organisation of foster family care,
- concerning employment and counteracting unemployment: registration of the unemployed, granting and disbursement of pre-retirement allowances, issuing decisions on employment, supervising activities of cultural associations,
- financing of statutory rights for a reduced fare on national bus transport,
- organisation and granting subsidies to regional passenger railway transport.

14. As a result of system changes in the principles of financing the tasks carried by local government units, an increase of their independence in administration of financial resources is expected, and the share of own revenues will be noticeably larger with reduced grants and general subsidies from the state budget.

STATISTICAL ANNEX

Table 14. Growth and associated factors

Percentage points (unless otherwise indicated)	ESA Code	2003	2004	2005	2006	2007
GDP growth at constant market prices (7+8+9)	B1g	3.8	5.7	5.0	4.8	5.6
GDP level at current market prices	B1g	814.9	884.6	953.1	1023.9	1107.1
GDP deflator		0.5	2.7	2.7	2.5	2.4
HICP		0.7	3.5	3.0	2.7	2.5
Employment growth		-2.3	-0.5	1.0	1.6	1.7
Labour productivity growth		6.2	6.2	4.0	3.1	3.8
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure*	P3	3.1	3.8	3.7	4.1	4.8
2. Public consumption expenditure	P3	0.2	2.0	1.5	0.8	0.8
3. Gross fixed capital formation	P51	-0.5	7.4	12.9	12.6	14.4
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52 + P53	0.6	0.7	0.0	0.0	0.0
5. Exports of goods and services	P6	14.7	14.2	12.0	11.1	11.0
6. Imports of goods and services	P7	9.3	11.1	12.0	12.1	12.4
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		1.8	4.1	5.1	5.3	6.3
8. Change in inventories and net acquisition of valuables (=4)	P52 + P53	0.6	0.7	0.0	0.0	0.0
9. External balance of goods and services (5-6)	B11	1.3	0.8	-0.1	-0.5	-0.8

* individual consumption of households

Table 15. Assumptions on the external economic environment

	2003	2004	2005	2006	2007
Short-term interest rate (in %, annual average)*	5.7	5.8	7.4	7.4	7.0
Long-term interest rate (in %, annual average)	5.8	n.a.	n.a.	n.a.	n.a.
USA: short-term (3-month money market)	1.2	1.6	2.9	3.6	n.a.
USA: long term (10-year government bonds)	4.0	4.3	4.7	5.3	n.a.
USD/€ exchange rate (annual average)	1.13	1.23	1.24	1.22	1.21
Nominal effective exchange rate of the euro area (% change)	11.8	2.8	0.6	0.3	n.a.
Nominal effective exchange rate of the EU (% change)	12.8	5.9	0.8	0.1	n.a.
PLN/€ exchange rate (annual average)	4.40	4.55	4.28	4.28	4.24
Real GDP growth: World excluding EU	4.2	5.7	4.8	4.6	n.a.
USA	3.1	4.4	3.0	2.9	n.a.
Japan	2.4	4.2	2.1	2.3	n.a.
EU-25 GDP growth	1.0	2.5	2.3	2.4	n.a.
Growth of relevant foreign markets	n.a.	n.a.	n.a.	n.a.	n.a.
World import volumes, excluding EU	10.3	11.6	8.8	8.3	n.a.
World import prices, (goods, in USD)	8.8	10.4	3.7	0.5	n.a.
Oil prices (Brent, USD/barrel)	28.5	39.3	45.1	40.1	n.a.
Non-oil commodity prices (in USD, % change)	6.6	12.9	-2.9	-0.5	n.a.

* NBP reference rate

DESCRIPTION OF DIFFERENCES BETWEEN THE SPRING 2004 FORECAST AND CURRENT FORECAST CONCERNING THE GENERAL GOVERNMENT

1. The forecast of the general government revenues and expenditure from November 2004 differs from the one presented in the May 2004 Convergence Programme due to the reasons presented below.
2. The Central Statistical Office (CSO) responsible for the development of the general government statistics in accordance with ESA 95, prepared the full sequence of revenues and expenditure of this sector for the first time in September 2004. In the Convergence Programme revenues and expenditure of the general government were estimated only on the basis of mutual relations in national accounts published by CSO. Additionally, in May 2004 full consolidation of the general government revenues and expenditure was not reached yet, in particular in the area of health care and education. As a result, the overall amounts of the general government revenues and expenditure presented by CSO were higher than the present estimates by ca. 7% of GDP.
3. An Interinstitutional Group for the Statistics of the General Government has been established by CSO to improve the quality of data on the general government revenues and expenditure presented by Poland. One of the basic tasks of the Group is an agreement on the common methodology for the development of data in accordance with the ESA 95 standards. The Group is composed of CSO representatives, experts from the Ministry of Finance and the National Bank of Poland. In consequence of the hitherto work of the Group agreements have been made which brought about methodological changes in revenues and expenditure accounts of the general government. Elaboration of a full sequence of general government revenues and expenditure by CSO and their correct consolidation resulted in much lower relations of revenues and expenditure to GDP presented now than those in the May 2004 Convergence Programme.
4. The work of the Group has not been completed yet, so further corrections of the data on the amount and structure of revenues and expenditure may be possible. In spite of the improvement of the data quality as compared with data presented in the Convergence Programme, many problems emerge during the elaboration of the revenues and expenditure of the general government sector, and appropriate solutions are required.
5. CSO utilises its own reporting to prepare general government statistics, whereas the Ministry of Finance uses data from budgetary reporting. An example can be the “taxes” item: to calculate this item, CSO utilises reports sent in by economic entities, while the data from the Ministry of Finance provided by the fiscal system for the purposes of budgetary reporting constitute merely a supplement.
6. One of major methodological problems which have to be resolved in the future is consolidation of transfers between general government units (inter alia transfers between the National Health Fund and independent public health care institutions). It should be emphasised, however, that consolidation of mutual transfers between general government units has no influence on the balance of the general government, but only on the general level of revenues, expenditure and their structure.
7. The work of the Group has been continued and it should be expected that an agreement will be reached soon as to the application of uniform data sources. A common methodology will be developed, making it possible to ensure cohesion of the presented statistics and forecasts.

8. Foundation of the Group is connected with meetings of the experts from CSO, Ministry of Finance and NBP organised for several years, and concerning standardisation of the scope of institutional sectors. It has been namely agreed that CSO, responsible for interpretation of ESA 95 principles, will set up an Interinstitutional Group for the Statistics of the General Government. The Group was established on June 3, 2004 under an internal order of the President of CSO. The responsibilities of the Group include co-ordination of information exchange and preparation of proposals for methodological and organisational solutions concerning:

- fiscal notification, annual and quarterly financial and non-financial accounts of the general government,
- ESA 95 tables (general government revenues and expenditure),
- general government finance statistics for the European Central Bank,
- general government finance statistics for the International Monetary Fund,
- budgetary classification, budgetary reporting, reporting for units with legal personality classified as general government,
- institutional scope of general government.

9. An effect of the Group's work should be inter alia preparation by CSO of a methodological manual. The Group shall consider problems concerning revenues and expenditure by mid-2005. Progress reports will be forwarded to the Council of Ministers.

Table 16. Comparison of main differences between data from the May 2004 Convergence Programme and its update

Difference in the level of total revenues and expenditure	ca. 7.0%
Of which:	
implementation of Regulation 1500/2000 defining the method of counting the social transfers in kind (D6311)	ca. 4.5%
consolidation in the range of health-care and education	ca. 1.9%
Other	ca. 0.6%