REPUBLIC OF POLAND

CONVERGENCE PROGRAMME
UPDATE 2008

Warsaw, December 2008

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INTRODUCTION

The Convergence Programme Update 2008 was adopted by the Polish government on 30 December, 2008. The document conforms to the guidelines regarding the stability and convergence programmes. It will be discussed by Sejm and Senate Select Committees.

Considerable uncertainty as to the development of the world economy and a need to ensure that Polish economic policy is coherent with actions undertaken by other European Member States resulted in a delay in the preparation of this document.

Main objectives and directions of the government's economic policy stated in the *Update* are in line with the *Convergence Programme Update 2007* approved in March 2008. The priority of the medium-term government's strategy is to meet the conditions necessary for the euro adoption.

The most important challenge for the fiscal policy in the *Update's* horizon is to reconcile the objective of fulfilling the fiscal convergence criterion in a sustainable way with actions necessary to mitigate the effects of the international financial crisis.

On 30 November 2008, Polish government presented the *Stability and Development Plan* aiming at strengthening the Polish economy in the face of the world financial crisis. It includes measures to support sustainable and long-term economic growth in Poland.

The forecasts of macroeconomic and fiscal variables presented herein are to a considerable extent influenced by the visible deterioration in the international financial market and its negative consequences for the world real economy. The main risk to the presented scenario is the uncertainty of the scale of the observed economic slow-down and the degree of its adverse impact on the Polish economy.

The *Update* contains the macroeconomic and fiscal forecasts up to 2011. Within the *Update's* horizon Poland shall fulfill the nominal convergence criteria. After other formal requirements are met, a positive European Commission's opinion is issued and the derogation is abrogated, Poland will be able to become a full member of the euro zone. According to the roadmap of Poland's integration with the euro zone, adopted by the Council of Ministers on 28 October 2008, it will be possible to replace the Polish zloty with the common European currency as of 1 January 2012, provided that no risk factors materialize.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

I.1. FRAMEWORK

The pace of economic growth in the medium term will slow down. The fundaments of the Polish economy remain solid, however, the scale of the problems in the international financial market and their impact upon the real economy adversely influence the macroeconomic variables in Poland.

Beside the global situation, Poland remains under strong influence of regional factors. Development of the salutation in our main trade partners' is of considerable importance, as well as the scale of the financial problems suffered by countries of the Eastern and Central Europe.

The consistent execution of the government's strategy of the adoption of the euro is an important factor supporting the favourable outlook for Poland.

I.2. INTEGRATION WITH THE EURO ZONE

Meeting the nominal convergence criteria in 2011, obtaining the positive opinion of the European Commission and abrogation of the derogation by the Ecofin Council shall allow Poland to adopt the common European currency as of 1 January 2012. In order to establish the sequence of actions necessary for the introduction of the euro in Poland, as well as to specify the institutions involved in this process, on 28 October 2008 the government adopted the *Roadmap for Poland's adoption of the euro*. The document is a plan of actions necessary for Poland's enjoying full rights of the membership in the euro zone. It contains the schedule for the execution of most important tasks (especially the ones of technical character) in subsequent stages of preparations.

Replacement of the Polish zloty with the European single currency shall require a number of preparations of the technical and organizational character related to, among others, exchange of cash money, adjustments in the financial and administration systems and monitoring of the price conversion process. A key element of the preparation process shall be to prepare and carry out the information campaign regarding introduction of the euro, with special regard to the so-called sensitive groups which may find it difficult to adapt to the new legal tender. The necessary actions in the abovementioned areas shall be described with more detail in the *National Plan for Introduction of the Euro*, to be prepared jointly by the Government and the National Bank of Poland (NBP), with the participation of social partners.

There is a political risk related to execution of the schedule outlined in the *Roadmap*, resulting from necessity to introduce appropriate amendments to the Constitution of the Republic of Poland.

I.3. OBJECTIVES OF MACROECONOMIC POLICY

The main objective of the government's economic policy in the medium term is to create conditions for high economic growth, while limiting the adverse impact of the crisis upon the economy.

This objective shall be executed under more adverse external conditions than assumed in the previous *Update*. The medium-term macroeconomic scenario for Poland has changed as well. At the same time, the strategy for entering the euro zone adopted by the government shall be an important factor influencing the economic policy.

The new conditions require the appropriate adjustments to be made in the fiscal policy. These include measures influencing revenues and expenditure to increase consumption and investments.

The main areas of the government's activities towards the achievement of the main objective of the economic policy, in line with the previous *Update*, include:

1) *Reducing fiscal burdens*

In the *Update's* horizon, the biggest systemic change towards reduction of financial burdens is the reduction of PIT rates as of the beginning of 2009. By increasing the households' disposable income, it will stimulate the consumption growth.

Other changes in the tax system being implemented or in the legislative phase shall also play a vital role. They will be of considerable importance for streamlining the entire system, especially in the area of carrying out business activity. Their impact on the general government sector and the economic growth shall be smaller than the structural changes in PIT.

Introduction of any other possible tax changes of systemic character in the *Update's* horizon shall depend on the macroeconomic situation and the situation in the sector of general government, including progress in reducing the growth of expenditure and changes of the expenditure structure.

2) *Growth of economic activity*

Apart from changes to the tax system and disability and pension system actions aiming at specific groups of population will be carried out. *The Solidarity of*

Generations' Programme – actions for increasing the economic activity of persons aged 50+ (called the *50+ Programme*) deserves special attention as a response to demographic changes and their consequences for economic activity.

3) Changes in the structure of expenditure and enhancing efficiency of expenditure

To support innovations the increased level of funds for science and education, research and development and development of infrastructure will be of considerable importance. In execution of infrastructure-related programmes, emphasis will be put on good utilization of UE funds as well. The changes will also cover expenditure of social character. They will be addressed to support the growth of economic activity and improvement in addressing the state aid. There is also work carried out to introduce changes in the health care system towards improving its efficiency.

The undertaken actions will serve as an incentive to increase first of all investment expenditure. The implemented changes will contribute to change in the expenditure structure towards supporting innovations in the long term.

Measures in these fields will be supported by changes in the domestic regulations on public finance (the Act on public finance).

4) Liberalisation of the economy

Actions limiting the obstacles in development of entrepreneurship will first of all include reduction of administrative burdens, simplification of regulations on opening and carrying out business activity and improvement of the functioning of courts. Tasks related to development of cooperation between the public and private sectors will be carried out (especially in the form of public-private partnership) as well as actions supporting innovation and entrepreneurship. They will also streamline investments. At the same time, changes to the general government administration leading to improvements in its efficiency will be implemented.

5) Accelerating privatization and improvement of management of the State Treasury assets

Undertaken actions aim at increasing the efficiency of privatization processes, finalizing the transformation of ownership in some industries and sectors and enhancing supervision over companies of key importance to the State Treasury. The proceeds will be directed in particular to finance the costs of the pension reform and restitution.

6) Limiting fiscal imbalance and the general government debt to GDP ratio

The government's objective in the *Update's* horizon is to reduce the fiscal deficit to the extent enabling a secure and sustainable fulfillment of the convergence criterion. The pace of limiting fiscal imbalance will depend on fiscal actions aimed at reducing effects of the crisis.

Reduction of the deficit will aim at reaching the medium-term objective (MTO). Due to a considerable adverse change of the conditions for performing fiscal policy since the *Update* of March 2008, the structural deficit will be limited to the MTO level (-1% GDP) after 2011.

Reduction of the fiscal imbalance will benefit the decrease in the general government debt to GDP ratio.

II. ECONOMIC OUTLOOK

II.1. CYCLICAL DEVELOPMENTS AND CURRENT PROSPECTS

In the first half of 2008, there were three factors adversely influencing the world economy: turmoil in the financial markets and the following tightening of credit conditions, a considerable increase in the prices of raw materials, including crude oil and downturn on market for real estate. As a consequence of the shocks, the global economic situation worsened and in the third quarter the GDP decreased in main world economies – for the second time in a row in the euro zone, the key Poland's trade partner. The leading indicators show further decrease in the activity in the last quarter of 2008. This adverse tendency and deteriorating expectations of further development restrained the economic growth and were followed by a drop in prices of natural resources which should, on the other hand, result in reduced inflationary pressure.

Since early autumn of 2008, the turbulences in financial markets turned into financial crisis which paralyzed a considerable part of the world financial system with a significant impact on current and expected developments in the real economy. The turmoil also influenced, so far relatively untouched, financial markets in emerging economies. Measures taken by economic authorities (including, among others, capital injections, state guarantees, increasing the minimum level of guarantees of bank deposits) resulted in some mitigation of tensions. Although the risk of sharp slump lowered, the economic conditions are still far from being normal.

The condition of the domestic banking sector looks well against the world financial system. Polish banks remained untouched by the effects of the subprime crisis. The adverse tendencies did not spread to a considerable extent to the Polish market. One of the reasons behind it is that Polish financial market (in particular the credit market) is still in the early phase of its development, thus the extent to which financial innovations are used is limited[1]. Furthermore, in response to the turmoil in the world markets, actions were undertaken to ensure the efficient operation of the Polish banking sector (cf. Frame 1).

In the first three quarters of 2008, the Polish economy was still on the path of relatively high, although gradually decreasing rate of economic growth (in Q3 of 2008 the GDP growth reached 4.8% year-to-year against 6.0% in Q1). The economic slowdown is, however, visible since the beginning of 2007 (when the GDP in Q1 reached 7.4%). In 2008 households' consumption grew fast (in Q1-Q3 reaching ca. 5.4%) and so were investments till Q3 2008. The former was supported by favourable labour market condition, with growing employment and wages and declining unemployment, which together with the decrease in the tax wedge favoured high dynamics of households' real disposable income. Investment development benefited from the low level of free production capacities, good financial standing of enterprises and inflow of foreign capital. Strong domestic demand also resulted from high, although gradually decreasing dynamics of credit to the non-financial sector. In Q3 2008, however, the investment demand sharply declined to 3.5% year-to-year from 15.4% year-to-year in the first half of 2008. The decrease was driven by a considerable decrease in Q3 2008 in investments of enterprises employing more than 50 persons. Due to growing risk aversion in global financial market and uncertainty about further economic development, Polish banks tightened the criteria for credits (especially mortgages) and increased incentives to collect deposits.

It is estimated that in 2008 the GDP growth will achieve 5.1% against 6.7% in 2007.

The high dynamics of domestic demand, still positive output gap and strong increase in prices of raw materials contributed to increased imbalance of the economy – inflation rose and the current account deficit increased. In monthly dynamics of consumer prices was above the upper level of allowed deviations from the Monetary Policy Council (RPP) inflation target, (reaching its maximum in August, 4.8% year-to-year); the core inflation maintained on the lower level, although it was increasing gradually as well. During this period trade dynamics grew, although the import growth rate remained higher than that of export. As a result, the deficit on the balance of goods account grew, which with a deepening negative balance of income and decreased surplus of services and current transfers had an influence on increased current account deficit (up to approx. 5.2% GDP in October 2008).

Between Q1 and Q3 2008 the labour market condition was favourable. The dynamics of labour demand was high[2]. It is estimated that the employment rate[3] in 2008

[1] At the end of Q3 2008, credits for non-financial sector to GDP ratio was 42% in Poland. In addition, credit activity in the Polish banking sector is mainly financed with deposits.

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

shall increase to 59.2% (from 57.0% in 2007). Growing labour demand is accompanied by strong decrease in unemployment. Positive changes also refer to labour supply – the economic activity is growing (in years 2006-2007 the economic activity decreased, which deepened the employers' problems with employing the appropriate staff).

Expectations about inflation staying above the target and increased risk of the second-round effects were behind further tightening of the monetary policy by the Monetary Policy Council in the 1st half of 2008. The base interest rates were increased in that period by 1 percentage point. As a result, at the end of June 2008, the reference rate grew to the level of 6.0%. Further in 2008 the deepening of the crisis in the world financial market and worsening prospects for the GDP growth made the Monetary Policy Council to keep the rates on hold, and finally to cut the cost of money by 0.25 percentage point in November 2008.

Rising interest rates, solid foundations of the Polish economy and positive investors' attitude to the currencies of our region contributed to the strengthening of the Polish zloty against the euro between January and July 2008. However, the unstable situation in world financial markets reversed the appreciation tendency of the Polish currency and then caused its distinct weakening. Between January 2008 and July 2008, the Polish zloty strengthened against the euro by 10.6%, whereas from August 2008 to November 2008 weaken by 17.3%. It should be stressed, however, that this weakening of the zloty resulted from developments in the region (in particular rapid decline in the financial stability in Hungary) not the foundations of the Polish economy. Unfortunately, the perception of Poland by foreign investors is still largely influenced by a regional factor – developments in the Central and Eastern European countries.

[3] Population aged 15-64 years old, LFS.

Frame 1. World financial crisis – decisions and domestic actions

Decisions and domestic action against the world financial crisis

I. Crisis in the world financial markets did not affect directly Polish banking institutions. However, decreased level of trust in the interbank market limits the interbank lending transactions. It leads to banks looking for other sources of funding (with deposit offers becoming more attractive) and limiting their lending activity.

II. This situation is especially visible in the **mortgage market**, where criteria for loan issuance were tightened. Loan margins, non-interest costs of loan and the required down-payment grew as well. In addition, limitations were introduced in issuance of loans denominated in foreign currencies and the maximum period of repayment was shortened. The analysis of creditworthiness became more strict. The Financial Supervision Commission issued some special recommendations on the assessment of borrowers' creditworthiness.

III. In case of **business loans,** a considerable growth of loan margins and increase in the required collateral were visible.

IV. In order to strengthen stability of the domestic financial system and to prevent further decline in trust in the financial market, the government and the National Bank of Poland, pursuant to the recommendations of the ECOFIN Council of 7 October 2008 introduced two comprehensive packages: the **regulation package** and the **trust package**.

THE REGULATION PACKAGE – announced by the Minister of Finance on 13 October 2008

It covers the following legislative solutions:

1) **the act on the Financial Stability Committee**

There are three institutions cooperating within the Committee (acting before on the basis of a multilateral agreement) which are critical to the financial security (the Ministry of Finance, the National Bank of Poland and the Financial Supervision Commission). The cooperation covers mainly exchange of information and supporting financial stability, especially by coordinating actions of the Committee members in case of the fiscal stability being put in jeopardy.

2) **the Act on the Banking Guarantee Fund**

The changes introduced in the Act aim at, among others, increasing the level of protection to deposits from the current amount of 22,500 EUR (guaranteed in 100% up to the amount of 1,000 EUR, and in 90% above this amount) to 50,000 EUR (guaranteed in 100%).

3) **the Act on the State Treasury instruments to support financial institutions**

The State Treasury will be able to provide support to seated in Poland banks threatened by loss of liquidity, investment funds, cooperative savings and lending organizations, brokerage houses, insurance companies and open pension funds. The support may be provided as, among others, guarantees issued by the State Treasury, loans of treasury securities, sale of treasury securities with deferred payment date or payment spread into installments. The State Treasury will be able to grant banks a guarantee for the repayment of the refinancing credit taken from the National Bank of Poland (up to 50% of the outstanding credit repayment) as well as a guarantee for the repayment of credits and interbank credit lines.

THE TRUST PACKAGE – announced by the NBP on 13 October 2008

It includes the following elements:

1) restoring efficiency of financial market operation;
2) improving liquidity in the market for domestic currency,
3) improving liquidity in foreign currencies;
4) closer cooperation between banks and the central bank.

Apart from standard money market operations (issuance of 7-day NBP bills), NBP uses, among others, the following instruments:

- FX swaps;
- Currency deposit as a collateral to refinancing credit;
- Regular repo transactions (every second Tuesday of the month) with a 91-day maturity and a possibility of repo transactions with shorter maturity in case of such necessity.

V. On 30 November 2008, the government presented the **STABILITY AND DEVELOPMENT PLAN**, aiming at strengthening the Polish economy against the world crisis. The document outlined the government's activities carried out so far in this regard as well as plans of further anti-crisis actions. The key activities covered by the Plan aim at increasing the investment demand and consumption demand. They include both the elements already being implemented and new actions. All actions subject to the Plan will be executed with ensuring the sustainability of the general government sector.

Frame 1. World financial crisis – decisions and domestic actions (continued)

STABILITY AND DEVELOPMENT PLAN – announced by the government on 30 November 2008

1) Actions aiming at increasing consumer demand will include mainly:

- A reduction of PIT rates in 2009 to 18% and 32% (from 19%, 30% and 40%) within the continued reduction of the tax wedge;
- Changes to VAT.

2) An increase in the investment demand will be achieved by:

- increasing availability of credits for businesses,
- support for financial market institutions,
- strengthening of the system of guarantees for small and medium enterprises,
- speeding up investments co-financed from the EU funds,
- introduction of higher investment allowance for newly established companies,
- abolishing barriers for investments in telecommunication infrastructure,
- enabling accounting of expenditure for research activities as tax costs,
- development of public - private partnership,
- supporting investments in renewable sources of energy,
- strengthening the position of energy recipients, strengthening the competition and position of the regulator with the purpose of protection of economy and households against an uncontrolled growth of energy prices.

3) For the needs of important social expenditure, the Social Solidarity Reserve was raised in the State budget. In case of adverse changes in the situation in the labour market, actions addressed to long-term unemployed will be strengthened within the Labour Fund.

II.2. MEDIUM-TERM SCENARIO

In years 2004-2007, the rate of the world GDP growth was close to 5% and clearly exceeded the long-term average. It is estimated that in 2008, the rate of the world GDP growth, thanks to good performance in the first half of 2008, will slightly exceed the average and amount to 3.7% (the IMF and EC estimates). In 2009, the growth will further slow down to the level of approx. 2%. A gradual improvement in the situation may be visible in 2010, although the forecasts in this regard are subject to considerable uncertainty.

The expected slowing down of the economic growth rate will be most visible in industrialized countries. A considerable decline in the average growth dynamics is expected in years 2008-2009 to be followed by a certain improvement of the situation in 2010. It is expected that in 2009, GDP in the euro zone, Poland's key trade partner, will be lower, as in the USA and Japan. The situation is expected to improve gradually in 2010.

Developments in Poland's key trade partners will adversely impact the dynamics of the Polish export. The export volume is expected to slow down visibly in 2009 (3.2%), with some improvements in years 2010-2011. A more favourable currency exchange rate to euro will be an easing factor, which is expected to maintain on a higher level in years 2009-2010 as compared to 2009. However, export dynamics will remain on the level clearly lower than the one reported in years 2006-2007.

It should be emphasized that currently, the forecasts relating to the world economy and main Poland's trade partners are subject to considerable risk. In the balance of risks the downside risks prevail, which may result in the worse execution of variables than assumed in the basic scenario. The extent and duration of the financial crisis is the biggest threat and so is its impact on the real economy.

The rate of growth of households' consumption will be lower (4.9%) in 2009 against 2007-2008 (5.1% on average) as a result of the expected slowing down of the dynamics of the fund of gross salaries in the national economy. The impact of the deterioration of the fund's dynamics will be mitigated by the reduction of PIT rates and indexation of disability and pension benefits.

Investment expenditure in 2009-2011 will be subject mainly to a less favourable assessment by entrepreneurs of the prospects for development of Polish economy, tightened conditions for credit availability and also high uncertainty as to the sales in foreign markets due to intensification of the crisis in Europe. Taking into account the abovementioned factors, the dynamics of investments is expected to slow down in the medium term (especially in years 2009-2010) as compared to 2006-2008. There are, however, a few factors which should mitigate the decrease in the dynamics of investments in 2009-2011. First of all, Polish enterprises finance their investments mainly with their own capital (in more than 70%). As a result, more difficult access to loans due to tightened banks' lending policies does not have to have a substantial adverse impact on funding of private investments. In addition, the current financial standing of enterprises is relatively good. They've managed to collect relatively large own funds. Second, in the short and medium term, public investments, less sensitive to market conditions, may play an important role in alleviation of the adverse impact of private investments on total investment processes[4]. In Poland, public investments are to a large extent funded from the EU structural funds. As a consequence, their impact on the general government balance is limited, which is important under the adverse economic conditions. The government's policy aims at more efficient and according to the schedule utilization of the EU funds supporting the development of the country[5].

According to the medium-term forecasts for Poland, the average real GDP in 2009-2011 will slow down against 2006-2008. In 2009 the GDP will reach approx. 3.7% as a consequence of unfavourable external situation, slower growth of investments and, to a smaller extent, of households' consumption. The GDP forecast for Poland for 2009 will be relatively high as compared to other UE countries. In years 2010-2011 the GDP will gradually increase and reach approx. 4.5% in 2011.

The external imbalance of the Polish economy is expected to improve in 2009 against 2008 due to, among others, lower deficit of goods and expected increase in the inflow of UE funds classified under current transfers. In 2010, further continuation of the tendency is expected (however, to a smaller extent), followed by stabilization of the current account deficit on the level around 4% of GDP in 2011. In the Update's horizon (apart from 2008) it is expected that the current account deficit will be fully financed by the inflow of long-term capital, i.e. direct foreign investment and funds classified under the capital account (mainly the European structural funds).

Slowing GDP growth, including the rate of investments, will be reflected in the labour market conditions. High rate of growth of labour demand in 2006-2008 will decrease to a considerable extent. It is expected that the employment will increase by approx. 0.1 million persons (against 1.7 million in 2006-2008). The level of economic activity in the following years will be under the influence of various factors. Worse economic situation will have an adverse impact on the economic activity, whereas changes in the retirement regulations (earlier retirement no longer possible) and re-emigration will increase the activity. Taking the above assumptions into account, it is estimated that the unemployment rate will increase from 7.1% in 2008 to approx. 7.4% in 2011.

In the nearest future, dynamics of inflation in Poland should be slowing down. It will be a result of both a lower economic growth weakening the demand pressure and earlier tightening of the monetary policy. The considerable decrease of prices of raw materials in the world markets will additionally facilitate the reduction of prices increase. In 2009, consumer price index (CPI) is forecast to reach 2.9% p.a. on average. It is expected that the monetary policy actions should result in the inflation coming back to the inflation target in the second half of 2009 and it maintaining on a similar level in years 2010-2011.

A forecast of NBP interest rates for years 2009-2011 envisages that due to the expected lower economic growth in Poland and the prospects for the inflation permanently reaching the inflation target in 2010, the Monetary Policy Council (MPC) will continue to ease the monetary policy in 2009. Reductions in interest rates will be facilitated by weakening tensions in the labour market, improved relationships between the growth of wages and labour productivity, as well as decreasing risk of the second round effects. At the same time, the scale of reduction of the cost of the central bank money will be conditioned by the prospects for fulfilling the inflation convergence criterion in 2011.

The projection of the exchange rate for years 2009-2011 envisages a gradual appreciation of the Polish zloty against the euro as compared to the currently reported levels. In terms of annual average, the Polish currency will weaken in 2009 and will return to the appreciation path in the following years. Solid macroeconomic foundations of the Polish economy, inflow of foreign direct investments, expectations of the zloty to enter the ERM II mechanism and Poland's accession to the euro zone will support the Polish currency. The pressure on the Polish zloty appreciation may be weakened by the forecast reductions of the NBP interest rates. The expected path of the Polish zloty exchange rate against the euro means that after the Polish currency is included into the ERM II mechanism, its exchange rate will be characterized by the stability required by the exchange rate convergence criterion.

[4] Public investments are approx. 19-20% of total investments.

[5] For this purpose, the Government prepared a draft of act on amendment to certain acts in relation to implementation of structural funds and the Cohesion Fund which was adopted by the Parliament (*Sejm*) in October 2008.

II.3. STRUCTURAL REFORMS – THE LABOUR MARKET

The labour market is an important area of structural reforms in Poland. The solutions supporting economic activity, described in detail in the *Update* of March 2008, will be continued with regard to this area. The most important action in this direction is the reduction of the tax wedge, started with the reduction of the disability contribution in 2007. The last stage of the tax wedge reform is the reduction of PIT rates in force as of 1 January 2009.

The already introduced changes resulted in the tax wedge[6] in Poland in 2007 being by 0.9 basic points lower than in 2006, which was one of the biggest changes in the tax and para-tax burdens among the EU states[7]. It is estimated that the tax wedge will be reduced to approx. 38.0% in 2009 against 42.5% in 2006.

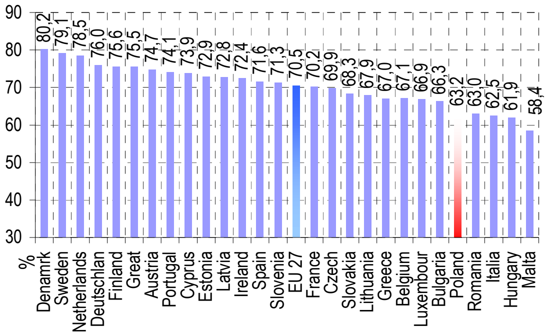
In spite of a considerable improvement of the labour market condition in Poland visible in the recent years (reduction of unemployment and growth of employment), the labour-supply related problems still remain up-to-date. Low labour supply results first of all from insufficient economic activity, labour migrations and demographic trends.

Furthermore, there is still a mismatch between the level of education and qualifications of workers offered and the market demand. In 2007, the economic activity ratio in Poland reached 63.2%[8] and was one of the lowest in the EU Member States. At the same time, the employment ratio reached 57.0%[9] and improved considerably (by 2.5% basic points) against 2006.

Economic activity in Poland is especially low among women and older persons. The main reasons for women not being active on the labour market, apart from their retirement (in case of persons in the working age – earlier retirement) are family duties and duties related to running households, and in case of men – illnesses and disabilities. There is a concern about declining economic activity of persons in years of their mobility (25-44 years old) caused mainly by labour migration.

Increase in the economic activity rate (especially among women and older persons) and the employment rate is one of the key objectives of the government.

Graph 1. Economic activity rate in 2007 according to LFS (aged 15-64)



Source: Eurostat

National Action Plans for Employment are basic documents defining the government's activities under the labour market policy. A draft of the *National Action Plan for Employment for years 2009-2011* (KPDZ/2009-2011) is being prepared (cf. Frame 2).

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[6] According to Eurostat, calculated for single person with no children earning 67% of the average salary;

[7] No data available for all EU states, including no information on the level of average tax wedge in EU;

[8] According to LFS (*Labour Force Survey*), 15-64 years old;

[9] According to LFS, 15-64 years old;

Frame 2. The draft of the *National Plan of Activities for Employment for years 2009-2011*

THE NATIONAL ACTION PLAN FOR EMPLOYMENT FOR YEARS 2009-2011 (KPDZ)

KPDZ is adopted by the Council of Ministers and includes the principles of execution of the European Employment Strategy and constitutes the basis for executing the State tasks towards promotion of employment, mitigation of effects of unemployment and economic activity.

The priorities and directions of the government actions were set out in the following government's documents: *The Strategy for the Country's Development for 2007-2015*, *The Strategic Management Plan*, *The National Reform Programme for years 2008-2011 for execution of the Lisbon Strategy, the National Action Plan for Employment for 2008, the Operational Programme Human Resources Development 2007-2013*.

KPDZ is prepared on the national level and forms the basis for the local governments to prepare annual regional plans of actions, outlining the preferred regional programmes, local projects, priority unemployment groups as well as groups of other persons who require support.

KPDZ/2009-2011 sets out activities in the area of employment for the following three years. The priorities include:

- **Growth of activity –** actions include development of factors and instruments encouraging undertaking of professional and educational actions, facilitating the balance between work and family life, increasing chances of maintenance and undertaking of employment and taking advantage of actions promoting activity, as well as actions strengthening a capability of work undertaking and adapting to changes;
- **Efficient labour market –** actions aim at improving the labour market performance by creating better conditions of enterprises' operations and staff employment, first of all by reducing barriers for development of entrepreneurship, promotion of flexible forms of employment and work organization, changes in social security in the labour market, creating better potential for being employed and for self-employment;
- **Improvement of active labour market policy** –actions cover an improvement of availability and suitability of addressing the labour market services and instruments and their efficiency, as well as improvement of the functioning of the labour market institutions.

The KPDZ/2009-2011 framework covers, among others, the *50+ Programme* approved by the Council of Ministers together with the draft of the first act in October 2008. Its main assumptions were outlined in the *Update* of March 2008.

The *50+ Programme* is designed first of all to create incentives for employers to employ and maintain employment of older staff and make it possible for persons older than 50 years to improve qualifications, skills and efficiency of work. Local governments are responsible for executing a considerable part of the tasks related to the labour market policy. The undertaken actions will be financed by the general government and from the European Social Fund.

Frame 3. *The Solidarity of Generations Programme – actions for increasing economic activity of persons aged 50+*

***THE 50+ PROGRAMME* – MAIN AREAS**

1) Actions for **improving work conditions, promoting employment of staff aged 50+ and age management,** including: promoting knowledge on management, underlining benefits of employing persons aged 50+, implementing the strategy for age management in enterprises, adjusting work conditions of 50+ staff to their needs;
2) Actions for **improving the competencies and qualifications of staff aged 50+** including: creating conditions for building education paths, promoting lifelong learning for persons aged 45+, adjustments to the training offered;
3) **Reducing labour costs** related to employing persons aged 50+, including: releasing employers from the obligation to pay contributions for the Labour Fund, reducing the number of sick-leave days to be paid by employer;
4) **Activating unemployed persons or persons threatened by unemployment aged 50+** including promotion of labour market programmes, building individual support plans, adjustment of the offer of active labour market programs;
5) **Economic activity of disabled persons,** including: building stable legal framework for employing and for professional rehabilitation of disabled persons, promotion of economic activity and integration with the labour market;
6) **Increasing the potential for employing women** by means of: developing the services to facilitate a balance between work and family life, simplification of regulations on opening of nursery schools, supporting extension of nursery school network especially in rural areas; enabling company nursery schools and kindergartens to be financed from the company social benefit funds; supporting other forms of child care;
7) **Reducing inactivity of staff in the social benefit system** including: implementation of bridge pensions and applying limits to earlier retirement, promotion of activities for extended retirement age, especially women's retirement age.

Important actions supporting economic activity of older persons covered by the *50+ Programme* include those aimed at preventing early professional inactivation of population at the working age, i.e. solutions encouraging extension of effective retirement age. With regard to this, the bridge pension act is of vital importance. Its entering into force in January 2009 will result in reduced number of persons authorized to earlier retirement from approx. one million to less than 250 thousand. Pursuant to the Act, only persons born after 31 December 1948 who till 1st January 1999 had worked at least 15 years under special conditions or performed work of special character throughout this time are entitled to the bridge pensions. Pre-retirement is possible to begin five years (or in some cases, such as e.g. pilots or engine drivers, 10 years) before reaching the retirement age (i.e. the age of 55 years for women and 60 years for men), with the suitable insurance seniority (20 years for women and 25 for men). The persons entitled will receive benefits in the amount of 100% of retirement calculated for a person aged 60 years old, indexed according to the same rules as the disability benefits and pensions from the Social Insurance Fund (FUS).

Limiting the number of persons entitled to early retirement due to health reasons and no possibility as of 2009 to take advantage of the interim regulations regarding early retirement (on general terms) means that in the following years the outflow of staff in the working age from the labour market will not be as considerable as now. It will be of key importance for the economic activity in the following years. It is estimated that as of 2009, the economic activity ratio will increase gradually (to reach the level of 62.4% in 2011).

Increase in the economic activity and the rate of employment is of crucial importance for the economic growth. High labour supply reduces tensions in the labour market, limits inflation pressure (by lower pressure on salary increase). A higher demand for labour is an opportunity for more dynamic economic growth, modernizing the economy and improving living conditions of the society.

In addition, positive effects of reducing tax and para-tax burdens, high in comparison to other EU states, should be a significant incentive boosting consumption.

III. General goverment balance and debt

III.1. Policy strategy and medium-term budgetary objective

The objective of the government's fiscal policy, in the *Update's* horizon is to reduce the fiscal deficit to the level enabling the fulfillment of the fiscal convergence criterion in a sustainable way. Its consistent execution will enable to limit the accumulation of general government debt and to reduce debt to GDP ratio. The fiscal policy will support mitigation of consequences of the financial crisis and the impact it has on the real economy. In a long term it will benefit the resistance of economy to external and internal risks.

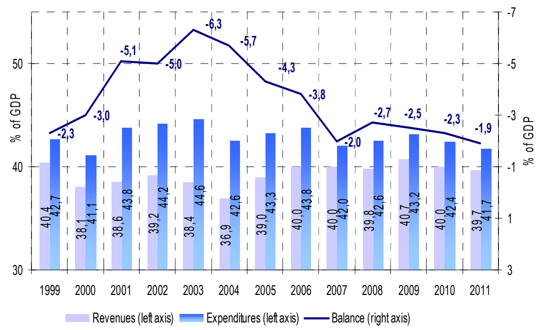
The fiscal path presented herein, less ambitious than the one presented in the *Update* of March 2008 due to worse external and internal conditions, is compliant with the government's objective. In case the risk factors to its execution materialize, actions will be taken to reduce the state budget expenditure in the first place. Expenditure subject to reduction will be selected with the least possible negative impact on the execution of the government's priority tasks.

III.2. Actual balances and implications of budget for next year

In 2007, the general government deficit decreased to 2.0% GDP from 3.8% GDP in 2006. Such a scale of reductions was possible thanks to favourable macroeconomic situation, resulting in high tax revenues and the expenditure being executed in the amount less than earlier assumed (including the EU funds). In 2007, the deficit of the state budget equaled 16.0 billion PLN on cash basis, against 30.0 billion PLN planed in the budget act.
Good performance of the general government sector in 2007 and favourable prospects for the fiscal balance and general government debt performance in the coming years resulted in the abrogation in July 2008 by the Ecofin Council of the excessive deficit procedure, in force since 2004.
In 2008, fiscal situation in Poland remains under strong influence of mainly two factors: the macroeconomic situation, in particular, the slow down of the GDP dynamics, and costly structural changes being introduced (in particular, the continued reduction of the tax wedge). The latest forecasts show that in 2008 the general government deficit will be slightly higher than planned in the *Update* of March 2008 and will reach 2.7% GDP. The deficit will be higher in spite of the executed state budget deficit being lower than assumed in the budget act for 2008.

The general government deficit planned for 2009 will be mainly determined by the state budget performance. The budget act for 2009 assumes that the state budget deficit may not be higher than 18.2 billion PLN. The mechanisms laid down in the Act on public finance ensure the execution of the deficit on this level (even under worse macroeconomic situation, leading to lower tax revenues). It is assumed that the general government balance in 2009 will reach - 2.5% GDP, -2.3% in 2010 and -1,9% GDP in 2011.

Graph 2. General government in Poland



Source: data for Poland 1999-2007 – Eurostat, 2008-2011 – Ministry of Finance

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

	ESA code	2007	2008	2009	2010	2011
General government balance (B.9)	S.13	**-2,0**	**-2,7**	**-2,5**	**-2,3**	**-1,9**
Central government	S.1311	-3,2	-3,6	-2,7	-2,5	-2,1
Local government	S.1313	0,1	0,4	0,2	-0,1	-0,2
Social security funds	S.1314	1,1	0,5	-0,1	0,2	0,3
General government debt	**S.13**	**44,9**	**45,9**	**45,8**	**45,5**	**44,8**

Source: 2007 – Central Statistical Office, 2008–2011 - Ministry of Finance

III.3. STRUCTURAL BALANCE

The latest forecasts for 2008 show an increase in the structural general government deficit[10] by 0.8 pp. against 2007, mainly as a result of the reforms such as the tax wedge reduction (further stage in 2008), family tax allowance (for families with children) and lower than assumed budget revenues related to the deterioration in the economy (resulting from the developments in the world economy). In the following years, the structural deficit to GDP ratio is expected to decline in 2009 by 0.6 pp., in 2010 by 0.4 pp. and in 2011 remain at the level of 2010. When taking into account the one-off effects of cancellation of Iraqi debt, the structural deficit in 2010 will fall by 0.6 pp against 2009. The table below also includes the general government structural balance assuming that the net costs of the tax wedge reform would not have to be covered.

Table 2. Cyclical developments (% of GDP)

	ESA code	2007	2008	2009	2010	2011
1. Real GDP growth		**6,7**	**5,1**	**3,7**	**4,0**	**4,5**
2. General government net lending/borrowing	EDP B.9	**-2,0**	**-2,7**	**-2,5**	**-2,3**	**-1,9**
3. Interest expenditure	EDP D.41	**2,4**	**2,4**	**2,6**	**2,5**	**2,4**
4. One-off and other temporary measures		**0,0**	**0,0**	**0,0**	**-0,2**	**0,0**
5. Potential GDP growth		5,3	5,1	4,8	4,6	4,5
6. Output gap		1,1	1,2	0,1	-0,4	-0,4
7. Cyclical budgetary component		0,4	0,4	0,0	-0,1	-0,1
8. Cyclically-adjusted balance (2-7)		-2,4	-3,2	-2,6	-2,2	-1,8
9. Cyclically-adjusted primary balance (8+3)		0,1	-0,7	0,0	0,3	0,6
10. Structural balance (8-4)		**-2,4**	**-3,2**	**-2,6**	**-2,0**	**-1,8**
11. Net costs of tax wedge reform		-0,3	-1,4	-2,1	-2,1	-2,1
12. General government net lending/borrowing excl. costs of the tax wedge reform (2-11)		-1,7	-1,3	-0,4	-0,2	0,1
13. Structural balance excl. net costs of the tax wedge reform (8-11)		**-2,1**	**-1,8**	**-0,4**	**-0,1**	**0,3**

Source: Ministry of Finance

[10] The structural deficit forecast has been prepared having considered the output gap estimation performed on the basis of Hodrick-Prescott filter. Elasticises of the general government revenues to the cycle, based on OECD data and the data of the European Commission (*New and updated budgetary sensitivities for the EU budgetary surveillance*), have been used when calculating a cyclical component of the general government deficit.

III.4. DEBT LEVELS AND DEVELOPMENTS

In the *Update's horizon*, debt management will, as in previous years, focus on the execution of the objective set out in the *Public Finance Sector Debt Management Strategy in the years 2009-2011*, i.e. the minimisation of the long term debt servicing costs subject to constraints on the level of risks.

Debt management will take place under significant variability and uncertainty in financial markets as well as slowing down GDP growth due to the influence of the global financial crisis on the real economy. Decreasing central bank interest rates in the domestic market as well as the activities related to the schedule of entering the euro zone should have a considerable influence on the level and shape of the yield curve, thus the debt servicing costs as well.

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

	ESA code	2007	2008	2009	2010	2011
1. Gross debt		**44,9**	**45,9**	**45,8**	**45,5**	**44,8**
2. Change in gross debt ratio		**-2,8**	**1,0**	**-0,1**	**-0,3**	**-0,7**
Contributions to changes in gross debt						
3. Primary balance		**0,5**	**-0,3**	**0,1**	**0,2**	**0,5**
4. Interest expenditure	EDP D.41	**2,4**	**2,4**	**2,6**	**2,5**	**2,4**
5. Stock-flow adjustment		**-0,1**	**-1,7**	**-2,6**	**-2,6**	**-2,6**
of which: Differences between cash and accruals		-0,1	-0,1	0,3	-0,2	-0,2
Net accumulation of financial assets		0,8	0,5	0,6	0,8	0,6
of which: privatisation proceeds		-0,1	-0,1	-0,2	-0,3	-0,2
Valuation effects and other		-0,8	-2,1	-3,6	-3,3	-3,0
p.m.: Implicit interest rate on debt (%)		**5,5**	**5,6**	**5,8**	**5,6**	**5,6**
Other relevant variables						
6. Liquid financial assets*		0,9	0,7	0,5	0,5	0,5
7. Net financial debt		44,0	45,2	45,3	45,0	44,3

* Data covers only the State Treasury

Source: Ministry of Finance

The forecast changes in the debt to GDP ratio in the years 2008-2011 will result from, first of all, the state budget borrowing requirements (the State Treasury debt constitutes approximately 95% of the general government debt), expected the GDP growth rate and the Polish zloty exchange rate in relation to other currencies, especially to euro.

In the years 2009-11 on the state budget borrowing requirements volume, apart from budget deficit, significant influence will have the refund to the Social Insurance Fund (FUS) due to contributions transferred to Open Pension Funds (OFE), privatization proceeds, the balance of prefinancing tasks executed with participation of funds from the EU budget as well as loans granted from the state budget.

The expected changes in other general government sector entities debt will result mainly from the local government entities debt growth. Local government entities borrowing requirements will in the considerable extent result from infrastructural projects execution, co-financed with EU funds within financial perspective of the years 2007-2013. As in the previous *Update*, no indebtedness is expected in the social insurance sector.

In the *Update's* horizon, debt to GDP ratio will be below both the first current prudential threshold, i.e. 50%, and the first prudential threshold from the new public finance act, i.e. 47% and will be significantly below the reference value of 60%. It is expected a temporary increase in mentioned above ratio to 45.9% in 2008, and then in the years 2009-11, a decline to 44.8% in 2011.

III.5. BUDGETARY IMPLICATIONS OF MAJOR STRUCTURAL REFORMS

The undertaken actions are the fulfillment of the government's declarations stated in the *Update* of March 2008. As a consequence of the crisis the importance of some of tasks being performed has increased. Apart from execution of the initially set long-term objectives, they favour growth of consumption and investment, thus alleviating the effects of the turmoil for Polish real economy.

1) Reducing fiscal burdens

In the *Update's* horizon, the biggest change of the structural character, limiting the fiscal burden, is reduction of the PIT rates as of the beginning of 2009. The three tax rates of 19%, 30% and 40% will be replaced by two rates - 18% and 32%[11]. Changes in PIT are an important element of the tax wedge reform put into force in 2007[12].

Reduction of the tax wedge benefits households (increase in their disposable income) and the domestic demand. Thus, it is a key incentive for the economic growth, though it generates high costs in the form of reduced revenues of the general government sector.

Table 4. Net costs of tax wedge reduction (% of GDP)

	2008	2009	2010	2011
Net costs of tax wedge reduction	-1,4	-2,1	-2,1	-2,1

Source: Ministry of Finance

Apart from reduced tax wedge, an additional incentive for the improvement of households' situation comes from the family tax allowance, introduced since the annual PIT settlement for 2007. Its negative impact on the general government sector as reduced PIT revenues is estimated to reach approx. 0.4% GDP annually[13].

Uncertainty as to the situation in the world economy, with prevailing downside risks to the economic growth (visible, among others, in the forecasts of the EC, IMF and OECD) result in government's activities focused on first of all the improvement of the efficiency and transparency of the existing tax system. These actions, the cost of which for the general government sector is lower as compared to structural reforms, will mainly benefit business activity. They will cover first of all introduction of simplifications in VAT, changes to income taxes for businesses and a reform of the tax law.

The most important VAT-related changes refer to:

- liquidation (December 2008) of an additional tax requirement in cases of the tax obligation being underestimated by a tax payer,
- introduction (January 2009) of a tax exemption for delivery of non-housing real estate (after the first settlement of a real estate),
- enabling a settlement of tax on import of goods according to some simplified procedures in a tax declaration (December 2008),
- unification of the term for a tax refund to 60 days (instead of 60-day and 180-day tax returns),
- increasing the limit for the subject exemption from 50,000 PLN to 150,000 PLN (2010).

With regard to individual and legal entrepreneurs main changes in force since 2009 relate to the possibility of including remuneration costs and social insurance contributions into tax costs on the accrual basis under condition the payment is settled in accordance with regulations.

As of 1 January 2010, the rules of advanced payments of CIT liabilities will be changed (the double-amount prepayment made in the last month/quarter of the fiscal year will be cancelled).

The costs (decrease in revenues) of changes introduced in the VAT as well as in income taxes (except for the tax wedge and family tax allowance) in 2009 and 2010 will amount to, respectively: approx. 3 billion PLN and approx. 3.5 billion PLN.

In 2009 changes to the taxation of capital companies will include, among others, the exclusion from tax obligations of restructuring activities of companies (pursuant to the EC Directive No. 2008/7/EC of 12 February 2008). Regulations will also be introduced to facilitate the flow of capital in capital companies, including mergers, division and transformation of companies. They will result in reduced costs incurred by businesses. Implementation of the changes should not result in any decrease in total revenues from taxes on civil-legal activities collected by local communities.

2) Change of the structure of expenditure and enhancing efficiency of expenditure

Changes in the structure of expenditure aim at making it more flexible and increasing the share of funds supporting the economic development. The main areas of activities include science, education, research and development and infrastructure. In the scope of social spending, the main effort will be focused on changes to health protection and the pension and retirement system. Activities in this area will also be facilitated by changes in the public finance (a new

[11] With one tax threshold in the amount of 84,426 PLN and the tax reduction amount of 556.02 PLN and with revenue-earning costs on the level of 1,335 PLN.

[12] Reduction of tax wedge covers: a) a two-stage (2007 and 2008) reduction of pension insurance contribution in total by 7 base points (from 13% to 6%), b) restoring (2007) valorization of tax thresholds in the PIT tax, the tax-free amount and revenue-earning costs, c) introducing (2009) two PIT rates.

[13] In case such allowance had not been introduced.

public finance act) and introduction of performance-oriented budgeting (cf. chapter VII). A part of the executed tasks is of organizing character, having an impact upon the growth of efficiency of spending.

a) infrastructure-related expenditure

The main activities herein will refer to the extension and modernization of national and local roads, development and modernization of railway transport, development of sea ports and development of sports infrastructure.

As for national roads, the *National Road Construction Programme for years 2008-2012*, approved by the Council of Ministers in September 2007 is continued. Its main objective is to create a road network with higher usage parameters, including the network of road connections between the biggest economic centres in Poland. Investments included in the Programme, total cost of which was assumed to amount to approx. 121 billion PLN, are financed mainly by the general government sector, especially the state budget and supported by the inflow of the EU funds. Construction of the national roads will be supported by the *National Programme for local roads construction for years 2009-2011* (the legislation work is underway). The main objective of the Programme is to create the connections of the local roads with the network of regional and national roads, enhancement of local and regional economic activity and improvement of road traffic safety. The costs of programme, estimated in total to approx. 6 billion PLN, will be financed by the local governments' funds and the state budget.

The directions for extension and modernization of the national railway network for the forthcoming years are set out in the *Master Plan for railway transport in Poland until 2030* a document, being currently at the advanced stage of government's work. It is a strategic document regarding the development of railway transport in Poland. Its preparation is at the same time the execution of the European Commission's decision of 2005.

Development of the sea infrastructure is executed under the *Strategy for sea harbours development until 2015,* approved by the government in November 2007. Its main objective is to improve competitiveness of Polish sea harbours by, among others, improving the condition of infrastructure and access to harbours, development of harbour services and improving cooperation between entities responsible for management, utilization and administration. The total cost of investment activities executed within the *Strategy* is estimated at 713 million euro. They are financed from the Cohesion Fund and cofinanced by the general government sector.

Investments in sports infrastructure in the nearest future will concentrate on the UEFA EURO 2012 European Football Championship, building sports facilities and local football pitches. The activities related to the EURO 2012 cover mainly construction and rebuilding stadiums in Warsaw, Wrocław, Gdańsk, Poznań, Kraków and Chorzów. The total cost of their execution, estimated at approx. 3.3 billion PLN, is financed from the state budget funds and local governments' funds. Construction of sports facilities is executed within the *Orlik 2012 – My Football Pitch Programme*. Its total cost is estimated at approx. 3.6 billion PLN and will be financed from the local governments' funds (2.4 billion PLN) and from the state budget (1.2 billion PLN).

b) expenditure on science, education, research and development

The main activities in this area aim at increasing efficiency of utilization of funds for science, increasing the level of scientific research and competitiveness of Polish science, stimulating innovations and implementing the outcomes of scientific research.

Some activities related to science and higher education are an execution of the *Assumptions for the Science System and the System of Higher Education Reform*. They mainly focus on:

- increasing competitiveness of scientific research and development work and increasing efficiency of their implementation,
- creating legal mechanisms enabling building stronger relationships between the science sector and economy sector,
- strengthening and ordering the sector of entities carrying out research and development activity, stimulating innovation and implementing outcomes of scientific research.

Actions in this field aim also at increasing the amount of implemented patents, an increase in the intellectual property awareness and growth of innovative academic entrepreneurship. These tasks are executed within the programmes implemented in 2008: *Patent Plus – supporting invention patents* and *Innovation Creator – supporting innovation of academic entrepreneurship*.

c) changes in health care

Changes in health care aim at making the system more efficient. The government's objective is to change both the organization and financing of the health care in Poland.

Changes in the organizational sphere will be focused on improving the functioning of health care units, in particular by changing their legal form. They will lead to increasing efficiency of the management of financial resources.

Actions under implementation aim at improving and enhancing the quality of benefits provided in ER medical services. These activities will to large extent be financed from the EU funds.

In health care financing, there are plans of decentralization and demonopolization of the payer institution within the common health insurance. In 2010, the base for the health insurance contribution is planned to be increased from 9% to 10% (a document on a government's draft stage) . Changes leading to decentralization and demonopolization of the payer institution will be executed to ensure an increased influence of the insured persons on the method of distribution of funds collected as their contributions to the common health insurance scheme. Flexibility of the system will increase as well thanks to the possibility of smaller institutions' quicker adapting to changes. Measures in this field are planned to be implemented between 2010 and 2012 in 3 stages :

- the first stage (2010) - a division of the National Health Fund into several Health Insurance Associations (TUZ) will be introduced, the base for the health insurance contribution will be increased and the Health Insurance Supervisory Institution will be established;
- the second stage (2011) – a selection of the Health Insurance Association (TUZ) by an insured persons will be introduced and a provider of the benefits will be allowed to sign agreements with more than one Health Insurance Association;
- the third stage (2012) - non-public payers will be allowed to participate in the common health insurance.

d) changes in the pension and retirement area

The main objective of undertaken actions is to increase the efficiency of the retirement and pension system. The measures include first of all changes in early retirement scheme (introduction of bridge pensions) and changes in the farmers' social insurance system.

Bridge pensions (cf. Chapter II.3) will be funded from contribution paid by employers and grants from the state budget. The total general government expenditure in years 2009-2040 (in 2007 prices) were estimated at 12.7 billion PLN. The costs will be lower than in case of the maintenance of the system of early retirement. In years 2009-2011, the net costs of this solution for the general government will amount to approx. 0.3 billion PLN.

Work has been continued on legal regulations of payments of life pensions from funds collected in the open pension funds.

In 2009, it is also planned to introduce changes in farmers' insurance system. A draft approved by the Council of Ministers in September 2008 aims at increasing farmers' participation in funding the system by differentiating contributions paid based on the area of a farm.

As in previous years, costs of the pension reform, introduced in 1999, will constitute a big burden to the general government sector in the *Update's* horizon.

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

	2008	2009	2010	2011
Net costs of the pension reform	**2,9**	**3,2**	**3,2**	**3,4**
a) transfer from the State budget to FUS by way of:	2,0	2,0	2,0	2,0
- loss of contributions	1,5	1,6	1,6	1,7
- earnings exceeding 30 times and more the average wage	0,4	0,4	0,4	0,4
b) net interest	0,9	1,2	1,2	1,4

Source: Ministry of Finance

3) Growth of economic activity

Activities aimed at increasing economic activity focus first of all on the growth of employment rate of persons aged 55-64 to 50% in 2020, creating the tools facilitating the reconciliation of life with work, increasing women employment rate and motivating unemployed persons receiving unemployment benefits to undertake work (a digressive unemployment benefit scheme). In spite of a relatively high burden to the general government sector during the implementation phase, in the long term the benefits should definitely outweigh the costs.

The highest costs relate to the execution of the *50+ Programme.* There are estimated at approx. 22 billion PLN (including bridge pensions) in years 2009-2015, will be financed by the general government (approx. 55%) and the EU funds (approx. 45%). Execution of approx. 40% of the total amount is planned for 2009-2011. General government costs of execution of the tasks related to introduction of tools facilitating the reconciliation of life with work and growth of women employment rate between 2009-2014 will amount to approx. 7.4 billion PLN. Execution of approx. 29% of this amount has been planed for 2009-2011. Activities in this area will be related to lengthening of maternity leaves, introducing exemptions from contribution to the Labour Fund (within 3 years after end of maternity leave and child-raising leave) and to increasing the retirement and pension insurance contribution base for persons on child-raising leaves.

Changes in unemployment benefits will consist of reducing the term of benefit payment and increasing the amount of benefit, with introduction of the digressive mechanism at the same time (after the first

3 months the amount of benefit will be reduced). Impact of the changes on the general government expenditure is negligible – an increase in the amount of benefits should be roughly balanced be their drop due to a declining number of unemployed.

4) Liberalisation of the economy

Changes, apart from reductions of tax burdens, include a package of measures supporting the entrepreneurship. Its objective is to simplify undertaking and carrying out business activity. An important change is the target introduction of full electronic servicing with regard to all formal issues related to setting up business activity. In a transition stage, such complex service will take place in one point (introduction of the so-called „single window"). The legal regulations of opening and carrying out business activity will be simplified, including issuance of necessary permits,.

Building the electronic administration is a significant area of changes. It aims at improving the conditions for carrying out business activity by increasing the digital form of availability of information resources of the public administration and public services. The undertaken actions focus on, among others, building fully integrated platforms for provision of e-services in the key areas of the economy (in particular, tax settlements, administration charges).

The undertaken actions aim also at stimulating the growth of the electronic economy, among other by creating new, innovative e-services and ensuring access to the Internet. They are mainly financed by the EU funds, as in case of building of the electronic administration, and co-financed by the general government sector.

Development of cooperation between the public and private sectors is an important direction of changes. The Act on public and private partnership (PPP) plays here an important role. Its main objective is to moderate limitations and requirements in the execution of PPP transactions. The Act should contribute to growth of public investments by using private sources of funding. The actual execution of the first PPP agreements (preceded with the preparations phase) is planned for 2011. Local governments will be the main contractors within the public administration.

Actions to support investment activity are being continued together with steps supporting an inflow of direct foreign investments and development of business activity in special economic zones.

Government's work is underway to streamline the development of small and medium enterprises. The main objective is to improve access of especially micro-enterprises and small enterprises to external sources of funding. Among others, is the *Programme for extension of loans and guarantees for small and medium enterprises*. Innovations are also supported by, among others, instruments introduced pursuant to the act on some forms of supporting innovation (of 2005), in particular the technological loan and tax relief for new technologies. Work is also undertaken aiming at supporting Polish entrepreneurs in internationalisation of their activities and promoting running business activity in Poland. To finance these activities funds from the EU are used.

Changes are also put in place as far as the economic judiciary is concerned. Their objective is to eliminate obstacles in entrepreneurship development by enhancing the legal certainty of business trading. They are related to, among others, improvements in the operation of courts, including strengthening of human resources and modernization of management, as well as informatisation of some processes.

Some work has also been undertaken on solutions supporting investments in renewable energy resources.

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

In the following years the privatisation strategy will be based on the *Privatisation Programme for Years 2008-2011* (approved by the Council of Ministers in April 2008) as well as the annual directions for privatization of the State Treasury assets included in the budget acts.

The objective of the Privatization Plan is to increase credibility and efficiency of privatization processes. It includes a privatization schedule for several years, as well as a list of companies not to be privatized. The Plan also provides for enhancement of supervision in the companies of key importance for the State Treasury. The undertaken activities aim at ordering the ownership structure in the economy and in the individual companies. One of the key activities is to continue and make more dynamic the programme of selling the State Treasury stocks and shares which guarantee no actual impact on efficient management of companies (the so-called 'leftovers').

Between 2009-11 gross proceeds from privatization, compliant with the assumptions of the Programme, should annually reach 6-12 billion PLN. The effects of the crisis in the international financial market are a risk factor for timely execution of the assumed schedule.

III.6. ACTIVITIES MITIGATING THE EFFECTS OF CRISIS IN THE INTERNATIONAL FINANCIAL MARKET

The government's activities addressed to mitigate the adverse effects of the crisis in the international financial market include first of all measures aiming at increasing the consumption and investment demand. They are executed within the package of actions

already being implemented to achieve the objectives of the government's economic policy, as well as within the frames of the new mechanisms created for this purpose (see Frame 1). The undertaken activities are of a sustainable character and are designed to support the economic growth in the long-term.
The key factor in executing the undertaken activities is to ensure sustainability of general government sector and sustainable meeting of the convergence criterion.

The main medium-term activities improving the quality of public finance and long-term fiscal balance as well as the structural activities supporting demand and enhancing resilience of economy were characterized in chapter III.5. Their specification is included in tables 7-8. Short-term activities cover the State Treasury guarantees to support the financial sector. Risk for the general government sector resulting from these instruments is low. Issuance of guarantees will be charged. In compliance with the European Central Bank recommendation, to ensure that charges on guarantees supporting the banking system amount to from 7% to 9% of the guarantee amount, it was assumed that any possible general government expenditure due to the above-mentioned guarantees will be balanced with revenues from the charges collected on them.

Table 6. Short-term actions with a direct impact on the general government balance (% GDP)

Action	Date when approved	Description	Direct impact upon result of sector			
			2008	2009	2010	2011
Guarantees to support liquidity of the banking sector	together with the budget act for 2009	Increasing the statutory limit for issuance of the State Treasury guarantees in 2009 to support the liquidity of the banking sector	0.0	0.0	0.0	0.0

Source: Ministry of Finance.

Table 7. Medium-term actions enhancing quality of public finance and long-term fiscal balance

Action	Description/objective
Changing the structure of expenditure and increasing the share of expenditure supporting economic development	Increasing the flexibility of expenditure and the share of expenditure supporting economic development, including: • increasing expenditure for infrastructure • increasing expenditure for science, education, research and development • changes in health care • changes in pension and retirement scheme
Increasing the economic activity	Improving the situation in the labour market and long-term stability of public finance, including: • increasing women's employment • introducing digressive unemployment benefit scheme • *50+ Programme*
Accelerating privatization and improvement of the State Treasury assets management	Enhancing credibility and efficiency of privatization processes.
Limiting deficit of state budget and general government sector	Execution of the government's objective of sustainable fulfillment of fiscal convergence criterion. In the budget act for 2009, the state budget deficit (on cash basis) was reduced to18.2 billion PLN, in spite of worse external and internal situation.

Source: Ministry of Finance.

Table 8. Structural actions supporting demand and enhancing resilience of economy

Action	Description/objective
Limiting fiscal burdens, including: • reduction of PIT tax rates • changes in VAT and other taxes on business activity	Continuation of the tax-wedge reduction and changes positively influencing business activity and stimulating the consumption demand at the same time.
Increase the economic activity, including: • The *50+ Programme*	The objective is to increase the employment rate of persons aged 55-64 to 50% in 2020
Liberalization of economy	Simplification of undertaking and carrying out business activity and improvement of cooperation between the public and private sectors by: • simplifying legal regulations setting out the rules for opening and carrying out business activity • target introduction of full citizen service using electronic methods in the scope of all formalities related to opening a business • building electronic administration • activities for stimulating development of electronic economy, among others by creating new, innovative e-services and ensuring access to the Internet • the new public and private partnership act • development of business activity in special economic zones • development of small and medium enterprises (including access to financial sources) • improvement of the operations of courts

Source: Ministry of Finance.

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

IV.1. RISK FACTORS AND SENSITIVITY ANALYSIS

1. KEY RISK FACTORS

There are several areas of risk which could change the values of fiscal variables from those assumed in the *Update*:

1) Macroeconomic risk

The main risk factors are:

- the depth and length of the current crisis in the international market and the scale of its negative impact upon the real sphere of the world economy,
- uncertainty as to further energy raw materials, especially oil prices in the world market,
- degree of impact of the crisis upon the Polish economy, including the main trade partners' situation, the conditions for obtaining financial funds,
- risk aversion and sentiment of foreign investors as to investing capital in Poland,
- labour market situation, including the scale of Poles' coming back from labour emigration,
- delays in execution of the tasks presented in the Roadmap for the euro adoption in Poland.

2) Other risks

a) Lower absorption of the European Union funds

Risk of delays in absorption of structural funds and the Cohesion Fund in the financial perspective of 2007-13, especially in the first years of execution is slightly higher than the one assumed in the previous *Update*. The results of the audit of the conformity of the description of the management of operational programmes and control systems are being under the process of approval by the European Commission. The European Commission's approval of the auditor's positive opinion will result in the possibility for indirect payments to be received by the individual programmes.

The additional risk-increasing factor may come from the status of the public aid notification and the status of adjustment to the community law on the environment. There are no serious threats to utilization of funds from the Common Agricultural Policy.

b) No settlement of the restitution claims

The lack of a final settlement of the restitution problem continues to be a source of risk. The total sum of restitution claims on properties left outside the current Poland's borders (the act of 2005) and from nationalization of properties in years 1944-1962 (a draft of the act) is currently estimated at approx. 111.5 billion PLN. The expected amount of payments due to these claims is much lower and should reach 20% of the amount of claims. The funds for payments of these claims will be collected in the Restitution Fund. They will come from, among others, the funds obtained from the sale of State Treasury shares and stock and real estate. Thus, the risk related to the claims for the general government balance is mitigated to a considerable extent.

Compensations from seizure of real estates located in Warsaw will be subject to separate statutory regulations. At present, work is underway to prepare the applicable draft of regulations.

c) Penalties and compensations

Payment of compensations may be necessary as a result of the possible arbitral awards unfavourable to the Polish side, issued in the arbitration proceedings currently underway. Currently, such risk is related to the proceedings brought by Eureko B.V. (the claimed amount of 35.6 billion PLN) and Vivendi S.A. and Vivendi Telecom International S.A. (approx. 1.9 billion EUR plus interest and cost refund).

d) Guarantees and other operations

The increase in contingent liabilities of the State Treasury arising from government guarantees is expected to rise from approx. 2.3% GDP forecasted at the end of 2008 to approx. 3.3% GDP in 2009, and then to fall to approx. 3.1% in 2011. The increase of the 2009 ratio results from taking into account the guarantees granted to the banking sector (draft of the act on State Treasury support to financial institutions within the *Stability and Development Plan*). At the same time, the portfolio risk is estimated to decline from approx. 27% at the end of 2008 to approx. 23% in the following years. In compliance with the assumptions included in the strategy for granting sureties and guarantees, these instruments will support first of all investments facilitating development in the spheres of infrastructure, environment protection and creating workplaces. The forecast payments of guarantees should not exceed 1% GDP per annum (with the limit on the level of 1.4% GDP specified in the strategy for sureties and guarantees).

Among other operations which may result in increased risk of additional burdens to public finance, public and private partnership (PPP) transactions should be mentioned. In the budget act for 2009, the limit for the government administration to draw upon financial liabilities in relation to PPP contracts was set at 5 billion PLN. However, their impact upon fiscal variables will depend on the distribution of risk related to execution of such agreement between public and private partners.

e) Legislative and political risk

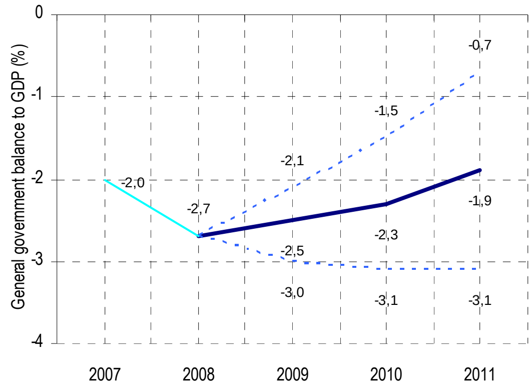
This area covers the adoption of legislative solutions that lead to an unexpected growth of expenditure or a loss of revenues of the general government or an increase of this sector's debt.

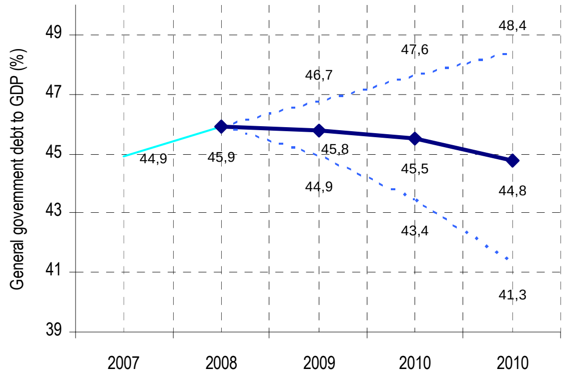
2. Sensitivity analysis

The sensitivity of the level of the general government balance and debt to deviations of the basic macro-economic variables from the base scenario is presented on graphs.

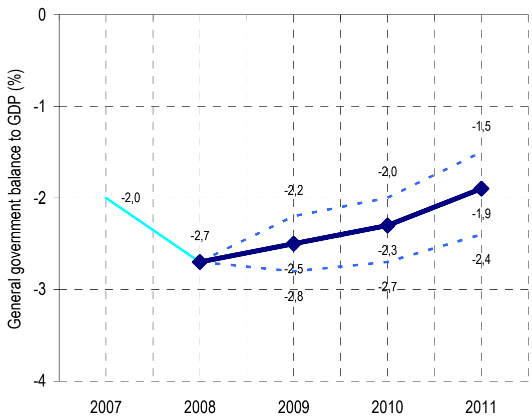
Graph 3. Sensitivity of net lending/borrowing and debt of general government to changes of real GDP growth, interest and exchange rates.

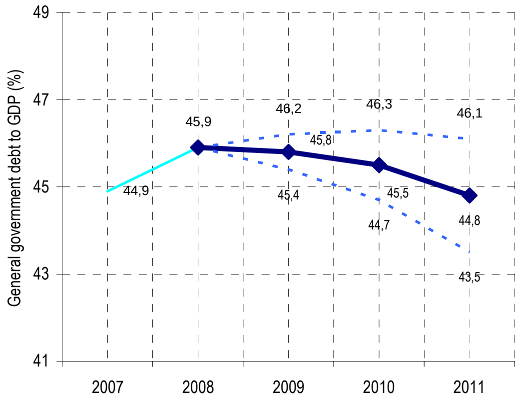
a) change of real GDP growth by 1%



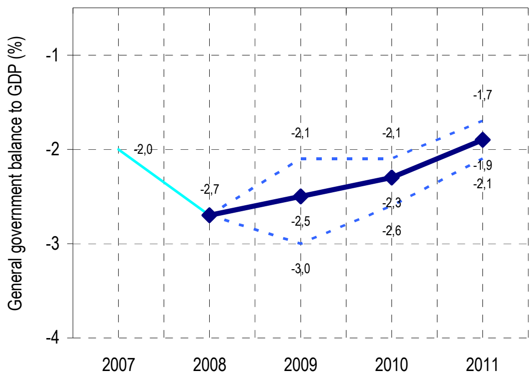


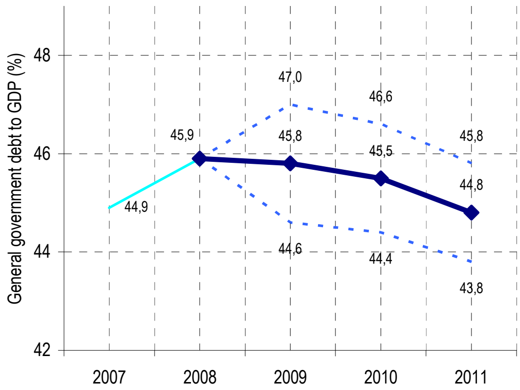
b) change of interest rates by 1 percentage point





c) change of exchange rate by 10%





Source: Ministry of Finance

IV.2. COMPARISON WITH THE PREVIOUS UPDATE

Table 9. Divergence from previous update

	ESA code	2007	2008	2009	2010	2011
Real GDP growth (%)						
Update 2007		6,5	5,5	5,0	5,0	-
Current update		**6,7**	**5,1**	**3,7**	**4,0**	**4,5**
Difference		+0,2	-0,4	-1,3	-1,0	-
General government net borrowing/lending (% of GDP)	EDP B.9					
Update 2007		-2,0	-2,5	-2,0	-1,5	-
Current update		**-2,0**	**-2,7**	**-2,5**	**-2,3**	**-1,9**
Difference		0,0	-0,2	-0,5	-0,8	-
General government debt (% of GDP)						
Update 2007		44,9	44,2	43,3	42,3	-
Current update		**44,9**	**45,9**	**45,8**	**45,5**	**44,8**
Difference		0,0	+1,7	+2,5	+3,2	-

Source: Ministry of Finance

Compared to the previous *Update*, the path of real GDP growth was corrected downwards in 2008-2010. The predicted rate of growth of both the domestic demand and foreign demand was decreased. Currently the predicted domestic demand growth rate in years 2008-2010 will amount to 3.8% on average, as compared against 6.1% growth rate on average assumed in the *Update* of March 2008. The lower real domestic demand growth rate results from a lower than expected revival in investment processes, as well as lower dynamics of private consumption which is a result of the predicted slower growth rate of households' income. As a result of the forecast weaker markets of the main trading partners, the adjusted export growth rate in years 2008-2010 currently amounts to 5.4% on average, compared to the average of 6.1% growth rate assumed in previous *Update*.

Compared to the *Update* of March 2008, the current forecast for the fiscal path takes into account the unfavourable economic situation predicted for the following years. As a consequence of the world financial crisis already starting to influence the real economy, the macroeconomic variables assumed for years 2009-2011 deteriorated. In spite of the strong fundamentals of Polish economy, as compared to other countries, it will also feel the global economic slowdown, by among others, lower export dynamics. This situation enforced revision of the fiscal path as compared to the one presented in March 2008. Attention should be brought to the fact that the currently forecasted worsening of the general government balance in years 2008-20011 leaves a secure margin against the reference value and that the principle of gradual reduction of the sector's deficit in the years to follow has been retained.

Differences in the general government sector debt forecasts in the years 2008-11 compared to the *Update* of March 2008 refer mainly to:

- changes in assumptions relating to the nominal GDP value, lower level of the nominal GDP value is expected in every year due to the economic

slowdown in the years 2009-10 resulting from the impact of the global financial crisis on the domestic financial market and the real economy;
- changes in assumptions relating to the state budget borrowing requirements;
- changes in assumptions relating to the exchange rate, with regard to considerable Polish zloty weakening in 2008.

V. QUALITY OF PUBLIC FINANCES

V.1. POLICY STRATEGY

Activities focused on improving the efficiency of the functioning of the public finance, included in the *Update* of March 2008 will be continued. They will cover mainly institutional changes related to the introduction of new regulations and solutions under the public finance act and within the performance-orienting budgeting (cf. Chapter VII).

In order to implement the renewed Lisbon Strategy, the government prepared the *National Reform Programme for years 2008-2011* (NRP). The structural reforms included in the Programme are necessary for the sustainable growth.

Reforms within the *National Reform Programme* will be carried out in the three priority areas:

- Active society

  Execution of tasks in this area will contribute to ensuring the appropriate conditions for the development of society and citizens, by among others: development of the education system, active labour market policies, modernization of the social security system (continued retirement reform), changes in the health service system, creating the conditions for social economy development.

- Innovative economy

  The solutions implemented in this area will support development of the sectors and branches with big value added and high innovation, which will have a considerable impact upon the long-term economic growth. The activities will include, among others, ensuring the legal and institutional environment which is entrepreneurship, innovation and investment-friendly, guaranteed transport, transfer, telecommunications and IT infrastructure suitable for the needs of the modern economy, improved quality of higher education, implementation of the solutions supporting innovative activity and research and development (R&D).

- Efficient institutions

  The efficient use of the public funds achieved thanks to carrying out activities within this area (with no additional burdens for citizens and entrepreneurs) will enable full execution of development-friendly policies and public investments, while ensuring the appropriate level of social security.

The implementation of the above mentioned reforms is also aimed at preparing Poland for adoption of the euro.

Scope of the *National Reform Programme* was based upon the Integrated Guidelines on Growth and Jobs *2008-2010* presented by the European Commission, i.e. the *Broad Economic Policy Guidelines* and the European Employment Strategy, recommendations and areas for monitoring as indicated by the European Council in March 2008.

The Update is compliant with the *National Reform Programme 2008-2011*. The priorities for the economic policy contained in these documents match the activities undertaken. The costs of the NRP activities which influence the general government sector were taken into account in the forecasts contained in the *Update*. Construction of road infrastructure (under priority 2, activity 4 of NRP) and the *50+ Programme* (under priority 1, activity 3.2 of NRP) belong to the most expensive ventures subject to the above-mentioned programmes from the sector's point of view. Coherence of both documents is ensured by the process of their preparation within cooperation of the government members and approval issued by the Council of Ministers. They both cover to the same timeframe.

Table 10. Basic data concerning the general government (EDP)

	ESA code	**2007** in billion zloty	**2007** % of GDP	**2008** % of GDP	**2009** % of GDP	**2010** % of GDP	**2011** % of GDP
Total revenues	TR	469,9	40,0	39,8	40,7	40,0	39,7
Total expenditure	TE	493,1	42,0	42,6	43,2	42,4	41,7
Balance	**S13**	**-23,2**	**-2,0**	**-2,7**	**-2,5**	**-2,3**	**-1,9**

Source: 2007 – Central Statistical Office, forecast for 2008-2011 – Ministry of Finance

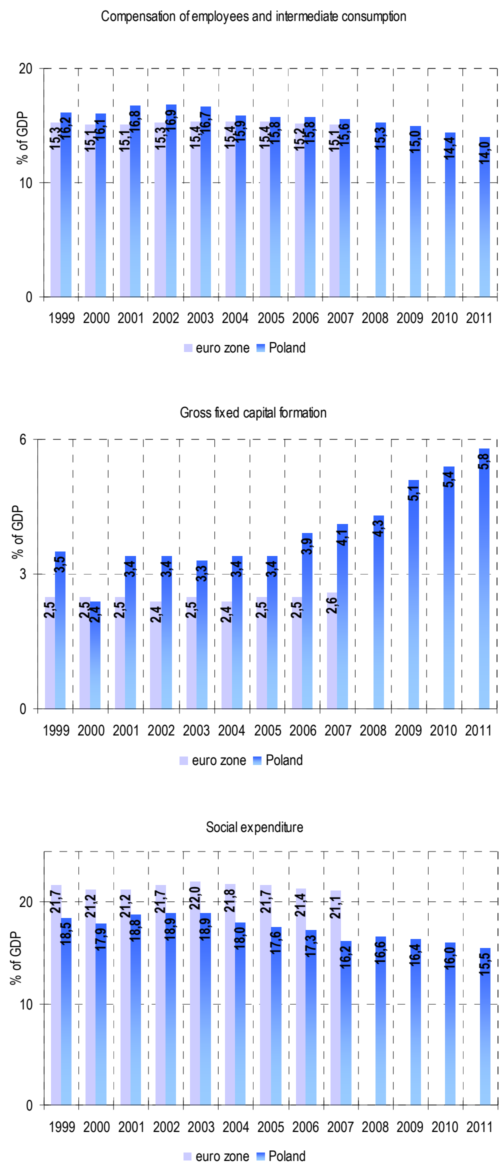
V.2. DEVELOPMENTS ON THE EXPENDITURE SIDE

The estimated level of expenditure of the general government sector to GDP ratio will be reduced from 42.0% in 2007 to 41.7% in 2011. This reduction will be reached in spite of higher gross expenditure for gross fixed capital formation (by approx. 1.7 bp.).

The level and structure of expenditure will be under substantial influence of measures undertaken to rationalize the level and structure of expenditure, make the expenditure more flexible and to increase the share of expenditure for development purposes. The most important assumptions are:

- within the scope of infrastructure-related expenditure: funds have been provided for the *National Road Construction Programme for years 2008-2012*, development of local roads under the *National Programme for local roads construction 2009-2011* and the investments related to preparations for EURO 2012;
- annual indexation of pension and retirement benefits (according to the formula: CPI+20% of the real salary growth in the national economy);
- growth of salaries in the state budget sphere according to the formula CPI+1 bp.;
- execution of activities within the *50+ Programme*;
- increasing expenditure for funding scientific research and development work, including, among others for research programmes and specific-purpose projects in the field of defense. These expenditure will be designed in particular to finance projects of considerable importance for the national economy, used to increase practical application of the scientific research outcomes.

Graph 4. Selected categories of expenditures in Poland and euro zone (% of GDP)



Source: Eurostat, forecasts for Poland for years 2008-2011 – Ministry of Finance

Table 11. General government expenditure by function (COFOG, % of GDP)

	COFOG code	2006	2011
1. General public services	1	5,9	5,4
2. Defense	2	1,2	1,1
3. Public order and safety	3	1,8	1,8
4. Economic affairs	4	4,4	4,3
5. Environmental protection	5	0,6	0,6
6. Housing and community amenities	6	1,2	0,9
7. Health	7	4,7	5,0
8. Recreation, culture and religion	8	1,1	1,0
9. Education	9	6,0	5,9
10. Social protection	10	16,9	15,7
Total expenditure		**43,8**	**41,7**

Source: 2006 – Central Statistical Office, forecast for 2011– Ministry of Finance

Comparing 2006 with forecasts for 2011, a considerable decrease of expenditure to GDP ratio may be noticed (2.1 basic points). The estimated decrease of expenditure will result from reduced expenditure for social protection to GDP ratio (among others, in consequence of lower unemployment rate, bridge pensions) and from general public services (mainly in view of decrease in interest on debt). The following areas remain the priority expenditure of the government: education, research and development and infrastructure (economic affairs). Expenditure for health were increased.

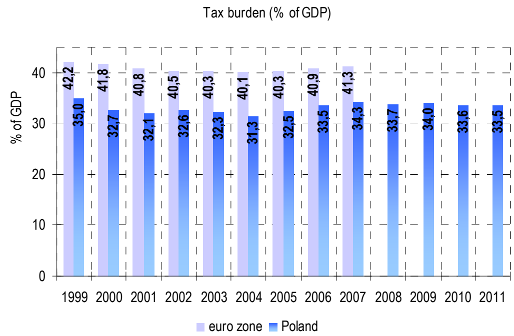
V.3. DEVELOPMENTS ON THE REVENUE SIDE

The general government revenues to GDP ratio reached 40,0% in 2007 and is expected to decrease in the following years to 39,8% in 2008 and 39,7% in 2011. The forecast of the general government revenues for years 2009-11 takes into account the assumptions as to the macroeconomic developments and planned changes. The most important changes in this area include:

- changes in PIT– introduction of two tax rates in 2009 – 18% and 32% instead of three tax rates of 19%, 30% and 40%,
- changes in CIT– changes in 2009 in accounting of costs of desisted investments,
- changes in VAT – changes in 2009 in VAT settlements from import of goods in some simplified procedures and increasing the subject based VAT exemption in 2010,
- in the excise tax – increase in 2009 of the excise rate for tobacco products, including cigarettes, by 18.1%, increase of excise for alcoholic beverages and passenger cars with engine capacity of more than 2000 cm³ and increasing the amount of allowance per litre of bio-component added to petrol and diesel oil, arising from the establishment of the National Indicator Targets (NCW)[14].

The changes in the tax system are designed to reduce labour costs with an aim to promoting employment and limiting unemployment. The changes also aim at facilitating companies to run business activity. They will also have a favourable influence on households through the reduction of the tax burden.

Graph 5. Tax burden in Poland and euro zone (% of GDP)



Source: Eurostat, forecasts for Poland for years 2008-2011 – Ministry of Finance

[14] Regulations concerning the determination of NCW are implemented into Polish law by Art. 3 item 1 of Directive 2003/30/EC of May 8, 2003 on the encouragement to use biofuels or other renewable fuels.

VI. SUSTAINABILITY OF PUBLIC FINANCES

The forecasts presented in table 11 for the long-term public finance stability were prepared within the work of the Economic Policy Committee (EPC) working group on Ageing Population (AWG). The previous forecasts were drawn up in 2005. Currently they are being updated. The data included in the table comes from previous projections (expenditure for long-term care, education), from the recent Commission's forecasts (health care) and from the projections of expenditure and revenues of insurance systems prepared by Poland. The data concerning security systems is the initial data which has not yet been accepted by the Commission within the AWG working group activities.

The new retirement system introduced as of 1 January 1999 leads to reduction of risk of the long-term retirement system insolvency by adapting it to the demographic and social and economic changes. The retirement and pension expenditure are predicted to decrease from 10.43% GDP in 2005 to 7.34% GDP in 2050. The decreased expenditure level is a consequence of implementing a new system for persons who were born after 1948, the effects of which will be noticed as early as after 2008. It is also a consequence of the classification adopted by Eurostat of capital pension systems with defined contributions.
The entire expenditure of security systems are expected to be reduced from 12.6% GDP in 2005 to 8.27% in 2050. The forecasts regarding expenditure for health care for Poland do not significantly differ from the previous projections.
In relation to the previous projections concerning social security, new assumptions reflect the following legislation changes introduced after 2004:

1) Shifting the possibility for early retirement

   According to the initial assumptions, possibility for early retirement under the old system for the persons who meet the conditions for taking advantage of such retirement were expected to be maintained until end of 2006. This deadline was finally extended until the end of 2008. It resulted in the increased state budget expenditure until approx. 2013. In the further years, this effect is expected to decrease.
2) Excluding miners from the new retirement system

   In 2005, the pension regulations relating to miners were changed. As a consequence, miners included into the employee pension system, obtained a right to early retirement and to calculate the amount of pensions based on the previous formula of defined benefit binding so far. This change results in the increased expenditure of the sector in view of the fact that miners' retirement benefits will be higher than the average retirement benefits and will be paid for a longer time.
3) Change of the benefit indexation principles

   In 2007, the indexation ratio was changed (to CPI + at least 20% of the real salary growth in national economy, compliant with the execution of the previous year). The annual indexation of benefits was brought back as well.
   Change of the indexation principles results in increased expenditure of the sector. Throughout the years, the scale of this effect will decrease due to the share of expenditure falling down in the repartition (collective) part in favour of the capital-based part of the system.
4) Decreased pension contribution.

   In 2007, disability contributions started to be reduced (within the reduction of the tax wedge) which resulted in decreased revenues from pension contributions to the Social Insurance Fund (FUS).
5) Granting a right to early retirement to men until the end of 2008.

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

Pension benefits under the new system will be paid as of January 2009. In the first decades, the indexed initial capital, reflecting the retirement rights acquired until end of 1998, will play a significant role in the amounts of pension benefits. With time (when the time of paying contributions to the new system, including contributions paid to the open pension funds, has been long enough), the pension benefits, including capital-based pension benefits, from the new system will begin to play an important role. Until end of December 2008, there are only the old system benefits granted. As pension is a benefit paid throughout several years, or even for decades, the rules for establishing the amounts of the benefits will determine the FUS expenditure for the nearest decades to follow. Expenditure for pension benefits in Poland will still constitute an important part of the general government sector's expenditure.
The new pension system adjusts to the changes in the labour market and to demographic changes automatically. Pension accounts with the Social Insurance Institution (ZUS) grow along with the growth rate of written premiums, thus both the liabilities and revenue of ZUS have the same dynamics.
The forecasts do not take into account the amendments to the legal acts or drafts:

- on bridge pensions, which according to the objectives of the reform were designed as the interim solution to replace early retirement. Introduction of this type of benefits will lead to increased state budget expenditure in the beginning, but these expenditure is expected to decrease along with expiration of these rights. Bridge pensions will be financed from a separate fund.
- on capital life pension funds and on capital pension benefits. The solutions are complementary to the capital part of the obligatory pension system, by specifying the benefits paid from the funds collected in the Open Pension Funds and the paying institutions.

Changes related to the functioning of the Demographic Reserve Fund which will be supplied with additional sums in the amount of 40% of the gross proceeds from privatization reduced by the amounts of allowances for the Restitution Fund, will also lead to enhanced stability.

Table 12. Long-term sustainability of public finances (% of GDP)

	2000	2005	2010	2020	2030	2050
Total expenditure						
Of which: age-related expenditure						
Retirement and disability pensions*	13,2	12,6	10,9	9,6	9,1	8,3
Retirement and disability pensions from social security	13,2	12,6	10,9	9,6	9,1	8,3
Retirement and early retirement pensions	10,3	10,4	9,4	8,7	8,2	7,3
Other benefits (disability, survivors)	2,9	2,2	1,5	1,0	0,9	0,9
Occupational pensions (if in general government)						
Heath care**		4,1	4,1	4,4	4,7	5,2
Long-term heath care***		0,1	0,1	0,1	0,1	0,2
Education expenditure		4,9	3,9	3,0	3,0	3,1
Other age-related expenditure						
Interest expenditure	0,0	0,0	0,0	0,0	0,0	0,0
Total revenue						
Of which: property income						
Contributions						
Of which from retirement and disability pension contributions	7,8	7,1	5,5	5,4	5,1	5,0
Pension reserve fund assets	0,0	0,2	0,4	0,4	0,4	0,6
Of which: consolidated public pension fund assets (assets other than government liabilities)						
Assumptions						
Labour productivity growth		3,5	3,7	3,1	2,7	1,7
Real GDP growth		3,6	4,2	2,5	2,0	0,3
Participation rate males (aged 20-64)	79,3	77,8	77,1	76,9	78,6	76,2
Participation rate females (aged 20-64)	66,0	63,7	62,9	64,3	67,1	63,5
Total participation rate (aged 20-64)	72,5	70,7	69,7	70,5	72,8	69,6
Unemployment rate (aged 15-64)	16,1	17,7	5,9	5,9	5,9	5,9
Population aged 65+ over total population		13,1	13,6	18,2	23,0	31,6

Compulsory private schemes

	2000	2005	2010	2020	2030	2050
Retirement and disability expenditures	0,0	0,0	0,0	0,1	0,3	1,4
Contributions	1,2	1,2	1,5	1,8	1,9	1,8

Source: Ministry of Labour and Social Policy;
* Preliminary forecasts
** Commission's preliminary forecasts – *"pure demographic scenario"*
*** Forecasts from 2005.

VII. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The public finance act is at the stage of advanced legislation work (work underway in the Parliament). The changes being introduced aim mainly at enhancing the discipline, security and stability of public finance as well as improvement of absorbing funds from EU. They also cover some organizational activities.

The act introduces 4-year planning (the current year and 3-year forecasts) in the scope of the state budget (*Multi-year National Financial Plan*) and local governments (multi-year financial forecast). These forecasts will be crawling forecasts and will form the basis for the work on, respectively: draft of the budget act and a local government's budget resolution for the given budget year.

The solutions included in the act tighten the prudential standards binding so far as well, among others by decreasing from 50% to 47% the lowest public debt to GDP ratio, at which it is necessary to introduce specific correction actions. They also set the rule focused on balancing the operational budgets of local governments. The Act also sets out the individualized approach to the issue of local governments' indebtedness by introducing the criterion of economic creditworthiness as a limit for the allowed level of debt.

The Act includes provisions as well enables full implementation of the performance-oriented budgeting.

Work on implementing the performance-oriented budgeting is at an advanced stage of execution. During the work on the draft of the budget act for 2009, a the performance-oriented budget, covering the plan of expenditure of administrating entities of all parts of state budget was prepared for the first time, along with the traditional budget. It covers 2009-2011. Implementation of performance-oriented budget in parallel with the traditional budget is planned in the budget act for 2013.

Implementing the performance-oriented budget will contribute to improved transparency of public expenditure, their efficiency and reasonable spending. Thanks to better identification of the state tasks, it will contribute indirectly to better coordination of objectives and enhanced coherence of the economic policy.

The performance-oriented budget based on assigning priorities to the objectives of the government's economic policy will improve multi-year planning. The performance-oriented budget puts emphasis first of all on the quality of expenditure. Level of the budget execution will not be the basic criterion of the assessment as in case of traditional budget, but the level of accomplishment of the set objectives.

ANNEX 1. TABLES

Table 13. Macroeconomic prospects

	ESA Code	2007 Level	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. Real GDP (PLN billion)	B1*g	1 114,1	6,7	5,1	3,7	4,0	4,5
2. Nominal GDP (PLN billion)	B1*g	1 175,3	10,9	8,4	6,6	6,5	7,1
Components of real GDP							
3. Private consumption expenditure	P.3	686,7	5,0	5,3	4,5	3,7	3,8
4. Government consumption expenditure	P.3	195,5	3,7	-0,1	2,0	1,0	0,5
5. Gross fixed capital formation	P.51	242,1	17,6	6,5	4,4	5,0	8,6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	29,9	2,7	3,0	2,0	1,9	2,1
7. Exports of goods and services	P.6	456,0	9,1	7,4	3,2	5,5	6,0
8. Imports of goods and services	P.7	495,8	13,6	7,0	1,8	4,4	6,1
Contributions to real GDP growth							
9. Final domestic demand		-	8,8	5,1	3,1	3,6	4,7
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	1,5	0,4	-1,0	0,0	0,3
11. External balance of goods and services	B.11	-	-2,1	-0,1	0,5	0,3	-0,2

Table 14. Price developments

	ESA Code	2007 Level	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. GDP deflator		**-**	**3,9**	**3,2**	**2,8**	**2,5**	**2,5**
2. Private consumption deflator		**-**	**2,4**	**4,2**	**2,9**	**2,5**	**2,5**
3. HICP		**-**	**2,6**	**4,2**	**2,9**	**2,5**	**2,5**
4. Public consumption deflator		-	5,1	6,0	2,9	2,5	2,6
5. Investment deflator		-	3,6	2,0	2,0	2,5	2,5
6. Export price deflator (goods and services)		**-**	**2,7**	**0,0**	**4,5**	**2,5**	**2,5**
7. Import price deflator (goods and services)		**-**	**1,0**	**0,8**	**4,0**	**2,5**	**2,5**

Table 15. Labour market developments

	ESA Code	2007 Level	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. Employment (in thousand of persons)*		**15 240**	**4,4**	**3,7**	**0,0**	**0,3**	**0,4**
2. Employment, hours worked							
3. Unemployment rate (%)**		**9,6**	**9,6**	**7,1**	**7,2**	**7,6**	**7,4**
4. Labour productivity (PLN thousand)***		**77,1**	**2,2**	**1,4**	**3,7**	**3,7**	**4,0**
5. Labour productivity, hours worked							
6. Compensation of employees (PLN million)		**417,1**	**10,8**	**12,4**	**5,6**	**5,7**	**7,0**
7. Compensation per employee (PLN thousand)		**35,8**	**4,7**	**8,9**	**5,3**	**5,4**	**6,5**

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

** Harmonized definition, Eurostat; levels.

*** Real GDP per person employed.

Table 16. Sectoral balances (% of GDP)

	ESA Code	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	**-3,6**	**-4,0**	**-1,8**	**-1,3**	**-1,5**
of which: - Balance on goods and services		-2,9	-3,2	-2,4	-1,9	-2,0
- Balance of primary incomes and transfers		-1,8	-1,9	-1,8	-1,7	-1,8
- Capital account		1,1	1,2	2,4	2,3	2,3
2. Net lending/borrowing of the private sector	B.9	**1,6**	**1,3**	**-0,7**	**-1,0**	**-0,4**
3. Net lending/borrowing of general government	EDP B.9	**-2,0**	**-2,7**	**-2,5**	**-2,3**	**-1,9**
4. Statistical discrepancy		**-**	**-**	**-**	**-**	**-**

Table 17. Basic assumptions

	2007	2008	2009	2010	2011
Short-term interest rate(annual average)*	**4,4**	**5,7**	**4,3**	**4,0**	**4,5**
Long-term interest rate (annual average)	**5,5**	**6,1**	**6,3**	**5,8**	**5,5**
Nominal effective exchange rate	**-4,9**	**-9,1**	**8,5**	**-2,4**	**-2,8**
Exchange rate vis-à-vis the € (annual average)	**3,78**	**3,49**	**3,68**	**3,60**	**3,50**
World GDP growth	**–**	**–**	**–**	**–**	**–**
EU GDP growth**	**2,6**	**1,0**	**-0,6**	**1,2**	**1,2**
Growth of relevant foreign markets ***	**8,8**	**6,8**	**2,3**	**5,0**	**5,0**
World import volumes	**–**	**–**	**–**	**–**	**–**
Oil prices (Brent, USD/barrel)	**72,7**	**97,8**	**60**	**60**	**60**

External assumptions for Poland based on OECD forecast from *Economic Outlook*, November 2008, forecasts for 2011 – data for 2010
* NBP reference rate (yield on 7-day NBP bills)
** Euro area GDP growth
*** Increase in import of goods and services from 10 main Poland's trade partners weighted according to the structure of foreign trade

Table 18. General government budgetary prospects

	ESA Code	2007 Level	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	**-23,2**	**-2,0**	**-2,7**	**-2,5**	**-2,3**	**-1,9**
2. Central government	S.1311	**-37,2**	**-3,2**	**-3,6**	**-2,7**	**-2,5**	**-2,1**
3. State government	S.1312			**does not apply**			
4. Local government	S.1313	**1,3**	**0,1**	**0,4**	**0,2**	**-0,1**	**-0,2**
5. Social security funds	S.1314	**12,7**	**1,1**	**0,5**	**-0,1**	**0,2**	**0,3**
General government							
6. Total revenue	TR	**469,9**	**40,0**	**39,8**	**40,7**	**40,0**	**39,7**
7. Total expenditure	TE	**493,1**	**42,0**	**42,6**	**43,2**	**42,4**	**41,7**
8. Net lending/borrowing	EDPB.9	**-23,2**	**-2,0**	**-2,7**	**-2,5**	**-2,3**	**-1,9**
9. Interest expenditure	EDP D.41	**28,6**	**2,4**	**2,4**	**2,6**	**2,5**	**2,4**
10. Primary balance		**5,4**	**0,5**	**-0,3**	**0,1**	**0,2**	**0,5**
11. One-off and other temporary measures		**0,0**	**0,0**	**0,0**	**0,0**	**-0,2**	**0,0**
Selected components of revenue							
12. Total taxes		**267,7**	**22,8**	**23,0**	**23,1**	**22,8**	**22,7**
12a. Taxes on production and imports	D.2	**166,3**	**14,2**	**14,3**	**14,8**	**14,7**	**14,6**
12b. Current taxes on income, wealth	D.5	**101,1**	**8,6**	**8,6**	**8,2**	**8,1**	**8,1**
12c. Capital taxes	D.91	**0,3**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**
13. Social contributions	D.61	**140,6**	**12,0**	**11,0**	**11,2**	**11,1**	**11,0**
14. Property income	D.4	**15,4**	**1,3**	**1,0**	**0,9**	**0,8**	**0,8**
15. Other		**46,0**	**3,9**	**4,9**	**5,5**	**5,3**	**5,2**
16. Total revenue	TR	**469,9**	**40,0**	**39,8**	**40,7**	**40,0**	**39,7**
Tax burden		**403,7**	**34,3**	**33,7**	**34,0**	**33,6**	**33,5**
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D1+P2	**183,2**	**15,6**	**15,3**	**15,0**	**14,4**	**14,0**
17a. Compensation of employees	D.1	113,2	9,6	9,8	9,8	9,5	9,1
17b. Intermediate consumption	P.2	70,0	6,0	5,5	5,2	5,0	4,9
18. Social payments		**190,6**	**16,2**	**16,6**	**16,4**	**16,0**	**15,5**
18a. Social transfers in kind supplied via market producers	D.6311 D.63121 D.63131	23,7	2,0	2,1	2,1	2,0	2,0
18b. Social transfers other than in kind	D.62	166,9	14,2	14,5	14,4	14,0	13,5
19. Interest expenditure	EDP D.41	**28,6**	**2,4**	**2,4**	**2,6**	**2,5**	**2,4**
20. Subsidies	D.3	**7,2**	**0,6**	**1,0**	**0,7**	**0,7**	**0,7**
21. Gross fixed capital formation	P.51	**48,1**	**4,1**	**4,3**	**5,1**	**5,4**	**5,8**
22. Other		**35,3**	**3,0**	**3,0**	**3,3**	**3,3**	**3,2**
23. Total expenditure	TE	**493,1**	**42,0**	**42,6**	**43,2**	**42,4**	**41,7**
p.m.: Government consumption (nominal)	P.3	211,0	18,0	17,8	17,4	16,8	16,3

Table 19. Impact of the *National Reform Programme* (NRP) upon public finance (% GDP)

NRP priorities	Activity	Implementation		Direct budget costs*			
		Status	Time frame**	2008	2009	2010	2011
1. Active society	1. Development of education in knowledge-based society and economy	in progress		0.0	0.0	0.0	0.0
	2. Modernization of the social security system	in progress		0.0	0.0	0.0	0.0
	3. Active labour market policies	in progress		0.0	0.0	0.0	0.0
	3.1. Improvement of institutional service of labour market	in progress		0.0	0.0	0.0	0.0
	3.2. Introduction of the system of incentives supporting economic activity of persons threatened with unemployment and social exclusion	in progress		0.0	0.1	0.2	0.2
	3.3. Execution of policy for labour migrations	in progress		0.0	0.0	0.0	0.0
	4. Development of institutions facilitating enhancement of civil society activity (...)	in progress		0.0	0.0	0.0	0.0
	5. Development of information society	in progress		0.0	0.0	0.0	0.0
	6. Improvement of the health care system efficiency	in progress		0.0	0.0	0.0	0.0
	6.1. Changes in the health care system financing	in progress		0.0	0.0	0.0	0.0
	6.2. Changes in health care institutions functioning	in progress		0.0	0.0	0.0	0.0
2.Innovative economy	1. Ensuring the legal ad institutional environment friendly towards entrepreneurship, innovation and investments	in progress		0.0	0.0	0.0	0.0
	2. Improvement of competitiveness of science by reform of the scientific entities financing and functioning	in progress		0.0	0.0	0.0	0.0
	3. Implementing solutions supporting innovative activity and R&D	in progress		0.0	0.0	0.0	0.0
	4. Guaranteeing the transport, transfer and telecommunications and IT infrastructure suitable for the needs of the modern economy	in progress		0.9	1.8	1.6	1.0
	5. Ensuring competitive conditions in network sectors	in progress		0.0	0.0	0.0	0.0
	6. Using innovative solutions in environment protection	in progress		0.0	0.0	0.0	0.0
	7. Finalization of the main privatization processes	in progress		0.0	0.0	0.0	0.0
3. Efficient institutions	1. Development of modern public administration	in progress		0.0	0.0	0.0	0.0
	2. Increasing effectiveness of the public finance sector functioning and improvement of public funds management	in progress		0.0	0.0	0.0	0.0
	3. Decentralization of public finance in favour of local governments, assigning new tasks and competencies to local governments	in progress		0.0	0.0	0.0	0.0
	4. Creating a modern and efficient system for promotion of Poland	in progress		0.0	0.0	0.0	0.0

Source: Ministry of Economy, Ministry of Finance
*Direct budget costs mean increased expenditures or lower income from the general government sector resulting from introduction of a given activity; the plus sign means the costs incurred in relation to the base scenario, the minus sign – the savings related to introduction of a given activity in relation to the base scenario.
**Most activities are of continuous character in the assumed perspective.