REPUBLIC OF POLAND

CONVERGENCE PROGRAMME
2005 UPDATE

Warsaw, January 2006

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INTRODUCTION

1. In line with the requirements of the Stability and Growth Pact, as set out in Council Regulation No. 1466/97, Poland presents an update of the Convergence Programme for the years 2006-2008. The document has been prepared in compliance with requirements of the updated Code of Conduct as approved by the Ecofin Council in October 2005.

2. The year 2005 has been an election year for Poland. In compliance with the requirements of the Constitution, elections to the Parliament took place on 25 September 2005 leading to a change of the ruling party in Poland. The government of Kazimierz Marcinkiewicz was appointed on 31 October and sworn by the President of the Republic of Poland, and given the vote of confidence from the Parliament on 10 November. Moreover, in the course of presidential elections, which took place in October: the first round on 9 October, the second round on 23 October, the new president Lech Kaczyński was elected. The newly elected president was sworn on 23 December 2005.

3. On 21 November 2005, the Minister of Finance asked the EU Commissioner for Economic and Monetary Affairs to prolong the period for submitting the Convergence Programme update until 10 January 2006. The request was justified with the recent appointment of a new government and the need to undertake an assessment of the condition of public finances by the new government. Because of the replacement of the Minister of Finance, which occurred on 7 January 2006, Poland asked for another extension of the deadline for submitting the document to the European Commission.

4. Introduction of the solutions foreseen by the new government requires them to be incorporated in legal acts drafts, agreements with social partners and then approved by the Parliament and the President. These actions need time and will take place in the course of 2006. The current Convergence Programme update combines solutions and decisions taken by the former government with the vision and programme of the new government. The update is based on the government's amendment to the State budget for the year 2006. An important element of this amendment was to limit the budgetary deficit in 2006 by 2.0 bn PLN to the level of 30.5 bn PLN. It also needs to be noted, that the deficit decreased in 2005 from the assumed 35 bn PLN to less than 30 bn PLN.

5. The government is currently preparing solutions for the fiscal policy, which will contain changes both on the revenue side (tax system reform) and the expenditure side of the budget. The solutions to be developed in the coming months will be reflected in the 2007 budget and in the Convergence Programme update planned for December 2006. They will not lead to any deficit increase, and the intention of the government is to anchor the State budget deficit (on a cash basis) at the level of 30 bn PLN. The budgetary anchor shall be one of the factors allowing for a gradual reduction of the general government deficit to GDP ratio. The continued pension reform will contribute to the long-term stability of public finances. Because of the fact, that the reform involves particular costs in the short and medium term, Polish authorities are counting on the understanding of other EU Member States, as well as cooperation and due to consideration of the impact of that reform on the public finance when assessed by the European Commission.

6. The present document was approved by the Council of Ministers on 18 January 2006 and reflects the knowledge of the economy and government programme as on that day.

I. FRAMEWORKS AND OBJECTIVES OF MACROECONOMIC POLICY

1. The government aims at employment creation by the Polish economy and - through buoyant economic development, which will increase the competitiveness of the Polish economy, *inter alia*, as a result of buoyant investments development - at regaining balance of the public finance and easing social tensions. Proposed changes in the public finances, involving State budget improvement by application of performance budgeting, consolidation and increase in expenditure flexibility, introduction of a three-year budgeting for general government finance planning, have one common goal. It is, through the exploitation of EU markets by Polish products, acceleration of investments, including those co-financed by the EU and related to the inflow of foreign direct investments, rise in the economic growth rate to the level of more than 5% and decrease in unemployment.

2. At the end of 2005 more than 17% of economically active Polish population remained unemployed, which is the highest in the EU. Therefore the main objective of the government programme is to make the employment policy more dynamic leading to a marked labour market improvement. The instruments proposed by the government - in particular taking active policy aimed at vocational development of currently unemployed persons as not to allow for marginalisation of middle-aged persons on the labour market - persons, whose problems result from the lack of required qualifications, introduction of modern educational programme, enhancement of qualifications and greater participation of population in the labour process - are aimed to result in sustainable employment growth, which constitutes one of social welfare fundamentals.

3. Employment creation and pick-up of investments in Poland will be supported by the proposed improvements and elimination of bureaucratic barriers in the start-up and conduct business activity. Therefore the government strive to simplify the economic system. Such simplification would mostly lie in a systematic pursuit towards shaping a simple, easily interpretable legal principles of economic activity. Considering the fact, that one of the major limitations of investments increase and employment growth are labour costs, the government aims to change public revenues structure in such a way as to reduce the fiscal burdens of employment. Achieving the abovementioned objectives and tasks set out by the government require time and therefore not all proposed solutions could have been taken into account in the 2005 update of the Convergence Programme.

4. The intention of the government is for Poland to meet the Maastricht criteria within the present term of the Parliament (upon the application of the "budgetary anchor"). It seems that in order to make the real convergence more dynamic, Poland may continue the integration process without any unnecessary risk and additional costs only if the economy is healthy, unemployment rate is low and investment growth is significant.

II. CURRENT ECONOMIC SITUATION AND OUTLOOK

II.1. WORLD ECONOMY

1. Growth rate of the global Gross Domestic Product (GDP) in 2005 remained at a high level, although lower than in the previous year, despite high oil prices. Negative impact of that factor was still neutralized by the accommodative macroeconomic policies, low level of long-term interest rates, the effect on households wealth of buoyant housing markets and rising stock markets, solid corporate balance sheets. It is estimated, that in 2005 the increase in the global GDP exceeded 4% and was lower than in the previous year by ca. 1 percentage point.

2. It is expected that the prospects of the world economy in the years 2006-2008 remain quite favourable, and the growth of the global GDP maintains the level of slightly over 4%. In the global scale, USA and China will remain – as in the previous years – the main engine of growth. It needs to be stressed that the balance of risks related to the expected development of economic situation is tilted to the downside. The possible increase of oil prices and the possibility of a disorderly adjustment of global imbalances and thus financial market conditions tightening remain the main threat to the forecast.

3. It is assumed, that the economic situation of our main trade partners in the forecast perspective will remain supportive of the further exports expansion of Poland. It is especially expected that the GDP in the euro-zone will increase more rapidly than in 2005. More than a half of the value of goods exported from Poland end in the euro-zone. It is forecast that the average weighted growth rate of the volume of imports by Poland's trade partners in the 2006-2008 period shall amount to 7.7% and will remain at the similar average growth rate for this category of the 2004-2005 period.

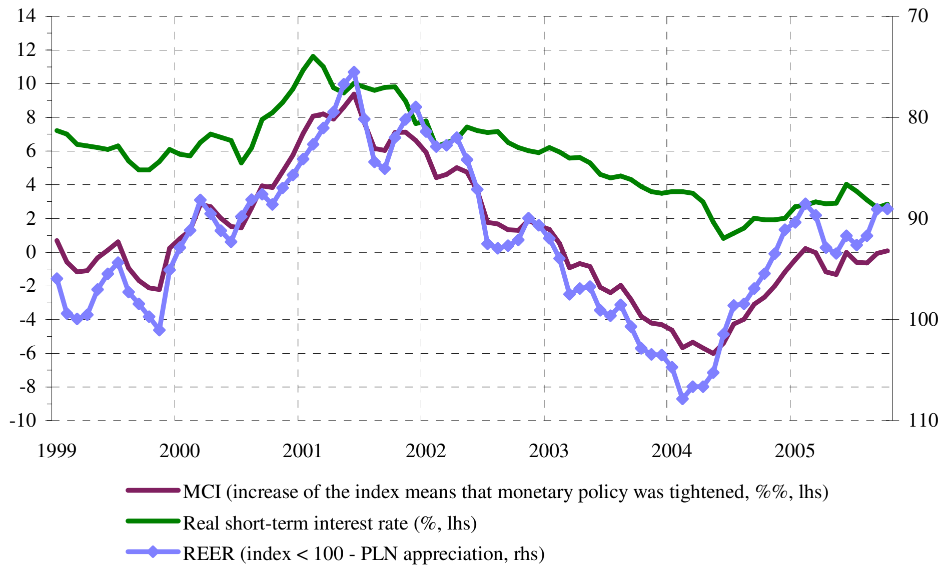
II.2. CYCLICAL DEVELOPMENTS AND CURRENT PROSPECTS

4. Gradual economic recovery visible in Poland since the second half of 2002 accelerated rapidly in 2004, when the real GDP growth increased by 5.3% against 3.8% in 2003 and 1.4% in 2002. Intensified economic activity concentrated in the period directly preceding the Accession (GDP growth in the first half of 2004 amounted to 6.3% as opposed to 4.3% growth in the second half of the year). The main factors responsible for the boost of economic growth were as follows: weakening of monetary policy, changes in legal and institutional conditions (in particular tax regulations), as well as the effect of Polish Accession to the European Union (so-called accession effect). Sudden increase of economic entities activity resulted in a short time in positive output gap. Producers made use of the demand growth to rise margin (which affected financial results of companies) and next to a number of supply-related factors influenced the increase of prices (which again resulted in one-off inflation increase). In subsequent quarters, considering the tightened monetary conditions[1], economy slowed down and the inflation pressure – despite the significant volatility of supply-related

[1] In the second half of 2004 an increase in the restrictiveness of the monetary policy took place. It resulted from reversing the downward trend of the real short-term interest rate and strong appreciation of the real effective exchange rate. In 2005, despite decreases in the basic NBP interest rate, the monetary conditions tightened at the end of the year.

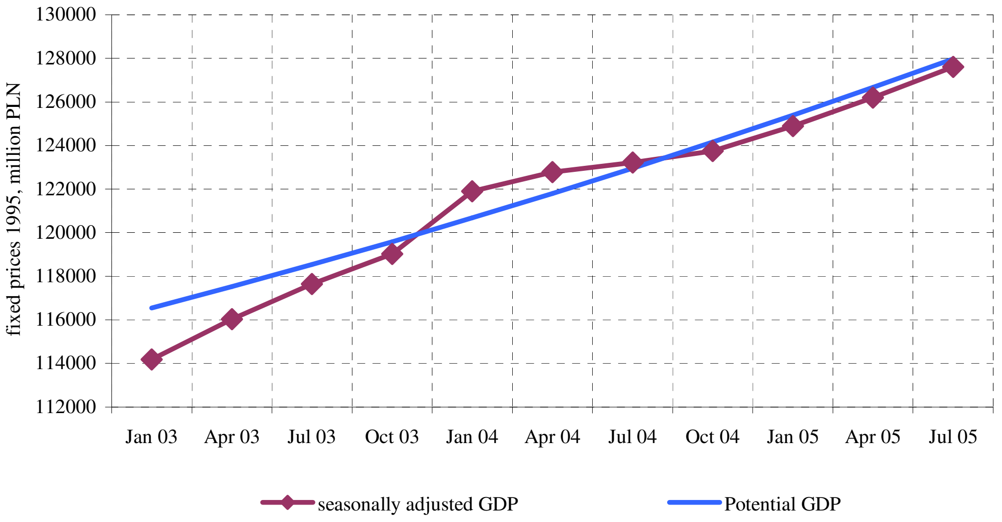
factors – disappeared. At the end of 2005 inflation rate decreased - to 1.0% in November and 0.7% in December.

Chart 1. Monetary Conditions Index (MCI)



The MCI index has been assumed as a linear combination of changes in real short-term interest rate and real effective foreign exchange rate, under the assumption that the relation between interest rate and foreign exchange rate is 2:1. February 1998 has been assumed as reference period.

Chart 2. Potential GDP



5. GDP growth rate in 2005 amounted to 2.1% yoy in the first quarter, 2.8% yoy in second quarter respectively, and accelerated to 3.7% yoy in third quarter. The main driving force of the economy in 2005 was net exports, which contribution to the GDP growth after three quarters of 2005 amounted to 2.2 percentage points (1.0 percentage points in first quarter, 3.4 percentage points in second quarter and 2.1 percentage points in third quarter respectively),

whereas the contribution of the exports itself to the GDP growth amounted to 2.4 percentage points and was the largest of all demand components.

6. After three quarters of 2005 total consumption rose in real terms by 2.1% against real growth of that category at the level of 4.5% in the corresponding period of 2004. In the last quarters some acceleration of the growth rate in that economic category from 2.0% in first quarter to 2.3% in third quarter is observed. Total consumer demand in 2005 has been influenced by low households consumption expenditure. After three quarters of 2005 individual households consumption rose in real terms by 2.0% against real growth in that category at the level of 4.5% in the corresponding period of previous year. Within the whole year of 2005, it is expected that individual households consumption will rise in real terms by 2.3%. Lower growth rate of households consumption in 2005 results also from the high statistical base.

7. In 2004 growth of gross fixed capital formation has been noted - first since 2001 - which amounted to 6.3% yoy. After three quarters of 2005, the growth rate of gross fixed capital formation amounted to only 3.8%, although in the light of the business surveys, it may be assumed that the investment barriers are gradually overcome by companies. At the end of the third quarter of 2005, as provided by the respondents, the evaluation of their own economic condition was the best in the whole history of the survey. An improvement has been noted in particular by importers, the public sector and construction companies. A significant improvement of the mood of the surveyed companies suggests maintenance of a good economic condition with a possibility of further improvement in the fourth quarter of 2005. A high level of capacity utilisation amounting to more than 80% in surveyed enterprises has also been noted. This confirms the suggestion that the possibilities of the further utilisation of the existing production capacity are limited. Thus, it is expected, that in 2005 the real investment growth will amount to 5.0%.

8. After five years of a difficult situation on the labour market (average paid employment in national economy in 1999-2003 decreased by over 1.2 million persons, i.e. by more than 12%, while the number of unemployed persons increased by more than 1.3 million, i.e. by more than 73%), in 2004 first signs of improvement was observed (number of unemployed persons at the end of 2004 was 176 thousand smaller than at the end of 2003), and labour demand stabilised. In 2005 the first and significant increase in paid employment was observed: in the first three quarters an increase in paid employment in national economy (without entities employing up to 9 persons) was observed and average annual paid employment increased by 1.4%. On the other hand, the situation on the labour market was and still is determined by high labour supply (increase in the number of persons in working age) and still high unemployment. Although the number of unemployed persons is decreasing (by about 277 thousand persons since January), still almost 2.7 million persons, i.e. 17.3% of economically active (civil) population remains unemployed (as at the end of November 2005). It is estimated, that the number of unemployed persons will amount to about 2.8 million persons at the end of 2005, whereas the average employment will increase by 1.5% as compared with the previous year.

9. After two years of very low inflation (in 2002 average increase in prices of goods and consumer services amounted to 1.9%, and in 2003 – 0.8% respectively), in 2004 the price growth rate accelerated to 3.5%. This was related mostly to previous depreciation of zloty and impact of the accession to the European Union, as well as temporary supply-related factors, such as: significant increase in oil prices and prices of other resources on global markets and limited supply of agricultural products.

10. In 2005 the annual inflation acceleration has visibly decreased, which was supported by the restrictive monetary policy, appreciation of zloty, weaker domestic demand dynamics and low prices of food products. The increase of prices in 2005 is estimated at the average level of 2.2% yoy. At the end of 2005 the inflation in Poland should fall again below the level of reference value for inflation convergence criterion (just as was the case in the period of August 2002 – July 2004).

11. After the improvement of the balance of risk factors for future inflation, the Monetary Policy Council lowered the reference rate five times in the period from March to August 2005 – in total by 2.0 percentage points. As a result, since August 2005, the reference rate remains at the level of 4.5%. Further softening of the monetary policy is supported by a significant inflation decrease, which is accompanied by the decrease in inflation expectations of households, decrease of all indicators of basic inflation and lack of demand-related inflation pressure, confirmed by low wage and salary dynamics. Average wages and salaries in enterprise sector in December 2005 were higher as compared to the previous year by 0.8% in real terms.

12. In 2005 the zloty exchange rate was highly volatile mostly due to temporary increases in political uncertainty. Fading of political tensions and improvement in macroeconomic fundamentals of Polish economy contributed to the appreciation of zloty at the end of the year. As a result, in the period from January to November 2005 average nominal effective zloty exchange rate (the exchange rate weighted by geographic structure of Polish exports) appreciated by 10.9% as compared to the same period of the previous year.

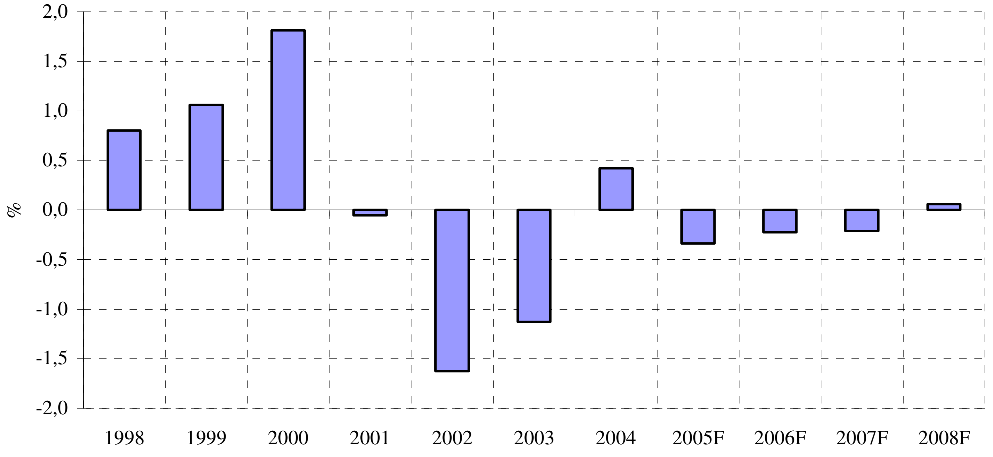
13. Taking into account very good financial results of direct investment companies, which have been classified as re-invested profits and increased the deficit of income account, deficit of current accounts in 2004 has been corrected from 1.5% of GDP to 4.2% of GDP. At the same time, foreign direct investments surplus in financial accounts has been increased by the same amount. Taking these methodological changes into account, it is estimated, that in 2005 the deficit of current accounts will be significantly limited and shall amount to about 1.5% of GDP, mainly through a continuation of the decrease in the imbalance in trade between Poland and other countries.

II.3. MEDIUM-TERM SCENARIO

Real GDP growth

14. Together with the expected acceleration of the economic growth in 2006-2008, a gradual closing of output gap is expected. On the other hand, the forecast increase in investment activity and increase of employment will contribute to potential product enlargement in Polish economy. The current forecast of economic growth for the years 2006-2008 indicates that the dynamics of GDP will shape at the level of 4.3%, 4.6%, 5.0% respectively. It is estimated that the implementation of the economic growth scenario assumed for the purposes of the Convergence Plan update will allow for the elimination of output gap in 2008.

Chart 3. Output gap in 1998-2008



Domestic demand

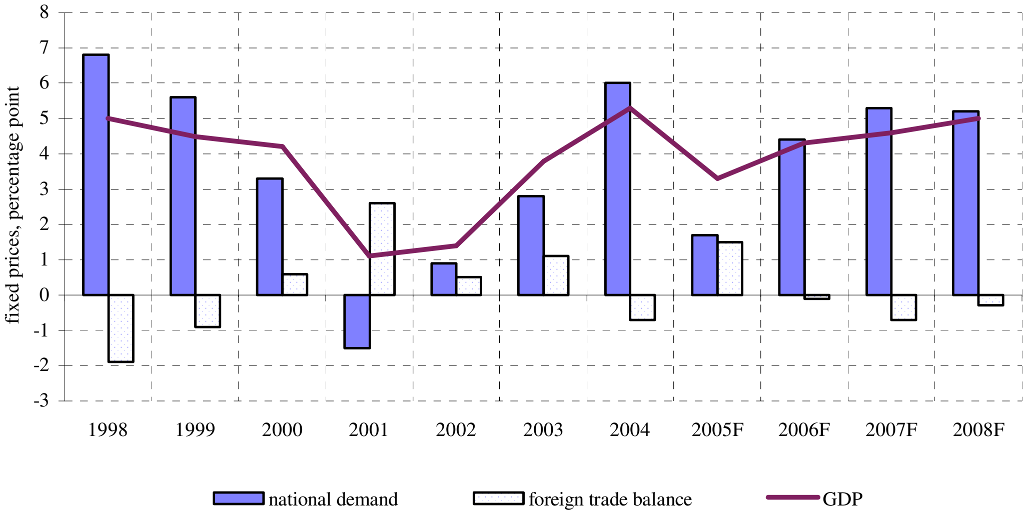
15. It is estimated that the year 2005 would be the last year of positive net exports contribution into GDP growth. The forecast for the years 2006-2008 assumes that the main factor influencing GDP growth in coming years will be the increasing domestic demand, especially investment demand. It is expected that in 2006 the domestic demand would increase in real terms by 4.3% compared to the increase by 1.6% in 2005, and in the consecutive two years by 5.3% (in 2007) and 5.1% (in 2008).

16. The major factor supporting investments in the forecast span will be the growing absorption of structural funds. The absorption of these funds should rise *inter alia* as a result of the government intention of simplifying the procedures, especially as regards financial settlements. One of such measures, which have already been taken by the government, is the creation of legal framework for the establishment of a management system supporting the efficient absorption of the resources of structural funds, Cohesion Fund and regional development measures. Facilitation of project management and changes in the area of settlements shall allow the participants of economic life access to capital of low leverage cost, which will make the implementation of more investment projects more realistic. Real growth rate of gross fixed capital formation is expected to double in the last year of the projected period as compared to the growth rate estimated for 2005, and in 2006-2008 it will amount to about 10.8% on average. As a result, the share of investments in GDP will increase from 18.0% in 2004 to 22.1% in 2008.

17. In 2006-2008 an acceleration of the growth rate of individual households consumption expenditure is expected to rise to the level of: 3.7%, 3.5%, 3.6% respectively, which will mostly be a result of a stable real wage fund growth in this period, estimated growth rate of which will amount to ca. 3.1% on average in the 2006-2008 period. Significant acceleration of households consumption expenditure growth rate in 2006 will mostly stem from the planned retirements and pensions indexation , which will translate into wages and retirements and pensions fund real growth by 3.9%, compared to the real growth rate of this fund at the level of 2.5% in 2005. It is estimated that in the entire forecast prospects wages and retirements and pensions fund will increase by 3.0% on average. The improvement of the income situation in

households sector, apart from the stable wages and retirements and pensions fund increase will also be affected by direct payments for individual holdings in agriculture, which allows the government to expect real disposable income growth rate to amount to 3.2% on average in the 2006-2008 period.

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



External sector, exports and imports

18. . On the assumption of accelerating domestic demand that is forecast to take over as the main source of economic growth, trade balance is forecast to worsen starting from 2006 due to increase in imports. Foreseen pick-up in import-intensive investment activity supports this kind of development in trade balance.

19. Despite the fact that within the forecast period negative income balance is likely to remain in excess of 8.0 bn EUR a year, balance of primary incomes and transfers is assumed to improve as a result of raising current transfers surplus. Additional policy measures are to be undertaken in order to improve Poland's absorptive capacity, including those classified at the current transfers account (introduction of legal solutions leading to more effective utilisation of the funds available). Consequently, current account deficit is estimated to remain below 3% of GDP in spite of widening trade imbalance.

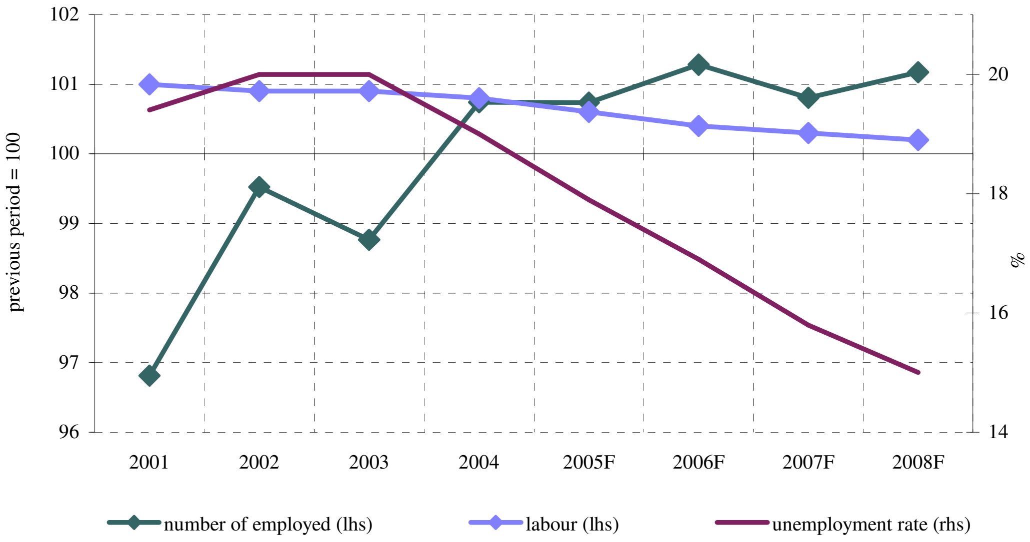
Labour market

20. Medium term situation on the labour market will be determined on the one hand by the continuation of restructuring and privatisation processes and by demographic factors, and on the other hand by relatively high economic growth, which will allow for the continuation of upward trend in employment, which began in 2005[2]. Economic growth promoting employment will be supported by the implementation of economic programmes, including the *National Employment Strategy 2007-2013.* Transfers of EU funds to Poland will be directed to a great extent for the improvement of the mobility of workforce and labour market

[2] According to LFS, conducted by CSO, the average number of economically active persons (15 years and more) in Poland, has risen already in 2004 (by ca. 178 thousand persons, i.e. by 1.3%).

flexibility, which should decrease structural demand-supply discrepancies and thus will have positive impact on the labour market. It is expected that in 2006-2008 employment will grow gradually and in 2008 will be higher by more than 3% compared with 2005. The increasing labour demand will lower the unemployment rate to the level of ca. 15% at the end of 2008. Because of the high number of unemployed persons (ca. 2.35 million at the end of 2008) in 2006-2008, high real increase in wages and salaries in national economy will not be really possible, despite high economic growth. It is estimated, that the real wages and salaries growth rate in national economy in 2006-2008 will amount to 2% on average. Assumptions concerning wages and salaries growth in budgetary sphere[3] and enterprise sector are the main basis for the above-mentioned forecast. The forecast assumes that indexation of wages and salaries in budgetary sphere will be equal consumer price index. It has also been assumed, that the real growth rate of wages and salaries in enterprise sector will increase from 1.0% in 2005 to 2.4% in 2008. The accelerating growth rate of wages and salaries will result mainly from the expected increase in labour productivity.

Chart 5. Labour market in 2001-2008 (end of period)



Inflation, interest rates and exchange rate

21. In 2006, similar as in 2005, inflation pressure should be limited. Low price dynamics will result also from the pertaining output gap and the situation on the labour market (low real dynamics of wages and salaries and high unemployment rate). While there are no negative supply shocks at the agricultural products market, average growth of prices of goods and consumer services in 2006 is forecast at the level of 1.5%. In subsequent years, the goal of the monetary policy will be to stabilise inflation at the level of inflation target established by the Monetary Policy Council. Average yearly increase in consumption prices – as forecast by the government – amounts to 2.2% in 2007 and 2.5% in 2008.

22. Considering the position of the Monetary Policy Council presented in *Monetary Policy Guidelines for the Year 2006*, inflation forecast and projections of other indicators, it has been

[3] Budgetary sphere includes budgetary units, budgetary establishments and auxiliary units at the central level.

assumed that in 2006 the monetary policy will not be tightened. It is expected that in the years 2007-2008 the monetary policy will be of a more accommodative nature. It is also assumed that in a longer perspective the restrictiveness of the monetary policy will lower as a result of the decrease in the real short-term interest rate.

23. The projection of the zloty exchange rate assumes that zloty will remain strong against euro in 2006-2008, while it will be less volatile.

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

24. The baseline macroeconomic scenario constituting a base for the projections of the tendencies in the area of public finance is generally consistent with the last forecast[4] of the European Commission. The differences in the forecast of economic growth are slight. Both the Ministry of Finance and the European Commission expect that in the forecast prospects, domestic demand will influence the GDP growth more and more, and net exports contribution, as of 2006, will be negative. They both assume a significant investment growth rate acceleration , while the national forecast is more optimistic, which results from the fact, that one of the main goals of economic policy of the government is the concentration and mobilisation as regards the absorption of structural funds.

Table 1. Comparison between forecasts of the European Commission and the Ministry of Finance for 2005-2007

	2004		2005		2006		2007	
	EC	MF	EC	MF	EC	MF	EC	MF
GDP	5.3	5.3	3.4	3.3	4.3	4.3	4.5	4.6
private consumption b)	3.2	4.0	2.8	2.3	3.4	3.7	3.5	3.5
gross fixed capital formation	5.1	6.3	5.5	5.0	8.2	8.7	10.4	12.5
exports	11.4	14.0	4.1	5.8	4.9	6.1	6.0	6.1
imports	8.7	15.2	1.9	1.4	5.6	6.2	7.1	7.8
Net exports c)	0.7	-0.7	0.8	1.5	-0.3	-0.1	-0.4	-0.7
Unemployment rate d)	18.8	18.8	17.8	17.8	16.8	16.7	15.5	15.7
GDP deflator	2.9	4.0	2.3	1.3	2.2	1.1	2.5	1.7
HICP	3.6	3.6	2.2	2.2	2.3	1.5	2.5	2.2
Trade balance e)	-1.1	-2.3	-4.3	-1.0	-4.4	-1.4	-4.6	-2.1
Current account balance e)	-4.2	-4.2	-3.2	-1.5	-3.5	-2.0	-3.9	-2.0

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

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

c) Contribution in GDP growth.

d) As defined by Eurostat.

e) In % of GDP.

25. Forecasts referring to inflation processes are shaped somewhat differently. The European Commission foresees a stabilisation of the inflation measured in average yearly harmonised index of consumer prices (HICP) for 2006 at the level similar to the one in 2005, while the

[4] *European Commission Autumn 2005 Economic Forecasts.*

Ministry of Finance forecasts a slowdown of the dynamics of consumer prices (slowdown of the average dynamics, dynamics measured at the end of the year, just as in case of the European Commission forecast, will increase). The consequence of that difference is the lower forecast of the GDP deflator, and slightly lower inflation scenario for 2007 in case of national forecast.

26. The European Commission, and the Ministry of Finance both expect an improvement of the situation at the labour market in the 2005-2007 period. Differences in the level of forecast unemployment rate are slight and may be a result of methodology differences. In both scenarios the decline in unemployment is an effect mainly of the growing demand for work and decreasing demographic pressure on the labour market.

27. The European Commission evaluates the level of external imbalance of Polish economy measured basing on the current accounts deficit in 2005-2007 much more pessimistically than the Ministry of Finance. Both the Ministry and the Commission expect that the current accounts deficit will increase, whereas its scale in the national scenario is much lower, which is a result of the varying estimates of the 2005 balance of payments. The currently available data for 2005 indicate that the probability of the delivery of national scenario is quite high, which means that the scale of external imbalance is significantly lower than in the forecast of the European Commission.

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

28. High economic growth rate must constitute the basis for the socio-economic development of Poland in the coming years. The analysis of the economic and social situation shows that the prerequisites of the acceleration of the economic growth and employment growth are as follows: public finance consolidation and creation of proper conditions for an efficient absorption of structural funds, stimulation of entrepreneurial initiative and innovation of enterprises, employment promotion and support for measures aimed at limiting unemployment. It is necessary to introduce measures, which will allow Polish companies to expand to a common European market. Making use of the potential of young and educated workforces is a prerequisite of the expansion of Polish economy.

29. High economic growth constitutes a basis for gradual elimination of development barriers, resulting from negative structural aspects of the economy and employment creation conditions, but does not eliminate all problems. To eliminate development barriers, intervention actions of the State are necessary i.e. actions focusing on stimulating and strengthening upward development trends, and thus creating such economic activity principles, which will decrease the costs of the functioning of companies and which will free the entrepreneurs of unnecessary bureaucratic and administrative burdens. These should strengthen the competitiveness of the economy and provide for the required level of social cohesion.

30. *National Reforms Programme for 2005-2008* for the implementation of Lisbon Strategy, adopted by the Council of Ministers on 27 December 2005 provides measures, which the Polish Government wishes to take in order to achieve the main goals of the renewed Lisbon Strategy. It is based on *"A Solidary State"* – Action Programme of the Government of Prime Minister Kazimierz Marcinkiewicz ["Solidarne Państwo"]. The main objective of the *National Reforms Programme* is to maintain high economic growth rate supporting employment creation, in compliance with sustainable development principles. Six priorities resulting from current socio-economic conditions have been presented in the *National Reforms Programme*. The main priority is to restore the ability of the economy to create

employment and to regain public finance balance through buoyant economic growth. For the implementation of each of these priorities, institutional, organisational and legislative measures were proposed, in particular aimed at:

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

III. General government balance and debt

III.1. Policy strategy

1. The priority of the new government's economic policy is to achieve buoyant and sustainable economic development through the employment development. High economic growth rate should be obtained while maintaining macroeconomic stability. The objective of the Polish fiscal policy will be – apart from stabilisation – public finance transparency and consolidation, which support the approximation of general government deficit-to-GDP ratio to the reference value (3% of GDP), reducing government debt growth rate at the same time.

2. The objective of the debt management strategy in the 2006-2008 period will be to minimise the debt servicing costs over a long time span, taking into account the assumed limitations regarding the level of: re-financing risk, exchange rate risk, interest rate risk, state budget liquidity risk, other risk types (especially credit risk and operational risk) and distribution of debt servicing costs over time.

3. The estimated general government balance-to-GDP ratio in 2005-2008 according to ESA 95 (i.e. with a periodical inclusion of Open Pension Funds, OPF), will amount to -2.9%; -2.6%; -2.2%; -1.9% respectively. This means that the balance will improve in the analysed period by 1.0 percentage points. General government debt in 2005-2008 - estimated using the same methodology – will be shaped at the level of 42.5%; 45.0%; 45.3%; 45.4% of GDP respectively. The improvement of the general government balance will determine maintaining the debt at a low level.

III.2. Medium-term objective

4. The reform of the Stability and Growth Pact, introduced in 2005, changed the principles of setting medium-term fiscal policy objectives for the Member States as well as differentiated the objectives. In order to minimise the risk of the general government deficit exceeding the threshold of 3% of GDP (especially under weak cyclical conditions), the Pact sets minimum medium-term reference values in cyclically adjusted terms, net of one-off and temporary measures - medium-term budgetary objectives (MTO). The reference level for structural balance-to-GDP ratio is differentiated for various Member State groups, depending on their potential growth and current debt level.

5. All Member States have been obliged to determine - as of the 2005 update of the Convergence Programme[5] - their own medium-term budgetary objectives (which may not exceed the reference value set in the Pact) and the adjustment paths towards these objectives. The medium-term budgetary objective for Poland has been set at the level of minus 1% of GDP.

6. Because of the implementation of important structural reforms (especially of the pension reform involving the introduction of a three-pillar pension scheme, including two capital pillars), despite a significant effort put in public finance consolidation (reduction of structural deficit from 3.9% of GDP in 2004 to 1.9% of GDP in 2008), Poland will not be able to achieve its medium-term budgetary objective in the period covered by the present

[5] Or the update of the Stability Programme in case of the euro area Member States.

Convergence Programme update. Public finance consolidation will be continued in the next years, and it will translate into a reduction of the structural deficit and achievement of the Polish medium-term budgetary objective after 2010.

7. It is necessary to emphasize that reforms implemented in Poland have been and will remain in coming years a significant burden for public finances. However, they will have a very positive impact not only on the medium-term, but also the long-term sustainability of public finances.

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

8. Basing on the data of the spring fiscal notification, which were sent to the European Commission in 2004, and which were confirmed in the May 2004 Convergence Programme, the Ecofin Council observed the existence of an excessive deficit in Poland and recommended it to be limited as soon as possible, so that by 2007 it reaches the level of less than 3% of GDP (Council decision 2005/183/EC of 5 July 2004).

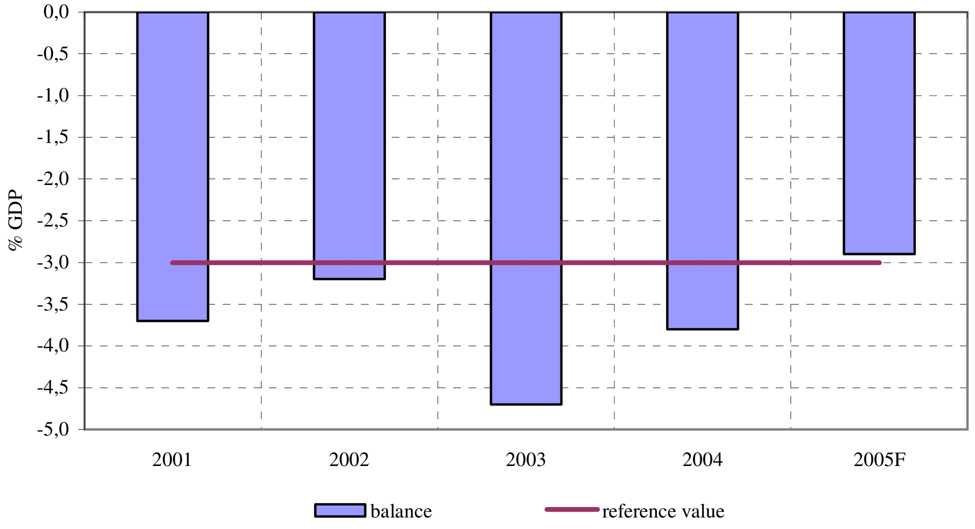
Table 2. General government balance and debt

% of GDP	ESA Code	2001	2002	2003	2004	2005
General government balance (B9)	S13	-3.7	-3.2	-4.7	-3.8	-2.9
Central government	S1311	-4.4	-4.3	-5.5	-5.3	-4.4
Local government	S1313	-0.4	-0.4	-0.5	0.0	-0.2
Social security funds	S1314	1.1	1.5	1.3	1.5	1.7
General government debt	S13	35.9	39.8	43.9	41.9	42.5

Source: for the 2001-2004 period the nominal level of deficit and debt – fiscal notification, September 2005; for 2005 – most recent forecasts. Calculations have been conducted basing on the new GDP level published by the Central Statistical Office in November 2005.

9. The data presented in the table above, compared to the update of the Convergence Programme of November 2004, have been verified by the Central Statistical Office as a result of the works of the Inter-ministerial Team for General Government Statistics (more on the works of the Team in Chapter 7 Institutional aspects of public finance).

Chart 6. General government balance in 2001-2005



Source: for the 2001-1004 period the nominal level of deficit and debt – fiscal notification, September 2005; for 2005 – forecasts.

10. In 2005, in accordance with the estimates of the Ministry of Finance, the general government deficit will amount to 2.9% of GDP. The correction of the previous forecasts results both from methodological adjustments and from the fact, that the state budget deficit in 2005 will amount to ca. 30 bn PLN compared to the one planned at the level of 35 bn PLN in the State Budget Act for 2005. In 2005 the general government deficit will be lower that the one assumed in the previous update of the Convergence Programme mainly because of the better situation of the state budget and local government units than the one estimated then, and as a result of methodological changes involving mainly the application of the new formula for the transition key from cash data to accrual data. The general government sector deficit-to-GDP ratio is also influenced by so-called large revision of the national accounts made by CSO at the end of November 2005.

11. On 29 November 2005, the government of Prime Minister Kazimierz Marcinkiewicz adopted its amendment to the draft State Budget Act for 2006 prepared by the previous government. The amendment assumed – in accordance with the proposed "budgetary anchor" - the achievement of the State budget deficit in 2006 at the level of 30.5 bn PLN. In the draft State Budget Act for 2006, prepared by the previous government, the State budget deficit for 2006 has been assumed at the level of 32.6 bn PLN. The new government also announced public finance consolidation and savings in public administration. These measures will have positive impact on the shape of general government in the years to come.

III.4. STRUCTURAL BALANCE

12. In order to estimate structural deficit, the output gap was estimated applying the Hodrick-Prescott filter. Calculations of the cyclical budgetary component took into account budgetary elasticities of revenues to the cycle on the basis of OECD data (the elasticity of indirect taxes and other revenues is 1; the elasticity of CIT is 1.39; and the elasticity of social contributions is 0.69). The output gap is expected to close in 2008, which means that the structural deficit

will actually correspond in 2008 to the general government deficit calculated according to ESA'95.

Table 3. Cyclical developments

% of GDP	ESA code	2004	2005	2006	2007	2008
1. Real GDP growth		5.3	3.3	4.3	4.6	5.0
2. Net lending of general government	B9	-3.8	-2.9	-2.6	-2.2	-1.9
3. Interest payments (incl. FISIM recorded as consumption)	D41	2.6	2.6	2.4	2.5	2.5
4. Potential GDP growth		3.7	4.0	4.3	4.6	4.7
5. Output gap		0.4	-0.3	-0.2	-0.2	0.1
6. Cyclical budgetary component		0.1	-0.1	-0.1	-0.1	0.0
7. Cyclically-adjusted balance (2-6)		-3.9	-2.8	-2.5	-2.1	-1.9
8. Cyclically-adjusted primary balance (7+3)		-1.3	-0.2	-0.1	0.4	0.6

Source: Ministry of Finance.

13. Structural deficit is calculated taking into account adjustments related to one-off measures. On the expenditure side in the 2005 State budget one-off measures will be insignificant. On the revenue side following one-off measures occurred: sale of UMTS licenses, which resulted in 0.3 bn PLN revenues to the state budget, as well as payment of 0.1 bn PLN from the dissolution of the Alimony Fund.

III.5. DEBT LEVELS AND DEVELOPMENTS

14. Pursuant to Polish regulations in force, the control of public debt level is vested in the Minister of Finance. In the case of State Treasury debt, the Minister of Finance has at her disposal instruments that allow her to directly manage this debt, while in the case of other units of the public finance sector such supervision is of an indirect nature (mainly through legal regulations). In the period covered by the Convergence Programme, management of State Treasury debt will be aimed at the implementation of the objective of the *Public Finance Sector Debt Management Strategy in the years 2006-2008*, namely at the minimisation of debt servicing costs in a long time span taking into account the assumed limitations regarding risk level. Limitations assumed in the *Strategy* concerned such risks as:

— re-financing risk: achieving average maturity of the State Treasury domestic debt at the EU Member States level (at the end of November 2005 this indicator amounted to 3.57 years), further reduction of treasury bonds share in total domestic debt, striving for even distribution of the payments arising from serviced and redeemed debt,

— exchange rate risk: potential periodical increase in this risk is allowed at the level acceptable within the horizon covered by the strategy; in case of issues to foreign markets, concentration of issues in euro is assumed (establishment of liquid benchmark issues),

— interest rate risk: the duration of the State Treasury domestic debt at the EU Member States level (at the end of November this indicator amounted to 2.81 years) and then the appropriate relation between the interest rate risk and the debt servicing costs, depending on the current and expected interest rates level, as well as maintaining a limited interest rate risk for foreign debt,

— State budget liquidity risk: maintenance of a safe State budget liquidity level while efficiently managing the liquid assets.

15. In 2004 in the general government debt-to-GDP ratio was significantly reduced as compared to the end of 2003 (by 2 percentage points from 43.9%). Such situation resulted mainly from high GDP growth and appreciation of Polish currency, as well as lower net borrowing needs (i.e. excluding the refinancing of maturing debt). It is expected that by 2006 debt-to-GDP ratio will rise and remain stable in the years 2007-2008. Although this growth rate will be lower every year, it will be higher than the nominal GDP growth rate in this period. Nevertheless, debt-to-GDP ratio in the discussed period will remain much below 60% of reference value.

16. Forecast changes in debt-to-GDP ratio will result mainly from the State budget borrowing needs (State Treasury debt represent approx. 94% of the government debt), estimated GDP growth rate and zloty exchange rate against other currencies, in particular against the euro.

17. In the years 2006-2008, similarly to 2005, the level of State budget borrowing needs will be influenced, apart from the deficit, mainly by tasks pre-financing from the EU funds (in particular in 2006, when the balance, together with advance payment, will amount to approx. 0.3% of GDP as compared to the expected 0.2% in 2005), as well as by the granted loans.

18. Changes in the other sector units debt will result mainly from the planned maintenance of upward trend in local government units debt (whereof the rate will depend mainly on their deficit growth) until 2007. Increased liabilities of independent public health institutions that could be observed in recent years (mainly in the form of overdue payments increasing accrual expenditure of those units) should be reduced through restructuring partly financed from loans granted from the state budget. Within the horizon covered by the Convergence Programme update it is expected that the National Road Fund debt will systematically increase (in particular in 2006), mainly in the form of credits for financing road infrastructure investments.

Table 4. General government debt developments

% of GDP	2004	2005	2006	2007	2008
Gross debt (OPF in the general government)	41.9	42.5	45.0	45.3	45.4
Change in gross debt ratio	-2.0	0.6	2.5	0.3	0.1
Contributions to change in gross debt					
Primary balance	-1.2	-0.3	-0.2	0.3	0.6
Interest expenditure (excluding FISIM)	2.6	2.6	2.4	2.5	2.5
Stock-flow adjustment					
of which: privatisation receipts	-0.8	-0.3	-0.4	-0.3	-0.2
exchange rate	-2.2	-0.3	0.3	-0.2	-0.2
p.m. implicit interest rate on debt	6.4	6.5	6.0	5.9	5.9
Gross debt (OPF outside the general government)	45.9	47.9	51.2	52.1	52.6

Source: Ministry of Finance.

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

19. In 1999 Poland introduced the pension reform involving the establishment of capital system (with Open Pension Funds) along the current *pay as you go* scheme (with the Social Insurance Fund – SIF). This decision has had a significant impact on the general government deficit and debt.

20. The pension reform also involved the establishment of the Demographic Reserve Fund (DRF). It is credited from the part of retirement pension contributions transferred by SIF. DRF funds may be used solely for the purpose of covering SIF pension fund deficit resulting from demographic reasons and it cannot take place before 2009. Due to the fact that DRF constitutes a part of the general government, the transfer of the part of contributions from SIF to DRF is a subject to consolidation within the entire sector. On the other hand, subsidy from the State budget to SIF, aimed at covering deficit resulting from the transfer of the part of contribution to DRF by SIF, increases State budget debt servicing expenditure and State Treasury debt.

21. The costs of reform, which is aimed at e.g. long-term stabilisation of the general government, encumber in the medium term both the state budget and SIF. Due to the introduced reform, social security contribution is not transferred to SIF in whole (as it was before the reform); instead, it is transferred both to SIF (full contribution for disability pension insurance, accident and sickness insurance and part of retirement pension contribution in the amount of 12.22% of the assessment basis) and to OPF (part of retirement pension contribution in the amount of 7.3% of the assessment basis), with the increasing share of contributions transferred to OPF resulting from the obligatory participation in OPF of the newly insured persons. Such distribution of social security contribution resulted in the revenues loss equal to the loss of contribution transferred to OPF. Moreover, the pension reform limited the assessment basis for retirement and disability contributions to the forecast average monthly salary in the national economy, multiplied by 30. Above that limit, contributions are not transferred to pension scheme. This restriction results in additional loss of SIF revenues from contributions, due to the introduction of the pension reform.

22. Deficit in SIF resulting from the pension system reform is financed from the state budget, which annually transfers funds for payments of disability allowances and pensions under *pay as you go* scheme to SIF. Thus, the state budget needs to acquire funds to finance the abovementioned transfer every year, which involves additional debt issue whereof the servicing costs are borne by the State Treasury. Debt servicing costs borne by the state budget also result from the assumption by the State Treasury of the Social Insurance Institution (SII) liabilities towards OPF caused by the failure to transfer contributions (in the first years after the introduction of pension reform problems occurred with respect to the precise identification of contributions, i.e. their allocation to relevant remitters accounts, which contributed to the creation of liabilities). None of the abovementioned costs would have been borne if the pension reform had not been introduced in order to ensure long-term stabilisation of public finance. Transfers from the state budget to SIF systematically increase borrowing needs, and thus influence the government debt.

Table 5. Net costs of the pension reform and the resulting debt

% of GDP	2004	2005	2006	2007	2008
Net costs of the pension reform	2.2	2.4	2.5	2.5	2.4
Transfer from the State budget to SIF related to:	1.5	1.6	1.7	1.6	1.5
loss in contribution	1.1	1.2	1.3	1.2	1.1
multiplication by 30	0.4	0.4	0.4	0.4	0.4
Debt servicing costs related to:	0.7	0.8	0.8	0.9	0.9
SIF deficit coverage in	0.7	0.8	0.8	0.9	0.9
assumption of SII liabilities	0.0	0.0	0.0	0.0	0.0
State Treasury debt resulting from the pension reform	10.5	12.7	15.0	16.9	18.5

Source: Ministry of Finance

IV. Sensitivity analysis and comparison with the 2004 Convergence Programme update

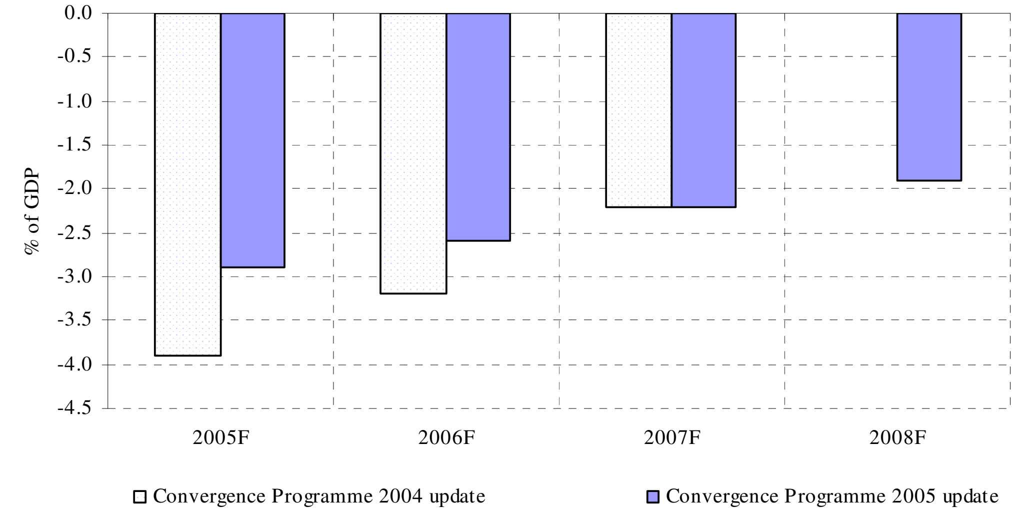
IV.1. Comparison with the Convergence Programme 2004 update

1. In general, a relatively lower GDP growth is forecast throughout the entire period of the current update, mainly due to expected lower increase in domestic demand. Lower GDP dynamics in 2004 than assumed in the previous update (5.3% as compared with 5.7%) resulted from the negative contribution of net exports to GDP growth (-0.7 percentage point vs. 0.8 percentage point). At the same time, the contribution of domestic demand to GDP growth (6.0 percentage points) was higher than projected. The negative contribution of net exports to GDP growth in 2004 results partly from methodological changes in national accounts introduced in the third quarter of 2005. Before this revision the contribution of net exports to GDP growth was positive, although lower than previously forecast (0.3 percentage point vs. 0.8 percentage point).

2. A lower GDP growth expected in 2005 (3.3% vs. 5.0% estimated in the previous update) is based on the data from three quarters of 2005 indicating low domestic demand (although it was already stronger in the third quarter than in the first quarter of 2005); its contribution to GDP growth amounted to 0.7 percentage point whereas GDP growth reached 2.9% after the first three quarters of 2005. Weaker domestic demand resulted mainly from a small dynamics of private consumption and a slower growth of gross fixed capital formation. Current information on main indicators of economic activity in the first months of the fourth quarter of 2005 together with strengthening domestic demand allow to expect acceleration in GDP growth to 3.3% for the whole year. The negative contribution of inventories to GDP growth in 2005 (-1.1 percentage points vs. 0.0 percentage point assumed in the 2004 update) results from a high reference level (statistical base) - in 2004 economic recovery was supported by the accession to the EU (so-called accession shock), and net acquisition of valuables rose markedly at that time, contributing to GDP growth by as much as 1.6 percentage points.

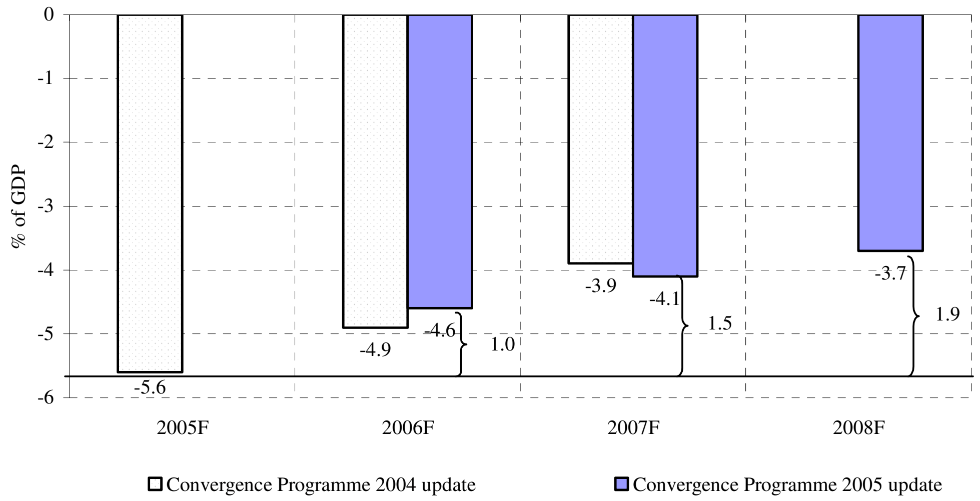
3. The projected acceleration in GDP growth in 2006 to 4.3% reflects stronger domestic demand which will become the main engine behind growth. Domestic demand will be driven by higher private consumption growth (e.g. due to planned indexation of retirement and disability pensions), and higher increase of gross fixed capital formation boosted, inter alia, by a better absorption of the EU funds. The rate of economic growth is forecast to further accelerate in 2007 and 2008, reaching 4.6% and 5.0%, respectively. Domestic demand will continue to be the driving force behind growth between 2007 and 2008, whereas the contribution of net exports to GDP growth will remain negative.

Chart 7. General government balance – comparison with the Convergence Programme 2004 update (OPF in the general government)



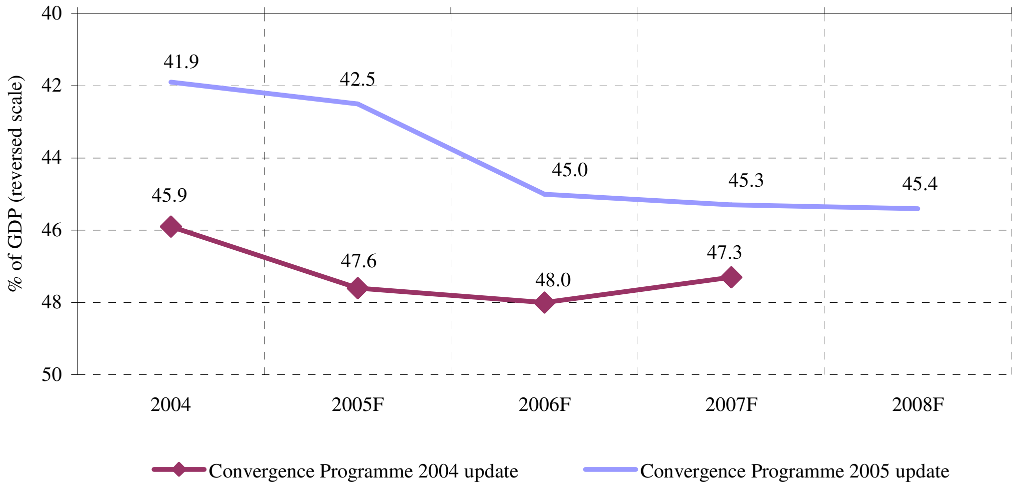
4. The current forecast of the general government deficit, which relies on the baseline macroeconomic scenario and takes into account systemic changes affecting the general government, assumes a reduction in the deficit by 1.9 percentage points of GDP between 2004 and 2008. The general government deficit should not exceed 2.9% of GDP in 2005, whereas in the next years it is expected to diminish by 0.3% of GDP on average. Hence, the budgetary target presented in the Convergence Programme 2004 update - the deficit of 2.2% of GDP in 2007 - is kept unchanged. The deficit is projected to fall to 1.9% of GDP in the last year of the projected period. An improvement in the general government balance is also clear when comparing the 2005 deficit target - 3.9% of GDP in the previous update - with the current 2006 deficit target of 2.6% of GDP.

Chart 8. General government balance – comparison with the Convergence Programme 2004 update (OPF outside the general government)



5. The projection of debt development has been revised in comparison with the 2004 update, and the government debt is forecast to grow by 3.4 percentage points in the years 2004-2008. However, the debt-to-GDP ratio shall remain stable over the period 2006-2008, and it will not exceed 46.0%. Compared to the 2004 update, the debt ratio will be lower throughout the entire period of the current update.

Chart 9. General government debt – comparison with the Convergence Programme 2004 update (OPF in the general government)

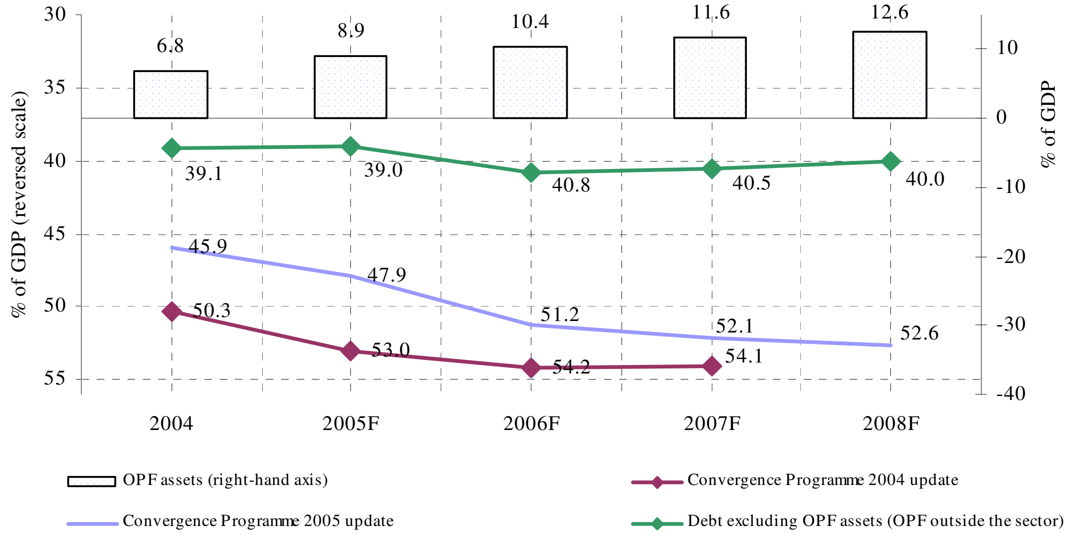


6. Classification of the second pillar Open Pension Funds outside the general government results in an upward adjustment of the debt-to-GDP ratio, for example by 4.0% in 2004 and by 7.2% in 2008. Such an adjustment is due to the fact that OPF invest, inter alia, in treasury securities issued by general government units. If OPF are recorded in the general government, the value of the securities is subject to consolidation within the government debt.

7. It is the opinion of the Polish government that such institutions as OPF, established under the reform of the previous social security system, should be recognized as part of the general government. This view is supported by a number of arguments, including the fact that participation in OPF is obligatory and that OPF are financed with a share of a single retirement contribution. When collecting the part of retirement contribution, OPF accumulate assets for the future payments of retirement pensions. Hence, OPF assets are financed from the increased government debt, whereas off-balance liabilities of the general government towards future pensioners are reduced.

8. In the next several years, before payments from the new pension system achieve the target level, OPF will accumulate significant financial assets. By the end of the last year of the projected period, i.e. in 2008, OPF assets are expected to reach approximately 12.6% of GDP, thus increasing the government debt (assuming that OPF are classified outside the general government). Had OPF not been established, the government debt would have been significantly lower, amounting to approximately 40% of GDP in the years 2004-2008.

Chart 10. General government debt – comparison with the Convergence Programme 2004 update (OPF outside the general government)



9. Differences between government debt forecasts for the years 2005-2007 presented in the current and previous update result from the outturn of 2004. The debt was significantly lower in 2004 than assumed in the 2004 update due to mainly the following factors:

— lower than estimated State budget deficit,

— surplus of the local government (cash basis) as compared with the forecast deficit,

— lower than expected debt of the Social Insurance Fund (Fundusz Ubezpieczeń Społecznych, FUS) in commercial banks,

— appreciation of the zloty.

10. Moreover, the revised government debt forecast reflects the following factors:

— revision of the GDP volume for previous years undertaken by the Central Statistical Office (CSO),

— modified assumptions on the borrowing needs of the State budget, and in particular revised forecasts of the State budget deficit and balance of so-called pre-financing[6] together with revised assumptions on net privatisation receipts,

— modified assumptions on the foreign exchange rate,

— changed definition of the general government – inclusion of the Agricultural Market Agency and of the National Road Fund in the general government.

[6] Pre-financing concerns, inter alia, involvement of the local government in projects co-financed from EU funds.

Table 6. Divergence from the Convergence Programme 2004 update

	ESA Code	2004	2005	2006	2007	2008
GDP growth (%)						
Convergence Programme 2004 update		5.7	5.0	4.8	5.6	-
Current update		5.3	3.3	4.3	4.6	5.0
Difference		-0.4	-1.7	-0.5	-1.0	-
General government net lending (% of GDP)	EDP B.9					
Convergence Programme 2004 update		-5.4	-3.9	-3.2	-2.2	-
Current update		-3.8	-2.9	-2.6	-2.2	-1.9
Difference		1.6	1.0	0.6	0.0	-
General government gross debt (% of GDP)						
Convergence Programme 2004 update		45.9	47.6	48.0	47.3	-
Current update		41.9	42.5	45.0	45.3	45.4
Difference		-4.0	-5.1	-3.0	-2.0	-

General government net lending (% of GDP)*	EDP B.9					
Convergence Programme 2004 update		-7.2	-5.6	-4.9	-3.9	
Current update		-5.6	-4.7	-4.6	-4.1	-3.7
Difference		1.6	0.9	0.3	-0.2	
General government gross debt (% of GDP)*						
Convergence Programme 2004 update		50.3	53.0	54.2	54.1	
Current update		45.9	47.9	51.2	52.1	52.6
Difference		-4.4	-5.1	-3.0	-2.0	

* In the case when OPF are classified outside the general government.

Source: Ministry of Finance.

11. The fiscal path in the Convergence Programme 2004 update assumed implementation of the government's *Programme for Rationalisation and Reduction of Public Expenditure*. However, a number of measures foreseen in that programme was subject to modification in

result of the public debate and parliamentary work as compared with the state presented in the previous update. The evaluation report on the *Programme for Rationalisation and Reduction of Public Expenditure*, adopted by the former government in May 2005, valued the total financial impact of measures described in that document at 2.6% of GDP: 0.9% of GDP on the revenue side and 1.7% of GDP on the expenditure side. The general government deficit is currently expected to improve in the years 2004-2007 by 0.1%, 0.8%, 0.7% and 1.0% of GDP, respectively. A part of savings stems from implementation of a number of measures in the area of administration and economy, such as decrease in operating costs of public administration, better organisation of special purpose funds and State Treasury agencies, reduction in low-efficient State budget expenditure, consolidation of certain government administration units, better organisation of defence expenditure, or rationalisation of state aid (mining, public health, PKP railway company). As a consequence of the public debate, many solutions reforming and rationalising social expenditure were adopted and implemented with respect to e.g. indexation of retirement and disability pensions, sickness allowances system, pre-retirement benefits system, disability pension system, disabled persons system and farmers' social security system.

12. The new government, confirming the necessity of further reductions in central and local government expenditure, has announced implementation of a number of measures within the framework of the *Low Cost Country* programme. Financial impact of that programme should allow for important savings already in the first year of its implementation. The Prime Minister has appointed the *Low Cost Country* programme implementation team. Implementation of solutions aiming at lower administration expenditure will be possible, inter alia, thanks to the introduction of a so-called performance budgeting instead of the current "ratio-based" system that provides for a transfer of expenditure to the subsequent year, calculated on the basis of the adopted ratio. It has been assumed that the first stage would cover decisions concerning dissolution of some public administration units or limitation of their operation, and dissolution of funds, agencies and certain offices, whereas the second stage would cover, after standardisation of the central and local government, the introduction of radical changes through abandonment of unnecessary posts, reduction in the number and use of passenger cars etc.

IV.2. RISK FACTORS

13. Risk factors which could significantly affect public finances include:

— macroeconomic risk, in particular:
  - a) lower than forecast economic growth,
  - b) higher than expected inflation rate,
  - c) large fluctuations of foreign exchange rates,
  - d) no significant improvement in the absorption of structural funds,
  - e) more restrictive monetary policy;

— political risk:
  - a) lack of a stable political support in the Parliament,
  - b) political tensions.

Macroeconomic risk

14. The main external risk factors for the macroeconomic scenario forecast are:

— worsening economic conditions of Poland's main trade partners,

— further increase in oil prices which would translate into a slowdown of the world economic growth and acceleration of inflation,

— intensified fluctuations of foreign exchange rates in the new Member States of the EU.

15. The shape of the general government is particularly influenced by the state of the national economy. Such macroeconomic factors as inflation, interest rates, foreign exchange rates, GDP growth rate, affect revenues and expenditure of the general government. A significant part of expenditure directly depends on the inflation level (retirement and disability pensions, social benefits) or on GDP (defence expenditure).

16. Moreover, macroeconomic conditions have an impact both on debt servicing costs and debt level. Worsening economic conditions push up the government debt (increase in nominal debt, and a higher debt-to-GDP ratio as a consequence of increased nominal debt and lower nominal GDP) due to larger borrowing needs of the general government. This, in turn, directly affects debt servicing costs in the following years.

17. Revenues from contributions (a marked share of the general government's revenues) correspond closely with the wage fund of the economy. The level of tax revenues is essentially influenced by nominal consumption and the wage fund of the economy.

18. Two macroeconomic scenarios have been developed in order to assess the impact of macroeconomic conditions on the shape of the general government. In the optimistic scenario, the GDP growth rate would accelerate to 6.0% in 2007 and would remain stable in 2008, whereas in the pessimistic scenario it would stay at 3.5% throughout the entire projected period.

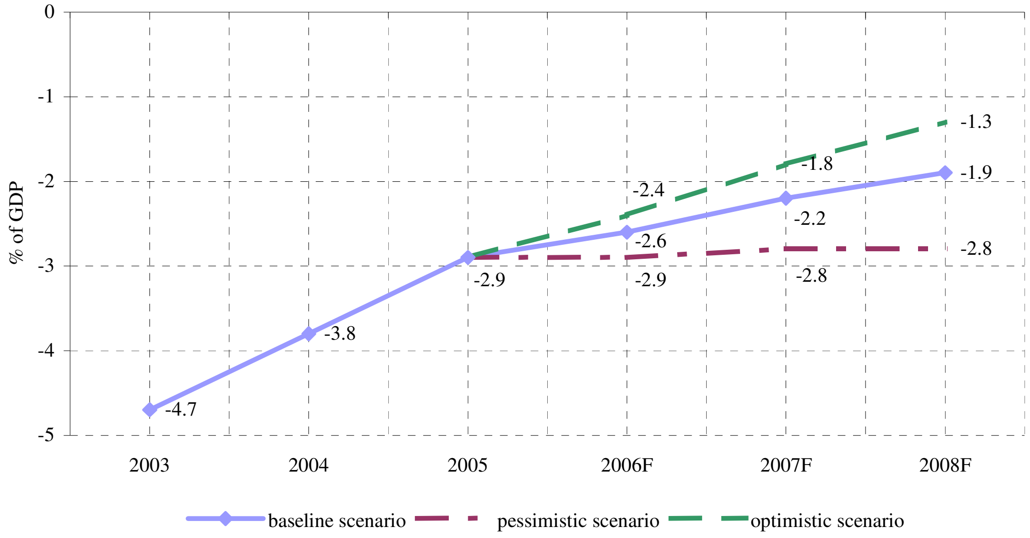
Table 7. Alternative economic scenarios

		2005	2006	2007	2008
Real GDP growth	baseline	3.3	4.3	4.6	5.0
	optimistic	3.3	5.0	6.0	6.0
	pessimistic	3.3	3.5	3.5	3.5
Inflation	base	2.2	1.5	2.2	2.5
	optimistic	2.2	1.6	2.6	2.7
	pessimistic	2.2	1.3	1.9	2.1
Wages and salaries fund (PLN billion)	baseline	249.7	261.2	274.5	290.4
	optimistic	249.7	262.8	279.6	298.4
	pessimistic	249.7	259.3	269.9	281.8
Interest rates	base	5.3	4.5	4.5	4.5
	optimistic	5.3	4.7	5.4	5.5
	pessimistic	5.3	4.5	4.2	3.8
Foreign exchange rate (PLN/EUR)	baseline	4.03	3.90	3.92	3.87
	optimistic	4.03	3.88	3.89	3.86
	pessimistic	4.03	3.93	4.00	4.00
General government net lending (% of GDP)	baseline	-2.9	-2.6	-2.2	-1.9
	optimistic	-2.9	-2.4	-1.8	-1.3
	pessimistic	-2.9	-2.9	-2.8	-2.8
General government gross debt (% of GDP)	baseline	42.5	45.0	45.3	45.4
	optimistic	42.5	44.3	43.3	42.4
	pessimistic	42.5	45.9	47.8	50.3

Source: Ministry of Finance.

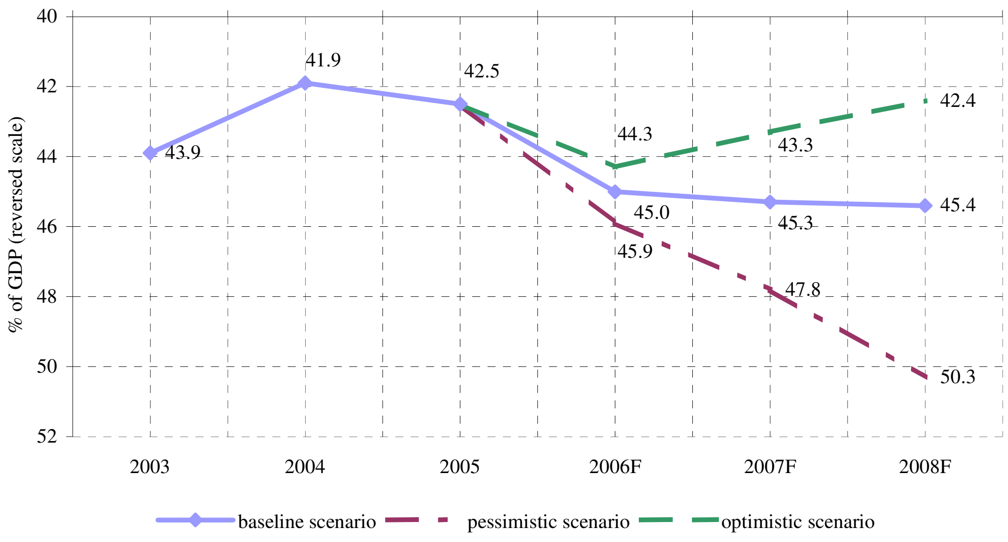
19. According to the baseline scenario, the general government deficit would decrease from 2.9% of GDP in 2005 to 1.9% of GDP in 2008. However, should the GDP growth slow down to 3.5% between 2006 and 2008 (pessimistic scenario), it can be expected that decrease in the deficit to below 2.8% would not be possible in the analysed period. Acceleration of GDP growth to 5.0% in 2006 and 6% in the years 2007-2008 (optimistic scenario) would allow for a reduction in the general government deficit to 1.3% of GDP in 2008.

Chart 11. General government balance in the years 2003-2008 in alternative scenarios



20. The baseline scenario assumes a reduction in the growth rate of the debt-to-GDP ratio in the years 2006-2008. In the optimistic scenario the debt-to-GDP ratio would start to fall rapidly. In the pessimistic scenario the government debt would grow at a relatively faster pace (both in nominal terms and in relation to GDP); such changes would result from different borrowing needs, foreign exchange rate and nominal GDP level.

Chart 12. General government debt in the years 2003-2008 in alternative scenarios



Political risk

21. The draft budget for 2006 adopted by the Council of Ministers and reflected in the present update will be subject to parliamentary debates. Moreover, the new minority government might find it difficult to achieve its objectives without the backing of parliamentary majority.

Risk factors specific for Poland

22. The Polish government noticed the Eurostat decision of March 2004 on the classification of funded pension schemes. The solution approved by the European Council on 22-23 March 2005 (a transitional regressive consideration of net costs of pension reforms during assessments of developments in EDP figures) means that stronger fiscal adjustment efforts are needed. Hence, it presents an additional challenge for the government. Poland was one of the pioneers that undertook a difficult task of reforming inefficient repartition pension scheme in order to ensure long-term stability of public finances. Considering the progressive process of ageing populations in the Member States, the government believes that Member States should not be discouraged from introducing such pension reforms.

23. Operations under public-private partnerships carried out by general government units could also influence the situation of the general government in the next years. The legal framework for concluding such transactions was established by the Act of 28 July 2005 on public-private partnerships. However, the impact of public-private partnerships on the general government deficit and debt is expected to be limited, at least in the first years after the Act's entry into force.

24. Lack of legal regulations concerning reprivatisation poses another risk to public finances. Should the parliament adopt acts currently in the pipeline, i.e. the "Reprivatisation" Act and Act on reprivatisation of "Warsaw real estate", the necessity of returning property to its former owners might be an additional burden for the State Treasury. At present, compensations for claims of former owners of property assumed by the State Treasury are paid from the Reprivatisation Fund on the basis of administrative decisions and court judgements. The total amount of reprivatisation claims with respect to the Reprivatisation Act is estimated at PLN 60.0 billion, whereas the total amount of planned compensations to be paid - at PLN 12.0 billion. In the case of the Act on Warsaw real estate, compensations worth PLN 6.0 billion are planned to be paid, out of the total number of claims for the total amount of PLN 20.0 billion. Moreover, PLN 2.1 billion has been allocated to the payment of compensations provided for in the Act on real property situated east of the Bug river, adopted by the parliament in July 2005. However, as applications for compensations are still being submitted, the final amount of compensations is not known yet (total amount of claims being estimated at PLN 10.5 billion).

25. The level of potential liabilities of the State Treasury related to granted guarantees and sureties is expected to increase from 3.2% of GDP at the end of 2004 to approximately 5% of GDP at the end of 2008. However, the growth rate of these liabilities will decrease as from 2007. At the same time, the level of portfolio risk is expected to decline from approximately 40% at the end of 2004 to approximately 26% at the end of 2008. This will mainly result from the strategy of granting guarantees and sureties, i.e. from focusing on the support for development-oriented investments in infrastructure and environmental protection, limiting the granting of guarantees and sureties on the basis of special "sectoral" acts, and maintaining the ratio of anticipated payments under guarantees and sureties (potential risk-weighted liabilities) to below 2% of GDP. The adopted strategy is aimed at preventing the situation when the State Treasury would assume the debt of the entity to which it had granted guarantee or surety.

26. Unless some modified general bridging pensions scheme is established, the current process of exclusion of particular employment groups from the reformed pension scheme, initiated by uniformed services and followed recently by miners, may lead to increased liabilities despite a temporary improvement in the general government balance in the first phase.

27. A delay in developing legal EU frameworks for Community programmes for the years 2007-2013 presents also an important risk factor. Late agreement on the new financial perspective and the following late finalisation of works on individual regulations may cause delays in implementation of programmes and projects in Poland. Moreover, it will be essential for Poland to generate appropriate national co-financing so as to reach a satisfactory absorption level of EU funds. Apart from the adoption of favourable solutions with respect to VAT and co-financing by the European Council in December 2005, we plan to undertake further measures aimed at improvement of the national financing system, including the introduction of multi-annual budgeting and performance budgeting.

V. QUALITY OF PUBLIC FINANCES

V.1. POLICY STRATEGY

1. The new government aims at a prolongation of the financial planning span and introduction of three-year planning prospect. The latter would allow a greater transparency and stability of the government's operations. Substantial consolidation of public finance will take place, which would improve transparency and allow a rationalisation of public expenditure. Introduction of performance budgeting is considered. This method would improve the planning process and allow a maximisation of profits from Polish membership in the European Union through improved capacity to absorb EU funds.

2. Poland will remain the net beneficiary of the EU non-returnable aid, whereas costs related to the membership in the European Union (membership contribution) will encumber the State budget in the amount of approximately 1.0% of GDP per year. It is assumed that more efficient utilisation of EU funds would result in higher State budget VAT revenues. According to the self-amendment to the State Budget Act for 2006, the amount of EU funds for Poland will total approximately 2.2% of GDP. At the same time, pursuant to the agreement concluded by the European Council on 17 December 2005 in Brussels, according to the estimates based on the assumptions of the European Commission, Poland will be able to acquire 91 bn euro in the years 2007-2013 (funds initially allocated to Poland under the agreement on the new Financial Perspective – level of commitments). In accordance with the compromise adopted by the European Council, the maximum rate of co-financing from the EU budget was increased up to 85% of the total costs of programmes implemented under structural funds. Inclusion of expenditure incurred by the private sector in the reference base will also be possible. Moreover, it was decided that VAT-related costs will still be considered as eligible costs. The above solutions will contribute to the substantial reduction in the expenditures of public finance sector.

3. Table 8 presents an overview of the general government up to 2008. Forecasts included therein reflect the adopted macroeconomic scenario, as well as baseline assumptions related to the future fiscal policy of the Polish government. Analyses are carried out in order to develop final solutions of the future systemic changes, which are planned to be introduced by newly established government. Final solutions will be known on the turn of the first and second quarter of 2006. The present Convergence Programme update provides all available information on the operations of the Polish government as of the day of its adoption by the Council of Ministers.

Table 8. General government budgetary prospects

	ESA Code	2004	2004	2005	2006	2007	2008
		PLN bn	*% of GDP*				
General government (B9)	**S13**	**-34.9**	**-3.8**	**-2.9**	**-2.6**	**-2.2**	**-1.9**
Central government	S1311	-49.1	-5.3	-4.4	-4.6	-4.1	-4.0
Local government	S1313	-0.2	0.0	-0.2	0.0	-0.2	-0.1
Social security funds	S1314	14.4	1.5	1.7	2.0	2.1	2.2
General government (S13)							
Total revenue	TR	361.8	39.2	42.0	42.1	41.5	40.5
Total expenditure	TE	396.7	43.0	44.9	44.7	43.7	42.4
Balance	S13	-34.9	-3.8	-2.9	-2.6	-2.2	-1.9
Interest payments (including FISIM)		23.6	2.6	2.6	2.4	2.5	2.5
p.m.: FISIM		-0.7	-0.1	0.0	0.0	0.0	0.0
Primary balance		-11.3	-1.2	-0.3	-0.2	0.3	0.6

Source: 2004 – CSO, 2005-2008 – Ministry of Finance forecast.
Data have been calculated on assumption that obligatory OPF are classified as the general government.

4. Until March 2007 Poland may benefit from the transitional period, during which Open Pension Funds are classified as a unit of the general government. The table below presents basic data related to the general government in the case when OPF are classified in the financial institutions sector.

Table 9. General government budgetary prospects - OPF classified outside the general government

	ESA Code	2004	2004	2005	2006	2007	2008
		PLN bn	*% of GDP*				
Total revenues	TR	346.2	37.6	40.4	40.3	39.9	39.0
Total expenditure	TE	398.2	43.2	45.1	44.9	44.0	42.7
Balance	S13	-52.0	-5.6	-4.7	-4.6	-4.1	-3.7

Source: 2004 – CSO, 2005-2008 – Ministry of Finance forecast.

V.2. DEVELOPMENTS ON THE EXPENDITURE SIDE

5. The most significant changes in expenditure included in the present Convergence Programme update are as follows:

— pursuant to the draft of the Act on the financing of land transport infrastructure, the maintenance of railway infrastructure and provision of inter-voivodship transports will be co-financed from the state budget. The amount of current and property expenditures will be related to the revenues from the excise tax on engine fuel and will reach not less than 12% of its value; from 2007, State budget expenditure due to the co-financing of the railway and road infrastructure and of the inter-voivodship transport in total will be equal to at least 18% of the revenues from excise tax on the engine fuel. Additionally, pursuant to the draft, State budget expenditure related to the co-financing of inter-voivodship transport cannot be included in this amount. According to draft, it is estimated that such expenditure will amount to 2.1 bn PLN in 2006, 2.6 bn PLN in 2007 and 2.8 bn PLN in 2008,

- the amendment to the Act on railway transport provides that the depreciation of PKP PLK S.A. will be financed from the State budget and Railway Fund in order to reduce network access rates. State budget contribution in 2007 and 2008 is estimated for ca. 0.4 bn PLN anually,
- it is expected that in the years 2006-2008 subsidies for fuel for farmers will be introduced and that they will reach 0.5 bn PLN annually,
- the draft of the amendment to the Act on establishment of multiannual programme *Equipment of armed forces of the Republic of Poland in multi-purpose fighter aircrafts,* which will soon be submitted to the government for discussion, provides for an increase of expenditure with funds for financing VAT on the price of the purchased aircrafts by 0.5 bn PLN in 2006, 1.0 bn PLN in 2007 and 0.7 bn PLN in 2008. However, due to the fact that the amounts paid will at the same time constitute State budget revenues, the expenditure covered by these funds will not affect the general government deficit,
- adoption of the multiannual programme entitled *The Aid of State in the Range of Nutritional Supplements* to be implemented in the 2006-2009 period, will result in an increase of expenditure from the State budget and local government units for the implementation of the programme in total amount of 2.9 bn PLN, i.e. 0.7 bn PLN each year,
- in the framework of social policy, in particular prevention of demographic crisis, which would have significant consequences for the economy and public finance as well as for the pension and health care system, the government has provided for an increase of expenditure for the extension of maternity leave (by 0.1 bn PLN annually), an increase of allowances for childbirth (by 0.1 bn PLN annually) and for a change of income criteria for the allocation of social care for farmers (1.0 bn PLN annually).

Table 10. Selected components of expenditure

	ESA Code	2004	2004	2005	2006	2007	2008
		bn PLN	*% of GDP*				
Collective consumption	P32	76.0	8.2	8.0	7.7	7.6	7.3
Total social transfers		237.4	25.7	26.1	26.0	25.3	24.4
Social transfers in kind	D63	89.1	9.6	10.0	9.7	9.5	9.2
Social transfers other than in kind	D62	148.3	16.1	16.1	16.3	15.8	15.2
Interest expenditure (incl. FISIM)	D41 (FISIM)	23.6	2.6	2.6	2.4	2.5	2.5
Subsidies	D3	4.6	0.5	1.0	1.0	0.9	0.8
Gross fixed capital formation	P51	30.9	3.4	3.9	4.0	4.0	4.0
Other		24.2	2.6	3.3	3.6	3.4	3.4
Total expenditure	**ESA**	**396.7**	**43.0**	**44.9**	**44.7**	**43.7**	**42.4**
Costs related to employment	D1	93.6	10.2	10.2	10.0	9.6	9.2

Source: 2004 – CSO, 2005-2008 – Ministry of Finance forecast.

Data have been calculated on the assumption that obligatory OPF are classified as the general government.

6. The level and the structure of general government expenditure in 2005-2008 will be determined mostly by the implementation of objectives and priorities of the government economic programme. The level of the general government expenditures in 2005-2008 will show a nominal increase, however, in relation to GDP it will decrease by 2.5 percentage points. It results from the fact that GDP growth rate will be higher than the expenditure growth rate.

7. Social transfers are the most significant item in the structure of expenditures. The level of expenditures is determined by the forecasted payment of retirement and disability pensions for 2005-2006 and by the planned implementation of the government family policy. The ratio of such expenditures to GDP will decrease in 2005-2008 by 1.7 percentage points. The ratio of collective consumption expenditures to GDP will systematically decrease i.e. by ca. 0.2 percentage points. It is related *inter alia* to government policy aiming at the reduction of expenditures for administration activity. In 2005-2008, investment expenditures will increase by ca. 0.1 percentage points.

8. In January 2005, the Central Statistical Office sent the preliminary version of table 11 entitled "Expenditure of general government by function" for 2003 to Eurostat. CSO is currently calculating the data according to new methodology prepared by the inter-ministerial Team for general government statistics. Therefore, the Ministry of Finance prepared expenditure according to the function (COFOG) for incomplete scope of the sector. Only the most significant units were considered: state budget, Social Security Fund, Retirement and Pension Fund, Labour Fund and National Health Fund. In 2004 total expenditure of these units reached 81.9% of total expenditures of the sector, which constituted 35.2% of GDP, and in 2005 the expenditures of the above units are estimated to constitute 81.7% of the expenditures of the entire general government, which amounts to 36.3% of GDP, whereas in 2006 the expenditures will constitute 83.6% of the total expenditures and will reach 36.9% of GDP.

9. The expenditures for social protection, which reached 17.4% of GDP, will constitute the largest part of expenditures in 2004; in 2005-2006 this expenditures will increase by 1 percentage point up to the level of 18.4% in 2005 and 18.5% of GDP in 2006. This results from the fact that general government in Poland implements wide range of tasks related to social care policy. Expenditures for general public services in 2004 reached 5.2% of GDP and in 2005-2006 it will reach 5.6% of GDP. The category includes: expenditures of executive and legislative authorities, financial and fiscal expenditures, external affairs expenditures, foreign economic aid expenditures, general services expenditures, expenditures for basic research, general services expenditures e.g. public debt transactions i.e. interest payments, and outlays for underwriting and floating government loans. Increase in expenditure in the category of general public services up to the level of 5.6% of GDP results mostly from the introduction of „contribution to EU budget" to this category in 2004 in amount of 0.6% of GDP, the share of which in 2005-2006 will increase to ca. 1.0% of GDP each year. Education expenditures constituted 3.8% of GDP in 2004, 3.9% of GDP in 2005 and, in 2006, it will be reduced to 3.7% of GDP. Health expenditures indicate stable share in GDP, remaining at the level of 3.7% of GDP during the three years in question. The actual share of the last two expenditure categories in the expenditure of the entire sector is higher because the data presented do not include *inter alia* funds saved up by the local government units, in the health care institutions and at universities.

Table 11. General government expenditure by function

% of GDP	COFOG code	2002	2003	2004	2005	2006
General public services	1	4.6	4.7	5.2	5.6	5.6
Defence	2	1.1	1.2	1.3	1.4	1.6
Public order and safety	3	1.7	1.8	1.7	1.8	1.9
Economic affairs	4	1.7	1.8	1.5	1.1	1.5
Environmental protection	5	0.1	0.1	0.1	0.0	0.0
Housing and communities amenities	6	0.3	0.3	0.3	0.2	0.2
Health	7	3.0	4.0	3.7	3.7	3.7
Recreation, culture and religion	8	0.1	0.1	0.2	0.2	0.2
Education	9	3.9	3.9	3.8	3.9	3.7
Social protection	10	18.3	18.8	17.4	18.4	18.5
Total expenditure		**34.8**	**36.7**	**35.2**	**36.3**	**36.9**

Source: calculations and estimates of the Ministry of Finance.

V.3. DEVELOPMENTS ON THE REVENUE SIDE

10. The current shape of the tax system does not differ significantly from the system being in force in 2004. Stabilisation of fiscal conditions and the effects of systemic changes introduced in 2004 and visible in 2005, which consisted in reduction of tax burden for business activity, had positive impact on the economic environment of taxpayers, in particular of business entities. One of the effects of the above issues for the State budget in 2005 was higher tax revenues and higher dividend revenues and profit payments which result from the improvement of the financial standing of the state-owned and partially state-owned companies. The high level of revenues in 2005 as compared to State budget revenues in the previous year resulted from the fact that in 2004 the stream of revenues from VAT and from excise tax was moved in time, due to changes related to Polish accession to EU and to budget procedures, which resulted in a one-off reduction of revenues.

11. Among the slight changes influencing fiscal system, which will have an impact on the revenues in 2006, the most significant are:

- introduction of reimbursement of part of housing expenditure made after 1 May 2004 to private persons (resulting from the difference between the currently applicable VAT rate for building materials at 22% and the 7% rate applicable before the Polish accession to EU),
- significant increase in the excise tax rate on cigarettes in order to meet the EU requirements for taxation of tobacco products,
- excise tax rate on engine fuels and spirit products, beer and wine remaining unchanged,
- implementation of the social housing programme,
- changes introduced by the Act on certain forms of support for innovative activity (the changes aim at increasing competitiveness and innovation of the economy by increasing research and development expenditure in private sector and enhancing the efficiency of public funds management related to research and development through the reduction of existing barriers and creation of tax incentives).

12. In 2005 the works on fiscal system reform were initiated; the reform aimed at the reduction of direct tax burdens and at simplification of the tax system. The planned solutions will enter into force in 2007 and their full financial impact on the general government will be visible in 2008 and on.

Table 12. Selected components of revenue

	ESA Code	2004	2004	2005	2006	2007	2008
		bn PLN	*% of GDP*				
Total taxes		181.8	19.7	21.1	22.4	22.7	22.3
Taxes on production and imports	D2	122.7	13.3	12.9	13.5	14.7	14.5
Current taxes on income, wealth, etc.	D5	58.9	6.4	8.2	8.9	8.0	7.8
Capital taxes	D91	0.2	0.0	0.0	0.0	0.0	0.0
Social contributions	D61	123.8	13.4	13.5	13.4	13.3	13.1
Property income	D4	14.1	1.5	2.0	1.6	1.3	1.2
Other		42.1	4.6	5.4	4.7	4.2	3.9
Total revenues	**ESA**	**361.8**	**39.2**	**42.0**	**42.1**	**41.5**	**40.5**
p.m.: Tax burden		302.5	32.8	35.0	36.2	36.3	35.8

Source: 2004 - CSO; 2005-2008 – Ministry of Finance forecast

Data have been calculated on assumption that obligatory OPF are classified in the general government.

13. As a result of the above systemic changes and the macroeconomic scenario assumed for 2005-2008, the nominal revenues of the general government will increase, although the ratio of these revenues to GDP will decrease by 1.5 percentage points.

14. Tax revenues and social security contributions have the most significant share in the revenues structure of the sector. The total of taxes and contributions, i.e. major determinants of the level of fiscal burdens in relation to GDP will increase in 2005-2007 and slightly decrease in 2008. Production and import taxes have the greatest influence on the level of fiscal burdens. It is estimated that the amount of revenues from these taxes will increase in relation to GDP in 2005 -2008 by 1.6 percentage points. The economic growth will have the most significant influence on the increase of revenues. Revenues from income and property taxes in relation to GDP in 2006 will increase by 0.7 percentage points as compared to the previous year, and in 2007 they will begin to decrease (in 2006-2008 the decline will reach 1.1 percentage point). Increase of income taxes in 2006 will result from the expiry of the overhaul relief with the end of 2005. In 2005-2008 the relation of social security contributions to GDP will decrease by 0.4 percentage points.

VI. SUSTAINABILITY OF PUBLIC FINANCES

1. Poland has prepared forecasts of long-term pension expenditure until 2050, within the work of the Economic Policy Committee. The forecast covers following pension systems: employees, farmers and supply system for uniformed services. The forecasts are based on the commonly agreed macroeconomic assumptions and on the demographic forecasts prepared by Eurostat in cooperation with demographists from Member States. Preliminary forecasts results of the expenditures for retirement and disability pensions are presented in Table 13. The forecasts for other expenditure – for health care, long–term care, education and expenditures related to labour market are currently prepared by the Commission on the basis of the assumptions and methodology agreed. Table 13 presents assumptions and preliminary results of the forecasts, which were prepared before the Convergence Programme update. The other results are to be announced by February 2006. Due to the advanced work on forecasts, separate national forecasts were not prepared.

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

3. According to the forecast, the ratio of public expenditure for retirement pensions to GDP should gradually decrease from 13.9% in 2004 to the level of ca. 9.3% in 2050 (estimates include payment of retirement pension from the capital part of the system. Amendments to the Act on retirement and disability pensions from the Social Insurance Fund - concerning retirement pensions for miners and extensions of early retirement period according to the current rules by the end of 2007 - were not included). Decrease in the expenditure level is a consequence of the new pension scheme implemented since 1999. As a result, the pensions granted after 2009 will depend on the level of the contributions paid and on retirement age (including s rights acquired before 1999 in the form of initial capital). This means that a higher effective retirement age has been assumed for the calculations; in 2004 it was only 58.7 for men and 56 for women.

Table 13. Long-term sustainability of public finances

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

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

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

b) The data will be prepared by the Commission at a later date.

c) The data prepared by the Commission have not been officially published.

d) Demographic Reserve Fund (DRF) and OPF.

e) DRF.

VII. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

VII.1. NATIONAL BUDGETARY RULES

1. Fiscal policy issues - as a significant part of economic policy of the State - are reflected in the Constitution of the Republic of Poland, various Acts, Laws, and other regulations e.g. ordinances. Apart from the rules of legislative nature, there are also rules resulting from the strategy approved by the government.

2. The government intention is to introduce a ”budgetary anchor” at the level of 30 bn PLN of the deficit annually when planning the State budget for next years. Introduction of this rule will guarantee that the State budget deficit to GDP ratio calculated according to the national methodology will systematically decrease.

3. There are no rules in Polish legislation determining the level of expenditure in the State budget. Provisions of special acts or previous commitments influence the State Budget Act by determining the level of larger part of the State budget expenditure, hence most of the expenditure borne by the state budget is fixed expenditure. The Public Finance Act provides that the limit of expenditures adopted each year in the State Budget Act constitutes the upper limit and that exceeding it requires amendment to the State Budget Act.

4. The most important budgetary rules of legislative nature include the competence rules and rules concerning the public debt related limits.

5. The draft of the State Budget Act prepared by the Council of Ministers and accepted by the Parliament is signed by the President of the Republic of Poland. Within the framework of works on the draft of the State Budget Act the Parliament has the right to amend the Act only in such a manner that it does not result in an increase of the level of budget deficit assumed by the Council of Ministers. Similar rules concern budgetary resolution of the local government units (determination of deficit level lies within the competence of the management of the local government unit).

6. The rules related to limitations resulting from the level of public debt are known as so called prudence and recovery procedures. In the case when debt-to-GDP ratio[7] at one of the threshold values (50%, 55% and 60% of GDP) is exceeded, procedures determined by law are automatically launched. The above rules are to ensure observance of the constitutional rules stating that the national public debt may not exceed 3/5 of the GDP value.

7. In the case of local government units, the additional rules have been introduced, which aim at preventing the local government from incurring excessive debt. Pursuant to those rules, in each budgetary year the amount of debt servicing costs (credit and loan instalments, potential payments due to granted guarantees, interest payments due in the given year and discount from the issued securities) cannot exceed 15% of the planned revenues for a given budget year (in case of exceeding the second prudence threshold at 55% of GDP, the rate is 12%). Additionally, the budget of local government unit must be constructed in such a way that at the end of each quarter of the year the total value of the debt of a given unit is lower

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[7] Pursuant to the Act of 30 June 2005 on public finance, which entered into force on 1 January 2006. According to the previously binding Act the precautionary and reformatory procedures concerned the relation of the national public debt enlarged by the amount of the anticipated payments of warranties and guaranties granted by the public finance sector entities to GDP.

than 60% of the planned revenues (for the I, II and III quarter) or the actual revenues at the end of the year.

VII.2. GENERAL GOVERNMENT STATISTICS

8. On June 3, 2004 the President of the Central Statistical Office appointed an inter-ministerial Team for general government statistics. One of the most significant tasks for the Team is to develop a common methodology for preparing the data according to the ESA ’95 standards. The Team includes representation form the Central Statistical Office, Ministry of Finance and National Bank of Poland.

9. As the result of the works undertaken so far, the Team has initiated the activities concerning the following methodological issues:

— the transition key from budget classification to ESA ’95 classification has been prepared,

— the methodology of transfer from the cash data to accrual data has been determined,

— the rate allowing estimation of taxes and social security contributions which will never be collected has been indicated,

— the preliminary version of the transition key from the reporting of legal persons in the general government to the ESA '95 methodology has been prepared,

— the analysis of reporting forms for extra-budgetary units has been done and the algorithms allowing calculation of cash and accrual revenues and expenditures of these units have been prepared,

— social transfers in kind in the frameworks of available information on budget reporting have been identified, the preliminary conclusions concerning necessary changes to the budgetary classification have been formulated,

— transfers between Poland and the European Union have been pre-identified.

10. The solutions have already been used by CSO in preparation of non-financial accounts of the general government and fiscal notification from September 2005. The works of the Team are still in progress, thus in the future further adjustments of data concerning revenues and expenditure of general government are possible.

11. The subsequent works of the Team will concentrate *inter alia* on:

— further preparation of registration methods of transfers between Poland and the European Union in the general government accounts,

— determination of the capital injections registration methods in statistics,

— verification of the institutional scope of general government,

— preparation of the methodological manual concerning revenues and expenditure of general government according to ESA 95.

12. Results of the work of the Team will be successively used for preparing subsequent statistics of the general government.

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

13. Newly established government anticipates the approval of certain institutional solutions, which aim at strengthening the system of public finance management. First of all, in order to ensure better absorption of structural funds and the Cohesion Fund, the government appointed the Ministry of Regional Development. The basic task of this Ministry is to coordinate processes for programming and use of structural funds and the Cohesion Fund including elaboration of the *National Development Plan* being the basis for the conclusion of agreement between the Polish government and the European Commission determining the absorption of the EU structural funds by Poland.

14. Institutional strengthening of the general government will take place through elimination of overlapping competences and tasks, liquidation of institutions with associated tasks or strengthening the supervision of public funds expenditures. In the case of health care, the government plans to undertake measures aiming at more rational expenditure of public funds for health through the granting of wider supervisory powers with respect to the National Health Fund to the Minister of Health.

15. Further implementation and application of internal audit system according to international and European Union standards and regulations will contribute to strengthening of the public finance sector management through improvement of the functioning of the public finance sector units, ensuring implementation of tasks for protection of public funds and their relevant and economical disbursement.

16. Within the framework of the reorganization of the public finance sector, the financial police has been established, which initiated the creation of professional, autonomous formation to fight against tax offences and irregularities of economy life. The second area where changes are introduced is the tax administration. There have been undertaken some measures aiming at consolidation of tasks that are related to the tax administration. The analytical works for simplification and improvement of administration functioning are carried out.

17. The government has initiated works on the proposal to implement performance budgeting. Performance budgeting is going to be a tool supporting the introduction of the principles for good public funds management, in order to achieve more transparent public funds. The gradual introduction of the performance budgeting with reference to State budget expenditure (or to all public funds) should be accompanied by the preparation of the system for multiannual budgeting in Poland. Introduction of multiannual budgetary planning will facilitate the development of programmes aimed at implementation of the given tasks and determination of the level of expenditure in the above programmes by the government administration units.

STATISTICAL ANNEX

Table 14. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP (PLN billion)	B1*g	886.5	5.3	3.3	4.3	4.6	5.0
2. Nominal GDP (PLN billion)	B1*g	922.2	9.5	4.6	5.4	6.4	7.2
Components of real GDP							
3. Private consumption expenditure*	P.3	564.7	4.0	2.3	3.7	3.5	3.6
4. Government consumption expenditure	P.3	168.8	3.9	2.0	2.0	3.5	3.2
5. Gross fixed capital formation	P.51	163.5	6.3	5.0	8.7	12.5	11.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	17.5	2.0	0.9	0.9	0.8	0.8
7. Exports of goods and services	P.6	320.2	14.0	5.8	6.1	6.1	6.5
8. Imports of goods and services	P.7	348.4	15.2	1.4	6.2	7.8	6.9
Contributions to real GDP growth							
9. Final domestic demand		-	4.4	2.8	4.4	5.3	5.2
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	1.6	-1.1	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	-0.7	1.5	-0.1	-0.7	-0.3

* - Individual consumption of households.

Table 15. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		-	4.0	1.3	1.1	1.7	2.1
2. Private consumption deflator		-	3.1	1.7	1.1	1.8	2.1
3. HICP		-	3.6	2.2	1.5	2.2	2.5
4 Public consumption deflator		-	3.0	1.6	1.1	1.8	2.1
5.Investment deflator		-	1.4	0.6	2.4	2.4	2.4
6. Export price deflator (goods and services		-	8.3	-3.3	1.0	1.0	1.0
7. Import price deflator (goods and services		-	4.8	-2.8	1.6	1.3	1.0

Table 16. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons *		13778	-0.3	1.6	1.0	1.1	1.0
2. Unemployment rate (%) **		18.8	18.8	17.8	16.7	15.7	14.7
3. Labour productivity ***		64.3	5.6	1.7	3.3	3.5	4.0
4. Compensation of employees (PLN million)	D.1	344140	4.0	6.1	4.6	5.1	5.8

* Average number of employed persons according to ESA'95.

** Harmonised definition, Eurostat; levels.

*** Real GDP per person employed.

Table 17. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	3.8	1.0	1.5	1.5	0.8
of which: - Balance on goods and services		1.9	0.1	0.8	1.5	1.6
- Balance of primary incomes and transfers		2.3	1.4	1.2	0.5	-0.2
- Capital account		-0.4	-0.5	-0.5	-0.5	-0.7
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	0.0	1.9	1.1	0.7	1.1
3. Net lending/borrowing of general government	B.9	-3.8	-2.9	-2.6	-2.2	-1.9
4. Statistical discrepancy		-	-	-	-	-

Table 18. Basic assumptions

	2004	2005	2006	2007	2008
Short-term interest rate* (annual average)	5.8	5.3	4.5	4.5	4.5
Long-term interest rate (annual average)	6.9	5.2	5.0	5.0	5.0
Nominal effective exchange rate	0.6	-11.3	-1.5	0.5	-1.3
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	4.53	4.03	3.90	3.92	3.87
World excluding EU, GDP growth **	5.9	5.1	4.9	4.6	4.6
EU GDP growth **	2.4	1.5	2.1	2.4	2.4
Growth of relevant foreign markets **	9.6	6.5	7.8	7.6	7.6
World import volumes, excluding EU **	13.9	8.6	8.7	8.4	8.4
Oil prices, (Brent, USD/barrel) **	37.8	55.0	61.4	60.3	60.3

* - NBP reference rate (yield on 7-day NBP money market bills).

** Source for the years 2004 to 2007 – the European Commission. Commission's forecasts for 2007 have also been used for 2008. Growth of relevant foreign markets - average increase (weighted by the structure of Polish exports) in import volumes of Poland's trade partners.