REPUBLIC OF POLAND

CONVERGENCE PROGRAMME UPDATE 2007

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TABLE OF CONTENT

Introduction 3
I. Overall policy framework and objectives 4
I.1. Framework 4
I.2. Objectives of macroeconomic policy 4
I.3. Fiscal policy in the European context 5
II. Economic outlook 6
II.1. Cyclical developments and current prospects 6
II.2. Medium-term scenario 7
II.3. Growth implications of "major structural reforms" 8
III. General goverment balance and debt 12
III.1. Policy strategy and medium-term budgetary objective 12
III.2. Actual balances and implications of budget for next year 12
III.3. Structural balance 14
III.4. Debt levels and developments 15
III.5. Budgetary implications of "major structural reforms" 16
IV. Sensitivity analysis and comparison with previous update 19
IV.1. Risk factors and sensitivity analysis 19
IV.2. Comparison with the previous update 21
V. Quality of public finances 22
V.1. Policy strategy 22
V.2. Developments on the expenditure side 23
V.3. Developments on the revenue side 24
VI. Sustainability of public finances 25
VII. Institutional features of public finances 26
Annex 1. Tables 27
Annex 2. Main domestic fiscal rules and rules governing the budgetary process 32

TABLES

Table 1. General government balance and debt (EDP, % of GDP) 13
Table 2. Cyclical developments (% of GDP) 14
Table 3. General government debt developments (end of year, % of GDP) 15
Table 4. Net costs of the pension reform (% of GDP) 16
Table 5. Net costs of tax wedge reduction (% of GDP) 16
Table 6. Expenditure of the general government associated with the road construction programme (% of GDP) 17
Table 7. Divergence from previous update 21
Table 8. Basic data concerning the general government (EDP) 22
Table 9. General government expenditure by function (COFOG, % of GDP) 23
Table 10. Long-term sustainability of public finances (% of GDP) 25
Table 11. Macroeconomic prospects 27
Table 12. Price developments 28
Table 13. Labour market developments 28
Table 14. Sectoral balances (% of GDP) 29
Table 15. Basic assumptions 29
Table 16. General government budgetary prospects 30
Table 17. Influence of the National Reform Programme (KPR) on public finance (% of GDP) 31

GRAPHS

Graph 1. Activity rate in 2006 according to LFS (aged 15-64) 8
Graph 2. Employment rate in 2006 according to LFS (aged 15-64) 9
Graph 3. Tax wedge in selected countries in 2006 9
Graph 4. Tax wedge in Poland in years 2006 and 2009 10
Graph 5. General government in Poland 13
Graph 6. Fiscal burden and social expenditure in Poland and the euro area (% of GDP) 13
Graph 7. Sensitivity of net lending/borrowing and debt of general government to changes of real GDP growth, interest and exchange rates. 20

INTRODUCTION

The update of the convergence programme for the years 2008-2010 called the 'Convergence Programme Update 2007' was adopted by the Polish government on March 25, 2008. The present document conforms to the guidelines regarding the stability and convergence programmes. The update will be discussed by Sejm and Senate Select Committees.

The Ecofin Council invited Poland, in December 2007, to set out in the upcoming convergence programme a medium-term budgetary strategy covering the whole legislature. This strategy should be consistent with a sustainable correction of excessive deficit and the achievement of the medium-term objective.

The update contains the macroeconomic projection up to 2010 and presents key assumptions and directions of the government's economic policy.

It also presents measures in the area of public finances and their consequences for the general government balance and debt in this period.

The general government data covering 2007 is the Ministry of Finance's estimate drawn up from data as available on February 15, 2008. Preliminary data will be presented by the Central Statistical Office (GUS) in the forthcoming fiscal notification (spring 2008).

A considerable reduction of the general government deficit is expected from 3.8% of GDP in 2006 to 1.5% of GDP in 2010. Such a large scale of this reduction will take place despite the high costs of the reform aimed at reduction of the tax wedge. The resulting significant burden will, however, lead to a transitory increase of the deficit in 2008. In the following year the deficit to GDP ratio will return to the downward trend and in 2011 the medium term objective (-1% of GDP) will be achieved. If it wasn't for these costs, the general government would be balanced by 2009.

A continued deficit reduction and a favourable macroeconomic situation will cause the general government debt to fall substantially from 47.6% of GDP in 2006 to 42.3% of GDP in 2010.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

I.1. FRAMEWORK

The rate of economic growth in the medium term will remain at a stable level, though lower than observed last year. Favourable tendencies on the labour market are expected to continue, including an increase in the employment rate and a drop in unemployment. Developments in the global economy, particularly in the euro are an area of significant risk. Internally, some risk is associated with the acceleration of the growth of prices of consumer goods and services at the beginning of 2008. In subsequent periods the CPI is expected to return within the target bounds set by the National Bank of Poland (NBP). A gradual increase in the external imbalance should also be expected but not on a scale which could endanger the sustainable economic growth. Economic policy will primarily focus on changes ensuring the achievement of the long-term goals of improving the innovativeness of the economy and of strengthening the economic growth. At the same time, it will be conducive to improving the situation in the public finances by permitting a more flexible approach to expenditure while ensuring stable budget revenues. Realizing these priorities will make it possible to meet the convergence criteria in a sustainable manner and to allow a decision to be made with regard to the date for joining the ERM II mechanism and adopting the euro.

I.2. OBJECTIVES OF MACROECONOMIC POLICY

The overall medium-term objective of the government's economic policy is to create conditions favourable to rapid economic growth and which increase the resilience of the economy to external and internal threats. The economic policy of the government will be subordinated to these objectives and will be based on actions in the following areas:

1) Reducing fiscal burdens

Cutting fiscal burdens is necessary to achieve faster economic growth and to reduce the shadow economy. Reduction of personal income tax rates will occur in 2009. Additional action will be taken aimed at a further reduction of the tax burden (PIT and CIT) in 2010 and 2011. However, the scale and scope of further changes will depend on progress made in limiting increases in public expenditure and maintaining the assumed rate of the economic growth.

2) Increasing economic activation of the population

Transformation in the area of the fiscal burden, pensions and disability benefits will foster the increase in the economic activity of the population, which still remains in Poland at an exceptionally low level. An increase in the labour supply will increase budgetary revenues and reduce inflationary pressure on wages and salaries.

3) Increasing pro-growth expenditure and justifiable social expenditure

The activities undertaken are aimed at boosting the innovativeness of the economy by increasing the amount of funds for education and science and innovation activities. However, in the forthcoming years the major focus will be placed on the development of infrastructure and making an adequate use of funds received from the EU to this end. Changes in the structure of social expenditure will be aimed at boosting economic activity of the population, supporting reforms in the healthcare system and a considerable reduction of poverty, achieved mainly through better distribution of aid.

4) Increasing the pace of privatisation

The objective of the privatisation strategy is to increase the pace of privatisation and to improve the management of assets of the State Treasury. Proceeds from these activities will be an important factor in curbing the growth of public debt.

5) Liberalising the economy

Structural changes have been introduced aiming at eradication of obstacles to the development of enterprises. Regulations associated with economic and tax laws will be simplified. At the same time, rules concerning the functioning of the administration will be changed and administrative procedures will be simplified. Focus will also be placed on improving the functioning of commercial courts.

6) Reducing the general government debt to GDP ratio through a gradual reduction of the fiscal imbalance

The scale of planned reduction of the structural general government deficit over the next few years aims to reach a level of MTO (-1% of GDP) in the year 2011. Reducing the scale of fiscal imbalance as well as the ratio of public debt to GDP will, in the long-term, have a favourable impact on the stability of public finances.

7) Preparing the Polish economy for the euro adoption

The implementation of the programme outlined above will allow to fulfil the fiscal convergence criterion in a sustainable way. Thus, one of key conditions will be met so as to decide when to adopt the euro.

I.3. FISCAL POLICY IN THE EUROPEAN CONTEXT

Poland has been implementing the *Broad Economic Policy Guidelines*[1], which include Council recommendations both for the whole European Union and for particular countries regarding macroeconomic and structural policy.

The Council, in its opinion on the previous update of the Convergence Programme, recommended that Poland correct its excessive deficit in 2007. The invitation to put an end to the excessive deficit situation by 2007 and reduce the general government deficit in a credible and sustainable manner was also included in the new Council recommendation based on Art. 104(7) of the Treaty establishing the European Community. It was accompanied by a request for Poland to reduce its structural deficit by at least 0.5 percentage points of GDP in 2007.

The update of the Convergence Programme from 2006 planned a reduction of the general government deficit to 3.4% of GDP in 2007. The latest forecasts from the Ministry of Finance February 15, 2008 show the general government deficit in 2007 to be significantly lower, at 2% of GDP. At the same time, the reduction of the structural deficit in 2007 was considerably above the size recommended by the Council and the Stability and Growth Pact (1.5 percentage points compared with the required 0.5 percentage points).

A better than expected macroeconomic and fiscal situation made it possible to significantly decrease the general government debt to GDP ratio. Preliminary data from the end of 2007 showed the ratio at 44.9% (compared with 50% forecast in the update of the Convergence Programme from 2006).

In the *Broad Economic Policy Guidelines* from 2007 Poland was inter alia recommended to lower the tax wedge. Reducing disability benefit contributions in 2007 and 2008, combined with the reduction of personal income tax rates in 2009, will have a favourable influence on the labour market and will contribute to limiting the grey market. The *Broad Economic Policy Guidelines* also encouraged Poland to continue fiscal consolidation and support institutional arrangements concerning public finances with mechanisms to enhance control over expenditure. This recommendation was reiterated in the proposal for *Broad Economic Policy Guidelines* 2008, which is currently being discussed in EU forums. The path for deficit reduction set out in the present update is an expression of the will of government to implement these recommendations.

The 2007 deficit and the fiscal path for subsequent years, with the perspective of achieving MTO (-1% of GDP) in 2011, give grounds for expecting the excessive deficit procedure for Poland to be abrogated in 2008.

[1] *Council recommendation on the 2007 update of the broad guidelines for the economic policies of Member States and the Community and on the implementation of Member States' employment policies.*

II. ECONOMIC OUTLOOK

II.1. CYCLICAL DEVELOPMENTS AND CURRENT PROSPECTS

Preliminary estimates put the average growth rate of the world's GDP in 2007 at a relatively high level, though slightly lower than in the preceding year. This favourable situation was primarily caused by a rapid expansion of emerging markets, especially in Asia. However, a sharp deterioration in the global economy was observed at the end of last year, caused by a considerable slowdown of the economic growth rate in the US.

Preliminary data shows that the real growth rate of GDP in Poland in 2007 amounted to 6.5% compared to 6.2% in 2006. In the course of these two years, the fast growth rate of GDP was associated with the activation of the growth reserves in the form of a high unemployment rate and low levels of the utilization of the potential of production. This activation was caused by a continuing revival of domestic demand, which was chiefly a result of stepping up the pace of investment, as well as growing consumer demand of households.

The favourable influence on consumer demand of households in 2007 was mainly caused by changes on the labour market, i.e. growth in both employment level and wages and salaries, which in turn improved the income situation of households. Consumption was additionally spurred by the reduction of 3 percentage points in disability contributions paid by employees which came into force at the beginning of July 2007. Furthermore, in 2007, household indebtedness towards banks continued to increase as the value of credits rose rapidly (both mortgage and consumer), while the growth of household deposits remained low. It should be pointed out that the scale of household debt within the banking system in Poland is still at a low level compared to other EU member states. At the end of 2007, the total household debt to GDP ratio equalled 21.7%, with mortgages accounting for 8.8%.

Factors contributing to the strong growth of investment spending include a high level of utilisation of production capacity, increasingly better utilisation of EU funds and the high profitability of enterprises.

A decline in growth dynamics, both of export and import was observed in 2007. High dynamics of domestic demand and a limited slowdown in the growth of demand in Poland's export markets caused the trade deficit to increase. On the other hand, an increase in the positive balance of services and current transfers took place. As a result, despite the deepening of the external imbalance last year it remained at the moderate level of ca. 3.6% of GDP.

Data concerning the labour market for the three quarters of 2007 confirms that the situation has improved to a considerable degree. Just as in 2006, labour demand[2] was characterised by a very high rate of growth, as a result of which the employment rate of the population aged 15-64 rose from 53.0% in 2005 to 54.6% in 2006 and ca. 56.8% in 2007. A considerable decline in the unemployment rate was observed for a second consecutive year. However one of key problems of the Polish economy remains the low level of economic activity of the population[3].

In spite of high economic growth, improving situation on the labour market and high dynamics of growth of food prices caused by weather conditions and the situation on international agricultural commodities' markets, for most of 2007 the inflation remained below the NBP inflation target of 2.5%. An acceleration in the dynamics of growth of prices was observed in the fourth quarter of 2007 when the CPI exceeded the inflation target, mainly as a result of the increased growth dynamics of food prices. In 2007, CPI rose by 2.5% on average. Net core inflation (CPI excluding prices of food and fuel) throughout 2007 remained at a low level, reaching 1.7% at the end of the year and the annual average of 1.5%.

In 2007, continued high economic growth and growing tensions on the labour market, accompanied by the risk of increase in inflationary pressure and in inflationary expectations inclined the Monetary Policy Council (MPC) to gradually the tighten monetary policy. In 2007 the Council delivered four interest rates hikes of 0.25 percentage points each. Further increases ensued in January and February of 2008. As a result of these decisions, the reference rate rose to the level of 5.50%.

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[2] Average number in employment (15 years and older according to LFS).

[3] Economic activity rate of population 15 years and older fell from 54.9% in 2005 to 54.0% in 2006 and to 53.7% in 2007.

II.2. MEDIUM-TERM SCENARIO

It is expected that in 2008 the slowdown of the growth of the world's GDP will be more visible, mainly as a result of a decrease in the rate of growth of the economic activity in developed markets, particularly in the US and the euro area. The balance of risks for the future of the global economy continues to be dominated by factors that may lead to a worse scenario than originally predicted. In particular, the risk of further deterioration of the US economic situation has increased, which could cause a slowdown in the euro area growth rate and as a result lead to lower dynamics of export of Polish goods and services.

According to the medium-term forecast for Poland, there will be a decrease in the rate of GDP growth in 2008-2010 compared to 2006-2007. In 2008, the GDP growth rate of the Polish economy is estimated at ca. 5.5%.

The growth rate of household consumption will be higher in 2008 (6.0%) than it was in 2007 (5.2%) as a result of a further lowering of the tax wedge, indexation of disability and pension contributions (in 2007, disability payments and pensions were by law not subject to indexation) and the introduction of a new family allowance. In 2009, income and consumption of households will be favourably influenced by the implementation of a two-tier tax scale (in accordance with the provisions of the legal act of 2006).

In 2008-2010, investment expenditure will be shaped by a favourable entrepreneurs' evaluation of the growth perspectives for the Polish economy in the light of the continuing revival of the domestic consumption demand, as well as a growing volume of investments financed by the EU.

It is forecasted that there will be a further increase in the external imbalance of the Polish economy in 2008-2010 and that the deficit on the current account will gradually increase to ca. 6% of GDP. A further decline in the growth dynamics of trade with foreign markets is predicted. However the rate of growth of imports is expected to be higher than of exports due to a combination of a relatively robust increase in domestic demand and a weaker growth rate of economic activity in our key trading partners. A slightly higher level of external imbalance should not pose any threat to macroeconomic stability due, among others, to an expected influx of foreign direct investments and an increase in transfers from Polish citizens working abroad.

An increase in consumption and investment will fuel economic growth in 2008-2010 by having a positive effect on the labour demand and as a result the rate of creation of new jobs. Lowering the tax wedge will contribute to an increase in labour demand and will have a favourable impact on labour supply. The upward trend in labour demand observed in the years 2005-2007 is expected to continue. It is estimated that employment will increase by ca. 0.6 million persons. Furthermore, it is assumed that the population will feel encouraged by rapidly increasing wages and salaries to take an active part in the labour market, which will be reflected in a stronger tendency to seek and take up work. Taking the above assumptions into account it is estimated that the unemployment rate will drop from 13.8% in 2006 to ca. 4.5% in 2010 (in accordance with the Eurostat definition).

Further growth in consumer price dynamics is visible in the first quarter of 2008, related to increases in state-regulated prices (electricity, gas, public utility services). Assuming there are no supply shocks, a gradual decline of annual inflation rates can be expected in the second half of 2008. Major factors shaping inflation in 2008 will include: high dynamics of domestic demand, salary and wage increases in the economy, the zloty exchange rate, growth dynamics of agricultural commodities and a tightening of monetary policy which has already been implemented. Average CPI in 2008 is forecasted to reach 3.5%.

It is assumed that inflation in Poland will return to the inflation target in 2010 as a result of pursuing a more restrictive monetary policy and stabilizing the prices of basic agricultural commodities.

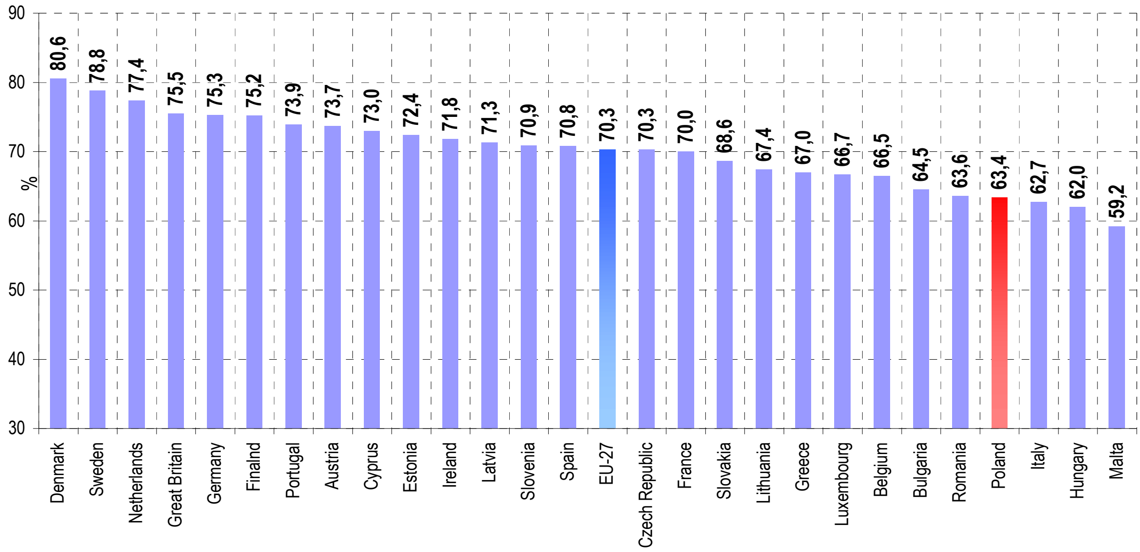
Forecast of the NBP interest rates assumes that in the years 2008-2010 the MPC decisions on the level of central bank interest rates will be made in a view of maintained risk of the increase in inflation pressure due to a high growth rate of domestic demand and an unfavourable relation between the increase in labour productivity and wages and salaries across the economy. The expected further tightening of the monetary policy should allow maintaining the inflation within the tolerance range for deviations in the monetary policy transmission horizon and it should ensure that the inflation convergence criterion will be met.

The projection of the exchange rate for the years 2008-2010 provides for a further gradual appreciation of the zloty against the euro, primarily as a result of the strong macroeconomic foundations of the Polish economy, an increase in the attractiveness of zloty denominated assets caused by the tightening of monetary policy by the MPC and the inflow of foreign direct investments to Poland.

II.3. GROWTH IMPLICATIONS OF "MAJOR STRUCTURAL REFORMS"

In February 2008, an initiative was undertaken which aims to strengthen coordination of the Lisbon Process in Poland. It took the form of a suitable resolution of the Council of Ministers. Pursuant to it, effective implementation of structural reforms is coordinated by the Minister of the Economy. This is of particular relevance in the context of the commencing next cycle of the implementation of the revised Lisbon Strategy.

Graph 1. Activity rate in 2006 according to LFS (aged 15-64)



Source: Eurostat

The labour market constitutes an important area for structural reforms in Poland. A low level of economic activity rate and employment rate are an acute problem. In 2006 the economic activity rate in Poland was at the level of 63.4%[4] being one of the lowest in the EU member states. In the same period the employment rate fell to the lowest level in the EU 27, i.e. 54.5%[5].

Increasing both the participate rate and the employment rate is one of the major objectives of the government. It is necessary to undertake remedial action in this area to ensure Poland's further stable and sustainable economic development, as well as systematically reduce the fiscal imbalance.

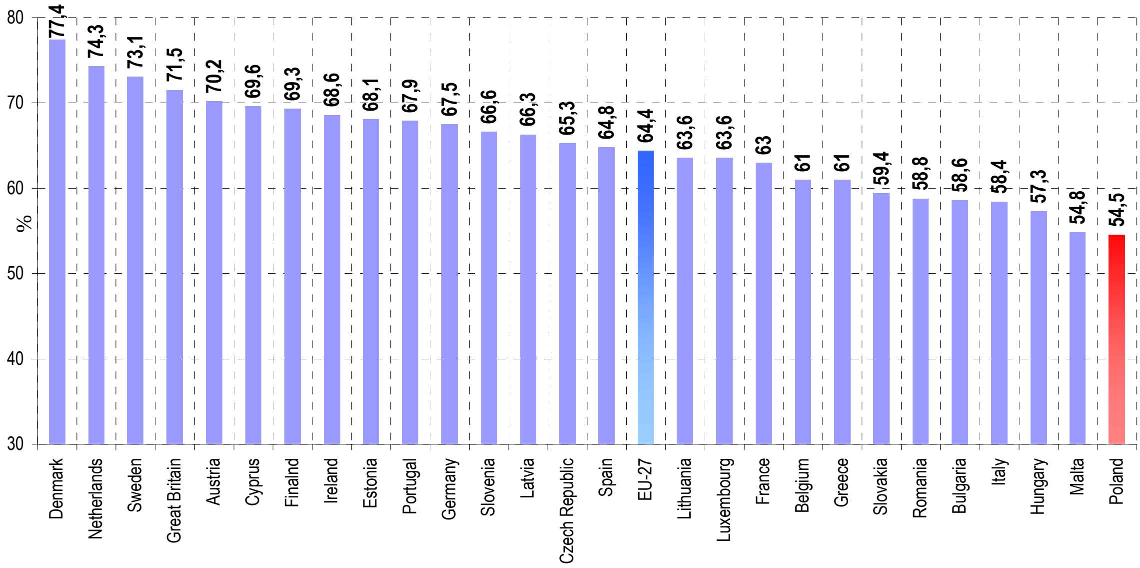
This objective coincides with the priorities of the revised Lisbon Strategy of fostering the economic growth and employment, as well as with recommendations formulated in 2007 in the *Broad Economic Policy Guidelines*.

Activities pursued by the government aiming at boosting the economic activity of the population and increasing the employment rate will focus especially on people aged 50 and more.

[4] According to LFS, aged 15-64

[5] According to LFS, aged 15-64

Graph 2. Employment rate in 2006 according to LFS (aged 15-64)

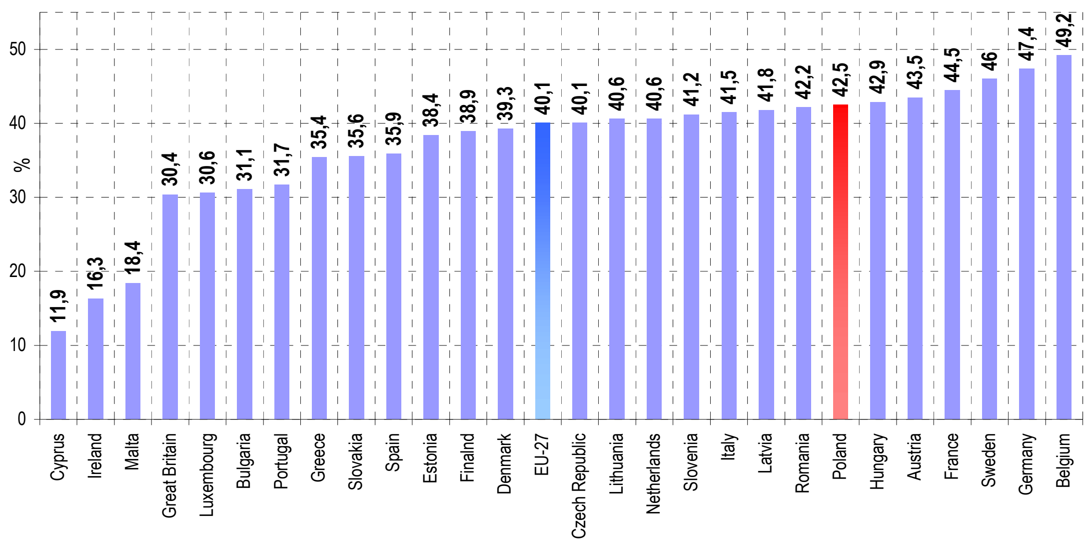


Source: Eurostat

The reduction of tax and paratax burden, being high compared to other EU states, will give positive results for both the economy and the public finances. The effect will be noticed gradually and should be of great significance in the longer term. The reduction should also lead to durable reduction of the scale of the shadow economy.

As a result of changes being introduced (see Frame 1.), the tax wedge calculated for an average salary and wage in the national economy will decrease from 44.0% in 2006 and 42.2% in the second half of 2007 to 39.9% in 2008 and to 39.5% in the year 2009. The scale of the tax wedge as a ratio of the change in the tax and paratax burdens (resulting from the social security system and income tax) to the total value of the burden for the whole economy will drop by ca. 13% compared to the situation before the reform.

Graph 3. Tax wedge[6] in selected countries in 2006



Source: Eurostat

[6] For a single, childless person earning 67% of the average wage.

Frame 1. Reduction of PIT and social security contributions (the tax wedge) in Poland – scope and timeframe

REDUCTION OF PIT AND SOCIAL SECURITY CONTRIBUTIONS IN POLAND – SCOPE AND TIMEFRAME

Scope: to lower the cost of employment by reducing personal income tax and social security contributions

Timeframe:

1. Amendments of November 16, 2006 to the law on PIT

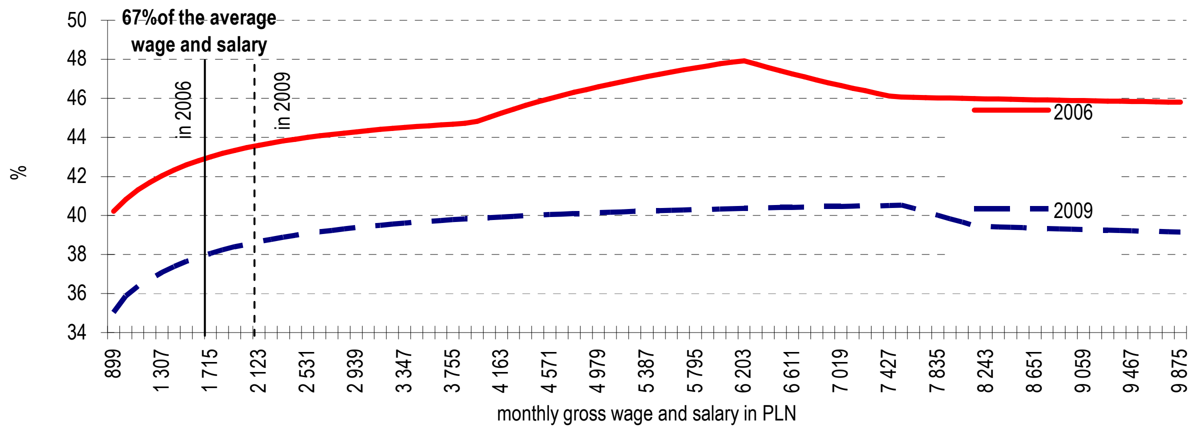
- 2007 onwards - restoring of the indexation of tax thresholds, tax-free allowances and costs of taxable income.
- 2009 onwards - introduction of two PIT tax rates, i.e. 18% and 32%, instead of 19%, 30% and 40% (with one tax threshold of PLN 84,426, the amount of tax-free allowances of PLN 556.02 and costs of taxable income of PLN 1,335).

2. Amendments of June 15, 2007 to the law on social security system

- two-stage reduction of the pension contributions (i.e. disability pension, survivals' pension and death grants) by 7 percentage points (from 13% to 6%):
  - I phase: reducing employee's pension contributions by 3 percentage points (from 6.5 % to 3.5% of the contribution assessment basis) from July 1, 2007,
  - II phase: reducing employee's pension contributions by 2 percentage points (from 3.5% to 1.5% of the contribution assessment basis) and by employer's pension contributions 2 percentage points (from 6.5% to 4.5%).

Source: Ministry of Finance

Graph 4. Tax wedge in Poland in years 2006 and 2009



Source: Ministry of Finance

The undertaken activities will contribute to the growth of the average net wage and salary[7] to the reduction of the labour costs borne by entrepreneurs. By the favourable influence on the domestic demand they will stimulate a labour demand and reduce the level of unemployment. It should also be expected that the undertaken activities will reduce the pressure on the increase in wages and salaries. Additionally, they will also be a factor reducing the scale of the economic emigration.

By 2010 the employment rate is expected to increase from 54.5% to 59.2%, which will reduce the distance to the current EU average by half.

[7] Growth of average wage due to reduction of the tax wedge is estimated at ca. 4.2% in 2008 as compared to 2007.

The government has also undertaken measures aimed at implementing legislative and administrative solutions to encourage the economic activity of the unemployed and persons looking for work. They will focus on the establishment of the economic activation centres (at a county level) and implementation of a degressive unemployment benefit.

Work on the *Solidarity between Generations – 50 plus* programme has been continued. The expected result of the program will be an increase in the employment rate of persons over 50 years old to 40% in 2013 and 50% in 2007[8]. The measures will concentrate on three key areas:

- promotion of the retention of staff aged over 45,
- launching economic activation programmes for the unemployed aged 45plus / 50plus,
- limiting the conditions conducive to non-employment by reducing the possible options of early retirement and other benefits that allow to economic deactivation.

Key objectives of the programme include:

1) improvement of working conditions, improvement in the employment of older workers and age management (implementation of an age management strategy and flexible working hours for older workers in particular),
2) improvement of competencies and qualifications of older workers (through continuous education and training in particular),
3) reducing the labour costs of employing older workers (exempting employers from paying contributions to the Labour Fund and the Guaranteed Employee Benefits Fund and financing the costs of training in particular),
4) activation of older people who are unemployed or in danger of unemployment,
5) activation of the disabled (by modifying the social benefits system towards creating incentives for economic activity),
6) boosting opportunities for women by developing schemes which allow to combine work with family life.

The government also plans to implement solutions aimed at encouraging the lengthening of an effective retirement age. These solutions include the following:

- ending the programme of early retirements,
- implementation of bridge-pensions for people requiring earlier deactivation on health grounds,
- gradual equalization of the retirement age of to 65 for both women and men.

These measures will be introduced at the initiative of the general government as well as of the employers and of people being under direct threat of unemployment and deactivation.

However, it should be stressed that in the medium term, the costs of implementing the above changes will constitute a serious burden for public finances. For this reason, they should be taken into account when further structural reforms are planned, especially in view of the endeavour to significantly reduce the general government deficit.

[8] In 2006, the employment rate of the population aged 55-64 (LFS) was at a level of 28.1% in Poland as compared to 43.5% for the EU 27.

III. GENERAL GOVERMENT BALANCE AND DEBT

III.1. POLICY STRATEGY AND MEDIUM-TERM BUDGETARY OBJECTIVE

The government aims to curb the fiscal imbalance in a sustainable way and reduce the structural deficit to the level of the MTO (-1% of GDP) in 2011. A consistent deficit reduction will allow a considerable reduction of the accumulation of the general government debt, and a fall in the debt-to-GDP ratio. The fiscal policy will be favourable to the sustainable economic growth and strengthening the resilience of the economy to external and internal threats.

III.2. ACTUAL BALANCES AND IMPLICATIONS OF BUDGET FOR NEXT YEAR

In 2006, the general government deficit reached 3.8% of GDP. Current estimates show[9], that in 2007 the level of this deficit was reduced to 0.2% of GDP, i.e. by as much as 1.8 percentage points on the year 2006. Such a huge reduction of the deficit was possible due to strong performance of the economy which contributed to high tax revenues and social security contributions. Expenditure was lower than planned. The favourable financial situation was particularly evident in the state budget (due to higher state revenues and lower expenditures; the cash deficit was less than PLN 17 billion compared to the assumed PLN 30 billion) and the Social Insurance Fund (FUS) (which reported a cash surplus of PLN 8.1 billion including grants from the State budget of ca. PLN 24 billion and refunds of ca. PLN 16 billion due to the transfer of part of the contributions to the Open Pension Fund (OFE)). Initial results for 2007 of local government entities also indicate a surplus.

Given the necessity of adopting the State budget within the statutory term, the Budget Act for the year 2008 was based to a large extent on the draft drawn up by the previous government.

However, amendments were introduced in the course of legislative work in the Parliament which aimed at realizing the economic objectives of the present government. The State budget deficit for 2008 was reduced from the initial prediction of PLN 28.6 billion to PLN 27.1 billion. The structure of expenditure was also partially altered to favour the pro-development expenditure (an increase in expenditure on education). An increase in the assumed cash deficit of the State budget compared to the actual performance in 2007 will be a major cause for the deterioration of the general government deficit to GDP ratio in 2008. To large extent the deterioration will be caused by the decrease in the pension contributions. As a result, in 2008 a temporary increase in the general government deficit to GDP ratio will be visible.

The general government deficit should return to its downward trend in 2009, as a result of sound macroeconomic situation and a reduction of the rate of growth of expenditures and their relation to GDP. Rationalization will improve the expenditure situation. Were it not for the high costs of lowering the tax wedge, it would be possible to balance the general government as soon as in 2009.

[9] The Ministry of Finance's estimate was prepared on the basis of the latest data obtained from a restricted number of general government entities as of February 15, 2008. Preliminary data for 2007 will be prepared by the Central Statistical Office by the end of March 2008 in the Spring fiscal notification.

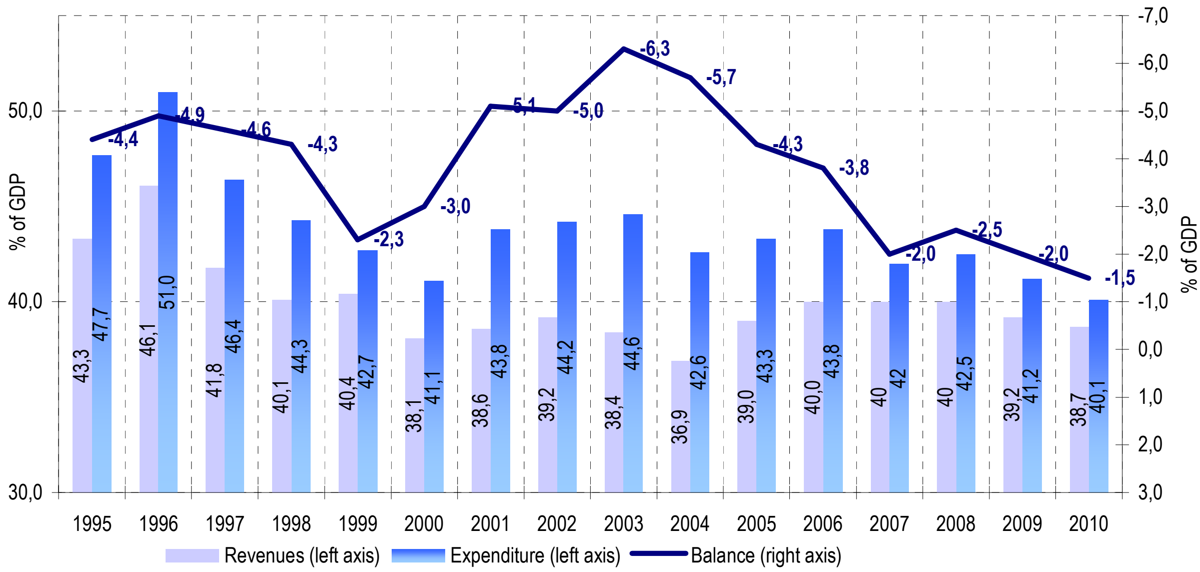
Table 1. General government balance and debt (EDP, % of GDP)

	ESA code	2006	2007	2008	2009	2010
General government balance (B.9)	S.13	**-3.8**	**-2.0**	**-2.5**	**-2.0**	**-1.5**
Central government	S.1311	-4.2	-3.2	-3.2	-2.5	-2.0
Local government	S.1313	-0.3	0.2	0.6	0.3	0.3
Social insurance funds	S.1314	0.7	1.0	0.1	0.2	0.2
General government debt	**S.13**	**47.6**	**44.9**	**44.2**	**43.3**	**42.3**

Source: 2006 – Central Statistical Office, 2007–2010 - Ministry of Finance

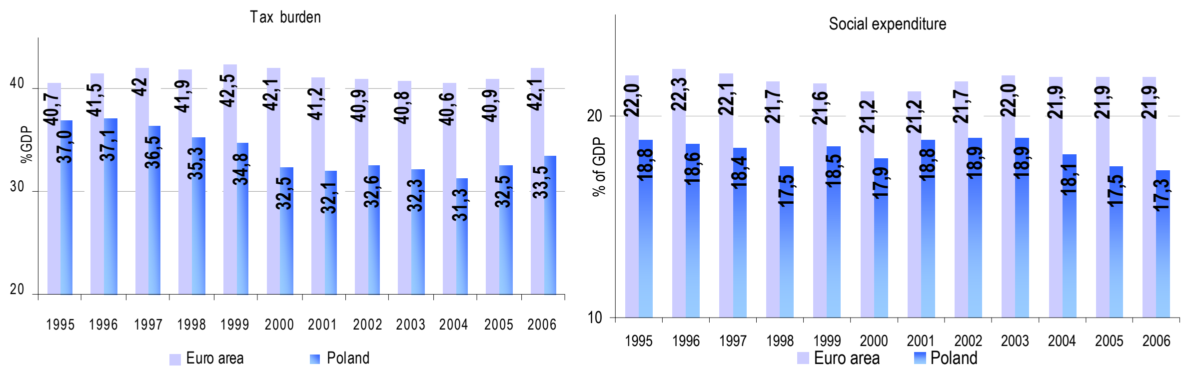
Graphs 5 and 6 present favourable changes in fiscal variables observed in Poland in recent years.

Graph 5. General government in Poland



Source: Eurostat, data for Poland 2007-10 Ministry of Finance

Graph 6. Fiscal burden and social expenditure in Poland and the euro area (% of GDP)



Source: Eurostat

III.3. STRUCTURAL BALANCE

In accordance with the Council recommendation of February 27, 2008 (pursuant to Art. 104.7 of the Treaty), Poland was to reduce the structural deficit by at least 0.5 percentage points between 2006 and 2007 and correct the excessive deficit by 2007.

Table 2. Cyclical developments (% of GDP)

	ESA code	2006	2007	2008	2009	2010
1. Real GDP growth		**6.2**	**6.5**	**5.5**	**5.0**	**5.0**
2. General government net lending/borrowing	EDP B.9	**-3.8**	**-2.0**	**-2.5**	**-2.0**	**-1.5**
3. Interest expenditure	EDP D.41	2.7	2.2	2.3	2.3	2.3
4. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth		5.3	5.5	5.5	5.4	5.2
6. Output gap		-0.3	0.6	0.5	0.1	-0.1
7. Cyclical budgetary component		-0.1	0.2	0.2	0.0	0.0
8. Cyclically-adjusted balance (2-7)		-3.7	-2.2	-2.7	-2.1	-1.4
9. Cyclically-adjusted primary balance (8+3)		-1.0	0.1	-0.4	0.2	0.8
10. Structural balance (8-4)		**-3.7**	**-2.2**	**-2.7**	**-2.1**	**-1.4**
11. Net costs of tax wedge reform			-0.3	-1.3	-2.0	-2.1
12. General government net lending/borrowing excl. costs of the tax wedge reform (2-11)			-1.7	-1.2	0.0	0.7
13. Structural balance excl. net costs of the tax wedge reform (8-11)			**-1.9**	**-1.4**	**-0.1**	**0.7**

Source: Ministry of Finance

The latest forecasts show that in 2007 the structural general government deficit[10] to GDP ratio was reduced by 1.5 percentage points compared to the year 2006. However, a temporarily increase is expected (by 0.5 percentage points) in 2008 compared to 2007, notably as a consequence of reforms which lead to a drop in revenues (reduction of the tax wedge). The deficit to GDP ratio is expected to return to a downward path in subsequent years.

Despite the reduction of PIT rates, the reduction of the rate of growth of expenditure will make it possible to lower in 2009 the structural deficit to GDP ratio by 0.6 percentage points. Maintaining the downward trend in the deficit to GDP ratio will enable to reach the MTO (-1% of GDP) in 2011. Table 2 presents the impact of the reduction of the tax wedge on the path of structural deficit.

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

III.4. DEBT LEVELS AND DEVELOPMENTS

In the period covered by the present update, as in previous years, the debt management strategy will aim at the minimisation of the long term debt servicing costs subject to constraints on the level of risks.

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

	ESA code	2006	2007	2008	2009	2010
1. Gross debt		47.6	44.9	44.2	43.3	42.3
2. Change in gross debt ratio		0.6	-2.7	-0.7	-0.9	-1.0
Contributions to changes in gross debt						
3. Primary balance		-1.1	0.2	-0.2	0.3	0.8
4. Interest expenditure	EDP D.41	2.7	2.2	2.3	2.3	2.3
5. Stock-flow adjustment		-3.2	-4.7	-3.2	-3.0	-2.5
of which: Differences between cash and accruals		0.2	0.0	0.1	0.2	0.3
Net accumulation of financial assets		0.5	0.4	0.3	0.3	0.5
of which: privatisation proceeds		*0.0*	*-0.1*	*-0.3*	*-0.3*	*-0.3*
Valuation effects and other		-3.9	-5.1	-3.6	-3.5	-3.2
p.m.: Implicit interest rate on debt (%)		6.0	5.1	5.5	5.5	5.5
Other relevant variables						
6. Liquid financial assets*		0.9	0.8	0.6	0.6	0.5
7. Net financial debt		46.8	44.1	43.6	42.7	41.8

* Data covers only the State Treasury

Source: Ministry of Finance

In 2007, the general government debt to GDP ratio was considerably reduced from 47.6% in 2006 to 44.9%. Main factors behind such a significant reduction were a reduction of the borrowing needs and the appreciation of the zloty (contribution to the decline of the ratio by 0.9% GDP).

The pace of the debt accumulation is expected to decline within the horizon of this update. This will be a consequence of the reduction of the scale of the fiscal imbalance and larger proceeds from privatisation. Just as in earlier years, changes of the general government debt will result mainly from financing of the borrowing needs of the state budget. The refund to the FUS due to contributions transferred to the Open Pension Funds will prove to be a considerable burden. Expected changes in debt accumulation by other entities will almost solely be caused by the growth of debt of local government entities.

The general government debt to GDP ratio will lower further from 47.6% reported at the end of 2006 to slightly above 42% at the end of the year 2010.

III.5. BUDGETARY IMPLICATIONS OF "MAJOR STRUCTURAL REFORMS"

1) The pension reform

Costs of the pension reform implemented in 1999 will continue to be a significant burden for the general government throughout the update horizon.

Table 4. Net costs of the pension reform (% of GDP)

	2007	2008	2009	2010
Net costs of the pension reform	**2.7**	**2.8**	**3.0**	**3.2**
a) transfer from the State budget to FUS by way of:	1.9	1.8	1.9	2.0
- loss of contributions	1.4	1.4	1.5	1.6
- earnings exceeding 30 times and more the average wage	0.5	0.4	0.4	0.4
b) net interest	0.8	1.0	1.1	1.2

Source: Ministry of Finance

2) Limiting the fiscal burden

Further activities aimed at reducing the tax wedge (reduction of pension contributions and lowering of PIT rates, see Frame 1.) will also prove to be a substantial burden for public finances and will limit potential reductions of the general government deficit. In September 2007, a family allowance was implemented which will be deductable for the very first time by tax payers in 2008 in their 2007 annual tax return. The loss of PIT revenues of the general government, caused by the tax allowance mentioned above, in the years 2008-2010 is expected to reach ca. 0.5% of GDP per annum.

Table 5. Net costs of tax wedge reduction (% of GDP)

	2007	2008	2009	2010
Net costs of tax wedge reduction	-0.3	-1.3	-2.0	-2.1

Source: Ministry of Finance

Given the magnitude of the costs, further changes aimed at reducing the still high fiscal burden will be dependent on the general economic situation and the condition of public finances.

The timing and magnitude of further possible reductions in the rates of PIT, CIT and other taxes will be contingent on the effectiveness of actions regarding expenditure (necessity to guarantee the financing objectives of the general government).

Apart from reducing tax rates, activities in the fiscal area will be geared towards simplifying VAT procedures and reforming the tax law. Measures to achieve this will be an important supporting factor for the liberalisation of the economy.

3) Increase in development expenditure

The government has undertaken activities aimed at preparing a comprehensive reform of public expenditure. However, the development of an effective and coherent operational strategy needs time and must be coordinated with other government priorities.

Expenditure related activities by the general government will be aimed at making the process more flexible and efficient.

Infrastructure investment will rise significantly. A key factor will be a steady increase in expenditure on learning and education. There will be increases in research and development expenditure (also by the private sector). These actions will serve to narrow the gap between Poland and other EU member states.

In the medium-term the most important infrastructure investments will concern road construction and modernisation.

The road construction strategy assumes expenditures of ca. PLN 121 billion. The main sources of financing for this purpose in 2008-2012 will come from the State budget and EU structural funds.

Table 6. Expenditure of the general government associated with the road construction programme (% of GDP)

	2008	2009	2010
Expenditure associated with the road construction programme (with the EU funds)	1.6	2.4	2.1

Source: National Road Construction Programme for 2008-12

Euro 2012 related infrastructure investments will mainly include the following: roads, airports, stadiums and accommodation resources. A schedule of projects associated with Euro 2012 will be drawn up in the second quarter of 2008 (by way of amending an order of the Council of Ministers). This will enable costs to be assessed and a financing structure to be determined (within the scope of a multi-year programme). Costs of building new stadiums and the expansion or refurbishment existing stadiums are estimated at PLN 3.4 billion. Road investments associated with Euro 2012 will be realised within the *National Road Construction Programme for 2008-2012*.

4. Restructuring of social expenditure

The changes will also encompass the social sector. Activities aimed at boosting professional activity and the rate of employment as well as modifications to the healthcare system will be supported.

Key activities in the sphere of social expenditure will be as follows:

a) Economic activation

Work is under way on the *Solidarity between Generations – 50+* programme. Activities undertaken within this project will be financed from the Labour Fund (ca. PLN 0.4-0.5 billion per annum) and the European Social Fund (ca. EUR 1.8 billion in 2007-2013). Legislative changes are being drawn up aimed at reducing pre-retirement benefits and early retirement.

Economic activation will also be helped by actions under the pro-family policy. Amendments to the Labour Code and some other Acts have already been submitted for interministerial discussions. These provide for longer maternity leave, raising the basic level of retirement and pension contributions for parents on child-raising leave. The costs of these proposals to the general government totals PLN 0.2 billion in 2009 rising to PLN 0.46 billion in 2011. Work is also in progress to implement legislative and administrative solutions aimed at economic activation of the unemployed and those seeking work. Plans provide for the establishment of economic activation centres at county level which would assist with job-seeking, offer career advisory, assist in active job searching and organize training.

Plans also provide for modifications to the unemployment benefit system. At present these benefits are low and are paid to only a small percentage of the unemployed. The criteria for entitlement to receive unemployment benefits will be loosened (the required period of employment will be shortened). Moreover, benefit rates will be increased while a diminishing mechanism will be implemented (i.e. benefits will be paid in full for the first 3 months and then gradually decline). Accurate general government costs will be known when specific legislative proposals have been drawn up.

b) Health care

A package of laws geared towards improving the efficiency of health centres has also been submitted for consultation. There are proposals to change the way these centres are managed, about the financing of health care benefits particularly through additional voluntary insurance and the co-financing of certain benefits.

c) Other social expenditure

Work is also in progress on legislative changes in the area of retirement and pension benefits, including a draft bill which alters how pensions are calculated on the basis of incapacity for work. It provides for a gradual reduction in spending by the Social Insurance Fund (savings will be negligible within the period of the update).

The reform of the insurance system for farmers within the Agricultural Social Insurance Fund (KRUS) has already been submitted for discussion. Raising contribution rates for large farm owners is part of the plan.

5) Acceleration of privatisation

In the next few years the privatisation strategy will be based on the four-year *Privatisation Programme for Years 2008-2011*, which is due to be debated by the Council of Ministers in March of this year. The strategy aims to privatize those sectors which are of key importance for the smooth functioning of the economy, such as financial institutions, the power, chemical and oil industries. Privatization will also include the electronics, electro-technical, distilling and food industries. The preferred methods of privatization will be public offerings and public invitations to strategic investors to open negotiations. The pre-privatisation and privatisation processes will be conducted with full transparency.

The programme of decentralising the State and devolving power to local governments provides for the gradual transfer of those assets held by the Treasury, and which are necessary for local governments to fulfil their obligations (this includes the transfer of stocks/shares of companies active at local or regional level).

Privatisation proceeds are expected to reach PLN 5-7 billion annually in the period 2008-2010.

6) Liberalisation of the economy

Activities in the field of liberalisation will be aimed at changing economic legislation and creating conditions conducive to rapid investment growth. The first proposals for legislative changes, including amendments to the laws on the freedom of economic activity and accounting have already been submitted to Parliament. Work is underway on a package of laws aimed at facilitating economic activity in Poland.

Action is being taken to simplify the tax system and modernise the customs service as part of the same initiative.

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

IV.1. RISK FACTORS AND SENSITIVITY ANALYSIS

1. Key risk factors

There are several areas of risk which could change the values of fiscal variables from those assumed in the update.

1) Macroeconomic risk

The basic sources of risk concerning macroeconomic variables and the economic situation are the following:

- Supply barriers in the labour market will be greater than originally forecast due to economic emigration and a continuing low level of spatial mobility;
- Larger than predicted supply constraints in the economy will lead to higher inflation and stronger tightening of monetary policy;
- Greater turmoil than predicted on global financial markets, especially the mortgage market will have a larger negative impact on the economies of Poland's chief trading partners, on the domestic financial market and on the assessment by potential investors of the economic outlook.

2) Other risks

a) Lower absorption of the European Union funds

The risk of delays in absorbing Structural and Cohesion Funding in the financial perspective for 2007-2013 is lower than had been estimated in the previous update. This is especially the case in the first years of the programme. It is caused by:

- all the Polish sectoral and regional operational programmes for the 'Convergence' objective of the Cohesion policy for 2007-2013 were accepted by the European Commission before the end of 2007,
- all programmes are expected to have been initiated by the end of the year 2008.

A fundamental factor which increases risk may be any delays in the execution or take-up of resources for infrastructure programmes co-financed with the Cohesion Fund 2000-2006. There are no serious threats to utilising funds from the instruments of the Common Agricultural Policy.

b) Lack of settlement of reprivatisation claims

The lack of a final settlement of the reprivatisation problem continues to be a source of risk. At present, the total sum of reprivatisation claims (including claims by ethnic Poles from expropriated eastern lands) is estimated at ca. PLN 100 billion. However, the expected settlement is assumed to be considerably lower[11].

Its accurate estimate is currently not available due to ongoing legislative work aimed at settling claims for properties in Warsaw and other real estate, especially land, forests, urban and industrial property.

c) Guarantees and other liabilities

The increase in potential liabilities for the Treasury arising from government underwritten guarantees is expected to rise from ca. 2.7% of GDP at the end of 2007 to ca. 3.6% of GDP in 2010. Moreover, a further decline of the average portfolio risk is predicted to take place, from ca. 26% at the end of 2007 to ca. 23% at the end of the year 2010. The existing strategy for granting guarantees requires that these be used primarily to support pro-development investment in infrastructure, environmental protection and job creation.

Predicted payments for guarantees accumulated within the whole maturity horizon of the guarantee portfolio (to 2040 at present) should not exceed 1% of annual GDP on an annual scale (with a limit of 1.4% of GDP assumed in the strategy[12]).

Other operations which could lead to a higher risk of additional burdens for public finances include transactions within public-private partnerships (PPP). However, their impact on fiscal variables will depend on the distribution of risk in the contract between the public and the private partners. The limit to which government agencies can incur financial obligations by way of PPP contracts has been fixed at PLN 5 billion in the 2008 budget act.

d) Risk of compensations with respect to the decree of the Court of Arbitration in the dispute between Eureko B.V and the State Treasury

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[11] Pursuant to the *Act on Exercising the Right to Compensation Arising from Loss of Real Estate Property Outside the Current Borders of the Polish State,* the estimated value of claims construed as 100% of value of the property claimed is estimated at PLN 11.5 billion while estimated compensation is predicted at PLN 2.5 billion.

[12] *Revision of the Medium-Term Strategy of Granting Warranties and Guarantees Issued by the State Treasury until 2013*, adopted by the Council of Ministers in June 2006.

Pursuant to the decree issued by the Court of Arbitration, Eureko B.V claimed compensation from the Polish government for its failure to honour the contractual undertaking for the sale of shares of Polski Zakład Ubezpieczeń S.A. (Polish Insurance Company). The initial amount of the compensation claimed by the Dutch company has been estimated at ca. PLN 35.6 billion.

In February last year, an agreement was signed by the State Treasury Minister and Eureko B.V concerning the schedule of negotiations on issues that are the subject matter of the dispute.

e) Legislative and political risk

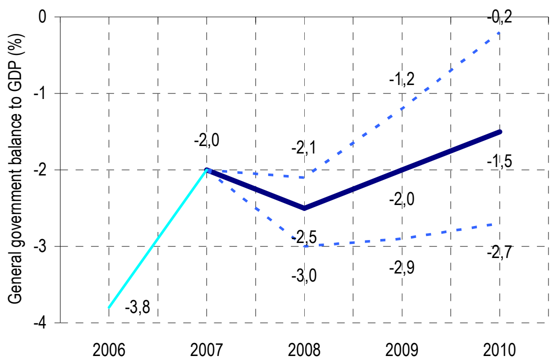
This area covers the adoption of legislative solutions that lead to an unexpected growth of expenditure or a loss of revenues of the general government.

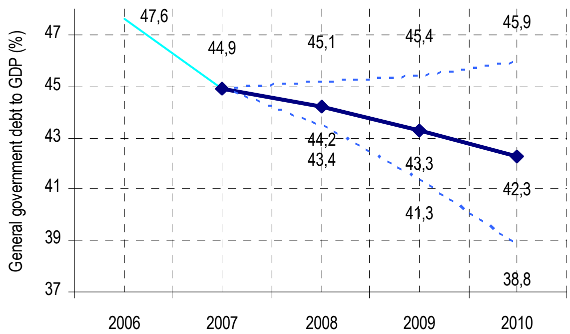
2. Sensitivity analysis

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

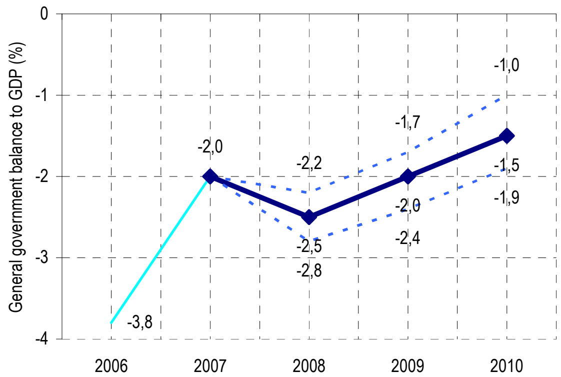
Graph 7. Sensitivity of net lending/borrowing and debt of general government to changes of real GDP growth, interest and exchange rates.

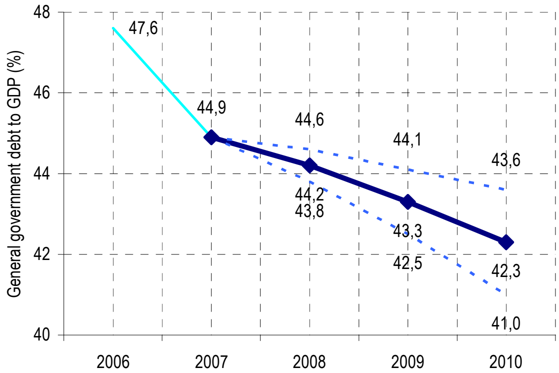
a) change of real GDP growth by 1%



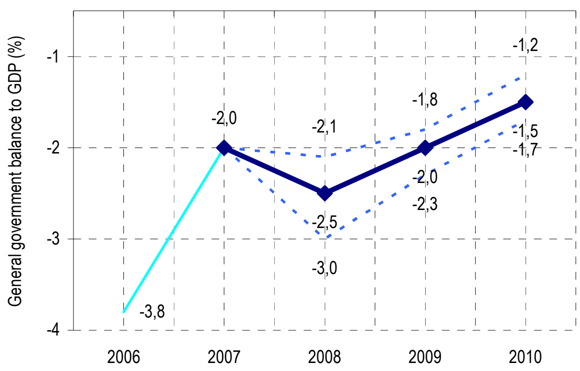


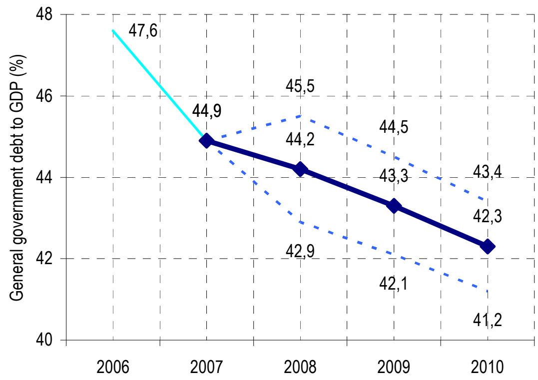
b) change of interest rates by 1 percentage point





c) change of exchange rate by 10%





Source: Ministry of Finance

IV.2. COMPARISON WITH THE PREVIOUS UPDATE

Table 7. Divergence from previous update

	ESA code	2006	2007	2008	2009	2010
Real GDP growth (%)						
Update 2006		5.4	5.1	5.1	5.6	-
Current update		6.2	6.5	5.5	5.0	5.0
Difference		+0.8	+1.4	+0.4	-0.6	-
General government net borrowing/lending (% of GDP)	EDP B.9					
Update 2006		-3.9	-3.4	-3.1	-2.9	-
Current update		-3.8	-2.0	-2.5	-2.0	-1.5
Difference		+0.1	+1.4	+0.6	+0.9	-
General government debt (% of GDP)						
Update 2006		48.9	50.0	50.3	50.2	
Current update		47.6	44.9	44.2	43.3	42.3
Difference		-1.3	-5.1	-6.1	-6.9	

Source: Ministry of Finance

Compared to the previous update of the programme, the path of real GDP growth was corrected upwards in 2006-2008. A higher rate of actual GDP growth in 2006-2007 and the rate predicted for 2008 are associated with a higher rate of growth of domestic demand. This is currently 7.2% for 2006-2008 compared to an average growth rate of 5.7% predicted in the previous update. The higher real growth rate of domestic demand is the result of a larger than expected revival in investment processes and, when compared to 2007-2008, of higher individual consumption dynamics, which is caused by a more favourable financial position of households (from the beginning of 2006).

The current forecast of the fiscal path was improved considerably compared with the update to the Convergence Programme 2006. The largest correction concerned the performance for the year 2007. The significantly lower general government deficit in 2007 is mainly the result of faster than previously predicted economic growth. More favourable results are expected for the general government balance for 2008-2009. In these years, the reduction of the deficit is associated with plans for further economic growth and increase in employment, which will partially compensate for the loss of revenues caused by the introduction of changes in the tax system. The lowering of general government expenditure to GDP ratio will also improve the fiscal path. The better condition of the State budget allows a reduction in the borrowing requirement and restricting the scale of issue of debt.

V. QUALITY OF PUBLIC FINANCES

V.1. POLICY STRATEGY

Activities aimed at improving the efficiency of public finances will be continued. Work on drafting a new law on public finance has been resumed. Key differences from the current law will include:

- changes in the scope of public finance, in particular its rationalization by consolidation and changes in the organizational form of some of entities,
- extending the framework of budgetary planning (3-year horizon),
- changes in debt limits for local government units and toughening of prudential and remedial procedures when debt to GDP ratio exceeds the safety thresholds.

Key activities for improving the condition of public finances will aim at the expenditure reform. There are plans to modify the current principles for drafting the State budget act. Liabilities which result in the rigidity of expenditure will be subject to an in-depth analysis. This process will be gradual and will encompass all ministries. The reform process will be associated with a bonus system rewarding the efficiency improving activities. The structure of expenditure will be altered to favour pro-development expenditures, including expenditure on infrastructure and education. Social transfers to GDP ratio will decrease.

An important task is to implement changes in the public administration, the decentralisation in particular. Changes aimed at ordering the division of competence between the central and local administration will also be implemented. They should result in a reduction of costs of administration .

Implementing the task-oriented budgeting will also increase the efficiency of the utilisation of public funds.

A pilot project of the task-oriented budgeting following these guidelines was presented the very first time in the justification to the Budget act for 2008. It currently only includes selected general government entities (government departments and provincial offices in particular).

Considerable emphasis will be placed on improving the efficiency of utilising the EU funds. They will mainly serve to promote activities aimed at boosting the innovativeness of the economy (including research and development) and infrastructure development.

Work has begun on the *National Reform Programme 2008-2011* (KPR). Due to its early stage, it is currently difficult to evaluate the precise impact of all new KPR projects on the fiscal path. However, they should not have any significant effect on the assumed path for the reduction of the general government deficit. Activities focusing on innovation and building of a knowledge-based economy as well as improving the conditions for economic activity will remain the crucial issues for action. The key areas are:

- freedom of economic activity – the main objective of undertaken initiatives will be to ensure a business friendly environment both in terms of regulations and institutions (including the use of information and communication technologies),
- support for innovation and R&D, especially in sectors which have considerable value added and a high level of competitiveness.

Activities undertaken within the KPR will also aim at ensuring access to competitive services and a suitable infrastructure in networked sectors. Focus will also be placed on synchronising activities in the labour market, social policy and education. The above mentioned activities will be supported by changes in the public finances.

Table 8. Basic data concerning the general government (EDP)

	ESA code	2006 in billion zloty	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP
Total revenues	TR	424.2	40.0	40.0	40.0	39.2	38.7
Total expenditure	TE	464.3	43.8	42.0	42.5	41.2	40.1
Balance	**S13**	**-40.2**	**-3.8**	**-2.0**	**-2.5**	**-2.0**	**-1.5**

Source: 2006 – Central Statistical Office, forecast for 2007-2010 – Ministry of Finance

V.2. DEVELOPMENTS ON THE EXPENDITURE SIDE

The expenditure in the coming years will be shaped by the structural changes described above. The scale and structure of expenditure will be heavily influenced by measures aimed at its rationalization and increasing its flexibility as well as increasing the share of pro-development expenditure.

Expenditure will also be affected by changes in the indexation mechanisms, including the restoration from 2008 of the annual indexation of pensions and disability payments according to the formula CPI + 20% of real growth of the average wage and salary. Additionally from 2008, pensioners and people entitled to disability benefits receive benefits based on the base amount increased to 100% of the average wage and salary constituting the basis for defining the amount of the benefit on the day that it is awarded (liquidation of the former portfolio).

In the next few years, the expenditure will be greatly influenced by the co-financing of projects financed from the EU funds. Therefore, a considerable increase in investment expenditure of general government is expected.

Table 9. General government expenditure by function (COFOG, % of GDP)

	COFOG code	2006	2010
1. General public services	1	5.9	5.1
2. Defence	2	1.2	1.0
3. Public order and safety	3	1.8	1.7
4. Economic affairs	4	4.4	4.1
5. Environmental protection	5	0.6	0.4
6. Housing and community amenities	6	1.2	1.0
7. Health	7	4.7	4.8
8. Recreation, culture and religion	8	1.1	0.8
9. Education	9	6.0	6.1
10. Social protection	10	16.9	15.1
Total expenditure		**43.8**	**40.1**

Source: 2005, 2006 (preliminary data) – Central Statistical Office, forecast for 2010 – Ministry of Finance

The general government expenditure to GDP ratio will drop by 3.7 percentage points between 2006[13] and 2010. The decline in expenditure will be primarily determined by a drop in the level of spending on social protection to GDP (a decreasing number of people entitled to social benefits, e.g. cased by a drop in the unemployment) and on general public services (due to lower interest and a reduction of costs of the administration).

The ratio of expenditure on economic affairs to GDP will decrease, however, there will be a nominal growth of expenditures by ca. 30% (17% in real terms) in this category between 2006 and 2010. This category includes expenditure on infrastructure, especially road construction and supplementary financing of investments associated with hosting the European Football Championships - Euro 2012. Expenditure on health protection and education to GDP will remain at a level comparable to that reported in 2006, which reflects the government policy in this area.

[13] Data for the year 2006 was sent to the Eurostat by the Central Statistical Office in December 2007 in table 11 *General government expenditure by function (COFOG)*.

V.3. DEVELOPMENTS ON THE REVENUE SIDE

The current forecast of general government revenue for 2008-2010 takes into account assumptions on the development of the macroeconomic situation and the scenario of planned structural changes of which the most important are:

- reduction of social security contributions and PIT rates as well as the introduction of the family allowance (for families with children),
- raising the excise duty for tobacco goods, including increasing duty on cigarettes by 23.3% in 2008 and 15.8% in 2009;
- increasing the amount of allowance per litre of bio-component added to petrol and diesel oil, arising from the establishment of the National Indicator Targets (NCW)[14].

Changing the amount of allowance for each litre of bio-component added to petrol and diesel oil in the excise tax will also have an influence (to a lesser degree) on VAT revenues as a result of changing the basis for the VAT calculation.

In addition, a change in the regulations on Corporate income tax introduces a tax allowance aimed at compensating part of the bio-component production costs. This allowance, which covers the years 2007-2014, will allow bio-component producers to deduct from their income tax 19% of the positive difference between the cost of producing bio-components over the cost of producing conventional liquid fuel (with the same calorific value and to which these bio-components can be added).

The changes in the tax system for 2008-2010 are designed to reduce labour costs with an aim of promoting employment and limiting unemployment. The changes also aim at facilitating companies to run business activity. They will also have a favourable influence on households through the reduction of the tax burden (e.g. PIT: allowance for families with children, revaluation of thresholds and tax-free allowances, implementation of two tax rates and reduction of the level of the pension contributions).

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

VI. SUSTAINABILITY OF PUBLIC FINANCES

The forecasts presented in table 10 were drawn up in 2005 by the Economic Policy Committee (EPC) and they are consistent with those published in the EPC and the Commission report (*The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050), European Economy Special Report No. 1/2006*). Further forecasts will be presented after the work on the second edition of the report has been completed, which is planned for 2009. As a result, changes implemented after the year 2005 are not included in these forecasts, especially the tax wedge reduction and the expected outcome of work to reform the pension system, which is currently ongoing.

The pension reform carried out in 1999 significantly reduced the risk that the aging of population would pose to the long-term general government sustainability in Poland. The main solutions within the reform were the introduction of a capital component to the *pay-as-you-go* component, replacing the defined-benefit scheme with the defined contribution scheme. Further changes aim at increasing the effective retirement age and development of voluntary retirement savings.

Table 10. Long-term sustainability of public finances (% of GDP)

	2005	2010	2020	2030	2050
Total expenditure					
Of which: 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 benefits (disability, survivors)	2.6	2.0	1.3	1.3	1.4
Occupational pensions (if in general government)	-	-	-	-	-
R Retirement pensions from the obligatory capital part of the system*	0.0	0.0	0.1	0.3	1.3
Heath care**	4.1	4.3	4.7	5.0	5.4
Long-term heath care***	0.1	0.1	0.1	0.1	0.2
Education expenditure	4.9	3.9	3.0	3.0	3.1
Other age-related expenditure	0.0	0.0	0.0	0.0	0.0
Interest expenditure	0.0	0.0	0.0	0.0	0.0
Total revenue					
Of which: property income					
Contributions	9.3	9.7	10.1	10.1	10.1
Retirement and disability pension contributions paid to Social Insurance Fund	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****	8.3	15.5	33.1	50.7	84.5
Labour productivity growth	4.2	3.6	3.1	2.7	1.7
Real GDP growth	3.3	5.0	3.2	2.2	0.4
Participation rate males (aged 20-64)	77.8	79.9	82.1	84.0	81.7
Participation rate females (aged 20-64)	65.1	67.0	71.3	74.4	70.3
Total participation rate (aged 20-64)	71.4	73.4	76.7	79.2	76.1
Unemployment rate (aged 15-64)	18.2	15.8	9.9	7.0	7.0
Population aged 65+ over total population	13.1	13.5	18.2	22.6	29.4

Source: Ministry of Labour and Social Policy; GDP growth rate and unemployment rate in 2005 r. – Ministry of Finance's estimates

* There are both voluntary pension schemes for employees and the obligatory capital system in Poland.

** Forecasts made in 2005 under assumption of no changes of the government policy.

*** Long-term heath care encompasses nursing and protecting care and palliative-hospital care.

**** Open Pension Funds (OFE) and Demographic Reserve Fund (FRD).

VII. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The system of precautionary fiscal principles in Poland was based on regulations laid down in the Constitution of the Republic of Poland and in the Public Finance Act (annex 2). It includes instruments supporting the long-term sustainability of public finances. It also facilitates efforts aimed at meeting the fiscal convergence criterion, though its limits and constraints are calculated in accordance with Polish methodology. Issues connected with the financial management, including certain principles of planning and implementation of budgets and financial plans as well as the incurring liabilities, were also regulated in specific laws and executive orders.

The major fiscal principles in the Polish legal system are:

1) Exclusive powers of the Council of Ministers to establish the deficit threshold for the State budget for a given fiscal year. The Sejm has no authority, whether by increasing expenditure or by reducing revenues, to determine a larger deficit for the State budget than that set out in the draft budget act by the Council of Ministers;

2) Prohibition against exceeding the limit of expenditure (and outlays) set out in budget acts (both for the State budget and local governments) and financial plans.

   In case of the higher than assumed revenues the deficit is automatically reduced or the surplus is increased. In principle, savings in one group of expenditure cannot be used to increase expenditure in another group and a lower than assumed level of revenues translates into a reduction of expenditure. In 2001-2007, cash expenditure of the State budget were executed at the average level of 97.7% against the level approved in the budget act.

3) Necessity to implement prudential or remedial procedures should the public debt to GDP ratio exceed certain thresholds (50%, 55% and 60%).

   The key objective of these procedures is to reduce debt accumulation by the reduction of the fiscal imbalance. In case the 60% threshold is exceeded both the State budget and local government budgets must be balanced.

The work has been carried out on supplementing the current form of the budget with a task-based approach. The timetable assumes a full implementation of this type of budget within the government's priority tasks by the year 2015. It will apply to the central government entities.

Analytical work is also ongoing with the aim at finding solutions for rationalization of general government expenditure and increasing its flexibility. This will result in adequate legal solutions in the functioning of public finances.

The works of the Team for general government statistics have been continued[15]. In the nearest future they will focus on: preparation of methodological principles for updating the indicator of non-collected taxes and contributions as well as undertaking measures aimed at ensuring full compatibility of financial accounts with non-financial accounts and with the fiscal notification.

[15] The Team was appointed by the head of the Central Statistical Office in order to agree the methodology of the general government statistics which would be common for the Central Statistical Office, the Ministry of Finance and the National Bank of Poland.

ANNEX 1. TABLES

Table 11. Macroeconomic prospects

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP (PLN billion)	B1*g	1 044.7	6.2	6.5	5.5	5.0	5.0
2. Nominal GDP (PLN billion)	B1*g	1 060.2	7.8	9.9	9.2	8.2	7.6
Components of real GDP							
3. Private consumption expenditure	P.3	649.4	4.8	5.2	6.0	5.4	4.5
4. Government consumption expenditure	P.3	188.1	5.8	1.0	2.0	1.5	1.6
5. Gross fixed capital formation	P.51	207.1	15.6	20.4	14.5	10.0	10.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	14.1	1.4	1.3	1.1	1.1	1.0
7. Exports of goods and services	P.6	418.0	14.6	9.0	6.0	6.2	6.2
8. Imports of goods and services	P.7	432.0	17.4	10.9	9.6	7.8	7.0
Contributions to real GDP growth							
9. Final domestic demand		-	7.3	7.4	7.2	6.0	5.6
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.4	0.0	-0.1	0.0	0.0
11. External balance of goods and services	B.11	-	-1.1	-0.9	-1.7	-1.0	-0.6

Table 12. Price developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. GDP deflator		-	1.5	3.2	3.4	3.0	2.5
2. Private consumption deflator		-	1.2	2.6	3.5	2.9	2.5
3. HICP		-	1.3	2.6	3.5	2.9	2.5
4. Public consumption deflator		-	3.0	2.4	3.5	2.9	2.5
5. Investment deflator		-	0.9	3.0	3.0	3.0	2.5
6. Export price deflator (goods and services)		-	2.3	3.4	0.0	1.5	1.5
7. Import price deflator (goods and services)		-	2.4	2.3	0.0	1.5	1.5

Table 13. Labour market developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Employment (in thousand of persons)*		14 594	3.4	4.3	1.6	1.2	1.1
2. Employment, hours worked							
3. Unemployment rate (%)**		13.8	13.8	9.4	7.2	5.8	4.5
4. Labour productivity (PLN thousand)***		72.6	2.8	2.1	3.9	3.8	3.8
5. Labour productivity, hours worked							
6. Compensation of employees (PLN million)		377.0	7.1	12.2	9.5	9.0	8.5
7. Compensation per employee (PLN thousand)		34.2	1.7	6.2	6.8	7.0	6.8

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

** Harmonized definition, Eurostat; levels.

*** Real GDP per person employed.

Table 14. Sectoral balances (% of GDP)

	ESA Code	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-2.6	-2.6	-3.5	-4.2	-4.6
of which: - Balance on goods and services		-1.4	-1.7	-3.1	-3.6	-4.0
- Balance of primary incomes and transfers		-1.8	-2.0	-1.7	-1.8	-1.8
- Capital account		0.6	1.1	1.3	1.2	1.2
2. Net lending/borrowing of the private sector	B.9	1.2	-0.6	-1.0	-2.2	-3.1
3. Net lending/borrowing of general government	EDP B.9	-3.8	-2.0	-2.5	-2.0	-1.5
4. Statistical discrepancy		-	-	-	-	-

Table 15. Basic assumptions

	2006	2007	2008	2009	2010
Short-term interest rate(annual average)*	4.1	4.4	5.5	5.8	5.5
Long-term interest rate (annual average)	5.3	5.5	5.9	5.9	5.9
Nominal effective exchange rate	-3.5	-4.9	-7.0	-1.1	-0.5
Exchange rate vis-à-vis the € (annual average)	3.90	3.78	3.57	3.50	3.43
**World GDP growth ** **	5.0	4.8	3.8	3.8	3.8
EU GDP growth	3.0	2.9	2.0	2.0	2.0
Growth of relevant foreign markets ***	11.4	8.7	~ 7.0	7.0	7.0
World import volumes *****	8.3	7.2	~ 7.0	7.0	7.0
Oil prices (Brent, USD/barrel) *******	65.4	72.7	~ 90.0	90.0	90.0

Main source for Polish external assumptions is the European Commission: *Interim Forecast. February 2008,* forecasts for 2009-2010 - data for 2008

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

** world GDP growth data for 2006 – IMF: *World Economic Outlook Update, January 2008*; the world GDP includes the EU

*** data for 2006-2007 – the European Commission: *Economic Forecast, Autumn 2007*; as a indicator for growth of relevant foreign markets in the years 2009-2010 – assumed GDP growth in the EU

**** data for 2006-2007 – the European Commission: *Economic Forecast, Autumn 2007*; the rise in world import volume (includes the EU) of goods and services for 2008 was taken from the *Interim Forecast* (... growth in export and import volumes of goods estimated at just below 7%)

***** Source of data for 2006-2007 – IMF.

Table 16. General government budgetary prospects

	ESA Code	2006 Level	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-40.2	-3.8	-2.0	-2.5	-2.0	-1.5
2. Central government	S.1311	-44.1	-4.2	-3.2	-3.2	-2.5	-2.0
3. State government	S.1312			nie dotyczy			
4. Local government	S.1313	-3.5	-0.3	0.2	0.6	0.3	0.3
5. Social security funds	S.1314	7.4	0.7	1.0	0.1	0.2	0.2
General government							
6. Total revenue	TR	424.2	40.0	40.0	40.0	39.2	38.7
7. Total expenditure	TE	464.3	43.8	42.0	42.5	41.2	40.1
8. Net lending/borrowing	EDPB.9	-40.2	-3.8	-2.0	-2.5	-2.0	-1.5
9. Interest expenditure	EDP D.41	28.7	2.7	2.2	2.3	2.3	2.3
10. Primary balance		-11.5	-1.1	0.2	-0.2	0.3	0.8
11. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes		229.8	21.7	22.8	22.9	22.8	22.4
12a. Taxes on production and imports	D.2	150.5	14.2	14.4	14.7	14.8	14.5
12b. Current taxes on income, wealth	D.5	79.3	7.5	8.4	8.2	8.0	7.9
12c. Capital taxes	D.91	0.3	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	129.1	12.2	11.9	10.9	10.7	10.6
14. Property income	D.4	17.1	1.6	1.2	0.9	0.9	0.8
15. Other		47.9	4.5	4.1	5.2	4.8	4.9
16. Total revenue	TR	424.2	40.0	40.0	40.0	39.2	38.7
Tax burden		355.3	33.5	35.1	34.2	33.8	33.3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D1+P2	167.6	15.8	15.1	14.5	14.0	13.4
17a. Compensation of employees	D.1	104.1	9.8	9.6	9.2	8.9	8.5
17b. Intermediate consumption	P.2	63.6	6.0	5.6	5.3	5.1	4.9
18. Social payments		183.9	17.3	16.6	16.5	16.2	15.8
18a. Social transfers in kind supplied via market producers	D.6311 D.63121 D.63131	22.6	2.1	2.0	2.0	2.0	2.0
18b. Social transfers other than in kind	D.62	161.3	15.2	14.6	14.5	14.2	13.8
19. Interest expenditure	EDP D.41	28.7	2.7	2.2	2.3	2.3	2.3
20. Subsidies	D.3	6.1	0.6	0.7	0.8	0.9	0.8
21. Gross fixed capital formation	P.51	40.8	3.9	4.6	5.2	5.0	5.0
22. Other		36.7	3.5	2.8	3.2	2.8	2.8
23. Total expenditure	TE	464.3	43.8	42.0	42.5	41.2	40.1
p.m.: Government consumption (nominal)	P.3	193.7	18.3	17.1	16.4	15.8	15.2

Table 17. Influence of the National Reform Programme (KPR) on public finance (% of GDP)

Priorities of KPR	Guideline number	Measure	Implementation		Direct budgetary costs*			
			Status of measure	Time scope	2007	2008	2009	2010
1. Consolidation of public finance and improvement of public finance management	1,2	1.4 - continuing the reform of the health protection system	under realisation		0.0	0.0	0.0	0.0
	2,3	1.5 - simplification of public expenditure on administration and tightening control over public assets at the disposal of special purpose funds and state agencies **	under realisation		0.0	-0.1	-0.6	-0.3
	3,7,13	1.9 - implementation of IT solutions in public finance	under realisation		0.0	0.0	0.0	0.0
	3,7,13	1.10 - further implementation of compulsory internal audits in public institutions	under realisation	ongoing	0.0	0.0	0.0	0.0
	3,7,13	1.11 - targeting public aid to horizontal objectives	under realisation	ongoing	0.0	0.0	0.0	0.0
2. Promotion of entrepreneurship	14	2.2 - simplification of administrative procedures and reduction of business expenses	under realisation		0.0	0.0	0.0	0.0
	14	2.3 - improvement of the functioning of commercial courts	under realisation		0.0	0.0	0.0	0.0
	not included in GRID	2.4 - completion of major privatisation processes	under realisation		0.0	0.0	0.0	0.0
3. Growth of enterprise innovation	7,8,9	3.1 - development of the innovation market and institutional environment for cooperation between R&D and the economy	under realisation	ongoing	0.0	0.0	0.0	0.0
	7,8,	3.2 - promotion of research and development	under realisation	2006-10	0.0	0.0	0.0	0.0
	9	3.3 - development of IT and communication technologies in the economy and administration	under realisation	2007-15	0.0	0.0	0.0	0.0
4. Development and modernisation of infrastructure and provision of competitive conditions in network sectors	16	4.1 - creation of a modern transport network (roads, local public transport, railways, airports, seaports)	planned	2008-12	0.0	0.9	1.5	1.3
	not included in GRID	4.3 - promotion of construction and modernisation of energy infrastructure	under realisation	2007-13	0.0	0.0	0.0	0.0
	16	4.5 - improving availability of housing for citizens	under realisation	2006-08	0.1	0.0	0.0	0.0
	14.15.16	4.6 - propagation and development of Public-Private Partnerships (PPP)	under realisation	continuous task	0.0	0.0	0.0	0.0
	12.13	4.8 - liberalisation of rail transport	under realisation	by 2013	0.0	0.0	0.0	0.0
5. Creation and maintenance of jobs and reduction of unemployment	22	5.1 - reduction of burden imposed on employees with lower income***	realised	since July 2007	0.3	1.3	2.0	2.1
	18	5.6 – economic activation of the disabled	under realisation	2005-10	0.0	0.0	0.0	0.0

Source: Ministry of Economy, Ministry of Finance

*Direct budgetary costs mean higher general government expenditure or lower revenues caused by the implementation of a given measure; the 'plus' sign indicates costs borne against the baseline scenario, the 'minus' sign indicates savings connected with the implementation of a given measure against the baseline scenario.

**With regard to the fact that the draft public finance act was not adopted, the measure was not taken into account in calculating the general government deficit.

***In measure 5.1. were also included the consequences of changes in PIT rates for persons who conduct a business and settle their accounts in accordance with the PIT scale. For this reason, the result has not been included in measure 2.2.

ANNEX 2. MAIN DOMESTIC FISCAL RULES AND RULES GOVERNING THE BUDGETARY PROCESS

Area	Description	Legal basis
1. Budget performance	1) The Sejm while increasing expenditure or limiting revenues cannot increase the level of the State budget deficit approved by the Council of Ministers in the annual draft budget act (on cash basis).	Constitution of the Republic of Poland
2. Expenditure	1) Public expenditure can only be used to finance objectives stated in budget acts (of the State budget and local governments) and financial plans and only to the levels stated therein; any revenues higher than expected in the budget act are used to reduce the deficit and not to increase expenditure.	Public Finance Act
	2) All but expenditure covered by own revenues of budgetary units stated in budget acts (of the State budget and local governments) and financial plans of budgetary units are limits.	Public Finance Act
	3) Any increase in costs stated in annual financial plans of entities from the public finance sector is subject to legal limits.	Public Finance Act
	4) In case of the execution of the State budget act being under threat planned budget expenditure can be blocked for the definite period (through an execution act of the Council of Ministers after approval of the budget commission of the Sejm).	Public Finance Act
	5) Any reallocation of expenditure (across budgetary items) is subject to strict legal limits.	Public Finance Act
3. Outlays	1) Outlays stated in the State budget, local governments' budgets and financial plans of budgetary units are limits.	Public Finance Act
4. Public debt	1) Incurrence of debt and issuance of guarantees is forbidden if it should lead to the public debt exceed 60%of GDP. The Minister of Finance controls obeying the rule.	Constitution of the Republic of Poland, Public Finance Act
	2) Precautionary and remedial procedures shall be executed in case of public debt exceeding thresholds set at the level of 50%, 55% and 60% of GDP; the procedures constrain mainly the deficits of the State budget and local governments and issuance of guarantees.	Public Finance Act
	3) The Minister of Finance prepares a 3-year strategy for managing the State Treasury debt and influencing the public debt (after the Council of Ministers' approval, the document is sent to the Parliament together with the justification to the draft budget act).	Public Finance Act
5. Incurrence of liabilities	1) The level of liabilities incurred by entities from the public finance sector is limited by law.	Public Finance Act
	2) Objective and amounts of loans incurred by the State Treasury are limited by law.	Public Finance Act
	3) Objectives of incurring loans and issuing securities by local governments are limited by law.	Public Finance Act
	4) Some parameters of liabilities incurred by entities from the public finance sector entities (excluding the State Treasury) are limited by law (e.g. capitalization of interest, value of discount).	Public Finance Act
	5) Annual level of repayments and servicing of liabilities by local governments as well as the level of local government debt is limited by law.	Public Finance Act
6. Issuance of guarantees	1) Issuance of guarantees by public finances' sector entities including their amounts is limited by law.	Public Finance Act
7. Other rules	1) Any changes in the financial plan of a central government entity included in the budget act require the agreement of the governing minister after approval of the Minister of Finance and a positive opinion of the budget commission of the Sejm.	Public Finance Act
	2) The range of financial assets in which given entities from the public finance sector may invest available financial resources is limited by law.	Public Finance Act