REPUBLIC OF POLAND

CONVERGENCE PROGRAMME

2013 UPDATE

Warsaw, April 2013

Table of contents

Summary 4
I. Overall policy framework and objectives 4
I.1. Fiscal policy in the EU context 4
I.2. Integration with the euro area 6
I.3. Economic policy objectives 6
II. Economic outlook 7
II.1. Cyclical developments and current prospects 7
II.2. Medium-term scenario 9
III. General government balance and debt 12
III.1. Policy strategy and medium-term objectives 12
III.2. Measures taken to reduce the excessive deficit 12
III.3. Actual balances 14
III.4. Medium-term budgetary outlook 15
III.5. Structural balance 21
III.6. Debt levels and developments 24
IV. Sensitivity analysis and comparison with previous update 25
IV.1. Risk factors 25
IV.2. Sensitivity analysis 26
IV.3. Comparison with previous update 29
V. Long-term sustainability of public finances 30
V.1. Policy strategy 30
V.2. Long-term budgetary prospects, including the implications of an ageing population 31
V.3. Contingent liabilities 33
VI. Quality of public finances 33
VI.1. Composition, efficiency and effectiveness of expenditure 33
VI.2. Structure and efficiency of revenue systems 36
VII. Institutional features of public finances 40
VII.1. Fiscal rules 40
VII.2. Budgetary procedures, incl. public finance statistics governance 42
VII.3. Other institutional developments in relation to public finances 43
Annex 44

List of tables

Table 1. Cyclical developments ... 23
Table 2. General government debt developments ... 24
Table 3. Divergence from previous update ... 30
Table 4. Long-term sustainability of public finances ... 32
Table 5. Contingent liabilities ... 33
Table 6. General government expenditure by function ... 36
Table 7. Fiscal rules concerning local government units in the current legal state ... 41
Table 8. Macroeconomic prospects ... 44
Table 9. Price developments ... 45
Table 10. Labour market developments ... 45
Table 11. Sectoral balances ... 46
Table 12. Basic assumptions ... 46
Table 13. General government ... 47
Table 14. No-policy change projections ... 48
Table 15. Amounts to be excluded from the expenditure benchmark ... 48

List of charts

Chart 1. Structural and nominal general government deficit between 2007-2012 ... 5
Chart 2. The impact of the change in revenue and expenditure on the change in general government balance in relation to GDP ... 14
Chart 3. General government expenditure ... 17
Chart 4. Changes in share of general government expenditure in relation to GDP ... 18
Chart 5. The impact of the change in national revenue and expenditure on the general government balance in relation to GDP ... 20
Chart 6. Revenue, expenditure and balance of general government ... 21
Chart 7. Structural and nominal general government balance between 2007-2016 ... 22
Chart 8. General government expenditure modified according to the methodology of the European Commission 23
Chart 9. EU import (left chart) and the impact of a change in global demand on general government balance and gross debt (right chart) ... 27
Chart 10. Volume of public investment (left chart) and its impact on general government balance and gross debt (right chart) ... 27
Chart 11. PLN/EUR exchange rate (left chart) and its impact on general government balance and gross debt (right chart) ... 28
Chart 12. Short-term interest rate (left chart) and its impact on general government balance and gross debt (right chart) ... 29
Chart 13. Administration costs (as a sum of remuneration and indirect consumption) ... 34
Chart 14. Gross fixed capital formation ... 35
Chart 15. Social expenditure ... 35
Chart 16. Structure of preferential taxation in Poland in 2011 (as a share of the total value of preferential taxation) ... 37

Summary

The annual update of the *Convergence Programme* (hereafter referred to as *Programme*) presents medium-term forecasts for Poland's economy and public finances. The document has been prepared in accordance with the guidelines on the format and content of stability and convergence programmes of the EU Member States. Due to the embargo on data concerning the general government balance in 2012 the *Programme* was submitted for interdepartmental consultation on April 22 this year, i.e. on the day of the publication of the data by Eurostat and the Central Statistical Office.

The current *Programme* update was prepared simultaneously with this year's edition of *the National Reform Programme* (NRP), which contains, *inter alia*, an overview of structural reforms aimed at Poland meeting the objectives of the *Europe2020* strategy and implementing the Council recommendations formulated on the basis of the NRP analysis of 2012.[1] Both the *Programme* and the NRP will be submitted to the European Commission and the Council in April, within the framework of the European Semester. The Council recommendations issued on the basis of the assessment of the two programmes should be taken into account before taking key decisions on the next year's budget.

As in 2012, the Council Opinion on this *Programme* as well as Council recommendations on the NRP 2012 will be discussed by the Polish Parliament.

I. Overall policy framework and objectives

I.1. Fiscal policy in the EU context

1) Excessive deficit procedure

In 2009 the Ecofin Council (i.e. Economic and Finance Ministers of the EU Member States) established the existence of an excessive deficit in Poland, and recommended that this be eliminated not later than in 2012, among others by a reduction of the structural deficit (the so-called fiscal effort) by at least 1¼ percentage points of GDP on average between 2010 and 2012. In the *Convergence Programme 2012 Update* the government maintained its commitment to duly correct the excessive deficit.

Assessment of the fiscal effort is made by the European Commission which uses its own calculations, and publication of this assessment is expected at the end of May this year. According to the latest Commission forecast from February 2013, the structural deficit - i.e. the part of the nominal deficit which is directly affected by the government through implemented actions - decreased from 7.9% of GDP in 2009 to 2.9% of GDP in 2012, thus exceeding the pace recommended by the Ecofin Council.

The present very conservative estimate of the structural deficit (cf. chapter III.5), prepared by the Ministry of Finance in accordance with the European Commission's methodology, indicates that it reached approx. 3.4% of GDP in 2012. This means that even under this conservative estimate the recommended fiscal effort has been overachieved. Moreover, not only does the government debt remain below the reference value of 60% of GDP, but in 2012 – for the first time since 2007 – its ratio to GDP was lower than in the previous year (cf. chapter III.6).

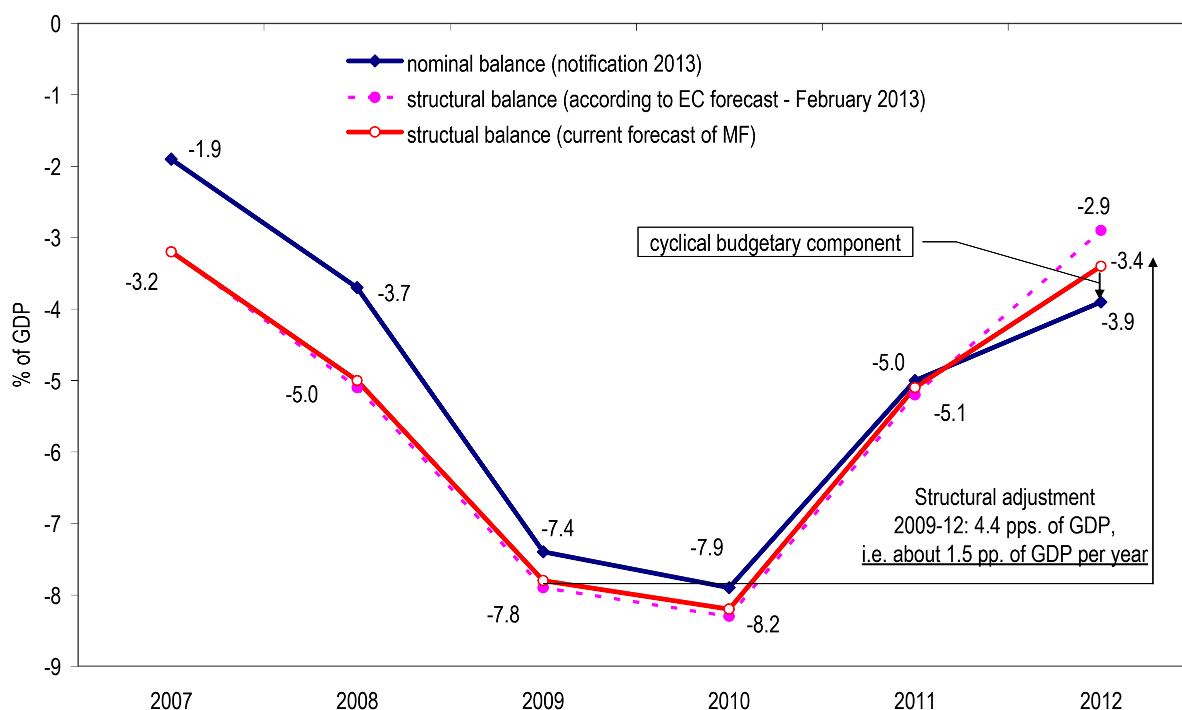
Nonetheless, the marked deterioration of the economic situation in Poland's external environment has translated into a slowdown in domestic economic activity. This has triggered a significant change of macroeconomic conditions in comparison with those assumed in the 2012 *Programme* update, and to a still greater extent in comparison with those assumed in the Ecofin Council recommendations for Poland of 2009. The economic slowdown fully manifested itself in a drop of tax revenue growth (triggered by automatic economic stabilizers). In spite of the fact that in 2012 the structural deficit (according to the Ministry of Finance estimate) decreased by

[1]Council Recommendation of 10 July 2012 on the National Reform Programme 2012 of Poland and delivering a Council Opinion on the Convergence Programme of Poland, 2012-15, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:219:0065:0068:EN:PDF

at least 1.7 percentage points of GDP vs. 2011 (or by 2.2 percentage points of GDP – according to the Commission estimate), this was not enough to achieve the 2012 nominal deficit target of 2.9% of GDP.

The pronounced economic slowdown led to a deterioration of the cyclical component of the general government balance (which is independent of the government's economic policy) by approx. 0.6 percentage points of GDP vs. 2011. Thus, although the nominal deficit decreased in 2012 by 1.1 percentage points of GDP in comparison with 2011, and reached 3.9%, that level means the excessive deficit procedure cannot be abrogated in 2013. Had it not been for the cyclical component of the general government balance, the structural adjustment implemented by the government in 2012 would have been sufficient to bring the nominal deficit below the level enabling the abrogation of the said procedure.

Chart 1. Structural and nominal general government deficit between 2007-2012



Source: European Commission, *European Economic Forecast. Winter 2013*, February 2013; Ministry of Finance

The general government deficit, however, is under control. It follows from the information included in this update (cf. chapter III.2) that the nominal deficit in subsequent years will continue on a downward trend. The forecasts published by the European Commission in February this year[2] also confirm the continuation of fiscal consolidation in Poland.

2) Coordination of economic policies

As in the previous year, the European Commission considered a growth-friendly fiscal consolidation one of the priorities for the EU Member States' economic policies.[3] In its periodic report, the *Annual Growth Survey*,[4] the European Commission emphasises that the scope and pace of the consolidation (as many as 20 countries are currently under the excessive deficit procedure) need to reflect the differentiated fiscal and economic positions of individual countries. In line with the EU's *Stability and Growth Pact*, the strategies aimed at stabilising public

[2]http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee1_en.pdf
[3] Cf. the European Council conclusions of 14-15 March 2013 at:
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/PL/ec/136156.pdf (in Polish)
[4]*Annual Growth Survey 2013*, November 2012, available at: http://ec.europa.eu/europe2020/pdf/ags2013_en.pdf

finances should focus on the improvement of the structural balance (cf. the aforementioned fiscal effort recommended by the Council). The progress achieved in structural terms, according to the Commission, is even more important than achieving planned nominal budgetary objectives.

The government remains determined to further reduce the imbalance in public finances in a way that would not pose a threat to the country's medium-term growth perspectives. This will be possible, among others, thanks to actions presented in this *Programme*. Over the next years the fiscal consolidation path will be continued so that the medium-term budgetary objective (in the case of Poland – a structural deficit of 1% of GDP) is achieved in accordance with EU regulations, as early as in the horizon of this *Programme* update.

In 2013 institutional strengthening of public finances will be continued, including the implementation of the *Council directive 2011/85/EU on requirements for budgetary frameworks of the Member States* (cf. chapter VII).

I.2. Integration with the euro area

The introduction of the euro constitutes Poland's strategic objective. The government's positive stand on the benefits of adopting the common currency remains unchanged. According to the government, the main reason for the current euro crisis was the way in which certain Member States implemented economic policy as well as some institutional solutions of the euro area - not the common currency itself. In the face of the aforementioned conditions, the strategy for the integration of Poland with the euro area has been supplemented by an additional, fourth pillar.

The first pillar concerns targeting sustainable fulfillment of the convergence criteria in the Polish economic policy framework, with particular focus on fiscal discipline. The credible prospect of meeting the Maastricht criteria within two years of inclusion in ERM II as well as the political agreement concerning legislative changes necessary for the common currency introduction are the conditions for joining this mechanism. In 2010, the government specified these conditions in the *Prerequisites for Implementation of the Next Stages of the Roadmap for Euro Adoption in Poland.*

Pillar two constitutes the undertaking of other measures, including institutional measures, aimed at strengthening the potential of the Polish economy. The lack of the aforementioned arrangements to proper functioning under the common monetary and exchange rate policies framework before adopting the euro, could lead to a repetition of the crisis scenario observed in the periphery countries of the euro area.

The third pillar includes early completion and subsequent updating of the *National Euro Changeover Plan*. So far, two key documents have been developed: *Strategic Guidelines for National Euro Changeover Plan* approved by the Council of Ministers in 2010 and the *National Euro Changeover Plan*, approved by the European Affairs Committee in 2011. Due to the significant reform agenda in the euro area, the current objective is to update the *National Euro Changeover Plan* with reference to the impact of those changes on Poland's euro adoption strategy. An updated version of the document is scheduled for as early as 2013.

The fourth pillar includes stabilisation of the situation in the euro area, especially its institutional strengthening, including the development of a crisis management system and crisis prevention mechanisms.

Due to the significant uncertainty about the time horizon in which the requirements for the safe adoption of the common currency will be met, the government at present is not specifying a target date for euro adoption. However, the government regards the continuation of preparations for the introduction of the euro as beneficial to Poland, especially within the scope of pillars one and two of the integration strategy.

I.3. Economic policy objectives

The objectives set in the *Europe 2020* strategy have been pursued harmoniously, taking into account Poland's specific circumstances, development stage and national strategy priorities, which is reflected in the NRP. Poland aims to achieve objectives set by the EU and at the same time strives to increase the competitiveness of its economy, improve institutional efficiency and ensure social and territorial integrity. The objectives of *Europe 2020* are to be pursued through the *National Development Strategy*.

The *Medium-term National Development Strategy 2020*[5], adopted by the Council of Ministers in September last year, defines the main medium-term objective of the government as one that *will strengthen and make use of the economic, social and institutional capabilities in order to ensure rapid and sustainable development of the country, and to improve the quality of life.* The *Strategy* indicates three strategic areas on which the main actions aimed at accelerating development processes should focus: *Effective and efficient State, Competitive economy and Social and territorial cohesion*.

It is also emphasised that the challenge is quite complex – the sustainability of public finances and the increase in savings needs to be accompanied by a development vision based on the elimination of the major growth limitations through education, digitalisation and innovation. The assumptions of the Strategy which concern the consolidation of public finances (carried out in line with subsequent updates of the *Convergence Programme*) mean that the rationalisation of expenditure and it's steering towards actions vital to the socio-economic and spatial development of the country are the precondition for the implementation of this vision.

Sustainable public finances are key for macroeconomic stability and, in consequence, for long-term economic growth. Other key drivers of macro-economic stability in Poland include the planned establishment of the Systemic Risk Board bringing together representatives of financial security bodies (the National Bank of Poland, Ministry of Finance, the Polish Financial Supervision Authority, Bank Guarantee Fund). The tasks of the Board will include, *inter alia*, the detection, evaluation and control of systemic risk, i.e. the risk of disruption in the functioning of the national finance system which may lead to macro-economic imbalance posing a threat to the stability of economic growth. Should any systemic risk be detected, the Board will be obliged to take actions aimed at reducing the probability of its occurrence or at reducing its potential effects. The appropriate document appointing the Board and equipping it with the necessary instruments, the draft *act on macro-prudential supervision of the national finance system*, will soon be subject to external consultation.

Moreover, actions are being taken to improve the security and stability of the whole Polish financial sector, including new solutions regarding bank resolution.

II. Economic outlook

II.1. Cyclical developments and current prospects

At the beginning of 2012 the Polish economy entered the phase of a marked GDP slowdown. However, contrary to some European countries, it managed to avoid the technical recession known as two subsequent quarters of GDP decline. Last year, GDP increased by only 1.9% compared to 4.5% registered the year before. The economic activity slowdown was influenced by two factors: the economic downturn on the main export markets, i.e. the remaining EU countries, and a relatively restrictive macroeconomic policy. The essential process of public finances consolidation was continued, which translated into public consumption stagnation and decreased general government investment. At the same time, the Monetary Policy Council (MPC) implemented a restrictive monetary policy. The MPC's decisions on interest rates allowed for the prolonged period of inflation exceeding the upper limit of the target as well as the risk of inflation remaining at an elevated level, including the persistence of increased inflation expectations.

The improvement of the situation on the EU financial markets resulting from lower anxiety about euro area break-up did not translate into an improvement of economic development in the main Polish export markets. The performance of the EU economy in the second half of the year turned out to be worse than predicted, and throughout 2012 the European economy registered a slight decline in GDP. The weak dynamics of domestic demand stemming mainly from the adjustment of external and internal imbalances, especially the deleveraging process, influenced a decrease in EU import, the main indicator of demand for Polish goods and services (¾ of Polish goods are exported to the EU). Although German import continued to grow, with Poland having the strongest trade links with Germany, the pace of that increase was notably slower.

The Polish economy is not isolated from changes occurring in the external environment and despite its relative immunity it was also afflicted by the downturn on the main export markets, which was reflected in the export

[5] *National Development Strategy 2020 – Active society, competitive economy, efficient state*, adopted by the Council of Ministers on 25.09.2012, available at:
http://www.mrr.gov.pl/rozwoj_regionalny/Polityka_rozwoju/SRK_2020/Documents/SRK_2020_112012_1.pdf

slowdown. This was mainly triggered by stagnation or even a fall in export (of goods) to the main economies of the euro area, i.e. Germany, France and Italy. Far more promising sales were noted in the case of Russia and Ukraine. Export dynamics, however, remained stronger than the activity on the Polish export markets thanks to the high price competitiveness of Polish products triggered by a substantial weakening of the real effective exchange rate of the zloty in the second half of 2011.

Between 2011 and 2012 industrial production achieved its peak and then entered a slight downward trend. Poor results were noted particularly in the divisions related to capital goods manufacturing, which was largely due to the slowdown of investments in means of transport, machines and machinery, installations, tools. The downturn in this category mainly resulted from poor financial results of enterprises, stagnation of investment loans and the gradual downward correction of the Polish economy growth forecast. The obvious slowdown of general government investments after the Euro 2012 championships resulted in a decrease of infrastructure investments. This was reflected in a downward trend of construction and assembly production, which reached its peak, similarly to industrial production, between 2011 and 2012. As far as GDP is concerned, there was only a slowdown of growth, but when it comes to industrial and construction production the decrease in sales has now been observed for a year.

The economic downturn influenced a slight, close to stagnation, increase in labour demand.[6] It was mainly the result of a low growth rate of employment and the first decrease in seven years in the number of employers and the self-employed. At the sector level, these changes were triggered by a decreased number of those employed in the broad-defined industry sector (including industry and construction) as well as the continuation of a downward trend in the number of people employed in agriculture. These could not be compensated by a relatively high increase in the number employed in the service sector. Low labour demand along with the continued growth of both activity rate and population contributed to a higher unemployment level. The unemployment rate rose to 10.1% (compared with 9.7% in the previous year) and was slightly lower than the average unemployment rate in the EU. The employment stagnation was accompanied by a limited wage pressure. Employees' bargaining power in wage negotiations was limited by the ongoing relatively high level of unemployment. So the already slow growth of real household disposable income decreased further.

As a result, private consumption increased by only 0.8% (2.6% was noted the year before), reaching the lowest level since publication of this variable began. Apart from the sluggish growth of household disposable income, this was also spurred by a downward trend of consumption credits as well as a continued low level of consumer confidence.

The continued growth of private sector investment could not compensate for the decrease in general government investment, which limited overall investment in the economy. This factor, along with the slowdown of private consumption and decline in inventories, resulted in a decrease of domestic demand. The main cause of GDP growth was net export, since export growth outpaced that of import.

Although real GDP growth was positive in 2012, it was significantly lower than the potential of the Polish economy would have indicated. The consequence of the lower economic growth was a rapid closing of the output gap, which was still positive in 2011. It is estimated that in 2012 the real GDP fell to a level below its potential (in 2011 it was still slightly higher), which resulted in a negative output gap of approx. 1.5% of potential GDP. This means a significant deterioration of cyclical conditions for economic activities and economic policy in comparison with the years 2009-2011, when the output gap still remained positive.

Despite the decrease in domestic demand and the negative output gap, inflation remained high throughout the greater part of 2012, mostly because of a rapid growth of energy and food prices. The lack of demand pressure was nonetheless reflected in a low core inflation, which has remained below the central bank's inflation target since the spring. Overall inflation only decreased significantly at the end of the year and in December fell slightly below the NBP target, reaching 2.4% (compared with 4.6% in December 2011). However, the average inflation was 3.7% compared with 4.3% the year before.

The structure of GDP growth with the low domestic demand significantly improved the negative current account balance in the balance of payments, which reached 3.5% of GDP compared with 4.9% of GDP in 2011. The reduction of external imbalance was mainly the result of the improvements in the trade balance as a

[6] Information on the labour market was based on the LFS data and applies to the population aged 15 and over.

consequence of the higher growth of export than import. The income deficit, reflecting mainly the income of foreign direct investors, still remained high, although this was accompanied by an increased share of non-residents' income on account of their participation in portfolio investments. The current account deficit was mainly financed by an inflow of long-term capital.

The high inflation observed in the first months of the year, along with the risk of its consolidation significantly above target, prompted the MPC to raise interest rates in May 2012. After this move, rates did not change until November due to inflation running above target despite early signs of economic slowdown, which indicated that inflationary pressure would soon be dampened. In November-December 2012 rates were lowered by 0.5 percentage points in total. As a consequence, the reference rate fell to 4.25% at the end of the year. The MPC decided to commence the monetary policy easing cycle relatively late. As a result, taking into consideration the scale of interest rate reduction at the beginning of the cycle, the *ex post* real interest rates increased.

In 2012, the zloty weakened on average, against the euro by 1.6% and against the US dollar by 9.9%. After a significant strengthening of the zloty noted in the first quarter of 2012, the currency depreciated between April and May. The zloty weakened as increased risk aversion caused by mounting concerns over Grexit and the worries about the situation of the Spanish banking sector, resulted in a shift by investors to safer assets. In the third quarter the appreciation of the zloty commenced again. The strengthening of the Polish currency was facilitated by the improvement of market sentiment after the European Central Bank decided to cut interest rates, together with revived hopes for the bank's effective measures in fighting the euro area crisis. In the closing months of 2012 the zloty exchange rate against the euro traded without any particular trend, and its volatility markedly decreased. The expectations of monetary policy easing by the MPC were the main factor influencing the Polish currency's exchange rate in that period.

II.2. Medium-term scenario

The anticipated course of the economic situation in Poland in subsequent years depends on assumptions concerning the shaping of trends in the European Union, the path and structure of fiscal consolidation in Poland and demographic tendencies, especially with regard to the decline of the working age population and changes in professional activities of the Polish people.

The forecasts for Poland's main trading partner, the EU, are based on a macroeconomic scenario developed by the European Commission in economic forecasts published in February 2013. According to this scenario it is expected that after the poor second part of 2012 the real GDP in the EU will hardly change throughout 2013. The estimated increase will be approx. 0.1%. Despite small overall growth, an important aspect in the context of Poland's economic growth is the anticipated time frame of the development of the economic situation in the EU. The European Commission estimates that the first half of 2013 will be relatively poor but in the second half the quarterly GDP growth rate of our greatest trading partner is to accelerate to 0.4% q/q and gradually reach a growth of approx. 0.5% q/q at the end of 2014. This means a 1.6% growth of GDP in the whole year 2014. This scenario assumes that in subsequent years the growth rate of the EU economy will be similar to the long-term average, reaching 1.8% y/y. According to the European Commission's scenario, the main EU growth factor in 2013 will be external demand. The necessity to reduce macroeconomic imbalances, including the continuation of public and private sector deleveraging, will result in relatively weak internal demand in the EU. Nonetheless, the European Commission expects import growth in the common economic area to accelerate in 2013, reaching 1.5% compared with a 0.1% fall noted in 2012. In subsequent years, internal demand is to become the main driver of EU growth. In this respect, it is forecast that in 2014 the real import growth rate in the EU will increase to 4.6% and to 4.8% in 2015 and 2016 respectively, which implies a significant improvement in demand for Polish exports.

Poland's economic growth scenario described in the following parts of the *Programme* allowed for, *inter alia*, the use of a substantial amount of EU funds within the last few years (Poland is their beneficiary under the current financial perspective), while the country has only just begun to make use of the new financial perspective. The change in the structure of beneficiaries which favours the private sector has also been taken into account. As a result, the share of public investment to GDP will decrease in subsequent years covered by the *Programme*. However, the scale of this fall will be somewhat smaller than in 2012. It is expected that in 2013 the share of public investment to GDP in Poland will decrease to approx. 3.8% in comparison to the extremes of 4.6% in the previous year and 5.7% in 2011.

The role of public investments in the creation of economic growth should be gradually taken over by private investments. This process has been noted from 2011, when the share of market sector gross fixed capital formation to GDP started to increase regularly. In order to maintain the current growth of investment in infrastructure projects, those investments which are directly financed by general government are to be supported through investments made under the *Polish Investments* programme. The programme is based on two pillars: Bank Gospodarstwa Krajowego (BGK) and Polskie Inwestycje Rozwojowe S.A. set up especially for this purpose. The aim of the first pillar is to increase its lending and guarantee operations related to the need for long-term financing of private sector investments in areas of strategic importance for the country. A particularly new tool used by the BGK will be a portfolio guarantee line *de minimis,* which will provide SMEs with easier and cheaper access to finance for current operations in the period of economic downturn. At the same time, the tool will lower credit risk for banks. The task of Polskie Inwestycje Rozwojowe S.A is to invest in special purpose entities, responsible for the preparation and implementation of infrastructure projects.

With regard to the ongoing actions aimed at reducing imbalance in public finances it is expected that within the time frame of the forecast the share of public consumption to GDP will decrease from 17.8% in 2013 to approx. 16.0% in 2016. In the years 2011-2012 this rate fell to 17.9% compared to the record-breaking 18.9% in 2010. Among factors that shape public consumption are the planned reduction of labour costs and expenditures included in the immediate consumption of the general government.

The demographic determinants of this forecast are based on future trends described in the EUROPOP2010 scenario, published by Eurostat in 2011, whose data has been supplemented with information on the actual shaping of chosen demographic categories such as overall population, working age population or employed population, available in the first quarter of 2013, including data from the National Census of Population and Housing 2011. According to the assumed scenario, the overall population in Poland will decrease by approx. 0.2% in relation to 2012 and the population aged 15 and over will decrease by approx. 0.3%. The assumed scenario of the activity rate (using the LFS methodology), allowing for such measures as governmental actions aimed at placing significant limitations on earlier retirement and raising the retirement age, will help to reduce negative demographic effects on the labour market. Within the forecast horizon, i.e. until 2016, the labour supply will increase by approx. 1.1% with regard to 2012, which means that the upward trend in professional activity noted in Poland since 2008 will be maintained.

Taking into account the expected increase of the economically active population, it is forecast that the unemployment rate will rise relatively quickly in the initial years described in this scenario, with GDP growth remaining below its potential. It is estimated that in 2013 the unemployment rate will rise to 10.8% compared to 10.1% noted in the previous year, and by 2014 it will reach 11.0%. This situation results from the fact that the growing labour supply will be faced with a sturdy barrier on the demand side of the labour market. It is forecast that in 2013 the number of the employed will decrease by approx. 0.3% after a 0.2% increase in the previous year. In 2014 the number of the employed will not change in comparison to 2013. Only in subsequent years, as a result of the revival of economic activity in the external environment forecast for 2014 and the improvement in economic conditions in Poland, will allow a faster growth in labour demand. It is predicted that in the years 2015-2016 the number of the employed will rise at a rate of 0.6%. As a consequence, the harmonised unemployment rate will fall to 10.6% in 2015 and 10.3% in 2016, while professional activity still increases.

The increase of remuneration in the economy sector will be limited by the on-going high rate of unemployment accompanied by an increasing supply of labour and planned strict limitations on the growth of the wage fund of the majority of central government sub-sector entities and in the social security sub-sector. The extent of this influence will be particularly visible in a relatively high rate of unemployment. It is estimated that in 2013 the nominal growth pace of average remuneration in the national economy sector will reach 2.8%. In 2014 there will be a slight acceleration to 3.5% which is the rate at which average remuneration rose in 2012. Within the next years, as a consequence of a predicted improvement on the labour market and a lower unemployment rate, it will reach 4.7% and 5.2% respectively.

The relatively low increase of the wage fund this year will be accompanied by a high increase of the retirement and disability pension fund as a result of the current pension adjustment system. As a consequence, the real growth of household disposable income in 2013 will reach 1.6%. Combined with the assumed increase in the rate of household savings resulting from considerable uncertainty as to the future of the economy (the so-called precautionary effect), this will allow real increase in private consumption at a rate of 1.1%. In 2012, private consumption rose by 0.8% in real terms. In subsequent years, due to better conditions on the labour market and

the expected improvement of consumer sentiment resulting from brighter economic prospects, the growth rate of household disposable income and consumption should rise. It is predicted that in 2014 the real increase in private consumption will reach 2.1% and in the years 2015-2016 it will be 3.2% and 3.5% respectively.

The continued competitiveness of Polish product prices helps companies to achieve high return on sales. In 2012 the overall return indicator of non-financed enterprises employing more than 49 workers came to an average of 4.3% compared to 5.3% noted in 2011. It is worth noticing that during the 2001-2002 crisis the indicator was on average below 3.0%. Despite a relatively unfavourable situation in the external environment, since 2011 private investments have undergone revitalisation after a severe deterioration in the years 2009-2010. The share of private investment to GDP grows continuously and in 2012 it reached 14.8% compared with 14.2% noted in 2010. It is forecast that this positive trend will be maintained in subsequent years. Although the real growth rate of private investments in 2013 will be lower than in the previous year (4.4% against 5.3% respectively), in subsequent years covered by the forecast a significant acceleration of this category is expected. An additional factor facilitating the growth of the private sector's investment demand will be the predicted decrease in capital costs resulted from lower interest rates and the establishment of the aforementioned *Polish Investments*. It is estimated that next year the share of private investment to GDP will rise to 16.2% and it will reach 18.6% in 2016.

In 2012, following the reduction of real growth rate of final demand (up to 0.7% against 4.8% growth in 2011) the change in inventories had a relatively high, negative contribution to GDP growth (minus 0.6 percentage points). Over the next years the development of inventories will result from expected changes of demand on domestic and foreign markets. It is estimated that in 2013, the forecast economic downturn will result in a 0.0 percentage points of contribution to GDP growth on the part of change in inventories. In subsequent years of the forecast the economic revival will have a positive effect on the increase of inventories. The contribution to GDP growth on the part of changes in this category will be positive, reaching 0.5-0.4 percentage points respectively.

The real growth rate of exports is predicted to stabilize this year, reaching values similar to those of last year (2.8%). In subsequent years real export growth will be similar to the growth rate of the export markets and will reach 4.3% in 2014 and approx. 5% in the years 2015-2016. The development of final demand will be, next to the exchange rate, the main determinant of the growth of Polish imports. It is expected that in 2013 real import growth will be significantly lower than the forecast export growth, which will allow the maintenance of a positive contribution of net exports to GDP growth. The level of this contribution, however, will be somewhat lower than in the previous year, reaching 0.8 percentage points in comparison with 2.0 percentage points in 2012. Over the next few years, with an acceleration in domestic demand, an acceleration of the real rate of import growth is predicted, reaching higher values than exports. As a consequence, the contribution of net exports to GDP growth will be slightly negative, reaching minus 0.1 percentage points in 2014, minus 0.2 percentage points in 2015 and minus 0.3 percentage points in 2016.

The development of net export is a determinant of the trade balance and a vital factor influencing the current account balance in the balance of payments. In 2013 the current account deficit will fall to 2.7% of GDP in comparison with 3.5% of GDP in 2012. The main reason for the external imbalance will continue to be an income deficit triggered by the negative net international investment position of the Polish economy. Over the next years of the forecast the deficit on the current account in the balance of payments will deepen and it will reach 3.3% in 2014, 3.9% in 2015 and 4,5% in 2016. It is predicted that within the forecast horizon this deficit will be mostly financed by the inflow of long-term capital, i.e. foreign direct investments and amounts classified on the capital account (mainly EU structural funds).

In summary, the forecasts concerning the development of GDP components indicate economic growth in Poland will amount to 1,5% in 2013, which is 0,4 percentage points lower than in 2012. The basic factor responsible for this year's slower growth rate is the stagnation of our main trading partners. Over the next years, along with the economic recovery in the EU, a higher GDP growth rate in Poland can be expected. It is estimated that in 2014 real economic growth will reach 2.5% and in the years 2015-2016 – 3.8% and 4.3% respectively. The expected economic recovery of our main trading partner will allow the continuation of consolidation efforts and weaken the effects of decreased public demand.

Within the forecast horizon, macroeconomic policy will be implemented with a maintained negative output gap. It is estimated that in 2013 the output gap in relation to potential GDP will deepen to minus 3.1% in comparison with

minus 1.5% in 2012. In 2014, the gap will increase even further, to minus 3.7% and from 2015 it will begin to close, reaching minus 3.1% and minus 2.3% in 2015 and 2016 respectively.

By the year 2016, the trend of zloty appreciation will continue. The strengthening of the Polish currency should be supported by the strength of the Polish economy, including a relatively small current account deficit, inflow of foreign investments and a significant decrease in risk premium related to the limiting of the imbalance of public finances. It is assumed that this last factor will have significant influence on the exchange rate. The planned reduction of the nominal general government deficit, allowing for unfavourable cyclical conditions, means a strong positive structural adjustment.

With regard to inflation, it is predicted that after a marked decrease at the end of 2012, a low level will be maintained in the current year. The average annual inflation (measured as CPI) will reach 1.6% this year, as compared to 3.7% the previous year. Over subsequent years, assuming stable prices on the raw material markets and allowing for an on-going high negative output gap and the expected appreciation trend for the zloty, it is predicted that inflationary pressure will be extremely limited. It is assumed, nonetheless, that these factors, along with the continued tightening of fiscal policy, are reflected in the decisions of the MPC on the extent and pace of changes in interest rates. A proper policy mix, one that accounts for the monetary policy decisions of the main central banks of the world, will allow CPI to approach the NBP inflation target. In 2014 the growth rate of prices of consumer goods and services will reach 2.4% and in the years 2015-2016 it will stabilize at a level of 2.5%.

III. General government balance and debt

III.1. Policy strategy and medium-term objectives

Public finance discipline is a key element for macro-economic stability, and therefore the ranking of the country, which is particularly significant in a period of turbulence on the financial markets and the accompanying insecurity and risk of sudden capital flows. Therefore reduction of the excessive deficit while paying attention to sustainable economic growth is the priority for the economic and fiscal policy of the government in the coming years.

In particular, emphasis will be put on undertaking actions, including introducing institutional solutions, which will minimize the risk of permanent imbalance in Poland's public finances. The introduction of a stabilizing expenditure rule will be one of the measures facilitating the achievement of this objective. The introduction of the rule will also allow us to meet the requirements arising from *the directive of the Council 2011/86/EU of 8 November 2011 concerning the requirements for the budgetary frameworks of the Member States*.

III.2. Measures taken to reduce the excessive deficit

Pursuant to the recommendations of the Ecofin Council, Poland should reduce the excessive deficit by 2012, e.g. by reducing the structural deficit (the so-called fiscal effort) by at least 1¼ percentage points of GDP in the period 2010-12. Structural adjustment in the years 2011-12 was much higher and reached 3.1 percentage points of GDP and at least 1.7 percentage points of GDP respectively. However, due to the slowdown of economic growth, reduction of the nominal deficit was lower and reached 2.9 percentage points of GDP in 2011 and a further 1.1 percentage points of GDP in 2012.

Consolidation measures by the government, between 2010 and 2012, led to decreasing expenditures by 2.3 percentage points of GDP. In turn, expenditure after deducting expenditure financed from EU funds whose final beneficiary is the general government unit decreased by 2.9 percentage points of GDP. Such a scale of decrease was made possible through:

- the disciplinary rule introduced in 2011 (Article 112a *of the Public Finance Act*), reducing the increase in discretionary expenditures and new fixed expenditure to 1% annually in real terms,
- reducing (from 2011) the remuneration fund in the state budget units, through adopting a general rule on freezing these at the nominal level from the previous year,
- temporary (while Poland is subject to the excessive deficit procedure) prohibition of adopting draft acts by the Council of Ministers that may result in a decrease of revenues in public finance sector units in relation to the

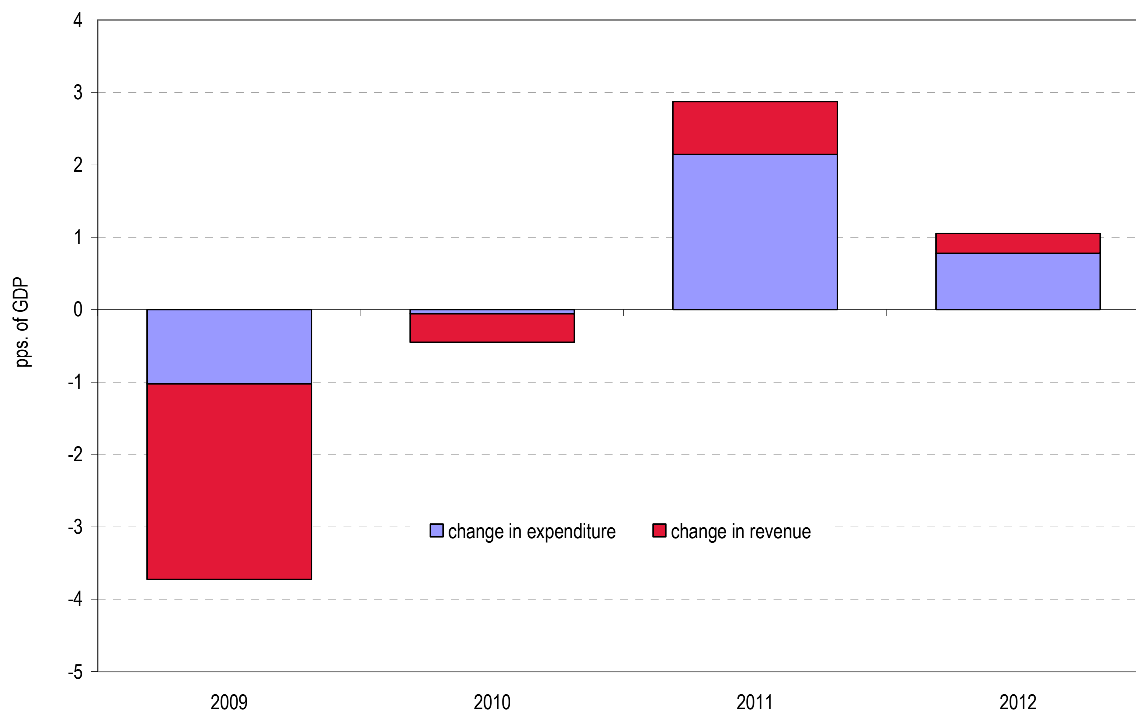
amounts resulting from applicable regulations and projects that would lead to an increase in expenditures (Article 112 c *of the Public Finance Act)*,

- currently binding – modified in 2009 – fiscal rules for local government units:
  - a rule that as a minimum, the current account parts of their budgets must be balanced, arising from Article 242 of the *Public Finance Act* (since 2011);
  - individual limits of debt – stipulated in Article 243 *of the Public Finance Act* (from 2014 – the limit will be calculated based on a three-year moving average, initially for the years 2011-13);
- reducing entitlements to earlier retirement;
- reducing the funerary benefit to PLN 4000 in 2011.

In the years 2010-12, the revenues of the general government increased by a further 1.2 percentage points of GDP (where 0.9 percentage points of this growth is due to revenues from EU funds). The major measures regarding revenues included:

- reduction of the share of the pension contribution transferred to the Open Pension Funds – OFE (the part transferred to OFE was reduced as of May 2011 from 7.3% of the base to 2.3%),
- increasing VAT rates from 22% to 23% and from 7% to 8%, while simultaneously decreasing the rates for basic food products from 7% to 5% (from January 2011),
- increasing the disability contribution, constituting a burden on the employer, by 2 percentage points (from February 2012),
- reduction of the right to deduct VAT on purchasing personal vehicles with certification of approval for goods vehicles, and their fuel (from the beginning of 2011),
- increasing the excise duty for oil and fuel fee (from January 2012),
- increasing the excise duty for cigarettes (annually from 2010),
- removing the excise duty relief for biocomponents (from May 2011),
- freezing PIT rates (at a nominal level from 2009),
- changes in the tax on the profits from bank deposits and reducing options for avoiding this tax (introduced in 2012),
- introducing a fee for using certain natural resources (tax on mining copper and silver from 2012),
- increasing the disability contribution in the part constituting the burden on the employers (an increase by 2 percentage points from February 2012).

Chart 2. The impact of the change in revenue and expenditure on the change in general government balance in relation to GDP



Source: Ministry of Finance

Explanations: grants from EU funds, which are neutral for the general government, are excluded from revenue and expenditure

III.3. Actual balances

In 2012 the fiscal consolidation which commenced in 2011 was continued. After reducing the general government deficit in 2011 by as much as 2.9 percentage points of GDP compared with the previous year, the deficit was further reduced by 1.1 percentage points of GDP in 2012, i.e. to 3.9% of GDP (compared with 5% of GDP in 2011). It is important to note that such strong reduction of the deficit took place, similarly to 2011, mainly on the expenditure side. The ratio of domestic expenditure[7] to GDP remained at a level of 40.8% over the past year, i.e. 0.8 percentage points lower than in 2011. In 2012 it was possible to lower the expenditures in relation to GDP to their lowest level since 2001. This was in part due to the reduction of the state budget expenditures in 2012, which turned out to be significantly lower (by PLN 10.8 billion) than had been predicted in the budget act.

In 2012, the expenditures on public investments fell by 1.1 percentage points of GDP, of which expenditures in the local government sub-sector by 0.6 percentage points of GDP. The decrease in investments observed in local governments was as much as 17.3% year to year. The expenditures of the central sub-sector, mainly infrastructural expenditures realized by the National Road Fund (NRF) under the *Programme for Construction of National Roads for the years 2011-2015*, decreased by 15.7% year to year in the same period.

[7] Expenditures after deducting expenditure financed from EU funds whose final beneficiary is the general government unit. Providing this category is important as, in accordance with the ESA'95 methodology, the influence of EU funds on the deficit is neutral, i.e. the sector's revenues from the EU are shown in the amount of the sector's expenditure financed from EU funds, irrespective of the cash flows. As a result, expenditure financed from EU funds is always neutral for the general government deficit. In 2012 the share of total expenditure in GDP in Poland decreased by 1.1 percentage points, but – as mentioned above – from the point of view of the influence on the general government deficit, it is the change in national expenditure that should be assessed. Similarly, when analysing the influence that the change in revenues has on the sector's balance, revenues from national sources should be taken into account.

Moreover, in 2012 the compensation of employees decreased by 0.1 percentage points and intermediate consumption, i.e. the purchases of goods and services of general government, also decreased by 0.1 percentage points. As a result, public consumption in 2012 nominally grew by only 3.7 % year to year, which was at the level of inflation. The reductions of current expenditures described above were mainly possible as a result of the effects of the temporary expenditure disciplinary rule introduced in 2011, which included the freezing of remunerations in the state budget sector.

An increase in the ratio of revenues from national sources to GDP was only 0.3 percentage points in 2012 (after deducting transfers from the EU), which was caused by the economic situation. The relation of revenues in GDP did not grow within the expected range, despite introducing measures described in the previous *Programme*. Revenues at a level lower than expected for 2012 were mainly caused by lower than expected VAT revenues and lower CIT revenues, which are strongly dependent on economic fluctuations. For VAT, the most important cause for a lower than expected performance was, in addition to slower GDP growth, its structure. The weighted indicator of the VAT tax base[8] in 2012 grew at a slower rate than planned by 2.4 percentage points.

Moreover, with regard to VAT, a high growth was noted (significantly exceeding the growth rate of the tax base) in the VAT tax returns paid into taxpayers bank accounts by the tax office. This is due to the deterioration in the liquidity of enterprises which increased the preferences of taxpayers to obtain a return in the form of direct tax refunds (compared to a return settlement consisting of a reduction in future tax payments). In addition an excessive increase in the VAT tax arrears was noted in 2012. All those mechanisms constitute the elements that form automatic economic stabilizers, whose activity becomes visible in periods of economic slowdown. The effective tax rate falls. These effects, along with the improvements in the overall economic situation expected in the second half of the year, should first decrease, and later increase (compared with the tax base growth) the dynamics of tax revenues. However, it is assumed for the entire year that these effects (negative in the first half of the year and predicted positive in the second half of the year) will be neutral to the growth of indirect tax revenues.

In the case of the other tax revenues, the actual performance was more in line with forecasts, yet the economic slowdown was also visible. In particular, this applied to corporate income tax and personal income tax for sole traders. Lower than expected demand for diesel oil (used mainly by enterprises) was the main reason for lower than previously expected revenues from the excise duty on engine fuels.

III.4. Medium-term budgetary outlook

1) Factors determining the revenues of the general government

The most important source of general government revenue is the revenue from the taxes related to production and import as well as indirect taxes. For this group, the major indicator of the tax base growth is the growth of private consumption, for which a significant acceleration of the growth rate (after 2013) is predicted. In turn, investments and net purchases by general government, which also comprise a part of the tax base, will remain stable after the decreases in 2012-13, and will not have a negative impact on the growth of tax revenues. However, the nominal growth rate of the tax base is predicted at a level much lower than the nominal GDP rate.

The revenues from the aforementioned taxes will be determined not only by the macro-economic situation, but also by the systemic changes. These changes will reinforce the revenues in the budget, contributing to the necessary reduction of the deficit. The actions planned for 2013 are mainly driven by the requirement of adapting national law to EU regulations. These measures include:

- changes in excise duty:
    - increasing the excise duty rate for cigarettes (from the beginning of 2013),
    - including dried tobacco leafs, which was illegally used as a tobacco product not covered by excise duty,
    - including natural gas used for heating purposes from 1 November 2013. This change will not have a major impact on revenues in 2013; its effects will become visible in subsequent years. At the same time,

[8] Sum of private consumption, net purchase, general government investments

in order to reduce the negative impact on the financial situation of the household sector, an extensive catalogue of tax reliefs is planned;

- changes in VAT:
  - increasing the VAT rate from 8% to 23% on folk art goods and folk arts and crafts registered by the Artistic and Ethnographic Commission,
  - changing VAT on non-universal postal services provided by the public operator to 23% from 1 April 2013. This is caused by the requirement to adapt national provisions to the ruling of the Court of Justice of the European Union C-357/07.

Due to the need to limit the imbalance of public finances, which is a necessary condition for macro-economic stability and long-term economic growth, as well as considering the very poor economic situation in the main export markets reducing the growth of the Polish economy, it was necessary to maintain the current VAT rates at the current level in the coming years (originally it was planned to decrease VAT rates by 1 percentage point from 2014).

Among other systemic changes in VAT, the following are planned further in the forecast horizon:

- extending the use of the *reverse charge* mechanism – the catalogue of goods, to which the reverse charge mechanism applies will be extended,
- introduction of the *mini one-stop-shop* system at the beginning of 2015 – this change is caused by the need to implement EU law into the national legal system and will involve changing the place of service provision for telecommunications, broadcast, radio and television services as well as e-services to persons who are not taxpayers,
- changes in the conditions for deducting tax charged when purchasing cars with a mesh partition and their fuel – this is connected to the expiry of the currently binding derogation in applying these restrictions,
- removal from 2014, of the VAT relief which reimburses individuals for certain expenditures connected with construction and renovation.

Introduction of the above mentioned systemic changes will not be sufficient to balance the difference between the nominal GDP growth and the tax base growth (the growth rate of all components of the tax base is lower than GDP growth), which will result, in the period covered by the forecast, in a drop in the ratio of revenues to GDP in the category "taxes on production".

The next biggest position in the revenues of the general government is from social insurance contributions. This category will depend on the shaping of the base for their calculation, the main component being the remuneration fund in the national economy. The nominal growth rate of the remuneration fund, after the estimated low growth in 2013, should accelerate in the coming years, to reach a level of slightly below 6% in the last year of the forecast horizon, still remaining below the nominal growth rate of GDP throughout the entire forecast horizon. The main institutional factor, which will influence the size of social insurance contributions will be the gradual increase of the capital part of the pension contribution transferred to OFE from 2.8% in 2013 to 3.3% in 2015 and 2016 (the target value is 3.5% from 2017 on), which, while maintaining the total value of the pension contribution at the current level, will result in a growth of revenues from the contributions that is slower than the growth of the base used to calculate them.

With regard to personal income tax, it is assumed that the current tax thresholds and the statutory flat income tax rates and the allowances exempt from tax will not be indexed within the entire forecast horizon. It means that the process of increasing the effective burden of the PIT tax (whose beneficiaries are almost equally the state budget and the local government) will continue.

Starting from 2014, the PIT revenues will be positively influenced by the significant reduction of the Internet tax relief. In the case of CIT, it is planned to introduce taxation for limited joint-stock partnerships from 2014 (and for limited partnerships from 2015) and to remove the exemption from CIT for dividend payments and other income (revenues) from inclusion in the profits of legal persons subjected to relief.

In 2013 increased dividends are expected from corporations partially owned by the State Treasury as well as an increase in income from wholly owned State Treasury entities, compared with the amounts that had been

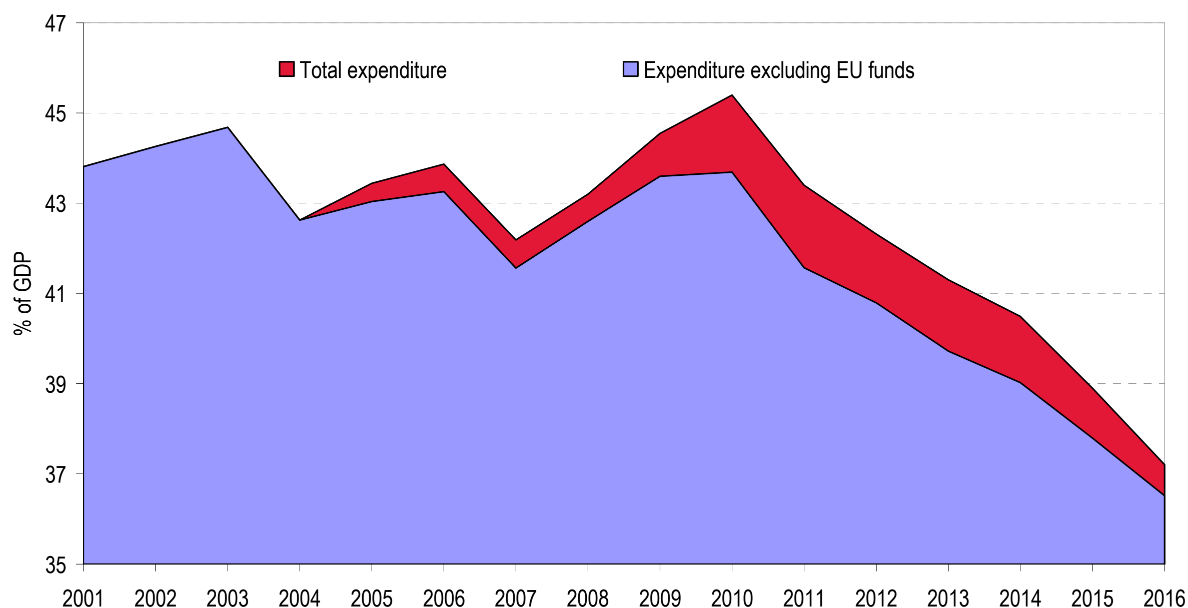
predicted in the budget, which is due to these entities good results in 2012. The revenue level in 2013 will also be influenced by the implementation of an automatic system for road traffic fines, which will be managed by the Centre of Automatic Supervision of Road Traffic, comprising a part of the Main Inspectorate of Road Transport Starting from 2014, an auction system for selling CO_2 emission rights will become a permanent source of general government revenue.

The predicted dividend revenues from the participation of the State Treasury in business entities and from the payment of profits from state enterprises and one-person State Treasury entities will result in decreasing the ratio of ownership revenues to GDP in subsequent years.

2) Factors determining the expenditures of general government

In addition to structural measures which increase revenues, the Government will continue a policy directed at decreasing the expenditure to GDP ratio in 2013. According to the most recent forecasts, the ratio of domestic expenditure to GDP in the general government will remain at a level of 39.7% GDP in 2013, which is 1.1 percentage points lower than in 2012.

Chart 3. General government expenditure



Source: AMECO, Ministry of Finance

Expenditure will be determined by: the mandatory expenditure discipline rule which prohibits the adoption by the Council of Ministers of draft acts which would result in increasing the deficit (pursuant to Article 112a and 112c of the *Public Finance Act* – both solutions were discussed in section III.2); the effect of the nominal freezing of the wage fund in the central and social security sub-sector (except for the remunerations of those employees of state higher education schools, which – pursuant to the arrangements of the Council of Ministers – are to grow at a nominal rate of 9.14% per year, reaching a total of 30% in the years 2013-15).

Despite a significant decrease in expenditures (the expenditures of the budget in total, according to the budget act for 2013 will grow only by 1.9% in nominal terms, compared with the expenditures included in the budget act for 2012), the government still managed to dedicate funds for measures in the pro-family policy area. Changes extend parental leave and increase access to pre-school education. Work is currently ongoing on the draft Act *on*

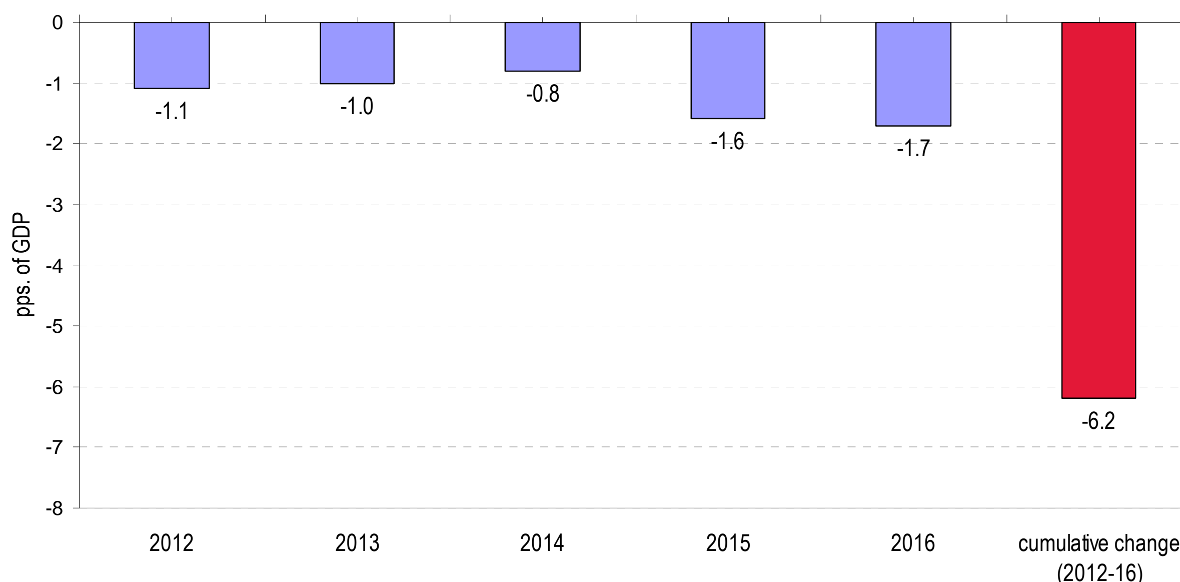
amending the Labour Code and some other acts. The draft Act provides for an increase in the duration of additional maternity leave (as well as additional leave on the same conditions as maternity leave) and introduces parental leave (26 weeks). It is recommended that the total amount of maternity leave, additional maternity leave and parental leave be 52 weeks, for a single birth, and in the case of multiple births from 65 to 71 weeks. Additionally assistance is being introduced for fathers to care for new born babies – new solutions will make it possible for both parents to make better use of maternity and parental leave than was previously possible. Moreover, the effect of the review of the *Act on family benefits and some other acts* that was adopted by the Sejm on 16 November 2012 has been taken into consideration, resulting in an increase in care benefits.

Changes are planned in the education sector, which are intended to increase the availability of pre-school education for children aged 3–5, in kindergartens and other forms of pre-school education and as a result to increase the indicator of availability of pre-school education of children to a level similar to other EU countries.

As a result of these changes, the general government deficit is predicted to remain at a level of 3.5 % GDP in 2013 that is 0.4 percentage point lower than in 2012.

In subsequent years, the main factors influencing the level and the structure of expenditure over the forecast horizon will be systemic changes which have already been introduced as well as those which are planned, changes in public investment expenditures arising from the investment cycle (in particular infrastructural investments), as well as the commitment to maintain expenditure discipline. It is assumed that over the entire forecast period, the growth of the current expenditures will be in line with predicted inflation. These measures are aimed at ensuring a further systematic drop in the ratio of general government expenditures to GDP in the coming years.

Chart 4. Changes in share of general government expenditure in relation to GDP



Source: Ministry of Finance

General government investments reached a maximum level in 2011, amounting to 5.7% of GDP. In 2012 this decreased to 4.6% of GDP and in the coming years the share of GDP will gradually decrease further, however remaining above the EU average over the entire forecast horizon, i.e.2.5% GDP in the years 2001-11. The level of investments in the sector is largely determined by the implementation of long-term programmes. The biggest of those programmes is the *Programme for Construction of National Roads for the years 2011-2015*, encompassing

investment tasks connected with the construction and re-construction of national roads and highways, financed from NRF funds. This programme provides for decreasing the investment expenditures from the NRF in 2013, as a large portion of the EU funds from the current financial perspective has already been used. The funds from the new EU financial perspective for the years 2014-20 will be released gradually. Another significant long-term programme is *the Multi-Annual Programme of Railway Investments to 2013, with the perspective to 2015* encompassing the investment expenditures on the construction and modernisation of railway lines, performed by PKP PLK SA. These investments are financed from the Railway Fund, the state budget and by PKP PLK SA.

The investment level in the sector will also be determined by the assumed reduction of investment expenditures in the local government sub-sector, which need to improve their financial condition, arising from the provisions of Articles 242 and 243 of the *Public Finance Act*. However, if the local government units realize the majority of the required savings in the form of reducing consumption, their investment activity is permitted to be higher. Assuming the above scenario, the share of public investments in GDP should decrease from 4.6% in 2012 to 2.8% in 2016.

Another important factor determining expenditures are the assumptions about the costs of labour in general government. It is assumed that the costs of labour, the nominal remuneration fund in the central sub-sector and social security sub-sector will not change compared with 2013 (except for the remunerations of employees of public higher schools, which – pursuant to the arrangements of the Council of Ministers – are to grow at a nominal rate of 9.14% per year, so that they will rise by 30% in total in the years 2013-15[9], and the remuneration fund in the local government sub-sector will grow at the forecast inflation rate.

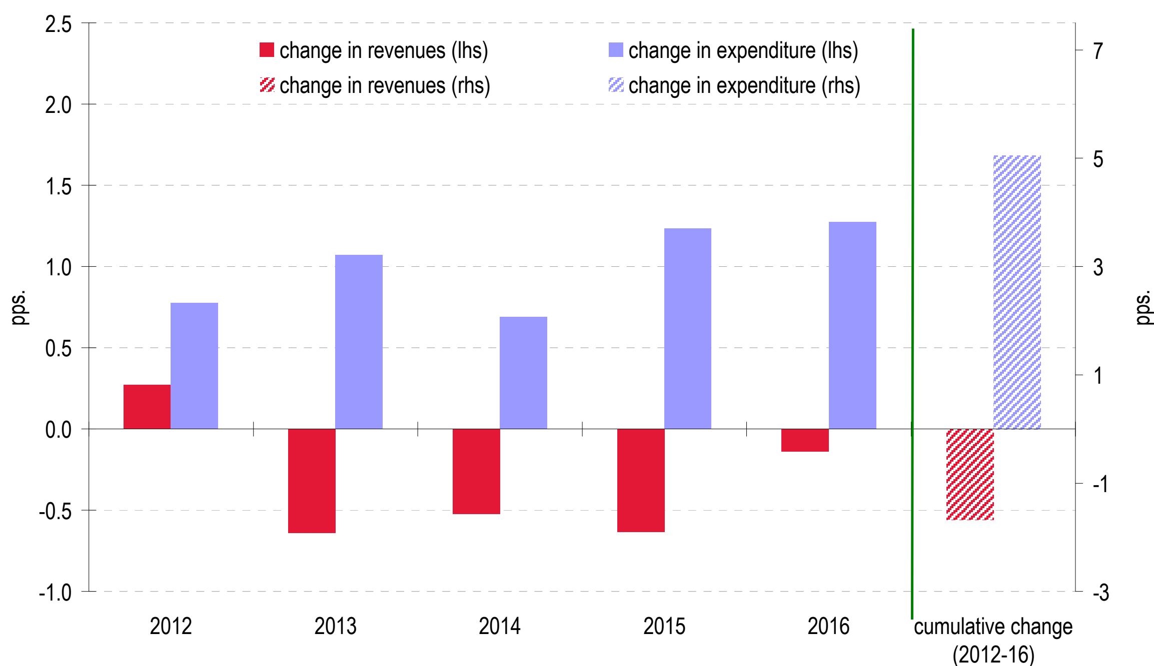
The social security benefits (or social transfers) will be determined by:

- annual indexation of old age pensions and other pensions according to the formula: CPI + 20% of the real growth in remuneration in the national economy,
- extension of maternity leave (and additional leave on the same conditions as maternity leave) and the planned introduction of parental leave.

The decreasing expenditures on the implementation of the *Common Agricultural Policy*, arising from the financing of supplementary area payments from the state budget, will limit the expenditures of the state budget over the course of the forecast horizon. As a result it is predicted that the general government deficit will reach 3.3% GDP in 2014, and in the coming years will be further reduced to 2.7% in 2015 and 1.6% in 2016.

[9] See the resolution of the Minister of Science and Higher Education of 5 October 2011.

Chart 5. The impact of the change in national revenue and expenditure on the general government balance in relation to GDP

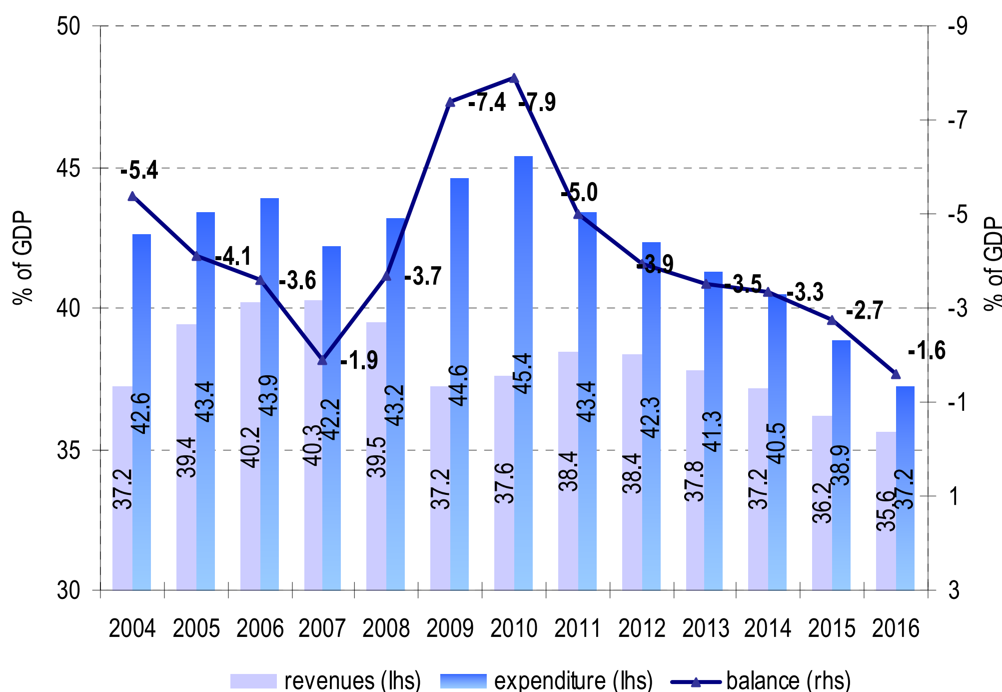


Explanations: revenue – "plus" column means an increase of the share of national revenue to GDP for respective years, "minus" column – the decrease. Expenditure – "plus" column means the reduction of the share of national expenditure to GDP for respective years, "minus" column – the increase.

Source: Ministry of Finance

Reaching the medium-term budgetary objective in 2016 will be largely the result of decreasing expenditures, not of increasing sector revenues in relation to GDP (see chart 5). In reality, in 2013 the share of the national general government expenditure in GDP should, for the first time since the transformation, fall below 40% of GDP. Moreover, over the forecast horizon this share should continue to decrease in each subsequent year (see chart 3/4).

Chart 6. Revenue, expenditure and balance of general government



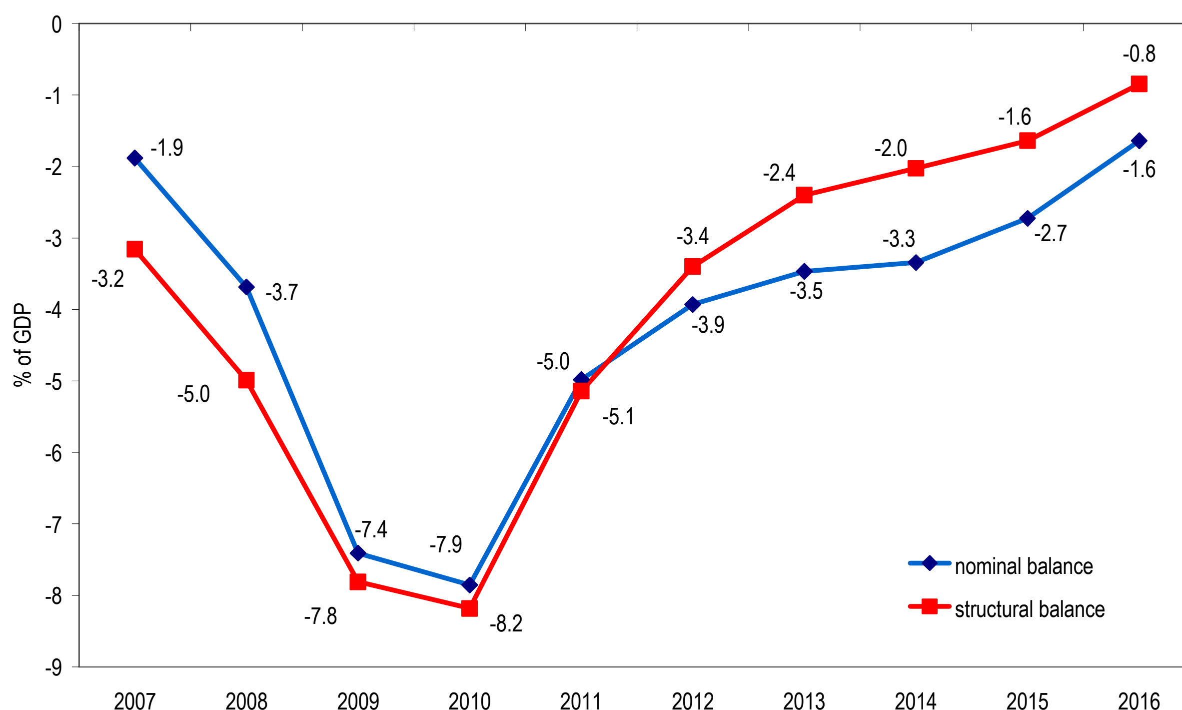
Source: 2004-2011 – Eurostat, 2012-2016 – Ministry of Finance

III.5. Structural balance

In 2009 Poland was subjected to the excessive deficit procedure, as the reference value for the general government had been exceeded in 2008. Simultaneously, the Ecofin Council recommended that Poland should eliminate the excessive deficit by 2012 at the latest, e.g. by reducing the structural deficit by at least 1¼ percentage points of GDP in the period of 2010-12. From the available data and cautious estimates provided by the Ministry of Finance and the European Commission it follows that the reduction of the structural deficit in Poland in the years 2010-12 was higher than that recommended by the Ecofin Council. However, due to the fact that the nominal deficit reached 3.9% of GDP in 2012, the excessive deficit procedure cannot be abrogated in 2013. The unexpected, significant slowing of economic growth resulted in worsening the cyclical part of the general government balance (which is independent of the economic policy of the government) compared to 2011 by about 0.6 percentage points of GDP. Had the macro-economic conditions been better, the structural adjustment achieved by the government in 2012 would be sufficient to bring the general government deficit below the level that would allow for abrogation of the excessive deficit procedure.

It is predicted that the structural deficit will decrease by 1 percentage point of GDP in 2013, while the reduction of the nominal deficit to 3.5% of GDP should allow abrogation of the excessive deficit procedure. According to this scenario, shaping the structural balance from 2014 on will be influenced by Poland's efforts at achieving the medium-term budgetary objective pursuant to the EU regulations.

Chart 7. Structural and nominal general government balance between 2007-2016



Source: Ministry of Finance

Further to the *Stability and Growth Pact*[10] that was amended in 2011, *sufficient progress towards the medium-term budgetary objective shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of expenditure net of discretionary revenue measures*. Poland adopted its medium-term budgetary objective, that is the target structural general government balance at the level of -1% of GDP and is currently on the adjustment path toward that objective.

The annual improvement of the structural balance by 0.5 percentage points of GDP constitutes the minimum rate of adjustment to the medium-term budgetary objective, which is normally required from euro area countries and participants in ERM II. Average forecast improvement of the structural balance in Poland from the critical point in 2010 to the end of the forecast horizon will be much faster and will exceed 1.2 percentage points of GDP annually. Considering the period 2012-16 presented in table 1, the average expected improvement of the structural balance will reach 0.6 percentage points of GDP annually. The only one-off measure undertaken in this period is planned for 2013 in the form of the revenues for the digital dividend amounting to PLN 1.8 billion (about 0.1% of GDP).

It is planned that Poland will achieve its medium-term budgetary objective by 2016. Until this target is achieved, the annual rate of general government expenditures – modified according to the methodology applied by the European Commission[11] – should not exceed the reference rate reduced by a value corresponding to 0.5% GDP. Currently, the reference rate, i.e. 10-year average of the potential real GDP growth, is 3.7-3.8% for Poland, which, considering the correction arising from the need to achieve the medium-term budgetary objective, gives the required lower reference rate of 2.5-2.6%.

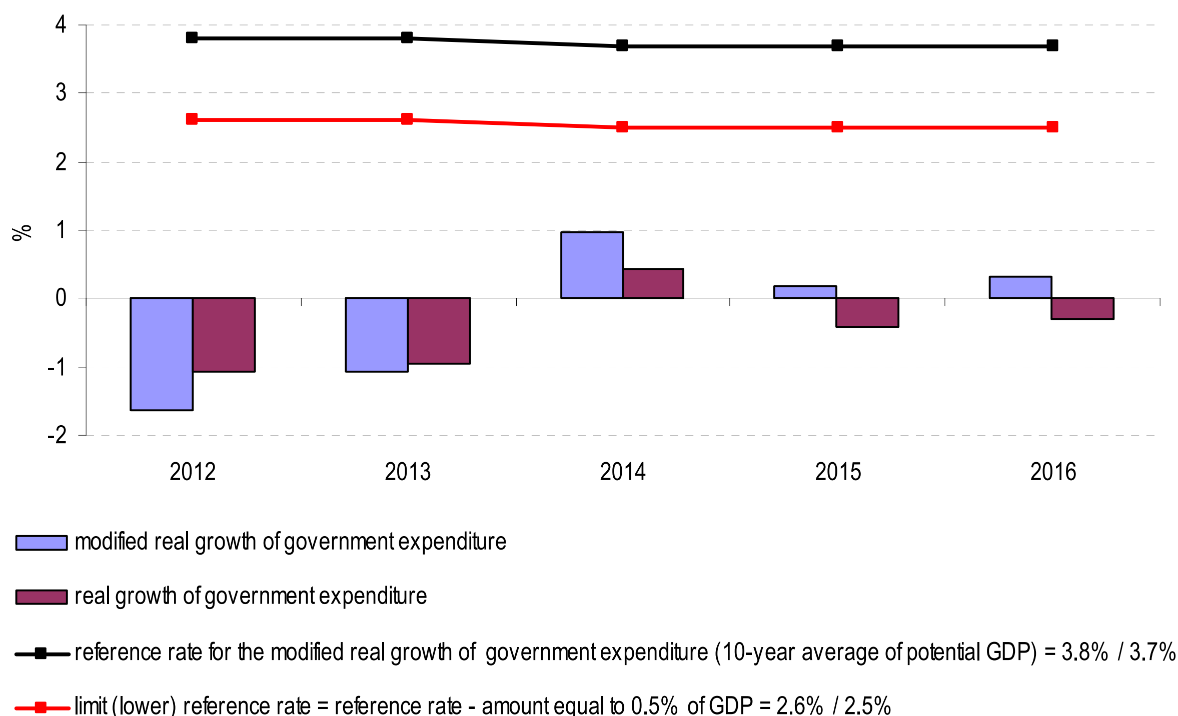
---

[10] See Article 9 point 1 *of the Resolution of the EU Council No. 1466/97/EC on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies* as amended.

[11] That is after deducting the costs of debt operation, expenditure financed from EU funds whose final beneficiary is the general government unit, periodic growth of expenditures for the unemployed as well as after replacing investment expenditures from the given year with an average for the past four years and after deducting net results of the discretionary activities in revenues.

According to forecasts, Poland respects the above requirement regarding the expenditure growth rate. It is expected that the annual real expenditure rate modified according to the methodology of the European Commission will vary within the range (-2%, +1%) in the years 2012-16, which is significantly below the lower reference rate.

Chart 8. General government expenditure modified according to the methodology of the European Commission



Source: Ministry of Finance

Table 1. Cyclical developments

% of GDP	ESA Code	2012	2013	2014	2015	2016
1. Real GDP growth (%)		1,9	1,5	2,5	3,8	4,3
2. Net lending of general government	EDP B.9	-3,9	-3,5	-3,3	-2,7	-1,6
3. Interest expenditure	EDP D.41	2,8	2,7	2,4	2,2	2,1
4. One-off and temporary measures		-	0,1	-	-	-
5. Potential GDP growth (%)		3,9	3,3	3,1	3,2	3,4
6. Output gap		-1,5	-3,1	-3,7	-3,1	-2,3
7. Cyclical budgetary component		-0,5	-1,1	-1,3	-1,1	-0,8
8. Cyclically-adjusted balance (2-7)		-3,4	-2,3	-2,0	-1,6	-0,8
9. Cyclically-adjusted primary balance (8+3)		-0,6	0,3	0,4	0,6	1,3
10. Structural balance (8-4)		-3,4*	-2,4	-2,0	-1,6	-0,8

Source: Ministry of Finance.

* Deficit of 2,9% of GDP was presented by the European Commission in the February forecast.

III.6. Debt levels and developments

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

Debt management will take place in conditions where the general government deficit is gradually limited and of uncertainty in the financial markets caused by the debt crisis in some of the Euro zone countries. In the domestic market, measures aimed at limiting the general government deficit should have a considerable influence on the level and shape of the yield curve, and as a consequence on the State Treasury debt operating costs. The currently historically very low profitability levels on the national and foreign markets caused by the positive assessment of the economic foundations and Poland's credit reliability will have an impact on reducing the costs of debt operations in the coming years.

The changes in the debt to GDP ratio in 2013-2016 will result from, primarily, the state budget borrowing requirements (the State Treasury debt constitutes over 85% of the general government debt), GDP growth and the zloty exchange rate in relation to other currencies, especially to the Euro. An essential factor influencing the borrowing needs of the state budget will be the introduction of the new EU perspective for the years 2014-2020, which will translate into the budget balance of EU funds in the coming years. The revenues from the privatization process as well as the balance of available funds of the public finance sector units in the course of consolidating liquidity management. It is assumed that another consolidation stage will be implemented for managing the liquidity of the public finance sector units, which will contribute to reducing the borrowing needs of the budget.

The decrease of the general government debt to GDP in 2012 was significantly influenced by: the drop in the ratio of the State Treasury debt, caused by low borrowing needs (the factors decreasing borrowing needs were revenues from the privatization process and the depositing of available funds by the indicated public finance sector units at the central level to the account of the Minister of Finance) and exchange rate differences, caused by the strengthening of the Polish currency in relation to other currencies in which foreign debt is denominated. After a dynamic increase of local government sub-sector debt in the years 2009-2011, the slowdown of this increase took place, caused by introduction of new fiscal rules for the local government units.

Changes in the debt of the other entities in general government will be mostly due to changes in the indebtedness of the NRF (the debt increase will be connected with incurring obligations to realize road investments within the new EU perspective) and the predicted gradual debt reduction for local government units.

In the update horizon, the ratio of debt to GDP according to EU methodology will be at the level of 54.5%.

Table 2. General government debt developments

% of GDP	ESA Code	2012	2013	2014	2015	2016
1. Gross debt		55,6	55,8	55,7	55,6	54,5
2. Change in gross debt ratio		-0,6	0,2	-0,1	-0,2	-1,0
Contributions to changes in gross debt						
3. Primary balance		1,1	0,8	0,9	0,5	-0,5
4. Interest expenditure	EDP D.41	2,8	2,7	2,4	2,2	2,1
5. Stock-flow adjustment		-4,6	-3,3	-3,4	-2,9	-2,7
of which: difference between cash and accruals		0,2	0,3	0,1	0,1	0,1
net accumulation of financial assets*		-0,6	-1,6	-0,3	0,8	1,1
of which: privatisation proceeds		-0,2	-0,1	-0,1	-0,1	0,0
valuation effects and other		-4,1	-1,9	-3,2	-3,9	-3,9

% of GDP	ESA Code	2012	2013	2014	2015	2016
p.m.: Implicit interest rate on debt (%)		5,3	4,9	4,6	4,3	4,1
Other relevant variables						
6. Liquid financial assets		3,0	1,8	1,7	1,6	1,6
7. Net financial debt (=1-6)		52,6	54,0	54,0	54,0	53,0
8. Debt amortisation (existing bonds) from the end of the previous year [1)]		8,7	5,8	5,4	5,6	4,4
9. Percentage of debt denominated in foreign currency (%)		30,4	29,7	29,8	28,9	27,7
10. Average maturity [2)]		5,5	5,3-5,5	5,3-5,6	5,3-5,7	5,3-5,8

1) In the case of public finance units' debt other than the State Treasury – estimate based on available reports.

2) Interval forecast for State Treasury debt.

Source: Ministry of Finance.

IV. Sensitivity analysis and comparison with previous update

IV.1. Risk factors

1) Economic situation of Poland's major trade partners

The development of economic activity in Poland's major trade partners is a basic risk factor for the macroeconomic forecast presented in Section II. The forecast was prepared based on up-to-date data concerning the current and projected situation in the EU. The debt crisis in some of the euro area countries and the situation in the major non-European economies may still have a significant impact on the situation dynamics, and present a basic risk to the forecast of economic growth in Poland. As a result, the main risk factor to economic development in Poland stems from the situation in the external environment, which in turn depends to a large extent on the effectiveness of measures taken by European institutions as well as the governments of the euro area countries, aimed at containing the crisis and ensuring a stable basis for economic recovery.

2) Implementation of the EU requirements concerning CO_2 emission reduction

Both quantitative and qualitative analyses assessing the effects of implementing the climate and energy package in Poland indicate that this carries the risk of a range of negative effects in the areas of energy, economic and social policy. Challenges for the Polish economy related to the implementation of EU climate and energy policy objectives result from the dependency of the Polish energy sector on fossil fuels – over 90% of electricity in Poland comes from brown and black coal-fired power plants. Fulfillment of these objectives will require significant investments in those sectors of the economy which have high levels of CO2 emissions. Furthermore, due to an increase in electricity prices, a slowdown in the rate of economic growth may be expected, as well as a lowering of the state budget income, with an increase in unemployment, lower household disposable income and an increase in the cost of energy as a proportion of household budgets.

Polish enterprises are characterised by low energy efficiency compared to the leaders in the EU. As a consequence, domestic enterprises operating in sectors having significant levels of energy consumption per production unit face the risk of a significant increase in operating costs and a loss of international competitiveness. Moreover, domestic entities are exposed to the risk of carbon leakage (transferring energy-intensive and high-emission production from the EU Member States implementing CO2 emission reduction policy to countries with lower environmental standards).

3) Lower absorption of EU funds and other risk factors

The risk of under-spending of funds from the Polish allocation of structural funds and the Cohesion Fund as well as from the Rural Development Programme (RDP) results from the economic situation in the EU , which has led

in recent years to the adoption of the EU's annual budgets at a level which is inadequate for the implementation of the cohesion policy and the RDP in Poland, as well as in other countries which are beneficiaries of EU funds (accumulation and prolongation of pre-financing expenditure from the budgets of general government).The necessity of ensuring the availability of public funds for national co- and pre-financing of projects is another source of this risk. The reimbursement of pre-financing takes increasingly longer (applications lodged in December 2012 will be refunded only in May/June of this year).

Moreover, attention should be paid to the risk associated with the ongoing negotiations for the EU multiannual financial perspective (2014-2020). Prolonged negotiations between the European Council and the European Parliament can lead to delays in the preparation of policy and operational documents necessary for using the new funds. The result of negotiations between the European Council and the European Parliament on the eligibility of VAT in the projects related to cohesion policy and rural development for the multiannual financial perspective for 2014-20 (agreed at the meeting of the European Council on 8 February this year) remains uncertain. Changing the decisions of the European Council would result in additional significant costs both for the state and local budgets.

4) Sureties, guarantees and other operations

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

The value of new sureties and guarantees granted by the State Treasury in a given year is limited by the budget act. The 2013 limit in the budget act was determined at PLN 300 billion and, apart from supporting the above projects, may also be allocated to measures which may have to be undertaken should the global financial and economic crisis cause a worsening in the functioning of the Polish financial system.

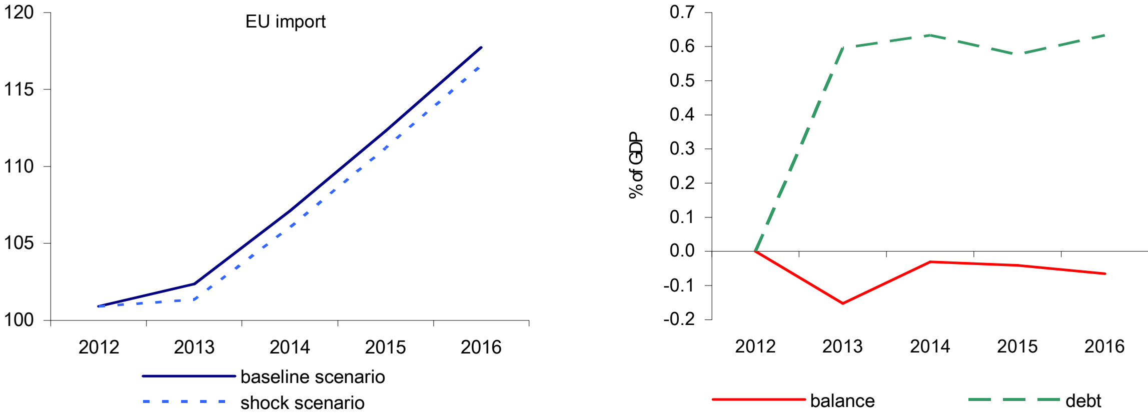
As of the end of 2012, the sum of potential obligations by the State Treasury for sureties and guarantees already granted amounted to ca. 6.1% of GDP. For the years 2013-2014, a further growth of this sum is predicted, but it is not expected to exceed 9% of GDP. According to forecasts the risk associated with the sureties and guarantees portfolio should be in the range of 5-10%.

An operation with risk of additional cost for the public finances is the potential launch of the guarantee granted for the liabilities of Autostrada Wielkopolska S.A. once the EIB requests the Minister of Finance to act as the Guarantor, which may result in an increase in the deficit and debt by the amount of the liability taken over.

IV.2. Sensitivity analysis

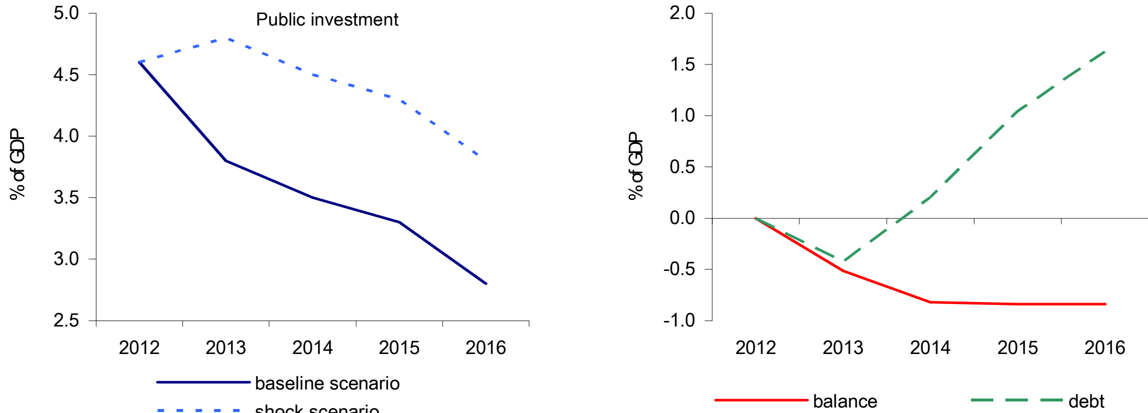
The sensitivity of the general government balance and debt in the years 2013-2016 to a decrease in global demand, increase in public investments, depreciation of the exchange rate of the zloty and the increase in the domestic interest rate is presented below. The analysis was made on the basis of the econometric Model of Public Finance (eMPF) developed by the Ministry of Finance. The simulations were performed for the years 2013-2016 when the economy is not in a steady state. Due to the eMPF model specification, the analysis assumes that the change in interest rates translates fully and immediately into changes in the cost of public debt service. In fact, debt service costs are fixed for a certain period of time, so the impact on the balance and debt of general government should be lessened. Therefore this is an extremely cautious approach to the sensitivity scenario.

Chart 9. EU import (left chart) and the impact of a change in global demand on general government balance and gross debt (right chart)



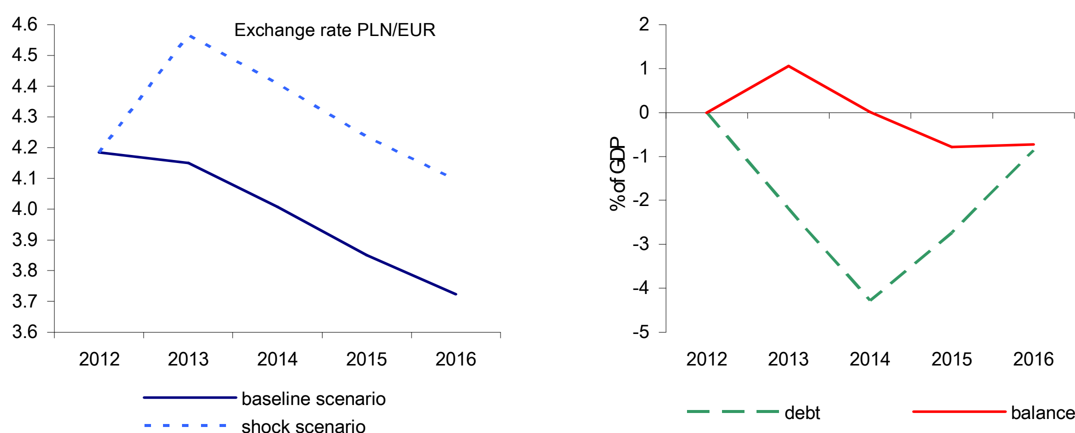
The impulse of the slowdown in global demand has been defined as a permanent 1% decrease in the global demand indicator (EU imports in the model) as compared to the baseline scenario. A direct effect of disturbances in the external environment for the national economy is a reduction in foreign trade. In the first year from the occurrence of the shock, the volume of exports declines by 0.5% against the baseline scenario, and in subsequent years it remains lower by 0.3-0.4%. Due to the high import intensity of exports, the decrease in the export volume is accompanied by a decline in imports (by 0.4-0.5%), additionally supported by depreciation of the national currency which is the result of worsening sentiments in the world economy. The decrease in global demand translates into a limiting of enterprise investment activity (gross fixed capital formation of the private sector in the first two years after the shock remains lower by approx. 0.7% compared to the baseline scenario, and in the following years they remain at the level of 0.2-0.3% below the base path), reducing employment and remuneration. Household disposable income goes down, which limits private consumption by 0.1-0.2%. As a result of these disruptions, GDP remains persistently lower by 0.1-0.2% as compared to the non-shock scenario. A restriction of domestic demand is accompanied by the lowering of inflationary pressure and a decrease in interest rates. Lower economic growth negatively affects the condition of public finances. The general government deficit increases (in the first year by 0.2% of GDP, and in subsequent years by a little less), as a result of which in 2016 the level of general government debt in the shock scenario is 0.6% of GDP higher than in the baseline scenario.

Chart 10. Volume of public investment (left chart) and its impact on general government balance and gross debt (right chart)



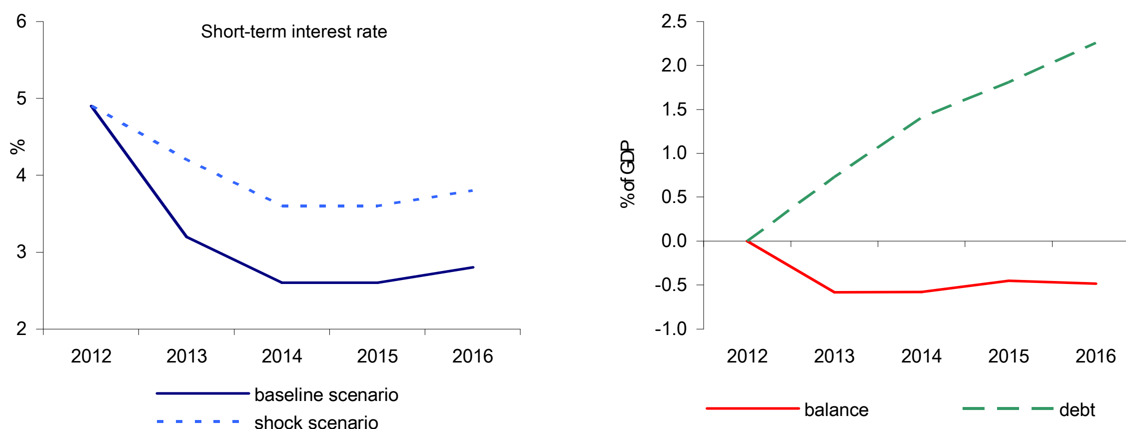
The fiscal impulse has been defined as a sustained increase in general government investments by 1% of GDP as compared to the baseline scenario. The direct effect of an increase in public expenditures is an increase in the deficit, which during the analysed period remains at a level of 0.5-0.8% of GDP above the base path. Higher public expenditures also imply an increase in private demand (household consumption increases by 0.1-0.4%, and private investments by 0.8-2.2%), which results in an improvement of the condition of the labour market, an increase in inflationary pressure and interest rates as well as worsening of the foreign trade balance. As a result of the introduced disruption, GDP increases by 0.1-0.2% as compared to the base path. Higher economic growth neutralises the negative effects of the increase in public expenditures at the beginning of the simulation period. In subsequent years, amid a sustained worsening of the general government balance, the effects become increasingly more visible and by 2016 the level of general government debt is 1.6% of GDP higher than in the no expenditure increase scenario.

Chart 11. PLN/EUR exchange rate (left chart) and its impact on general government balance and gross debt (right chart)



The exchange rate impulse has been introduced as a sustained 10% depreciation of the PLN/EUR exchange rate. The weakening of the zloty improves the competitiveness of domestic products, which results in an increase in exports of approx. 2.9% in the first year and 0.3-1.2% in subsequent years after the shock. Due to the high import intensity of exports, at the beginning of the simulation period there is also an increase of imports in comparison to the baseline scenario path (slower in the first year, while in the second one faster than exports increase). However, in the following years, a negative exchange rate effect starts to dominate and the import volume falls below the base path. An increase in demand for Polish goods also influences the improvement of labour market conditions and an acceleration of investment activity. As a result, in the first two years from the occurrence of the shock, GDP remains 1.3-1.9% higher than in the stronger exchange rate scenario. Along with the increase in import prices, leading to accelerated growth of the general price level and rising interest rates, the positive effects of the Polish currency depreciation will gradually fade in subsequent years. The higher economic growth facilitates the increase in general government revenue, which exceeds the growth of expenditures associated with the servicing of debt denominated in foreign currencies, and in the first year after the shock the balance improves. In subsequent years, the significance of negative factors increases, but in 2016 public debt still remains lower than in the baseline scenario (by 0.9 percentage point of GDP).

Chart 12. Short-term interest rate (left chart) and its impact on general government balance and gross debt (right chart)



The interest rate impulse has been defined as an increase in the nominal short-term interest rate of 1 percentage point for the entire period covered by the analysis. A rise in short-term interest rates results in an increase in long-term interest rates and consequently leads to a higher cost of obtaining capital and therefore lower investment (with permanently higher interest rates, private investments in 2016 are almost 5% lower than in the baseline scenario) and higher debt financing costs. Due to a shift in consumption over time due to inter-temporal substitution and as a result of tightened conditions for obtaining loans, private consumption is also slightly lower. As a result, the monetary impulse leads to a decrease in GDP volume of 0.1-0.4% in the forecast horizon. The general government balance remains permanently lower by 0.5-0.6% of GDP and the general government debt in 2016 is 2.3% of GDP higher than in the baseline scenario.

IV.3. Comparison with previous update

Compared with the previous *Convergence programme update*, the predicted path of real GDP growth in the years 2013-14 has been lowered. GDP growth in 2012 also proved to be lower than expected. This was due primarily to the deterioration in the external economic environment, greater than predicted adjustments in public sector investments and a worse-than-expected income situation of households, which was reflected in a reduction in consumption demand of the private sector, which was greater than projected.

Slower-than-expected economic growth has contributed to a significant deterioration in cyclical conditions in which the macroeconomic policy is implemented. According to the estimates from the Ministry of Finance, the output gap relative to potential GDP achieved in 2012 was minus 1.5% compared with plus 0.4% in 2011. The scale of the deterioration of the economic cycle was significantly higher than expected in the spring of 2012, at the stage of preparation of the previous Programme update. Due to changes in the methodology for estimating the output gap by the Ministry of Finance, European Commission forecasts were used for the purposes of this comparison. According to estimates by the European Commission in the spring of 2012, the output gap in 2012 relative to potential GDP was to be minus 0.9% as compared to minus 0.2% in 2011. In February 2013, the Commission presented estimates according to which the output gap relative to potential GDP in 2012 was minus 1.3% compared to plus 0.5% in 2011. According to the forecast presented in this *Programme* update, in the period to 2016 the output gap will remain negative on a scale well above 2% of potential GDP.

The fiscal adjustment path has deteriorated compared to the last *Programme* update. The nominal general government deficit in 2012 proved to be 1 percentage point higher than expected. A higher nominal deficit in 2012 than that predicted in the previous *Programme* has led to a revision of the forecast for the general government balance in the coming years. The worsening of the fiscal adjustment relative to the previously presented path results primarily from lower general government revenue projections, determined by the relatively less favourable economic situation in the country and in the external environment. Nevertheless, it can be estimated that the annual average fiscal effort in Poland in the years 2010-12, adjusted for factors beyond the control of the

government, exceeded the minimum 1¼ percentage points recommended by the Ecofin Council. The continuation of the consolidation measures introduced in the years 2011-2012, despite the deterioration in the macroeconomic environment, and as a result the decelerating pace of fiscal adjustment, as well as the introduction of new measures in the coming years will enable the continuation of a fiscal policy aimed at reducing the deficit at least until the medium term objective (MTO) is met.

The difference in the general government debt-to-GDP in 2012 compared to the forecast in the previous *Programme* update is primarily due to the higher borrowing needs of the State budget, significant pre-financing of borrowing needs in 2013, and slower nominal GDP growth in comparison to the previous update. Differences in the subsequent years result *inter alia* from the higher-than-anticipated borrowing needs of the State budget and the current forecast for nominal GDP growth which is slower compared to the previous *Programme*.

Table 3. Divergence from previous update

	Kod ESA	2012	2013	2014	2015	2016
Real GDP growth (%)						
2012 update		2,5	2,9	3,2	3,8	-
Current update		**1,9**	**1,5**	**2,5**	**3,8**	**4,3**
Difference		-0,6	-1,4	-0,7	0,0	-
General government balance (% of GDP)	EDP B.9					
2012 update		-2,9	-2,2	-1,6	-0,9	-
Current update		**-3,9**	**-3,5**	**-3,3**	**-2,7**	**-1,6**
Difference		-1,0	-1,3	-1,7	-1,8	-
General government gross debt (% of GDP)						
2012 update		53,7	52,5	50,6	49,7	-
Current update		**55,6**	**55,8**	**55,7**	**55,6**	**54,5**
Difference		1,9	3,3	5,2	5,8	-

Source*:* Ministry of Finance, Central Statistical Office.

V. Long-term sustainability of public finances

V.1. Policy strategy

Sustainable public finances support long-term economic growth and are a crucial element of macroeconomic stability. A high deficit in the public finance sector, through its negative influence on domestic savings, escalates the country risk premium, thus increasing the cost of capital and the cost of debt servicing, hampers capital accumulation and results in slower potential GDP growth.

Consolidation efforts made to date and the strong fundamentals of the Polish economy have resulted in an improved market reliability assessment, as evidenced by the fall in interest rates on Polish bonds to their lowest levels in recent history.

Ensuring the continued optimum pace of fiscal consolidation, while fostering sustainable economic growth, is particularly important in the face of the deepening debt crisis in some euro area countries. Therefore, the improvement of public finances accomplished through a consistent strengthening of fiscal discipline, remains one of the main objectives of the fiscal and economic policies pursued by the government.

A particularly important role will be played by measures, including the establishment of institutional arrangements that after elimination of the excessive deficit, and then reducing the deficit to the MTO level will minimise the risk of the recurrence of imbalances in Poland's public finances. An important tool for achieving this will be the introduction of an expenditure rule which will stabilise the general government balance.

V.2. Long-term budgetary prospects, including the implications of an ageing population

The projections for the long-term sustainability of public finances presented in table 4 have been prepared by the Economic Policy Committee (EPC) Working Group on Ageing Populations and Sustainability (AWG).The AWG results were published in 2012 in a European Commission report on the effects of ageing by the year 2060 (*The 2012 Ageing Report*). The forecasts for Poland contained in this report were later updated to include the effects of three important reforms carried out in 2012 which will contribute to the strengthening of the sustainability of public finances in Poland.

These projections were based on demographic assumptions prepared by Eurostat in 2011, the extrapolation of historic trends and technical assumptions on the convergence of basic economic growth factors, such as labour, capital and labour productivity. The macroeconomic assumptions were updated to take into account the effects of reforms to the pension system. The calculations take into account the legal situation and include the effects of the reforms which are most significant to the sustainability of public finances, namely the reforms to the pension system which were introduced on 1 January 1999. The main component of the reform of the general pension system was the replacement of the defined benefit system by a defined contribution system, which led to a reduction of the risk of long-term insolvency of the pension system by adapting it to demographic and socio-economic changes.

The new projection primarily includes the effects of increasing and equalising the retirement age for women (currently 60 years) and men (currently 65 years) to 67 years. These changes have been implemented from 2013 - the target retirement age will be reached by men in 2020 and women in 2040. The reform applies to both the public and the agricultural system, as well as to judges and prosecutors. Secondly, the projection takes into account increasing the contribution to disability insurance by 2 percentage points in part financed by the contribution payer (from 4.5% to 6.5%) with effect from 1 February 2012, to improve the balance of the disability fund as a part of the Social Insurance Fund. Another significant change in the social security system was reducing pension benefits for the uniformed services. In particular, starting from 2013, those entering the services will acquire pension rights after 25, instead of the current 15 years of employment; they will also be required to reach 55 years of age.

The package of pension reforms has resulted not only in a reduction of public expenditure, but also in an increase in the amount of future pension benefits and improves the balance of the universal pension system. Increasing the statutory retirement age has a positive effect on labour supply which translates into faster economic growth.

The European Commission's estimates indicate that the retirement age reform in Poland will result in an increased level of GDP in 2060 by approx. 6.5% compared to the baseline scenario (i.e. without these changes).These estimates are consistent with the effects anticipated by the government in the implementation phase of the reform and those presented in the regulatory impact assessment for the act increasing the retirement age.

It should also be remembered that in May 2011, an act amending the separation of pension contributions between the pay-as-you-go and the funded scheme came into force. The coming into force of the Act reduced the costs of the pension reform, without a deterioration of the long-term sustainability of public finances, while maintaining the neutrality of solutions adopted for pensions from the mandatory capital part of the pension system. As a result and effective from 2013 the contribution to OFE amounts to 2.8% of the basis for assessment and is intended to ultimately increase to 3.5% from 2017, whereas the remaining part of the contribution, i.e. 4.5% of the basis for assessment, is recorded in a subaccount maintained by the Social Insurance Institution (ZUS) within the account of the insured and this is due to ultimately decrease to 3.8% from 2017. In 2013, the government will review the pension system, and based on the resulting diagnosis will take any further decisions regarding the rationalisation of the pension system (in particular, this may affect the operating costs of the second pillar of the pension system).

Table 4. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure							
Of which **age-related expenditure**	19,9	21,3	19,9	20,6	20,2	20,9	21,8
Pension expenditure	11,1	11,8	10,3	10,3	9,6	9,7	9,8
Social security pension	11,1	11,8	10,3	10,3	9,6	9,7	9,8
Old-age and early pensions	9,3	10,2	9,1	9,1	8,1	8,1	8,5
Other pensions (disability, survivors)	1,7	1,5	1,2	1,3	1,5	1,5	1,3
Occupational pensions							
Health care	4,0	4,9	5,4	5,8	6,2	6,5	6,8
Long-term care	0,4	0,7	0,8	1,0	1,3	1,5	1,7
Education expenditure	4,4	3,9	3,4	3,5	3,1	3,2	3,5
Other age-related expenditures							
Interest expenditure	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Total revenue							
Of which: property income							
Of which: from pension contributions	6,9	5,8	7,1	7,2	7,2	7,3	7,3
Demographic Reserve Fund	0,3	0,7	1,9	3,2	4,7	6,9	10,1
Of which: pension fund assets (assets other than government liabilities)							
Systemic pension reforms							
Social contributions diverted to mandatory private scheme	1,3	1,6	0,9	1,0	1,0	1,0	1,0
Pension expenditure paid by mandatory private scheme	0,0	0,0	0,1	0,3	0,6	1,0	1,3
Assumptions							
Labour productivity growth	3,0	2,5	2,3	2,1	2,1	1,8	1,5
Real GDP growth	6,8	3,9	2,3	1,7	1,5	0,5	0,5
Participation rate males (aged 20-64)	77,4	79,1	81,7	82,2	80,5	80,7	81,2
Participation rate females (aged 20-64)	62,2	64,1	66,0	68,7	68,8	70,2	71,0
Total participation rate (aged 20-64)	69,7	71,5	73,8	75,5	74,7	75,5	76,2
Unemployment rate (aged 20-64)	9,8	9,6	7,5	7,2	7,2	7,1	7,1
Population aged 65+ over total population	13,4	13,5	18,2	22,6	25,3	30,6	34,6

Source*: The European Commission (DG ECFIN) and the Economic Policy Committee (EPC) Working Group on Ageing Populations and Sustainability (AWG).*

As a result of the reforms, the projected total pension expenditures will decrease from 11.8% of GDP in 2010 to 9.8% of GDP in 2060. Until 2040, changes in spending will be favourable from the perspective of public finances: gradually raising the statutory retirement age will result in a reduction of the number of pensioners and the total benefits paid. After this period, pension expenditures will grow faster compared to the period prior to the introduction of the reform, which is the result of an accumulation of pension liabilities in the general system and postponing the moment of their payment. As a result, the impact of the reform will increase spending by 0.2 percentage points of GDP by 2060, which translates into a simultaneous increase in the replacement rate compared to the calculations of 2012.

Resulting from the reforms, especially by increasing the pension contribution paid by employers (by 2 percentage points), the pension system revenue is expected to increase. The need to work longer resulting from increasing the retirement age also leads to an increase in revenue, but the total revenue in relation to GDP remains

constant, while compared to the projections prior to the introduction of the reforms it would have reduced during the period concerned.

The reforms foster an increase in labour supply, and thus enhance the long-term growth potential of the economy, contributing also to the creation of new jobs. As a result, the unemployment rate is lower and the labour force participation rate for both women and men is higher compared to the projections prior to the introduction of the reforms by: 5.7 and 1.5 percentage points, respectively, by the end of the forecast period.

V.3. Contingent liabilities

Potential contingent liabilities on account of sureties and guarantees granted by general government in Poland as of the end of 2012 amounted to 6.3% of GDP, as compared to 6.4% of GDP at the end of 2011. A significant share comprised sureties and guarantees granted by the State Treasury. As of the end of 2012, these constituted 6.1% of GDP, as compared to 6.2% of GDP at the end of 2011. Within the State Treasury sureties and guarantees portfolio, guaranties granted for financial sector liabilities (excluding guarantees granted for supporting the NRF at Bank Gospodarstwa Krajowego) were only approx. 0.2% of GDP.

Table 5. Contingent liabilities

% of GDP	2012	2013
Public guarantees	**6,3**	-
Of which: linked to the financial sector*	0,2	-

* Data on potential liabilities of other public finance sector entities on account of sureties and guarantees for the financial sector are not subject to reporting (only total potential liabilities are available). Therefore, the presented value of guarantees granted for financial sector liabilities refers to the State Treasury sureties and guarantees portfolio (excluding guarantees granted for supporting the NRF at BGK).

The State Treasury exposure with regard to sureties and guarantees does not impose a significant risk to public finances. At the end of 2012, almost 90% of contingent liabilities on account of sureties and guarantees granted by the State Treasury were classified as a low-risk group. The long-term risk ratio for the State Treasury sureties and guarantees portfolio remained at the level of approx. 6%. The increase in the potential contingent liabilities on account of sureties and guarantees granted by the State Treasury, which translated into an increase in ratios of these liabilities to GDP, was, similarly to the previous year, mainly the result of the significant volume of guarantees granted for the support of infrastructure development. In subsequent years, the possibility of further growth of potential contingent liabilities on account of sureties and guarantees granted by the State Treasury is assumed, which might translate into a slight increase in the ratio of these liabilities to GDP.

VI. Quality of public finances

VI.1. Composition, efficiency and effectiveness of expenditure

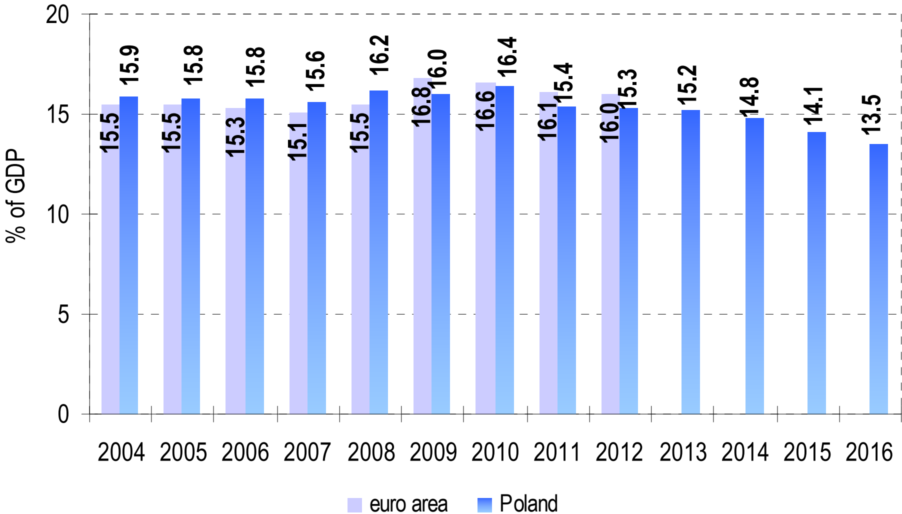
According to the forecast, the general government expenditure to GDP ratio will decrease from 42.3% in 2012 to 37.2% in 2016, so in comparison to 2011, the general government expenditure proportion of GDP will have decreased by as much as 8.2 percentage points. However, it is the change in domestic expenditure (i.e. expenses after adjusting for the deficit-neutral expenditures financed with EU funds), which has a more significant impact on the general government balance and should have decreased as a proportion of GDP from 40.8% in 2012 to 36.5% in 2016.

The institutional changes, both planned and those already implemented which are aimed at consolidating, rationalising and increasing the flexibility of expenditure, as well as additional measures aimed at the strengthening of public finance discipline will all affect the level and structure of expenditure. In addition to the measures outlined in the previous Programme update, it is worth mentioning those initiatives described below.

Improvement of the effectiveness of public spending will be supported by the implementation of the tasks included in the amended Public Finance Act. The Minister of Finance has been empowered to carry out a general audit of the efficiency and effectiveness of the implementation of the performance budget, while holders of budget sections have been authorised to supervise and audit the efficiency and effectiveness of the execution of the performance budget in accordance with the indicators of the degree of accomplishment of the objectives. Work will continue on improving performance budgeting, in particular through the development and launch of a system for evaluating the implementation of public tasks included in task-planning and executed by the government. This system, combined with the evaluation of public policies in the framework of the development policy, will increase the level of coordination and coherence of financial management and strategic planning processes, and provide holders of public funds with information on the efficiency, effectiveness and cost-effectiveness of the implementation of public tasks, while enhancing the holders' responsibility and accountability for the results.

It should also be noted that work on improving the quality of regulatory impact assessment (RIA) has been intensified recently. As a tool facilitating correct decision making, RIAs influence the choice of solutions which are optimal in terms of benefits and costs. RIAs are thoroughly checked by a specialist team of analysts in the Chancery of the Prime Minister. In other ministries, teams have also been established whose task is to control RIAs. There is a need to continuously strengthen the RIA system and harmonise methodologies for RIA development. A well-functioning RIA system based on a reliable multi-dimensional analysis makes it possible to identify the most important opportunities and threats posed by a planned or existing regulation. RIAs carried out at an early stage of legislative work facilitate the process of decision making, provide an assessment of the potential effects of government actions and allow for the elimination of solutions which are ineffective from the perspective of the economy, society and public finances. *Ex-post* RIA enables the assessment of the actual impact of the adopted regulatory framework, and at the same time forms the basis for the formulation of ex ante RIA for further action. The measures taken to improve RIAs are complemented by the requirement to monitor draft acts that generate financial consequences in terms of changes in the level of expenditure of public finance sector units in relation to the volumes provided for in the applicable regulations. This requirement has been effective since the beginning of 2011.

Chart 13. Administration costs (as a sum of remuneration and indirect consumption)

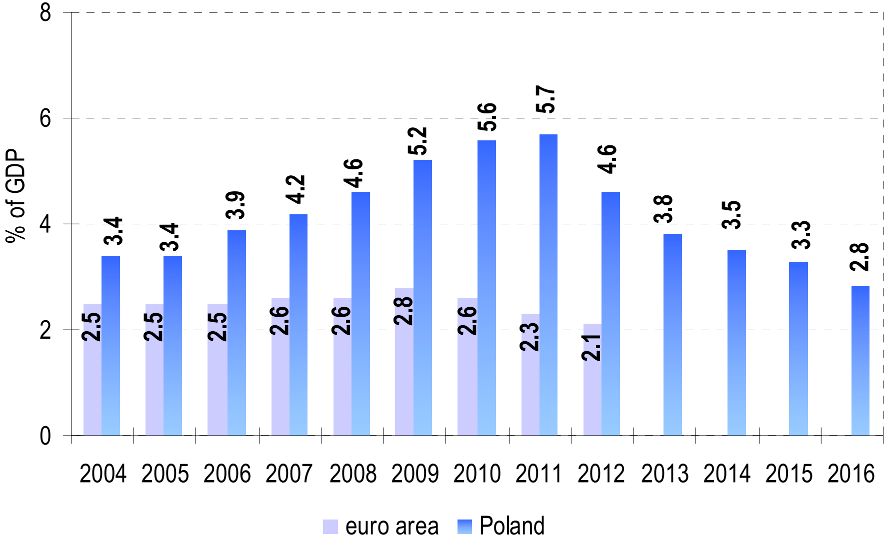


Source: Eurostat, Ministry of Finance.

As in the previous *Programme* update, the biggest decrease of expenditure is predicted in the area of economic affairs – by 1.8 percentage points of GDP, which is due primarily to a decrease in public investment from 5.7% of GDP in 2011 to 2.8% of GDP in 2016 (the proportion of capital expenditure in economic affairs is more

than 40%). A decline is projected in both infrastructure investments carried out at the central level by the NRF and those carried out by local governments.

Chart 14. Gross fixed capital formation

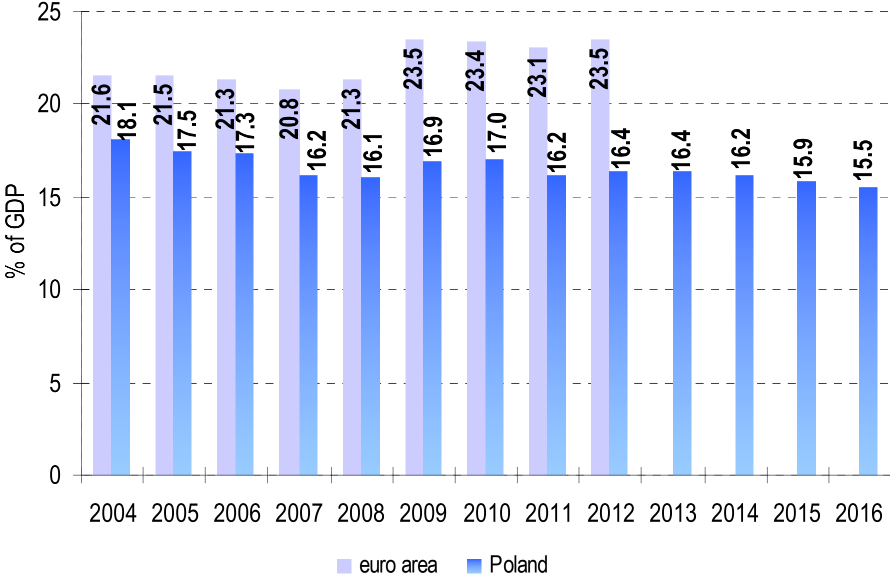


Source: Eurostat, Ministry of Finance.

A significant decrease in spending is also expected in general public services (by 1 percentage point of GDP) which results from a substantial reduction in debt servicing costs over the forecast horizon.

Furthermore, social protection spending is also expected to decline by 0.8 percentage points of GDP. This will result partly from limiting (introduced in 2009) entitlements to early retirement and the minimum indexation of pensions in accordance with the formula: CPI + 20% of the real increase in wages and salaries in the national economy.

Chart 15. Social expenditure



Source: Eurostat, Ministry of Finance.

Table 6. General government expenditure by function

% of GDP	COFOG Code	2011	2016
1. General public services	1	5,8	4,8
2. Defence	2	1,2	1,0
3. Public order and safety	3	1,8	1,5
4. Economic affairs	4	5,6	3,8
5. Environmental protection	5	0,7	0,4
6. Housing and community amenities	6	0,9	0,9
7. Health	7	4,7	4,2
8. Recreation, culture and religion	8	1,3	0,9
9. Education	9	5,5	4,7
10. Social protection	10	15,9	15,1
Total expenditure	TE	**43,4**	**37,2**

Source*:* Ministry of Finance, Central Statistical Office.

VI.2. Structure and efficiency of revenue systems

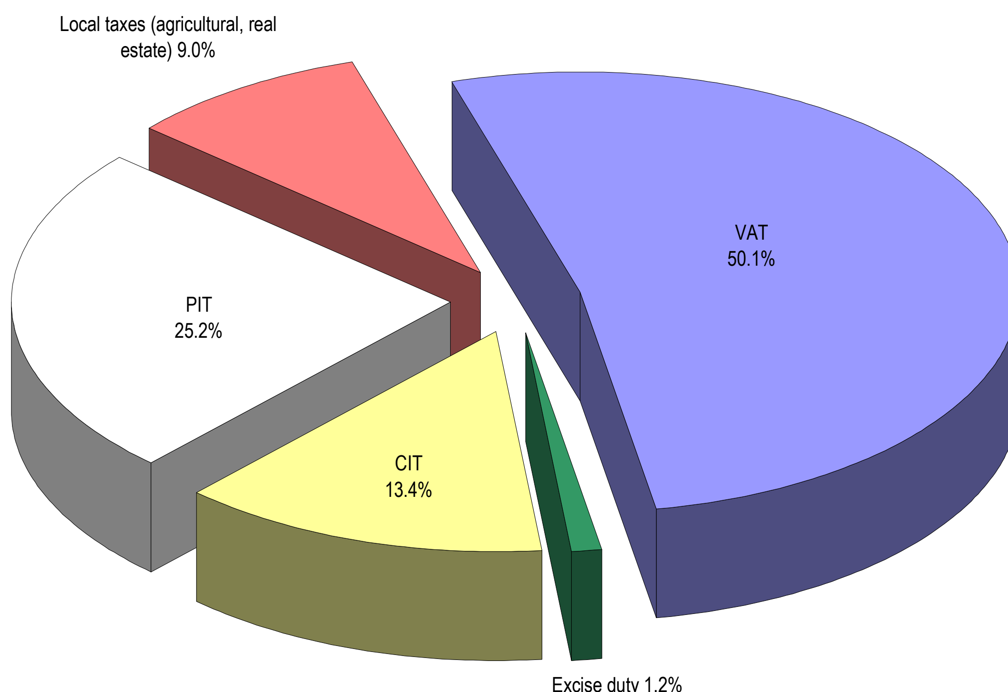
The revenue of general government in 2012 reached 38.4% of GDP. In 2013, this ratio is projected to decline to 37.8%, while the decline over the forecast horizon is anticipated to be at a level of 35.6%. From the perspective of the impact on the general government balance, the change in domestic revenue is more significant (i.e. revenue after adjusting for deficit-neutral transfers related to non-reimbursable EU aid), whose share in GDP in the current year is projected at a level of 36.3% (36.9% in 2012), and in 2016 at 34.9%.

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

One of the elements of the review of the tax system and its performance is a cyclical analysis of tax preferences which exist in the tax system that is the source of state budget revenue (VAT, excise tax, PIT and CIT), as well as local taxes contributing to the budgets of local government units. In 2011, the value of the various areas of preferential taxation was PLN 79.1 billion, which is, as in 2010, 5.2% of GDP. The increase in the total value of preferential taxation compared to the previous reporting period amounted to PLN 5.3 billion, of which PLN 4.2 billion is due to an increase in the value of preferential taxation with respect to taxes on goods and services, mainly due to changes in consumption patterns.

The main area supported by the State through the tax preferences it grants is invariably family and social welfare. This area accounts for one half of preferential taxation. The economy (17%) and agriculture and health (9%) are other areas supported by the State through preferential taxation.

Chart 16. Structure of preferential taxation in Poland in 2011 (as a share of the total value of preferential taxation)



Source: Ministry of Finance, *Preferential taxation treatment in Poland* no. 3, Warsaw 2013.

Work is currently underway to amend the *Tax Ordinance Law.* The guidelines to the draft *Act on the amendment to the Tax Ordinance and certain other acts* provide for comprehensive regulation of the issuing of powers of attorney, modernisation of the rules of service of letters, increasing the flexibility of jurisdiction of tax authorities, as well as improving tax procedures through the implementation of information technology.

Drawing on international experience on counteracting tax evasion, it is planned to return to the concept of introducing a clause against the circumvention of the tax law and the establishment of an independent expert and social supervisory authority. There is a plan to create a Council for the Prevention of Tax Avoidance by 2014. The solution is aimed at a systemic and sustained reduction of legal ways of circumventing the tax law.

The improvements to the system also include plans to simplify procedures for overpayments, as well as expanding access to bank information for the purposes of the tax collection process. Legislative improvements and adjustments dictated by practical experience are also planned to be made with regard to individual interpretations and advance pricing agreements. Improvement of the quality and efficiency of tax administration can also be expected thanks to existing and planned IT projects. The Polish tax administration is implementing the following projects:

1) e-Podatki Programme

This project includes a set of measures aimed at the transforming Polish tax administration. Implementation of the programme will contribute to an increase in the voluntary fulfilment by taxable persons of their obligations through the provision by the tax administration of high-quality public services and a reduction of the costs of the tax system for both taxpayers and taxable persons and the tax administration. This will increase the efficiency of the administration. The strategic objectives of the programme are as follows:

- reducing the tax gap,
- improving the efficiency of tax assessment, collection and distribution of taxes through their integration, and reducing collection costs to the OECD average,

- simplifying the procedures of tax assessment, collection and distribution by the use of advanced technology,
- improving the registration and recording of tax administration stakeholders and information exchange processes.

At the beginning of 2013, formal work was started to design, implement and maintain the *e-Podatki* system, together with additional services, which will allow for the creation of an integrated system designed to comprehensively facilitate the operations of the tax administration. It is planned to create the following five key subsystems by 2015:

- Central Register of Entities - whose functionalities ensure the collection of identification, address, classification and other data, undergoing occasional changes and concerning entities to be registered in the system by law,
- Settlement Centre – which will record and monitor any financial settlements made by the tax administration which are associated with the collection of taxes. An automatic record of accounting events will be a key service of the subsystem to which other subsystems will provide information relevant to financial settlements of the tax administration with the environment,
- Centralised Tax Collection System - an application responsible for services facilitating key processes related to tax assessment, planning and implementation of tax audits, administrative enforcement, proceedings under the Fiscal Offences Act and the application of decision-making rules implementing strategies for dealing with the risks associated with taxable persons/taxpayers who do not meet their obligations under tax law,
- Tax Administration Service Platform - through which virtually any information exchanged between the tax administration and its environment will pass. This includes other national public institutions and their systems, as well as tax administration customers and applications used by them,
- Tax Portal – designed to disseminate valid and current tax information about changes in legislation, the interpretation of existing regulations and other general information, as well as information dedicated to an individual taxable person, such as upcoming deadlines for filing tax returns required of that taxable person, deadlines for payment of taxes, with the option of composing and sending information to taxable persons, etc.

2) Centralisation of service processes (auxiliary)

Part of this project will centralize activities which are common for organisational units of the tax administration and increase efficiency in the area of office support (auxiliary processes) provided by those units, such as financial and human resources support for office, property, renovation and investment management, procurement, IT services, audit, management audit, quality management, communications, protection of classified information and occupational health and safety, as well as the achievement of measurable benefits resulting from changes in their organisation and the way they in which they are managed. Auxiliary processes relating to office support and maintenance which have so far been carried out by tax offices will be moved to a higher level, i.e. that of the tax chamber. Tax offices will be relieved of the burden of administrative processes so that they can focus on tasks related to tax collection. The integration of processes related to the management and organisation of these units will have positive effects on the performance and transparency of operations carried out by the tax administration. It will also allow the tax administration to act more rapidly and will enable efficient coordination and effective supervision of its statutory tasks and the provision of an efficient public service.

For the last few years, in accordance with customs law, there has been a very strong drive to make customs procedures simpler and more user friendly for business while remaining effective at counteracting various pathologies. This aims to reduce costs and other burdens for business as well as the administration. In 2012 procedures were introduced aimed at popularising electronic import customs declarations, in paperless form and without most of the accompanying documents. Guidelines were developed for paper documents to be submitted as attachments to CELINA, ECS and NCTS customs declarations, which aim to ensure the uniformity of practice by customs offices for the submission of paper documents as attachments to electronic customs declarations, processed by the CELINA, ECS and NCTS systems. In addition, technical and organisational simplifications, as well as those related to handling

Authorised Economic Operators (AEO) were introduced to meet very high criteria of solvency, security, record keeping and compliance with the law.

The e-Cło Programme is another project designed to consistently improve the effectiveness of public administration. It is a package of legislative, organisational, financial and technical solutions aimed at an e-implementation of public services for businesses involved in international trade in goods, and payment of the relevant duties and taxes. The implementation of this project (in the years 2008-2014) will allow for more efficient risk management, monitoring of international trade and movement of goods which are subject to excise duty. In particular, this will make the collection system tighter and increase proceeds from customs related activities.

Full implementation of the *e-Cło* project will translate into accelerating and streamlining the servicing of applications and a reduction of related costs, as well as simplification of procedures relating to the issuing of permits. It will also result in a reduction of transaction costs incurred by entrepreneurs in completing customs formalities. Implementation of the project will also result in cost rationalization in the maintenance of customs service information technology as well as improvement of data quality by having one common system of reference data.

VII. Institutional features of public finances

VII.1. Fiscal rules

1) Stabilizing expenditure rule

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

A new rule, in force from 2011, is the temporary expenditure rule. It limits the growth rate of discretionary and new legally mandated expenditure, which also covers current legally mandated expenditure, if the act defining them is modified. The rate of growth of this expenditure cannot exceed the projected CPI inflation rate plus 1 percentage point. The temporary expenditure rule shall be binding until the Ecofin Council abrogates the excessive deficit procedure for Poland.

After the abrogation of the excessive deficit procedure, a priority for Poland will be the further improvement of the general government balance, and thus public debt, and then maintaining these categories at safe levels. This will be achieved with the permanent stabilizing expenditure rule, which will replace the temporary disciplining expenditure rule. Reducing the expenditure dynamics of a specific part of government expenditure is supposed to result in a gradual decline in the debt-to-GDP ratio.

This limit will be imposed on government expenditure and the NRF – with two exceptions. First, expenditure financed with non-refundable EU grants, where general government is the ultimate beneficiary will be excluded. This is justified by the fact that the impact of EU funds on the deficit (calculated according to ESA95) is neutral, i.e. government revenue from the EU is always recognised in the amount of government expenditure financed by the EU, regardless of the cash flows. Second, it is also considered to exclude the expenditure of those units which are obliged by a statutory requirement to balance their budget plan. The expenditure (costs) of these units must be fully covered by income (revenue), so their impact on the deficit is also neutral. Therefore, there is no justification for a situation in which the dynamics of their spending would affect the dynamics of the spending of other units.

The limit defined in this way will be then adjusted for the expected level[12] of expenditure of local governments, the entities, referred to in Article139(2) of the Public Finance Act and the National Health Fund. The remaining part of the limit - the so-called sublimit - will be divided between the remaining parts of the public finance sector. The sublimit will be binding. Thus, although only this group of entities will be subject to the rule, this will ensure stability of the balance and debt of the entire general government. At the same time it should be noted that the expenditure sublimit will not apply to all entities or transactions in the same way – it will have aggregated effects, and thus it will reduce the total increase in spending. This means that it will be possible for some expenditure to increase faster, as long as it is adequately offset with slower growth (or decline) of other expenditure under the sublimit.

In a state of fiscal sustainability the expenditure limit growth rate will be a product of the real part (in the form of the medium-term indicator of real GDP growth) and the nominal one (i.e. projected CPI inflation or the GDP deflator growth rate for the year to which it pertains). This growth will be reduced in the event of excessive debt or deficit. This will make it possible for Poland to fulfill her obligations in the area of fiscal policy under the Stability and Growth Pact.

The development of the permanent expenditure rule is directly related to the need to implement by the end of 2013 Council Directive 2011/85/EU of 8 November 2011, on requirements for budgetary frameworks of the Member States, requiring all EU countries to use, *inter alia*, strong numerical fiscal rules. Such rules should be used both in the annual budget acts and in long-term budget planning. In the medium term, they help

[12] This will be a value in PLN (in current prices) determined on the product of the medium-term indicator of GDP growth and the average share of expenditure made by LGUs, excluding expenditure financed from EU funds, in the GDP of the last eight years.

to maintain government balance at the level of the medium-term objective (MTO), which is -1% of GDP for Poland. Fiscal rules should have a specific purpose and scope so that they prevent pro-cyclical fiscal policy and are subject to effective and timely monitoring. The Directive also requires precise definition of escape clauses (allowing for temporary suspension of the rules) and the consequences of non-compliance with the rules and their effective enforcement mechanisms. Poland is obliged to implement this Directive by the end of 2013, and immediately communicate to the Commission the text of the provisions necessary to implement it.

The stabilizing expenditure rule will be of key importance in the annual budget process. The focus as regards the budget process will be on how to distribute the expenditure sublimit, determined adequately to the condition of public finances and the economy, and not on the amount of the sublimit. Furthermore, expenditure limits will be determined in a manner which will be indicative in the long term, in accordance with the formula and projected values of the variables, which will improve the budgetary planning process.

The formula that determines the limit for the year t+1 will consist of four parts:1) expenditure limit for the year t, which will be multiplied by 2) a nominal part and by 3) an eight-year average real GDP growth rate (for the period from t-6 to t+1). The adoption of such a formula will prevent the possibility of pro-cyclical fiscal policy. In the case of identifying public finance imbalances (in relation to the general government balance or public debt ratio) the limit will be further reduced by 4) a correction component.

Escape clauses allowing for the determination of arbitrary expenditure limits disregarding the expenditure limit formula are provided only in the event of martial law or a state of emergency, or a natural disaster throughout the territory of the Republic of Poland. Failure to comply with the rule will entail the same consequences as a violation of the Public Finance Act.

The structure of the rule will thus ensure sustainability of public finances by improving and stabilising the general government balance and public debt. In the longer run, maintaining expenditure limit growth at the level of the medium-term GDP growth rate and adequate and stable revenue should contribute to the stabilisation of general government in the medium term at the level of -1% of GDP.

2) Rules in the local government sub-sector

In 2014, the existing limits on the level of debt and the level of debt servicing costs will be replaced by individual debt constrains reflecting the economic capacity of local government units (LGUs) to pay off liabilities. The new limit will depend on the ability of the unit to generate adequate surpluses in the current budget and income from the sale of property. The debt constraint, calculated on the values from the previous three years, on one hand removes restrictions on local government units for which borrowing even fairly substantial amounts can be an instrument safety development policy, while on the other, it disciplines those units from which high repayment liabilities relative to their incomes require significant caution when taking out new loans or issuing securities. The debt constraint is to safeguard local government units against excessive accumulation of payments due to debt servicing relative to their economic capacities.

As originally intended, the planned target permanent expenditure rule was to be complemented with a legally binding limit for the deficit of the local government sub-sector. However, analyses of the existing rules, both those applicable to LGUs and other units at the local government level, indicate the existence of sufficient potential to limit fiscal imbalances in this sub-sector. The only solution in this regard was the introduction of mechanisms reinforcing the ongoing monitoring of the financial situation of LGUs and multi-annual planning (cf. Section VII.3).

Table 7. Fiscal rules concerning local government units in the current legal state

	2009	2010	2011	2012	2013	From 2014
Debt rule* liabilities to revenue ratio			60%			none

	2009	2010	2011	2012	2013	From 2014
Exclusions from the debt rule	Securities and credits or loans contracted in conjunction with the use of funds defined in an agreement signed with an entity having at its disposal European Union funds (for financing and co-financing)					
Debt servicing costs rule debt servicing costs (principal instalments t + interest) to revenue ratio	15% (12%)**					System of individual constraints
Exclusions from the rule of debt servicing costs	Repayment (principal instalments t + interest) of securities and credits or loans contracted in conjunction with the use of funds defined in an agreement signed with an entity having at its disposal European Union funds					Pay off (principal instalments) of securities and credits or loans contracted in conjunction with the use of funds defined in an agreement signed with an entity having at its disposal European Union funds and eurobonds, issued before *the Public Finance Act* from the year 2009, came into force (**excluding interest expenditure**)
Rule of balanced budget principle of local government units	None		YES			

* In December 2010, the criteria for instruments rated to public debt was tightened. Introduction of *de facto* economic criteria of debt classification, effectively reduced the possibility of circumventing the debt limit (60% of revenue) by local government units.

** 12% when public debt exceeded the threshold of 55% of GDP.

In years 2013-18, liabilities of the transformed independent public healthcare facilities that were taken over by local government units, are excluded from the fiscal rules.

Source: Ministry of Finance.

VII.2. Budgetary procedures, incl. public finance statistics governance

For efficient implementation of the permanent expenditure rule, the national fiscal framework will be further strengthened. The process will involve increasing the importance of top-down budgeting, improving the ongoing monitoring of the financial situation and reporting (as described in the previous Programme update).

Intensive work to improve the scope and frequency of data collection in units of general government will enable Poland to meet the requirements of *Council Directive 2011/85/UE of 8 November 2011 on requirements for budgetary frameworks of the Member States*. The following fiscal data will be published on the website of the Ministry of Finance: monthly - concerning the central government sub-sector and social security funds sub-sector (with a one-month delay) and quarterly - concerning the local government sub-sector (with a one-quarter delay). A reconciliation table showing the methodology of transition between data from public accounting and the statistics of general government, in accordance with ESA 95, will also be available on the website. The Central Statistical Office will publish data concerning: contingent liabilities with potentially significant impact on the

budget, including those relating to non-performing loans, liabilities of public enterprises, public-private partnership agreements considered off-balance sheet, guarantees granted by the sector as a whole and all sub-sectors, as well as the shares of general government in the capital of private and public companies (if the amounts are economically significant).

VII.3. Other institutional developments in relation to public finances

The provisions of the *Public Finance Act* provide a number of actions as part of the prudential and remedial procedures, in case public debt (PD) exceeds specified GDP thresholds.

Until the end of 2012, foreign currency denominated debt used to be converted at the exchange rate of the zloty as of the last working day of the year. Hence it was possible that exchange rate movements on the last business day of the year, often due to external factors, unrelated to the Polish economy, could be the reason for exceeding prudential thresholds, and could thus trigger changes in fiscal policy which were without economic justification. Using the exchange rate as of the last business day of the year to convert foreign debt for the purposes of prudential and remedial procedures could also encourage speculative attacks on the Polish currency and be a cause for concern among market participants that the Minister of Finance or the National Bank of Poland would possibly attempt to influence the level of the market exchange rate at the end of the year.

Furthermore, it is customary for State Treasury debt management, that liabilities are incurred in the fourth quarter of the budgetary year to finance the borrowing needs of the next year, thus reducing the risk to the refinancing of public debt. Such measures have a positive impact on the sustainability of public finances, but they increase gross debt at the end of the year and thus the risk of exceeding the prudential thresholds.

To increase the predictability of the fiscal policy of the State a new measure, which is a benchmark for imposing restrictions in the case of exceeding the 50% or 55% threshold of public debt to GDP ratio, was introduced to eliminate the risk of triggering severe sanctions that would influence both income (e.g. increase in VAT rates) and expenses (e.g. reducing the indexation of pensions) of the public finance sector, and would arise out of a transitional depreciation of the zloty, or pre-financing of the borrowing needs of the State budget. From 1 January 2013, PD denominated in foreign currency is recalculated using the arithmetic mean of average exchange rates of foreign currencies to the zloty published by the National Bank of Poland that applied to working days of the budget year concerned.The amount thus calculated is then reduced by the value of liquid funds that will be used to finance the borrowing requirements for the following budget year.

In 2013, changes in the law that strengthen mechanisms for monitoring the financial situation and long-term the planning in public finances, in particular in relation to LGUs, were introduced. Further to the amended provisions of the Public Finance Act a uniform type of long-term financial forecast for all LGUs will be developed. It should contribute indirectly to the development of comprehensive and realistic forecasts by individual LGUs, thus making it possible to compare the effectiveness of these units.

In order to ensure consistency of long-term planning, a new deadline was established in 2013 regarding the preparation of an update to *the Multi-Annual State Financial Plan* by the Council of Ministers, consistent with the European Semester in force from 2011, and *the amended Council Regulation (EC) No 1466/97/EC on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*.

Annex

Table 8. Macroeconomic prospects

	ESA Code	2012 Level	2012 Rate of change	2013 Rate of change	2014 Rate of change	2015 Rate of change	2016 Rate of change
1. Real GDP* (PLN billion)	B1*g	1318,0	1,9	1,5	2,5	3,8	4,3
2. Nominal GDP (PLN billion)	B1*g	1595,3	4,4	3,0	4,8	6,3	6,9
Components of real GDP*							
3. Private consumption expenditure	P.3	790.2	0,8	1,1	2,1	3,2	3,5
4. Government consumption expenditure	P.3	219,6	0,0	0,9	0,0	-0,6	-0,1
5. Gross fixed capital formation	P.51	280,8	-0,8	-0,7	4,4	7,8	9,2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	14,7	1,1	1,1	1,6	2,0	2,3
7. Exports of goods and services	P.6	564,7	2,8	2,8	4,3	5,0	5,1
8. Imports of goods and services	P.7	553,4	-1,8	0,9	4,9	5,5	5,9
Contributions to real GDP growth							
9. Final domestic demand			-0,2	0,8	2,7	4,0	4,6
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		-0,6	0,0	0,5	0,4	0,4
11. External balance of goods and services	B.11		2,0	0,8	-0,1	-0,2	-0,3

Table 9. Price developments

	ESA Code	2012 Level	2012 Rate of change	2013 Rate of change	2014 Rate of change	2015 Rate of change	2016 Rate of change
1. GDP deflator			2,5	1,5	2,2	2,5	2,5
2. Private consumption deflator			3,6	1,6	2,4	2,5	2,5
3. HICP			3,7	1,6	2,4	2,5	2,5
4 Public consumption deflator			3,7	1,6	2,4	2,5	2,5
5. Investment deflator			1,0	2,1	3,5	2,4	2,7
6. Export price deflator (goods and services)			4,0	-0,8	2,1	1,5	2,0
7. Import price deflator (goods and services)			5,5	0,0	3,2	1,6	2,1

Table 10. Labour market developments

	ESA Code	2012 Level	2012 Rate of change	2013 Rate of change	2014 Rate of change	2015 Rate of change	2016 Rate of change
1. Employment (in thousands of persons)*		15591	0,2	-0,3	0,0	0,6	0,6
2. Employment (hours worked)**							
3. Unemployment rate (%)***		10,1	10,1	10,8	11,0	10,6	10,3
4. Labour productivity (in thousands of persons)****		84,5	1,7	1,7	2,5	3,1	3,6
5. Labour productivity (hours worked)*****		-	-	-	-	-	-
6. Compensation of employees (PLN billion)	D.1	574,2	3,5	2,4	3,4	5,3	5,8
7. Compensation per employee (PLN thousand)		47,5	2,7	2,2	3,2	4,7	5,2

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

** National accounts definition.

*** Harmonised definition, Eurostat; levels.

**** Real GDP per person employed.

***** Real GDP per hour worked.

Table 11. Sectoral balances

% of GDP	ESA Code	2012	2013	2014	2015	2016
1. Net lending / borrowing vis-à-vis the rest of the world	B.9	1,3	0,2	1,1	2,4	3,8
of which: - balance on goods and services		0,1	-0,3	0,3	0,6	0,9
- balance of primary incomes and transfers		3,4	3,0	3,0	3,3	3,6
- capital account		-2,2	-2,5	-2,3	-1,5	-0,7
2. Net lending/borrowing of the private sector	B.9	2,6	3,3	2,2	0,3	-2,2
3. Net lending/borrowing of general government	EDP B.9	-3,9	-3,5	-3,3	-2,7	-1,6
4. Statistical discrepancy		-	-	optional	optional	optional

Table 12. Basic assumptions

	2012	2013	2014	2015	2016
Short-term interest rate (annual average)	4,9	3,2	2,6	2,6	2,8
Long-term interest rate (annual average)	5,0	3,6	3,1	3,0	3,3
Nominal effective exchange rate	1,6	-1,0	-3,5	-3,7	-3,9
Exchange rate vis-à-vis the € (annual average)	4,19	4,15	4,00	3,85	3,70
World, excluding EU, GDP growth*	3,9	4,0	4,5	–	–
EU GDP growth*	-0,3	0,1	1,6	–	–
Growth of relevant foreign markets**	-0,1	1,5	4,6	4,8	4,8
World import volumes, excluding EU*	3,8	4,4	6,1	–	–
Oil prices (Brent, USD/barrel)*	111,8	113,7	106,4	–	–

* Source: EC, *European Economic Forecast. Winter 2013*, February 2013

** EU imports taken as foreign markets indicator.

Table 13. General government

	ESA Code	2012 PLN billion	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP
Net lending (EDP B9) by sub-sector							
1. General government	S.13	**-62,7**	**-3,9**	**-3,5**	**-3,3**	**-2,7**	**-1,6**
2. Central government	S.1311	-61,5	-3,9	-3,4	-3,4	-3,0	-1,9
3. State government	S.1312						
4. Local government	S.1313	-4,5	-0,3	0,3	0,2	0,2	0,2
5. Social security funds	S.1314	3,4	0,2	-0,3	-0,2	0,0	0,0
General government							
6. Total revenue	TR	612,3	38,4	37,8	37,2	36,2	35,6
7. Total expenditure	TE	675,0	42,3	41,3	40,5	38,9	37,2
8. Net lending/borrowing	EDPB.9	-62,7	-3,9	-3,5	-3,3	-2,7	-1,6
9. Interest expenditure	EDP D.41	45,3	2,8	2,7	2,4	2,2	2,1
10. Primary balance		-17,4	-1,1	-0,8	-0,9	-0,5	0,5
11. One-off and other temporary measures		0,0	0,0	0,1	0,0	0,0	0,0
Selected components of revenue							
12. Total taxes (=12a+12b+12c)		321,1	20,1	19,7	19,7	19,5	19,4
12a. Taxes on production and imports	D.2	205,6	12,9	12,8	12,8	12,6	12,3
12b. Current taxes on income, wealth, etc	D.5	115,2	7,2	6,9	6,9	6,9	7,0
12c. Capital taxes	D.91	0,3	0,0	0,0	0,0	0,0	0,0
13. Social contributions	D.61	196,1	12,3	12,2	12,0	11,8	11,7
14. Property income	D.4	21,6	1,4	1,2	1,0	0,8	0,9
15. Other		73,5	4,6	4,8	4,5	4,1	3,6
16. Total revenue	TR	612,3	38,4	37,8	37,2	36,2	35,6
Tax burden (D.2+D.5+D.61+D.91-D.995)		515,3	32,3	31,8	31,5	31,2	30,9
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D1+P2	243,2	15,2	15,2	14,8	14,1	13,5
17a. Compensation of employees	D.1	154,1	9,7	9,7	9,5	9,1	8,6
17b. Intermediate consumption	P.2	89,2	5,6	5,5	5,3	5,0	4,8
18. Social payments		261,0	16,4	16,4	16,2	15,9	15,5
of which Unemployment benefits		4,3	0,3	0,3	0,3	0,2	0,2
18a. Social transfers in kind supplied via market producers	D.6311 D.63121 D.63131	34,7	2,2	2,2	2,1	2,1	2,1
Social transfers other than in kind	D.62	226,3	14,2	14,3	14,1	13,7	13,4
19. Interest expenditure	EDP D.41	45,3	2,8	2,7	2,4	2,2	2,1
20. Subsidies	D.3	5,9	0,4	0,3	0,4	0,4	0,3
21. Gross fixed capital formation	P.51	73,8	4,6	3,8	3,5	3,3	2,8
22. Capital transfers	D.9	10,8	0,7	0,6	0,6	0,6	0,6
23. Other		34,9	2,2	2,3	2,6	2,4	2,3
24. Total expenditure	TE	675,0	42,3	41,3	40,5	38,9	37,2

	ESA Code	2012 PLN billion	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP
p.m.: government consumption (nominal)	P.3	285,0	17,9	17,8	17,4	16,7	16,0

Table 14. No-policy change projections

	2012 Level	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP
1. Total revenue at unchanged policies	**612,3**	37,0	37,5	37,2	36,3	35,4
2. Total expenditure at unchanged policies		-	-	-	-	-

Table 15. Amounts to be excluded from the expenditure benchmark

	2012 Level	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	**24,3**	1,5	1,6	1,5	1,1	0,7
2. Cyclical unemployment benefit expenditure	**6,0**	0,4	0,4	0,4	0,4	0,3
3. Effect of discretionary revenue measures	**21,8**	1,4	0,3	0,0	-0,2	0,2
4. Revenue increases mandated by law		-	-	-	-	-