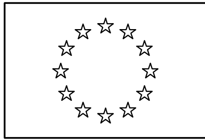

COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

Poland

Report prepared in accordance with Article 104(3) of the Treaty

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1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its Spring 2004 forecasts. According to these forecasts, which took into consideration data reported by Poland and validated by Eurostat in March 2004, the general government deficit in Poland reached 4.1% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value[1].

Table 1: General government balance and debt (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
General government balance	-2.1	-1.9	-1.8	-3.5	-3.6	-4.1	-6.0	-4.5
General government gross debt	39.1	40.3	36.6	36.7	41.2	45.4	49.1	50.3

Source: Eurostat and Commission Spring 2004 forecasts.

At this stage, the estimated figure for the 2003 deficit provides evidence on the existence of an excessive deficit in Poland, in the sense of the Treaty and the Stability and Growth Pact. The Commission therefore has decided to initiate the excessive deficit procedure (EDP) for Poland.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria[2], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. …"

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[1] As the Eurostat decision on the classification of funded pension schemes (2nd March 2004, EUROSTAT News Release 30/2004) is of a generic nature with the individual cases to be assessed in time for the reporting due by 1 September 2004, this figure still considers the open pension funds as part of the government sector. If the open pension funds are classified outside the general government sector, the deficit figure for 2003 might increase to 5.7% of GDP.

[2] The criteria are (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3%, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; (b) whether the ratio of government debt to gross domestic product exceeds the reference value of 60 %, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The present report prepared by the Commission according to Article 104(3) assesses recent and current budgetary developments in Poland and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

2. Recent macroeconomic developments and prospects

After the initial output collapse caused by transition, Poland enjoyed a period of robust economic growth up to 1998. Subsequently, economic activity slowed down. Real GDP growth dropped from an average of 5.5% during 1993-1998 to about 4% in 1999-2000, reflecting both the Russian crisis of August 1998 and the maturing of the economic cycle. Economic activity weakened more sharply in 2001, with output growth falling to a mere 1%. Domestic and external cyclical factors were at the origin of the downturn. In particular, the collapse in investment and the economic slowdown in the EU played a role. From 2002, the economy started to recover. The export-led upswing gradually gained strength and real GDP growth reached 3.7% in 2003. The Commission Spring 2004 forecasts expect real GDP growth to accelerate further to 4.6% in 2004 and 4.8% in 2005. In purchasing power standards, GDP per capita in Poland reached 42.7% of the EU average in 2003.

From 1998 to 2000, domestic demand was the main driving force behind growth. In 2001, domestic demand declined sharply but strong export growth contributed to maintaining positive GDP growth. In parallel, the external account deficit narrowed markedly. Since 2002, the recovery has been mainly driven by exports, in part boosted by the sharp real effective depreciation of the zloty. The strong export performance coupled with weak imports led to a further reduction of the external account deficit to 2% of GDP in 2003. Domestic demand, and in particular investment, is projected to strengthen in 2004-05 while the contribution of net exports would turn slightly negative in 2005.

Table 2 : Macroeconomic developments and outlook

	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.8	4.1	4.0	1.0	1.4	3.7	4.6	4.8
Contribution: Domestic demand	6.5	5.2	2.7	-1.9	0.9	1.8	3.7	4.8
Change in inventories	0.1	-0.1	0.3	-1.2	-0.2	0.2	0.0	0.1
External trade	-1.7	-1.1	1.2	2.9	0.7	1.7	0.8	-0.1
Unemployment rate (% of labour force)	10.2	13.4	16.4	18.5	19.8	19.8	19.6	19.3
Unit labour costs (% change)	13.4	15.1	-4.4	11.5	0.5	-3.2	-1.1	0.9
HICP (% change)	11.8	7.2	10.1	5.3	1.9	0.7	2.3	3.0
External account[a] (% of GDP)	-3.9	-5.3	-6.0	-2.8	-2.6	-2.0	-1.9	-2.2
GDP/capita, PPS (% of EU-15 avg.)	41.2	41.8	41.8	41.9	41.7	42.7		

[a] Net lending/ borrowing vis-à-vis the rest of the world = current account + capital account

Source: Eurostat and Commission Spring 2004 forecasts.

After dropping to about 10% in 1998, the unemployment rate rose to a peak of some 20% in 2002. This surge in unemployment reflected a combination of cyclical, demographic and structural factors. The acceleration of enterprise restructuring following the Russian crisis played a key role. The slowdown in activity, coupled with a rise in the labour force due to demographic factors, also contributed to worsening the labour market situation. The persistence of high unemployment in 2003 despite stronger growth points to the importance of structural problems hampering the functioning of the labour market. A major reform of the labour market legislation was adopted in 2002 as a first step to tackle these problems. In 2004 and 2005, unemployment is forecast to fall only moderately in a context of still large job losses linked to the ongoing restructuring process in industry and agriculture.

The steady disinflation process was briefly interrupted in 2000 when headline inflation returned to double-digit figures as a result of hikes in fuel and food prices. The weakening of domestic demand, in part owing to the severe tightening of monetary policy in 2000, helped to quell inflationary pressures from mid-2000, and inflation declined markedly in 2001-03, reflecting below-trend growth and falling oil and food prices. Headline inflation dropped from 10.1% in 2000 to 0.7% in 2003. Despite the recovery, inflationary pressures remained subdued in 2003 in a context of moderate wage growth and weak domestic demand. Inflation is forecast to increase significantly in 2004 and 2005, due to the acceleration of GDP growth, the pass-through of the depreciation of the zloty and accession-related tax and price adjustments.

3. THE SITUATION OF GOVERNMENT FINANCES

The general government deficit has been on an increasing path since 2000 rising from 1.8% of GDP to 4.1% in 2003. Both in the Commission's and in the authorities' view, it is expected to stay well above the 3 % reference value in 2004-2005. The debt-to-GDP ratio remains below the 60% of GDP reference value (45.4% of GDP in 2003) but is increasing considerably. If the open pension funds are classified outside the general government sector, the deficit figure for 2003 will increase to 5.7% of GDP. The debt ratio will also deteriorate by approximately 3.3 percentage points for 2003 and 4.5 percentage points in 2004[3].

The analysis of budgetary developments is hampered by still existing data gaps. In particular a consistent series of ESA95 data on the general government revenues and expenditures over recent years is not yet available. The lack of ESA95 data concerns both the functional sub-components of revenues and expenditures and the institutional sub-components of the general government.

3.1. Recent budgetary developments until 2002

The general government deficit increased from 1.9% of GDP in 1999 to 3.6% in 2002. The deterioration in Poland's budgetary position over this period reflects a combination of cyclical factors and some discretionary relaxation of fiscal policy mainly stemming from the increase in social spending[4]. Subsidies to the Social Security Fund increased from 7.2% of total expenditures in 1999 to 14.8% in 2002, and to the Labour Fund from 0.47% in 1999 to 2% in 2002. The high costs of three major reforms implemented at the beginning of 1999, namely in

[3] These figures reflect the value of the Treasury securities detained by the open pension funds.
[4] Social expenditures constituted 41% of the total general government expenditures in 2002.

public administration, health care and social security, constituted an additional burden for the central government's budget.

Since 2001, there have been many attempts by the Polish authorities to tackle the increasing deficit but none of the reform plans were implemented and the deficit continued to deteriorate. In 2002, for instance, the government adopted a spending rule, according to which the growth rate of central government expenditures had to be limited to one percentage point above the inflation rate. This spending rule was never applied.

The primary balance has been deteriorating since 1998 and became negative in 2001. Interest payments declined to 2% of GDP in 2000 from almost 4% in 1998, to which lower interest rates contributed, but have been on an upward trend since then in parallel with the debt stock. They have represented around 3% since 2001.

Looking at the sectoral breakdown, most of the deterioration of the overall deficit is attributable to the deficit of the central government and the growing financing needs of local governments. By contrast, the sub-sector of the social security funds has been improving its net lending situation since 2000.

Table 3: GDP growth and general government balance and debt

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.8	4.1	4.0	1.0	1.4	3.7	4.6	4.8
General government balance	-2.1	-1.9	-1.8	-3.5	-3.6	-4.1	-6.0	-4.5
Primary balance	1.6	1.2	0.3	-0.5	-0.7	-1.0	-2.8	-1.2
Total expenditures	43.1	42.6	42.0	44.8	44.9	45.1	46.8	45.7
of which: gross public investment	3.9	3.5	3.5	3.5	3.5	3.5	3.5	3.7
Total revenues	41.0	40.8	40.2	41.3	41.3	41.0	40.8	41.2
General government gross debt	39.1	40.3	36.6	36.7	41.2	45.4	49.1	50.3

Source: Eurostat and Commission Spring 2004 forecasts.

3.2. Budgetary developments in 2003

The pre-accession economic programme (PEP) submitted in August 2002 projected a stabilisation of the deficit in 2003 compared to 2002. The growth forecast underlying the 2003 PEP remained comparable to the one underlying the 2002 PEP. Nevertheless, the 2003 PEP contained an upward revision of the deficit. The actual general government deficit as presented in the Commission 2004 forecasts deteriorated from 3.6% of GDP in 2002 to 4.1% of GDP in 2003 and was in line with the revised figure, despite a considerably higher growth rate (see table 4).

Table 4: Successive targets for the 2003 general government deficit and estimated outcome

	Real GDP growth assumption (%)	General government balance (% of GDP)
August 2002: 2002 Pre-accession economic programme	3.1	-3.6
December 2002: budget for 2003	3.5	-4.2[a]
April 2003: Fiscal notification	3.0	-4.0
August 2003: 2003 Pre-accession economic programme	3.0	-4.1
April 2004: Commission Spring 2004 forecasts	3.7	-4.1

[a] On SNA93 basis (Polish methodology)

Source: Commission services.

The revenue-to-GDP ratio for the general government sector decreased by 0.3 percentage points compared to 2002 and represented 41% of GDP. In spite of a higher growth and various measures to improve tax administration, revenues in 2003 were lower than foreseen in the central budget by 2.3%. Corporate tax receipts were slightly smaller than in 2002, which is partly explained by a 1 percentage point cut in the tax rate from 28 to 27%. Personal income tax revenues, which were also over-estimated in the 2003 budget reflecting an optimistic wages and employment forecast, reached a comparable level to 2002. Indirect taxes (excise duties and VAT) received by the central government were lower than expected, but still higher than in the previous year. The higher dividends from shares held by the Treasury contributed to higher-than-expected non-tax revenues.

Central budget expenditures on a cash basis were smaller than planned in the budget as some 0.4% of GDP were saved on costs of servicing public debt. However, they increased compared to 2002 despite lower inflation, which is used as the basis for the indexation of some expenditures. The expenditure-to-GDP ratio increased in 2003 by 0.2 percentage points compared to the previous year and represented 45.1% of GDP. The higher expenditure level in 2003 compared to 2002 resulted from additional outlays for various social allowances (e.g. child and family allowances) and foreign debt servicing. Subsidies from the central budget to the social insurance fund (ZUS) have also increased.

3.3. Prospects for 2004

The budget for 2004 targets a significant widening of the deficit to 5.7% of GDP despite the strengthening of economic growth. The deterioration of the deficit is mainly due to increased expenditures. The Commission Spring 2004 forecast projects a somewhat higher deficit (6% of GDP) because of the inclusion of additional expenditures related to the old-age and disability pensions and because of a higher contribution to the EU budget (due to different exchange rate assumptions).

In 2004 the revenues-to-GDP ratio is expected to decline slightly by 0.2 percentage points to 40.8% of GDP compared to 2003, which is the combined effect of the reduction of the

corporate tax rate and an increase of indirect taxation. The alignment of the VAT regime to EU legislation leads to an increase of the tax rate on various products to 22% (e.g. construction materials) from May 2004. Excise taxes also rise. Despite the economic recovery, a decline in corporate tax revenues is expected caused by an additional reduction of the corporate tax rate from 27% to 19%[5] representing overall a decrease of the tax rate by 9 percentage points over two years.

The 2004 budget foresees an important increase in the expenditures-to-GDP ratio from 45.1% of GDP in 2003 to 46.8% in 2004. Central government expenditures on a cash basis are expected to increase by approximately 10.8% between 2003 and 2004 in nominal terms (or 8.5% in real terms). The biggest increase in spending is foreseen for the mining sector (0.14% of GDP), public administration[6] (0.12% of GDP), followed by defence, justice, and higher education. The 2004 budget, adopted in December 2003, has not been amended to incorporate the savings in spending on public administration representing 0.4% of GDP foreseen for 2004 by the "Programme of Rationalisation and Reduction of Public Spending", the so-called Hausner plan (see section 4.1 below), approved in January 2004.

3.4. Recent debt developments and prospects

After falling in 2000, the debt-to-GDP ratio has been on an upward path. The widening of the deficit combined with the slowdown in privatisation resulted in an increase in the debt ratio by 8.7 percentage points between 2001 and 2003. In 2003, the debt increased mainly because of lower privatisation receipts with only 40% of the initial expectations met.

The gross debt ratio is expected to increase from 45.4% in 2003 to above 49% of GDP by the end of 2004 mainly because of the growing negative contribution of the primary balance and the announced delays in the privatisation process. If the open pension funds are classified outside the government sector, this figure will increase by approximately 4.5 percentage points. The debt ratio is approaching the thresholds that trigger corrective mechanisms under Polish fiscal rules laid down in the Polish Constitution and the Public Finance Act[7] while remaining well below the Treaty reference value.

The debt stays vulnerable to interest rate shocks and also to the foreign exchange rate risk notwithstanding the significant achievements to date in terms of reducing the foreign currency component of public debt (its share decreased from 49% in 1999 to 33.1% in 2002). The outstanding stock of guarantees[8] and the contingent liabilities represented by the large loss-making state-owned enterprises also represents a further risk.

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[5] In addition, some revenues are foreseen to be lost due to the introduction of the possibility for small companies (self-employed) to pay the corporate income tax rate of 19% if they renounce all tax exemptions and rebates. Until 2004, the self-employed paid taxes according to the personal income tax thresholds (19%, 30% and 40%), but subject to various tax exemptions and rebates.

[6] Mainly for wages, but also for modernisation of public institutions.

[7] The Public Finance Act provides for a series of prudence procedures when the public debt ratio (calculated according to the Polish definition that requires guarantees to be included in the calculations of the public debt) breaks the levels of 50%, 55% and 60% of GDP. If the public debt exceeds 55% of GDP in year "t", in year "t+2" the State Treasury debt to GDP ratio assumed in the budget made in year "t+1" cannot exceed the ratio observed in year "t".

[8] The public debt calculated following the Polish methodology includes the risk-weighted stock of outstanding treasury guarantees (resulting in higher debt levels than in ESA 95). At the end of 2002, the risk-weighted stock of treasury guarantees amounted to 1.6% of GDP. The total stock of outstanding guarantees at face value was estimated by the IMF at 4.2% of GDP.

Table 5: Debt dynamics

(% of GDP)	1998	1999	2000	2001	2002	2003	2004	2005
Government gross debt	39.1	40.3	36.6	36.7	41.2	45.4	49.1	50.3
Change in debt ratio (1=-2+3+6)	-4.9	1.2	-3.6	0.1	4.5	4.3	3.7	1.2
Primary balance (2)	1.6	1.2	0.3	-0.5	-0.7	-1.0	-2.8	-1.2
Snow-ball effect (3=4+5)	-2.6	-0.8	-1.8	1.2	1.9	1.3	0.3	-0.1
Interest expenditure (4)	3.8	3.0	2.1	3.0	2.9	3.1	3.2	3.3
Contribution of nominal GDP growth (5)	-6.4	-3.8	-4.0	-1.8	-0.9	-1.7	-2.9	-3.4
Stock-flow adjustment (6)	-0.6	3.1	-1.5	-1.7	1.8	1.9	0.6	0.1

Source: Eurostat and Commission Spring 2004 forecasts.

4. OTHER RELEVANT FACTORS

4.1. Medium term prospects

The Polish pre-accession economic programme submitted in August 2003 forecasts the deficit to peak at 5% of GDP in 2004 from 4.1% in 2003 and to gradually fall thereafter to 3.4% by 2006. A "Medium-term fiscal strategy", which indicates the way forward without, however, showing the precise measures, was unveiled shortly after the submission of the 2003 PEP. The strategy complemented the 2003 PEP by presenting various scenarios for public finances depending on different growth and reform hypotheses.

The Hausner plan for the period 2004-2007, approved in January 2004, updates the forecast presented in the 2003 PEP (i.e. revising upwards the deficit for 2004) and reflects the goals unveiled in the above-mentioned strategy. It constitutes an ambitious response to an increasing deficit and debt independently of the economic cycle and aims at creating room of manoeuvre in the budget for the continuation of structural reforms and the absorption of the EU structural funds. It is based on a reduction of social and administrative spending, as well as savings thanks to the rationalisation of certain economic sectors corresponding in total to 5.2% of GDP over the entire period. The savings are however back-loaded. Their time schedule foresees major expenditure reductions for 2006 (1.8% of GDP) and for 2007 (1.6% of GDP), but also eventually for 2005 (1.4% of GDP). The measures targeting social spending aim among others at diminishing the burden of the indexation of various social expenditures (disability pensions and retirements benefits), reforming the highly inefficient and costly social security system for farmers and addressing the relatively high increase in the old age-dependency ratio.

If the plan is fully implemented, the deficit is expected to decrease below the 3% reference level by 2007. But at this stage the implementation of the Hausner plan remains subject to uncertainty. Furthermore, if the open pension funds are excluded from the general

government sector, and in the absence of additional savings measures, reaching the 3% reference level will most likely be delayed.

4.2. Investment

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure". Since 2001, the general government deficit of Poland consistently exceeded general government gross fixed capital formation (see table 3), which has been around 3.5% of GDP also over the period of weak growth in 2001 and 2002. Public investment has been well above the EU-15 average of 2.3% of GDP over the same period. The developments in investment rates have to be assessed against the public investment needs linked to the catching-up process of the Polish economy. Moreover, the government is likely to make commitments related to co-financing of EU-financed investments.

4.3. External account

The external account[9] deficit widened significantly through the last two years of the decade, peaking at 6% of GDP in 2000. This reflected strong import growth and the combined effect on exports of the Russian crisis and of a sizeable appreciation of the real effective exchange rate in 2000. Subsequently, the weakening of domestic demand, coupled with the improvement in Poland's external competitiveness from 2002, resulted in a marked reduction of the external account deficit which dropped to 2% of GDP in 2003. During this period 2001-03, the increase in the private savings-investment surplus mitigated pressures on the external account stemming from the deterioration of the general government accounts. The economic upswing, and in particular the recovery in investment activity, will entail a reduction in net private savings this year and next, against the backdrop of a widening general government deficit in 2004. However, higher transfers from the EU will limit the deterioration of the external account deficit which is projected to rise to only 2.2% of GDP by 2005. In the coming years, reining in the government deficit will be crucial to maintain the external account deficit at sustainable levels as the savings-investment surplus of the private sector will likely diminish further.

5. CONCLUSIONS

The general government deficit increased to 4.1% of GDP in 2003 in Poland, in a context of an economic recovery. The excess of the general government deficit over the 3% of GDP reference value does not result, in the sense of the Stability and Growth Pact, from an unusual event outside the control of the Polish authorities, nor is it the result of a severe economic downturn. Following three years of rapid increase, the debt-to-GDP ratio reached 45.4% of GDP at the end of 2003.

According to the Commission Spring 2004 forecasts and to the Polish authorities, the general government deficit will, at around 6% of GDP, be well above 3% of GDP in 2004. The debt-to-GDP ratio is expected to increase by 3.7 percentage points to around 49% of GDP in 2004.

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[9] Net lending/borrowing vis-à-vis the rest of the world = current account + capital account. In the current system of national accounts, this is what corresponds to the concept of the "balances of payments on current account" mentioned in Article 121(1) of the Treaty.

The deficit and the debt figures will have to be adjusted upward if the open pension funds are excluded from the general government sector following the EUROSTAT decision on the classification of the funded pension schemes.