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Recommendation for a

COUNCIL RECOMMENDATION TO POLAND

with a view to bringing an end to the situation of an excessive government deficit

Application of Article 104(7) of the Treaty

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. Background: Article 104 and the excessive deficit procedure

Article 104 of the Treaty establishes the requirement to maintain sound public finances and avoid excessive deficit as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The Stability and Growth Pact, namely its corrective part laid down in Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1], implements Article 104 of the Treaty. In 2005, the Pact was amended to anchor fiscal discipline, strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

2. The excessive deficit procedure for Poland

On the basis of the Commission services' spring 2004 economic forecasts[2], which revealed a deficit of 4.1% of GDP for 2003[3], the Commission initiated the excessive deficit procedure for Poland on 12 May 2004, in accordance with Article 104(3) of the Treaty. In May 2004, Poland submitted its first convergence programme and the Council adopted an opinion on it on 5 July 2004[4]. At the same time, the Council decided, on the basis of a Commission recommendation in conformity with Article 104(6) that Poland had an excessive deficit[5] and consequently, pursuant to Article 104(7), issued a recommendation to the Polish authorities for its correction[6]. In this recommendation, the Council invited the Polish authorities "*to put an end to the present excessive deficit situation as rapidly as possible*" and to "*take action in a medium-term framework in order to achieve their objective of bringing the deficit below 3% of GDP in 2007 in a credible and sustainable manner, in accordance with the path for deficit reduction specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004*" with the following annual targets: "*5.7% of GDP in 2004, 4.2% of GDP in 2005, 3.3% in 2006 and 1.5% of GDP in 2007*". The Council established the deadline of 5 November 2004 to take effective action "*regarding the measures envisaged to achieve the 2005 deficit target*". Poland was also recommended to "*allocate possible extra revenues to decrease the general government deficit*". In addition, the Council invited the Polish authorities "*to ensure the rise in the debt ratio is brought to a halt*".

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1 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

2 European Economy No 2/2004. The Commission services' spring 2004 economic forecast took into consideration data reported by Poland in March 2004 and published by Eurostat (Eurostat News Release 38/2004 of 16.3.2004).

3 In the meantime, the deficit figure for 2003 has been revised, according to the usual procedures. It now stands at 4.7% of GDP.

4 OJ C 320, 24.12.2004, p. 15.

5 OJ L 62, 9.3.2005, p. 18.

6 See http://register.consilium.eu.int/pdf/en/04/st11/st11220.en04.pdf

3. The general government data in the excessive deficit procedure and systemic pension reforms

The Eurostat decision of 2 March 2004 on the sectoral classification of pension schemes established that defined-contribution funded schemes cannot be classified as social security and thus cannot be considered as part of general government[7].

Poland currently avails itself of this transitory period for the pension reform which will expire with the first fiscal notification of 2007 (of the actual deficit and debt data for 2006 and preceding years), due by 1 April 2007[8]. Therefore, social contributions and other revenue collected (and expenditure incurred) by funded defined-contribution schemes have been recorded as government revenue (and expenditure), which result in deficit and debt figures being somewhat smaller than otherwise. At the expiry of the transition period, only the definitions that include the budgetary cost of the pension reform will be valid.

4. Recent developments and prospects for 2007

Based on the assessment of the 2007 draft budget and the Commission services' autumn 2006 forecast the Council adopted, on the basis of a Commission recommendation, on 28 November 2006 a decision establishing, in accordance with Article 104(8), that the action taken by Poland in response to the recommendation of the Council in accordance with Article 104(7) is proving to be inadequate[9]. According to the Treaty and the Stability and Growth Pact, this can only be followed by another Council recommendation under Article 104(7) given that Poland is not participating in the single currency and is therefore not subject to the next steps of the procedure (Article 104(9) and Article 104(11)).

In the latest update of the convergence programme, submitted on 30 November 2006, Poland revised downwards the estimated deficit outcome for 2006 and the deficit targets for 2007-2009 compared to the draft 2007 budget. The new deficit target for 2007 is 1.4% of GDP (3.4% if the pension reform cost is included). The downward revision of the 2007 deficit target is not based on additional measures but reflects the better-than-expected outturn for 2006 (from a deficit of 2.1% of GDP expected in the budget for 2007 to an estimated outturn of 1.9% in the convergence programme) and better growth prospects for 2007. In structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures), the deficit would improve by ½% of GDP in 2007, after ¼% in 2006.

Taking into account the most recent economic and budgetary developments, the outturn for 2006 is likely to be around 1.9% of GDP, i.e. closer to the figure in the programme than to the 2.2% of GDP projected in the Commission services’ autumn 2006 forecast, with a potential favourable base effect on 2007. However, the deficit target for 2007, based mainly (i) on the assumption of an incomplete execution of expenditure plans of local authorities and (ii) on some revenue measures, seems subject to risks stemming from (i) a possible acceleration of co-financing resulting from rising absorption of EU funds and (ii) from the strong reliance on positive macroeconomic developments. According to the Commission services’ autumn 2006

[7] See Eurostat News Release No 30/2004 of 2 March 2004 and Chapter I.1.3 – Classification of funded pension schemes and impact on government finance of the Eurostat’s Manual on government deficit and debt, available for download at: http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-BE-04-002/EN/KS-BE-04-002-EN.PDF.

[8] See Eurostat News Release No 117/2004 of 23 September 2004.

[9] OJ L 414, 30.12.2006, p. 81.

forecast, the impact of the 2007 budget would be to bring about a structural improvement of only ¼% of GDP. In nominal terms, taking into account the latest information, the deficit projection for 2007 would be around 1.7% of GDP.

The most recent update of the convergence programme envisages the correction of the excessive deficit by 2007 counting on the possibility to consider part of the pension reform costs according to Article 2(7) of Council Regulation (EC) No 1467/97 and the implementing provisions in the code of conduct[10]. In particular, Article 2(7) of the Regulation specifies that "*in the case of Member States where the deficit exceeds the reference value, while remaining close to it, and where this excess reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory, fully-funded pillar, the Commission and Council shall also consider the cost of the reform to the publicly managed pillar when assessing developments in EDP deficit figures. For that purpose, consideration shall be given to the net cost of the reform on a linear degressive basis for a transitory period of five years. This net cost shall be taken into account also for the decision of the Council under Article 104(12) (…)* [i.e. to abrogate previous decisions under the excessive deficit procedure] *if the deficit has declined substantially and continuously and has reached a level that comes close to the reference value*" [of 3% of GDP]. Taking into account the implementing provisions in the code of conduct, the applicable share of pension reform cost is 60%. As pension costs are estimated at 2% of GDP in 2007, the part of costs to be considered would correspond to around 1.2% of GDP.

For Poland to benefit from this provision, the deficit should be shown to (i) have declined substantially and continuously and (ii) have reached a level that comes close to the reference value. The table below supports that the deficit (whether including or excluding the pension reform cost) has declined substantially and continuously over the period 2004-2006; however, the deficit (including pension reform costs) was not yet close to the reference value in 2006. The outcome for the 2007 deficit will thus determine whether this provision of the Pact can be applied to Poland; in the absence of corrective measures to bring the deficit clearly closer to the reference value, this provision cannot be applied.

[10] Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005. See in particular paragraph 5 of section I B of the code of conduct.

General government balance targets and outcomes and pension reform cost (% of GDP)

		2004	2005	2006	2007	2008	2009
CP May 2004	PRC not included	-5.7	-4.2	-3.3	-1.5	n.a.	n.a.
	PRC	*1.6*	*1.6*	*1.6*	*1.6*	*n.a.*	*n.a.*
	PRC included*	**-7.3**	**-5.8**	**-4.9**	**-3.1**	**n.a.**	**n.a.**
CP Nov. 2004	PRC not included	-5.4	-3.9	-3.2	-2.2	n.a.	n.a.
	PRC	*1.5*	*1.5*	*1.5*	*1.5*	*n.a.*	*n.a.*
	PRC included*	**-6.9**	**-5.4**	**-4.7**	**-3.7**	**n.a.**	**n.a.**
CP Jan. 2006	PRC not included	-3.8	-2.9	-2.6	-2.2	-1.9	n.a.
	PRC	*1.8*	*1.8*	*2.0*	*1.9*	*1.8*	*n.a.*
	PRC included*	**-5.6**	**-4.7**	**-4.6**	**-4.1**	**-3.7**	**n.a.**
FN Oct. 2006 and budget 2007	PRC not included	-3.9	-2.5	-2.1	-1.7	-1.2	-0.5
	PRC	*1.8*	*1.9*	*2.0*	*2.0*	*2.1*	*2.3*
	PRC included*	**-5.7**	**-4.4**	**-4.1**	**-3.7**	**-3.3**	**-2.8**
COM Nov. 2006	PRC not included	-3.9	-2.5	-2.2	-2.0	-1.8	n.a.
	PRC	*1.8*	*1.9*	*2.0*	*2.0*	*2.1*	*n.a.*
	PRC included*	**-5.7**	**-4.4**	**-4.2**	**-4.0**	**-3.9**	**n.a.**
CP Nov. 2006	PRC not included	-3.9	-2.5	-1.9	-1.4	-1.0	-0.6
	PRC	*1.8*	*1.9*	*2.0*	*2.0*	*2.1*	*2.3*
	PRC included*	**-5.7**	**-4.4**	**-3.9**	**-3.4**	**-.1**	**-2.9**

Notes:
PRC = pension reform cost; CP = Convergence Programme; FN = Fiscal Notification
COM = Commission services' autumn 2006 forecast
***** Definition of the general government balance that is applicable from spring 2007.
Sources:
Commission services, convergence programmes and Polish budget for 2007

The most recent update of the convergence programme plans a further reduction of the deficit in 2008 and 2009, to 3.1% of GDP and 2.9% respectively (pension reform cost included). In structural terms, the planned improvement is around ½% of GDP in each year.

In its assessment of the programme, which forms the basis for a recommendation for a Council opinion on the programme, the Commission highlights risks to the achievement of these budgetary targets, stemming from the possibility of lower-than-expected growth and the non-specification of the measures underlying the adjustment.

Comparison of key macroeconomic and budgetary projections[1]

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Nov 2006**	**3.5**	**5.4**	**5.1**	**5.1**	**5.6**
	COM Nov 2006	3.5	5.2	4.7	4.8	*n.a.*
Output gap (% of potential GDP)	**CP Nov 2006[2]**	**-0.4**	**0.5**	**0.5**	**0.3**	**0.4**
	COM Nov 2006[6]	-0.3	0.4	0.3	0.1	*n.a.*
General government balance (% of GDP)	**CP Nov 2006**	**-2.5**	**-1.9**	**-1.4**	**-1.0**	**-0.6**
	COM Nov 2006	-2.5	-2.2	-2.0	-1.8	*n.a.*
Primary balance (% of GDP)	**CP Nov 2006**	**0.1**	**0.5**	**1.0**	**1.4**	**1.7**
	COM Nov 2006	0.1	0.2	0.4	0.6	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Nov 2006[2]**	**-2.4**	**-2.1**	**-1.6**	**-1.1**	**-0.7**
	COM Nov 2006	-2.3	-2.3	-2.1	-1.8	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2006[4]**	**-2.4**	**-2.1**	**-1.6**	**-1.1**	**-0.7**
	COM Nov 2006[5]	-2.3	-2.3	-2.1	-1.8	*n.a.*

Notes:
[1] The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated programme would be -4.3% of GDP in 2005, -3.9% in 2006, -3.4% in 2007, -3.1% in 2008 and -2.9% in 2009.
[2] Commission services calculations on the basis of the information in the programme.
[3] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[4] There are no one-off and other temporary measures in the programme.
[5] There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.
[6] Based on estimated potential growth of 4.1%, 4.4%, 4.8% and 5.0% respectively in the period 2005-2008.
Source:
Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

5. Conclusions

The following conclusions can be drawn:

– The most recent deficit target for 2007 (1.4% of GDP excluding pension reform costs), set in the November 2006 update of the convergence programme, is just below the one endorsed by the Council in July 2004 (1.5% of GDP) in a context of much better-than-expected budgetary outcomes in the years 2004-2006. The deficit target reflects a growth assumption that is broadly as expected in July 2004. There is no reason to extend the deadline for the correction of the excessive deficit beyond 2007.

– In spring 2007, the transitional period for implementing the Eurostat decision of 2 March 2004 on the classification of pension schemes will expire and funded defined-contribution pension schemes will need to be classified outside general government. This will entail an upward revision of the Polish deficit series since 1999 by the amount of the pension reform costs. For 2007, the deficit target of 1.4% of GDP (excluding pension reform cost) translates into around 3.4% of GDP (including pension reform cost).

– According to the Commission services' autumn 2006 forecast, the general government deficit was projected to reach 4% of GDP (including pension reform cost). However, taking into account more recent information that has become available since the cut-off date of the forecasts, notably on the strength of the economy in 2006 and the better-than-previously-expected deficit outturn for 2006 (now estimated at 1.9% of GDP), the deficit projection for 2007 would be lower, to around 3.7% of GDP (including the pension reform costs). The difference with the most recent deficit target is due to higher-than-expected

GDP growth and the operation of the automatic stabilisers, namely higher tax revenues (predominantly value-added tax) and dividends as well as lower social expenditure (thanks to lower unemployment). On the basis of currently available information, a structural adjustment of 0.5% of GDP in 2007 should ensure that the most recent official target of 3.4% of GDP is achieved.

– The November 2006 update of the convergence programme confirms that Polish authorities envisage the correction of the excessive deficit by 2007. With a deficit target for 2007 including the pension reform cost at 3.4% of GDP, i.e. above the reference value, the programme assumes that Poland will be able to benefit from the provision in the Stability and Growth Pact allowing for a degressive consideration of the pension reform costs (60% in 2007, or 1.2% of GDP) in a possible decision to abrogate the decision on the existence of an excessive deficit. Given that the deficit has declined continuously and substantially over the period 2004-2006, the deficit outcome for 2007 and its closeness to the 3% of GDP reference value will determine whether Poland can benefit from this provision.

The November 2006 update of the convergence programme envisages a further reduction of the deficit, to 2.9% of GDP in 2009 (including the pension reform cost). Budgetary outcomes may be worse than targeted in the programme because the growth outlook for 2008-2009 is favourable and the non-specification of the measures that support the adjustment. Addressing these risks will be necessary to ensure a durable correction of the excessive deficit.

Recommendation for a

COUNCIL RECOMMENDATION TO POLAND

with a view to bringing an end to the situation of an excessive government deficit

Application of Article 104(7) of the Treaty

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) According to Article 104 of the Treaty, Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) On 5 July 2004, the Council decided, in accordance with Article 104(6), that an excessive deficit exists in Poland[11].

(4) Having decided on the existence of an excessive deficit in Poland, the Council recommended on 5 July 2004, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[12], that the Polish authorities take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner, in accordance with the path for deficit reduction as specified in the Council opinion of the same day on the convergence programme submitted in May 2004[13].

(5) The Council recommendation under Article 104(7) referred to figures that did not include the deficit-increasing impact of the Eurostat decision of 2 March 2004 on the classification of defined-contribution pension schemes outside general government. However, the recommendation under Article 104(7) and the Council opinions on the May 2004 convergence programmes and its subsequent updates (of November 2004 and January 2006) took explicitly into account the risks for the correction of the

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[11] OJ L 62, 9.3.2005, p. 18.

[12] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

[13] OJ C 320, 24.12.2004, p. 15.

excessive deficit from the implementation of this Eurostat decision, which, as was decided by Eurostat in September 2004, has to be implemented by 1 April 2007 (deadline for the first notification of actual debt and deficit data for the year 2006 and preceding years). At the time of the Council recommendation under Article 104(7), the deficit-increasing impact of implementing the Eurostat decision (i.e. the annual cost of the 1999 Polish pension reform) was estimated at around 1½% of GDP.

(6) On 28 November 2006, the Council adopted a decision in accordance with Article 104(8) stating that the action taken by Poland in response to the Council recommendation of 5 July 2004 under Article 104(7) was proving to be inadequate to correct the excessive deficit by 2007[14]. The decision was based on (i) the upward revision of the deficit target for 2007 in the budget for 2007 compared to the recommendation (in spite of much better-than-expected budgetary outturns for the period 2004-2006); (ii) risks of a higher-than-targeted deficit for 2007 as identified in the Commission services' autumn 2006 forecast; and (iii) the implementation of the above-mentioned Eurostat decision as of spring 2007, estimated to result in an increase in the 2007 deficit by around 2% of GDP.

(7) Poland is currently a Member State with a derogation within the meaning of Article 122(1) of the Treaty, which means that it is to avoid excessive deficits but that Article 104(9) and Article 104(11) of the Treaty do not apply to it; further recommendations can be addressed to Poland only on the basis of Article 104(7).

(8) According to Article 3(4) of Regulation (EC) No 1467/97, a recommendation made in accordance with Article 104(7) has to specify that effective action is to be taken by the Member State concerned within six months at most and that the correction of the excessive deficit should be completed in the year following its identification unless there are special circumstances. Article 3(4) also specifies that in a recommendation to a Member State to correct an excessive deficit the Council should request the achievement of a minimum annual improvement in the structural balance of at least 0.5% of GDP as a benchmark.

(9) Special circumstances – namely, the size of the deficit and the ongoing structural shift in the economy – were considered to exist when the Council issued its recommendation to Poland under Article 104(7), which allowed for a correction in a medium-term framework, namely by 2007. Given that the deficit outturns in the period 2004-2006 were well below the targets underlying the Council recommendation under Article 104(7) and economic growth expected for 2007 is broadly confirmed, there is no reason to extend the deadline for the correction of the excessive deficit.

(10) The November 2006 update of the convergence programme, covering the period 2006-2009, also envisages the correction of the excessive deficit by 2007, the same as in the previous programmes. Building on a better-than-expected outturn for 2006 as estimated in the programme (1.9% of GDP), the deficit target for 2007 is set at 1.4% of GDP. Thereafter, the deficit is planned to be reduced to 1.0% of GDP in 2008 and 0.6% in 2009. These targets do not include the impact on the deficit of the above-mentioned Eurostat decision. Including this impact, the deficit series becomes: 3.9% in 2006, 3.4% in 2007, 3.1% in 2008 and 2.9% in 2009. In structural terms (i.e. in

[14] OJ L 414, 30.12.2006, p. 81.

cyclically-adjusted terms net of one-off and other temporary measures), the deficit is planned to improve by around ½ % of GDP annually in 2007-2009.

(11) The 2007 deficit of 3.4% of GDP would exceed the 3% of GDP reference value. The programme assumes that, for the purpose of abrogating the decision on the existence of an excessive deficit under Article 104(12), the Commission and the Council could, as foreseen in Article 2(7) of Council Regulation (EC) No 1467/97, consider the cost to the budget of the 1999 pension reform according to a linear degressive scale amounting to 60% in 2007, or around 1.2% of GDP. For Poland to benefit from this provision, the deficit should have declined substantially and continuously and have reached a level that comes close to the reference value. As the deficit has declined substantially and continuously over the period 2004-2006, the outcome for the 2007 deficit will crucially determine whether this provision can be applied to Poland.

(12) The Commission services' autumn 2006 forecast showed that there are risks attached to the deficit target for 2007. Taking into account more recent information that has become available since the completion of the autumn forecast, especially the better-than-expected outturn for 2006 (now estimated at 1.9% of GDP), the 2007 deficit is likely to be around 3.7% of GDP (including the cost of pension reform), that is, somewhat better than projected in the autumn forecast (around 4% of GDP) but worse than the most recent official target (3.4% of GDP).

(13) In its opinion of [27 February 2007] on the November 2006 update of the convergence programme, the Council reviews the medium-term budgetary plans of the Polish authorities. The overall conclusion is that the programme envisages the correction of the excessive deficit by 2007 but that the action taken so far does not appear adequate and the planned measures appear insufficient to achieve that result. While in subsequent years the programme envisages to make appropriate progress towards the MTO in a context of strong growth prospects, there are important risks to the achievement of the budgetary targets, and the durability of the adjustment. The risks to the budgetary targets stem notably from (i) a favourable macroeconomic scenario for the period 2008-2009; (ii) significant uncertainties about the effective implementation of planned reforms; and (iii) a lack of information on the measures supporting the envisaged expenditure restraint, which appear to be in an early conceptual phase.

(14) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

HEREBY RECOMMENDS:

1. The Polish authorities should put an end to the present excessive deficit situation by 2007 at the latest.

2. The Polish authorities should reduce the general government deficit in a credible and sustainable manner and to this end ensure an improvement of the structural balance by 0.5 percentage point of GDP between 2006 and 2007.

The Council establishes the deadline of [27 August 2007] for the Polish authorities to take effective action to this end.

In addition, the Council invites the Poland to ensure that budgetary consolidation towards its medium-term objective of a structural deficit of 1% of GDP is sustained after the excessive deficit has been corrected.

This recommendation is addressed to the Republic of Poland.

Done at Brussels, [27 February 2007].

For the Council

The President