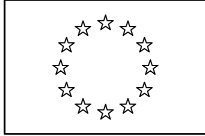

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 14.11.2006
SEC(2006) 1443 final

Recommendation for a

COUNCIL 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) of the Treaty establishing the European Community is proving to be inadequate

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. Background: the excessive deficit procedure for Poland

The excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by Council Regulation (EC) No 1467/97 of 7 July 1997[1] on speeding up and clarifying the implementation of the excessive deficit procedure, which is part of the Stability and Growth Pact.

On the basis of the Commission 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[4]. In May 2004, Poland submitted its convergence programme and, based on a Commission recommendation, the Council adopted an opinion on it on 5 July 2004[5]. 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 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 "*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*".

2. 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 contributions funded schemes cannot be classified as social security schemes and thus cannot be considered as part of general government. This was a framework decision which required bilateral discussions with Member States before implementation.

In the discussions following that decision, Eurostat acknowledged that "*some Member States might need a transitional period to implement the decision and to avoid disruptions in the*

---

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. The Commission spring 2004 economic forecast took into consideration data reported by Poland in March 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. See http://ec.europa.eu/economy_finance/about/activities/sgp/edp/edppl_en.htm.
5. OJ C 320, 24.12.2004, p. 15.
6. See http://register.consilium.eu.int/pdf/en/04/st11/st11220.en04.pdf

conduct of their budgetary policies"[7]. The 3-year transitional period established by Eurostat will expire with the first fiscal notification of 2007, due by 1 April 2007.

Poland currently avails itself of this transitory period for the pension reform it implemented in 1999. 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 definition that includes the cost of the pension reform will be valid.

About 20% of the revenue from pension contributions has been redirected from the pay-as-you-go system to the fully-funded defined-contribution pension schemes. While this reform improves the long-run sustainability of public finances, it will have a negative impact on the budget in the short term: on the basis of the recent information, the annual cost of the reform will be about 2% of GDP in 2006 and 2007.

The path for deficit reduction endorsed by the Council on 5 July 2004 did not include the cost of the pension reform that Poland implemented in 1999. At the time of the Council's assessment of the first Polish convergence programme (5 July 2004), the annual cost of the Polish pension reform was estimated at 1.6% of GDP. Accordingly, the Council stated in its opinion on the programme that "*the deficit may have to be revised upwards by 1.6 percentage point of GDP*". Given a deficit target for 2007 of 1.5% of GDP – and also taking into account the prevailing negative risks attached to the budgetary consolidation strategy – the Council concluded in its opinion that "*the budgetary stance in the programme may not be sufficient to reduce the deficit below 3% of GDP during the programme period*" [i.e. by 2007].

3. Developments until 2005

After the expiry of the deadline of 5 November 2004 set in the Council Recommendation of 5 July 2004, the Commission concluded, in its Communication to the Council of 14 December 2004, that – in view of the 2005 deficit target – no further steps were necessary under the excessive deficit procedure for Poland[8].

On 17 February 2005, the Council delivered its opinion[9] on the November 2004 update of the convergence programme of Poland, based on a Commission recommendation. The update revised the 2007 deficit target upwards as it foresaw a gradual reduction of the general government deficit from 5.4% of GDP in 2004 to 2.2% of GDP in 2007 (compared to the previous 2007 target of 1.5% of GDP). This upward revision occurred in spite of continued strong growth (projected in the programme to average more than 5% per annum), while deficit outcomes / projections for the years 2004-2006 were all lowered. In its opinion, the Council pointed out the negative risks attached to the consolidation strategy and warned that "*the deficit level will have to be adjusted upwards by about 1.5 percentage point. This*

---

[7] See Eurostat News Releases No 30/2004 of 2 March 2004 and No 117/2004 of 23 September 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] Communication from the Commission to the Council: The action taken by the Czech Republic, Cyprus, Malta, Poland and Slovakia in response to the Council recommendations under the excessive deficit procedure - SEC(2004) 1630.

[9] OJ C 136, 3.6.2005, p. 23.

adjustment means that based on the update and in the absence of additional savings measures, Poland will not be able to bring the deficit below 3% in the end year of the programme" as the deficit target for 2007 would reach about 3.7% of GDP including the pension reform costs. Besides, the Council noticed a risk of a delayed or incomplete implementation of the measures envisaged in the plan of fiscal consolidation. Accordingly, the Council invited Poland *inter alia* to strengthen the fiscal adjustment beyond 2005 and to lower the deficit target for 2007. In effect, only a small number of measures was implemented. The fiscal outcome for 2005 was nevertheless better than expected at 2.5% of GDP.

4. Developments in 2006 and prospects for 2007

Despite the invitation in the Council opinion of 17 February 2005, the January 2006 update of the convergence programme only aimed at a slow reduction of the general government deficit (by ca. 0.3% of GDP annually on average in the period 2006 to 2008) in order to meet the budgetary convergence criteria by the end of the legislature (i.e. by the end of 2009). Also, while deficit outcomes and projections for the years 2004-2006 were again revised downward, the programme confirmed the deficit target for 2007 at 2.2% of GDP (excluding the cost of the pension reform). Moreover, the programme revised upwards the costs of the pension reform, by 0.4% of GDP. With the pension reform cost included, the 2007 deficit target was higher than in the previous update (4.1% of GDP compared to 3.7% of GDP) as the re-estimated cost of the pension reform was expected to reach 1.9% of GDP in 2007.

Based on a Commission recommendation, the Council adopted its opinion on the January 2006 update of the convergence programme on 14 March 2006. The Council pointed to various risks attached to the budgetary consolidation strategy, such as relatively favourable growth assumptions in the last year of the programme period (2008), relatively optimistic assumptions about tax elasticities and possible difficulties with expenditure control in the face of social spending pressures. The Council concluded that "*the convergence programme envisages some progress, but not the effective correction of the excessive deficit in 2007* (…) *and that the Commission intends to recommend further steps under the excessive deficit procedure as required by the Stability and Growth Pact*". In addition, the Council mentioned that the planned adjustment in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures calculated by the Commission services on the basis of the information provided in the programme according to the commonly agreed methodology) was planned to improve on average by ¼% of GDP per year over the programme period.

In the draft 2007 budget (adopted on 27 September 2006), the 2006 general government deficit is estimated to reach 2.1% of GDP (pension reform cost not included), compared to 2.6% of GDP targeted in the January 2006 update of the convergence programme (and 3.3% underlying the July 2004 Council Recommendation under Article 104(7)). The more positive outcome reflects higher revenues (especially personal income tax) owing to stronger-than-projected growth as well as more contained expenditure growth, notably lower-than-planned public investment. In the draft 2007 budget, the Polish government presents the following deficit targets for the subsequent years: 1.7% in 2007, 1.2% in 2008 and 0.5% in 2009.

At 1.7% of GDP, the revised deficit target for 2007 (without pension reform costs) is now closer to but still above the original target set in the Council recommendation under Article 104(7), of 1.5% of GDP. However, according to the Commission services' autumn 2006 forecast, the 2007 deficit will reach 2% of GDP (pension reform cost not included). This reflects a more cautious view of revenue projections of the Commission services, especially

for direct taxes (nominal revenue increase by 9.7%, despite planned indexation of tax brackets and introduction of pro-family tax reliefs, compared to the assumed nominal GDP growth of 6.2%). In addition, there are also uncertainties with respect to budgetary outcomes for 2007 at local authorities' level. Finally, social expenditure is likely to be higher as a result of the adopted legislation which is not fully consistent with the draft 2007 budget.

Budgetary developments, 2005-2008

% of GDP, unless indicated otherwise	2005	2006		2007		2008	
		COM	MF	COM	MF	COM[3]	MF
General government balance	−2.5	−2.2	−2.1	−2.0	−1.7	−1.8	−1.2
Pension reform cost[2]	1.9	2.0	2.0	2.0	2.0	2.1	2.1
General government balance incl. Eurostat decision	−4.4	−4.2	−4.1	−4.0	−3.7	−3.9	−3.3
Primary balance	0.1	0.2	0.3	0.4	0.8	0.6	1.3
Structural balance[1]	−2.3	−2.3	n.a.	−2.1	n.a.	−1.8	n.a.
Structural primary balance[1]	0.2	0.1	n.a.	0.3	n.a.	0.6	n.a.
Government gross debt	42.0	42.4	42.4	43.1	43.1	42.7	42.7
Pm Real GDP growth (%)	3.5	5.2	5.2	4.7	4.6	4.8	4.8
Pm Output gap	−0.3	0.4	n.a.	0.3	n.a.	0.1	n.a.

(1) Cyclically-adjusted balance excluding one-off and temporary measures (zero in the case of Poland).
(2) The pension reform cost is measured as the difference between (i) the government deficit compiled according to ESA95 rules and the Eurostat decision of 2 March 2004 and (ii) an alternative government deficit compiled as if the pension scheme remained classified in the government sector.
(3) No-policy change assumption.
Sources: Commission services' autumn 2006 forecast (COM) and 2007 budget of the Ministry of Finance (MF)

5. Conclusions

The following conclusions can be drawn from above assessment:

– The deficit target for 2007 (1.7% of GDP excluding pension reform costs) is higher than 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 Commission services' autumn 2006 forecast projects that the 2007 deficit will be 2.0% of GDP, i.e. 0.3% of GDP higher than targeted by the Polish authorities.

– In 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 funds will be classified outside general government. This will entail an upward revision of the Polish deficit series. For 2007, the deficit target of 1.7% of GDP (excluding pension reform cost) translates into around 3.7% of GDP (including pension reform cost). According to the Commission services' autumn 2006 forecast, the general government deficit would reach 4% of GDP (including pension reform cost).

– Taking into account the risk of a higher-than-targeted deficit outcome in 2007, as identified in the Commission services autumn 2006 forecast, this is well above the 3% of GDP deficit reference value and cannot be considered as being in line with the recommendations of the Council for a correction of the excessive deficit by the 2007 deadline.

In the light of these findings, the Commission is of the opinion that, while there has been an improvement in the fiscal position in Poland, the action of the Polish authorities in response to

the July 2004 Council recommendations in accordance with Article 104(7) is proving inadequate to correct the excessive deficit by 2007 and it recommends that the Council decides accordingly under Article 104(8)[10].

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

		2004	2005	2006	2007	2008
CP May 2004	PRC not included	–5.7	–4.2	–3.3	–1.5	n.a.
	estimated PRC	*1.6*	*1.6*	*1.6*	*1.6*	*n.a.*
	PRC included*	**–7.3**	**–5.8**	**–4.9**	**–3.1**	**n.a.**
CP Nov. 2004	PRC not included	–5.4	–3.9	–3.2	–2.2	n.a.
	estimated PRC	*1.5*	*1.5*	*1.5*	*1.5*	*n.a.*
	PRC included*	**–6.9**	**–5.4**	**–4.7**	**–3.7**	**n.a.**
CP Jan. 2006	PRC not included	–3.8	–2.9	–2.6	–2.2	–1.9
	estimated PRC	*1.8*	*1.8*	*2.0*	*1.9*	*1.8*
	PRC included*	**–5.6**	**–4.7**	**–4.6**	**–4.1**	**–3.7**
FN Oct. 2006 and draft budget 2007	PRC not included	–3.9	–2.5	–2.1	–1.7	–1.2
	estimated PRC	*1.8*	*1.9*	*2.0*	*2.0*	*2.1*
	PRC included*	**–5.7**	**–4.4**	**–4.1**	**–3.7**	**–3.3**

PRC = pension reform cost; CP = Convergence Programme; FN = Fiscal Notification
* Definition of the general government balance that is applicable from spring 2007.

[10] Article 104(8) states that, when the Council establishes that action in response to its recommendation according to Article 104(7) has been inadequate, it may decide to make this recommendation public. However, in line with Resolution of the European Council on the Stability and Growth Pact (OJ C 236, 2.8.1997, p. 1), Poland already agreed to make the recommendation public in July 2004 (see http://register.consilium.eu.int/pdf/en/04/st11/st11220.en04.pdf).

Recommendation for a

COUNCIL 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) of the Treaty establishing the European Community is proving to be inadequate

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(8) 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. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[11] which was adopted to further the prompt correction of excessive general government deficits.

(3) The Resolution of the Amsterdam European Council of 17 June 1997[12] solemnly invites all parties, namely the Member States, the Council and the Commission, to implement the Treaty and the Stability and Growth Pact in a strict and timely manner.

(4) The Eurostat decision of 2 March 2004 on the sectoral classification of pension schemes[13] established that a defined contributions funded scheme cannot be classified as a social security scheme. This scheme cannot therefore be considered as part of general government. This was a framework decision which required bilateral discussions with Member States before implementation. In the context of those discussions, Eurostat acknowledged that "some Member States might need a transitional period to implement the decision and to avoid disruptions in the conduct of their budgetary policies"[14]. The transitional period, allowed by Eurostat, will expire

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

[12] OJ C 236, 2.8.1997, p. 1.

[13] Eurostat News Releases No 30/2004 of 2 March 2004 and No 117/2004 of 23 September 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.

[14] Ibidem

with the first fiscal notification of 2007, due by 1 April 2007. Poland decided to avail itself of this transitional period. 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 smaller than otherwise.

(5) By Council Decision 2005/183/EC[15] of 5 July 2004, it was decided, in accordance with Article 104(6) of the Treaty, that an excessive deficit existed in Poland.

(6) In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, on 5 July 2004, the Council also adopted a recommendation to the Polish authorities to bring the existence of an excessive deficit to an end as rapidly as possible and to take action in a medium-term framework to achieve the objective of bringing the deficit below 3% of GDP by 2007 in a credible and sustainable manner, in accordance with the path for deficit reduction specified in the convergence programme submitted by the authorities in May 2004 and endorsed in the Council Opinion of 5 July 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".

(7) The deficit reduction path endorsed by the Council on 5 July 2004 did not include the cost of the pension reform implemented in 1999. About 20% of the revenue from pension contributions has been redirected from the pay-as-you-go system to the fully-funded defined-contribution pension schemes. At the time of the recommendation under Article 104(7), the Council took explicitly into account the fact that the deficit targets would have to be revised upwards, with an estimated annual cost of the Polish pension reform of around 1½% of GDP. In view of this, and also of the prevailing negative risks attached to the budgetary consolidation strategy, the Council pointed out in its opinion on the May 2004 convergence programme that "the budgetary stance in the programme may not be sufficient to reduce the deficit below 3% of GDP during the programme period" [i.e. by 2007].

(8) After the expiry of the deadline of 5 November 2004 set in the Council recommendation under Article 104(7), the Commission concluded, in its Communication to the Council of 14 December 2004, that no further steps were necessary under the excessive deficit procedure for Poland as the Polish government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target[16].

(9) On 17 February 2005, the Council delivered its opinion on the November 2004 update of the convergence programme of Poland. The update revised the 2007 deficit target upwards to 2.2% of GDP in 2007 (from 1.5% in the May 2004 convergence programme), i.e. about 3.7% of GDP including the cost of pension reform. This upward revision occurred in spite of continued strong growth (projected in the programme to average more than 5% per annum), while deficit outcomes/projections

---

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

[16] Communication from the Commission to the Council: The action taken by the Czech Republic, Cyprus, Malta, Poland and Slovakia in response to the Council recommendations under the excessive deficit procedure - SEC(2004) 1630.

for the years 2004-2006 were all lowered. The Council noticed a risk of a delayed or incomplete implementation of the fiscal adjustment measures. Referring to the negative risks attached to the budgetary consolidation strategy, the Council invited Poland inter alia to strengthen the fiscal adjustment beyond 2005 and lower the deficit target for 2007. In effect, only a small number of measures was implemented. The fiscal outcome for 2005 was nevertheless better than expected at 2.5% of GDP.

(10) On 14 March 2006, the Council adopted its opinion on the January 2006 update of the convergence programme of Poland. The update aimed at a slow reduction of the general government deficit (by ca. 0.3% of GDP annually on average in the period 2006 to 2008) in order to meet the budgetary convergence criteria by the end of the legislature (i.e. by the end of 2009). Also, while deficit outcomes and projections for the year 2004-2006 were again revised downward, the programme confirmed the deficit target for 2007 at 2.2% of GDP (with the cost of the pension reform not included). Given the upward revision of the pension reform cost, the 2007 deficit target including this cost was 0.4 percentage point of GDP higher than in the previous update (4.1% of GDP compared to 3.7% of GDP). The Council pointed to various risks attached to the budgetary consolidation strategy, such as relatively favourable growth assumptions in the last year of the programme period (2008), relatively optimistic assumptions about tax elasticities and possible difficulties with expenditure control in the face of social spending pressures. The Council concluded that "the convergence programme envisages some progress, but not the effective correction of the excessive deficit in 2007 (…)". In addition, the Council mentioned that the planned adjustment in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures calculated by the Commission services on the basis of the information provided in the programme according to the commonly agreed methodology) was planned to improve on average by ¼% of GDP per year over the programme period.

(11) The draft budget for 2007, adopted on 27 September 2006, estimates the 2006 deficit at 2.1% of GDP (pension reform cost not included), compared to 2.6% of GDP targeted in the January 2006 update of the convergence programme (and 3.3% underlying the July 2004 Council recommendation under Article 104(7)). The more positive outcome reflects higher revenues (especially personal income tax) owing to stronger-than-projected growth as well as more contained expenditure growth, notably lower-than-planned public investment. The draft 2007 budget presents the following deficit targets for the subsequent years: 1.7% in 2007, 1.2% in 2008 and 0.5% in 2009.

(12) The assessment of the action taken by Poland to correct the excessive deficit by 2007 in response to the Council recommendation under Article 104(7) leads to the following conclusions:

– The revised 2007 deficit target of 1.7% of GDP (excluding pension reform costs), in the draft budget for 2007, is above the target of 1.5% of GDP endorsed in the Council recommendation of 5 July 2004 for the correction of the excessive deficit. The revision of the 2007 deficit occurred against the background of much lower deficit outcomes in the period 2004-2006 than foreseen in the recommendation.

– The transition period for implementing the Eurostat decision of 2 March 2004 on the classification of funded pension schemes will expire with the first

notification in 2007 due by 1 April. The inclusion of the pension reform cost leads to a 2007 deficit target of around 3.7% of GDP.

– The Commission services' autumn 2006 forecast projects the 2007 deficit by 0.3% of GDP higher than targeted by the Polish authorities. In particular, revenues from direct taxes are expected to be lower than planned by the authorities, while social expenditure and public investment are likely to be higher.

– This leads to the conclusion that the 2007 deficit would be well above the 3% of GDP deficit reference value which is not in line with the recommendations of the Council for a correction of the excessive deficit by the 2007 deadline.

In line with the Resolution of the Amsterdam European Council on the Stability and Growth Pact, Poland agreed to make the Council recommendation of 5 July 2004 public[17].

HAS ADOPTED THIS DECISION:

Article 1

The action taken by Poland in response to the Council Recommendation of 5 July 2004 under Article 104(7) of the Treaty is proving to be inadequate to correct the excessive deficit within the deadline fixed by the Recommendation.

Article 2

This decision is addressed to the Republic of Poland.

Done at Brussels,

For the Council
The President

[17] See http://register.consilium.eu.int/pdf/en/04/st11/st11220.en04.pdf