REPUBLIC OF POLAND

Report on action taken by Poland in response to the Council recommendation of 10 December 2013 in order to bring an end to the situation of an excessive deficit

Warsaw, October 2014

Contents

List of charts

List of tables

Annexes

1) Impact of the main measures taken by the government on the general government balance in the years 2014-15
2) *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-17*. Status of implementation as at 30 September 2014

Introduction

The *Stability and Growth Pact* requires the EU Member States subject to the excessive deficit procedure to provide the Ecofin Council and the European Commission with periodical reports on measures reducing the deficit, as well as to publish those reports. This is the second consecutive report[1] since the Ecofin Council issued its recommendation of 10 December 2013 calling Poland to eliminate the excessive deficit in 2015.

At that time Poland was recommended to achieve the following nominal deficit targets in the years 2013-15, respectively: 4.8% of GDP, 3.9% of GDP and 2.8% of GDP (excluding the impact of the assets transfer from open pension funds to the Social Security Fund). On the basis of the up-to-date forecast of the European Commission[2] the Ecofin Council also stated that the achievement of those budgetary targets implied an improvement in the structural balance (i.e. in this part of the nominal deficit which the government may directly influence through the policy implemented) by 1% of GDP in 2014 and by 1.2% of GDP in the following year. This meant the need for the Polish authorities to take additional structural measures amounting to 0.4% of GDP in 2014 and 1% of GDP in 2015.

In addition, the Ecofin Council recommended that Poland:

- improve the quality of public finances, in particular through minimising cuts in growth-enhancing infrastructure investments, a careful review of social expenditures and their efficiency;
- improve tax compliance and increase the efficiency of tax administration;
- make the institutional framework of public finances more binding and transparent, including through adjusting the definitions used in national accounting to ESA standards and ensuring sufficiently broad coverage, improving intra-annual monitoring of budget execution and ensuring an effective and timely monitoring of compliance with the permanent expenditure rule, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities.

This report presents the current economic and budgetary situation and measures aimed at eliminating the excessive deficit in 2015.

1. Budgetary situation 2014-15

► *Macroeconomic outlook*

Following a period of a relatively weak growth of economic activity in Poland in 2012, the real GDP growth since the 2nd quarter of last year has stayed, on average, at a level of 0.8% q/q, whereas on an annual basis, the real GDP level in the 2nd quarter of 2014 was higher by 3.3% than in the 2nd quarter of 2013. The clear upward trend was maintained in export, which was fostered by the high competitiveness of Polish enterprises, and, since the 2nd quarter of 2013, also by the improvement in the dynamics of activity in the Polish main export markets. The improvement of the situation in the domestic labour market is also observed, demonstrated by the increase in the demand for labour and decrease in unemployment rate, under the growing occupational activity of the Poles and still limited wage pressure. Domestic demand has an increasing importance for the GDP growth (y/y). Positive contribution of net export to the GDP growth was recorded until the 1st quarter of this year, however, its level was systematically decreasing, reaching a negative value already in the 2nd quarter. The declining contribution of net export is accompanied by acceleration of the real export growth rate. This indicates that the decreasing share of foreign trade in the GDP growth is not the result of deteriorating competitiveness of the Polish economy (on the contrary, this indicator is still improving), being rather associated with import growing under the recovery of the domestic demand. The recovery of the domestic demand results mainly from the strong growth rate of private investment and the relatively high growth rate of private consumption.

The improvement of Polish economy results was accompanied by the recovery in the euro area. Following a year and a half of recession, in the 2nd quarter of 2013, the euro area returned to the growth path and the improvement of the economic cycle covered the majority of the Member States. However, in the 2nd quarter of 2014, the slowdown in the GDP growth rate occurred, both in the euro area and in the whole EU, and the data

[1] http://www.mf.gov.pl/documents/764034/1010438/EDP+report_2014.04_EN.pdf

[2] http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee7_en.pdf

turned out to be worse than the expectations. At the same time, a part of negative risk factors related to the economic growth perspectives in the EU materialised, associated with the situation in Ukraine. Their economic effect shall lead to the limitation of trade between Russia and the EU Member States and the scale of this limitation may be of significant importance for the growth perspectives of the Polish economy in the forthcoming years. Due to the relatively limited share of Russia and Ukraine in Polish export markets (ca. 6%, with 11% share of food and livestock in the total export of Poland), the direct impact of sanctions in trade with Russia on the Polish economy should not be high and it is compensated by the growing share of Polish export in other export markets. The impact of sanctions will be more significant for the economic results of the whole EU which is the biggest trade partner of Poland.

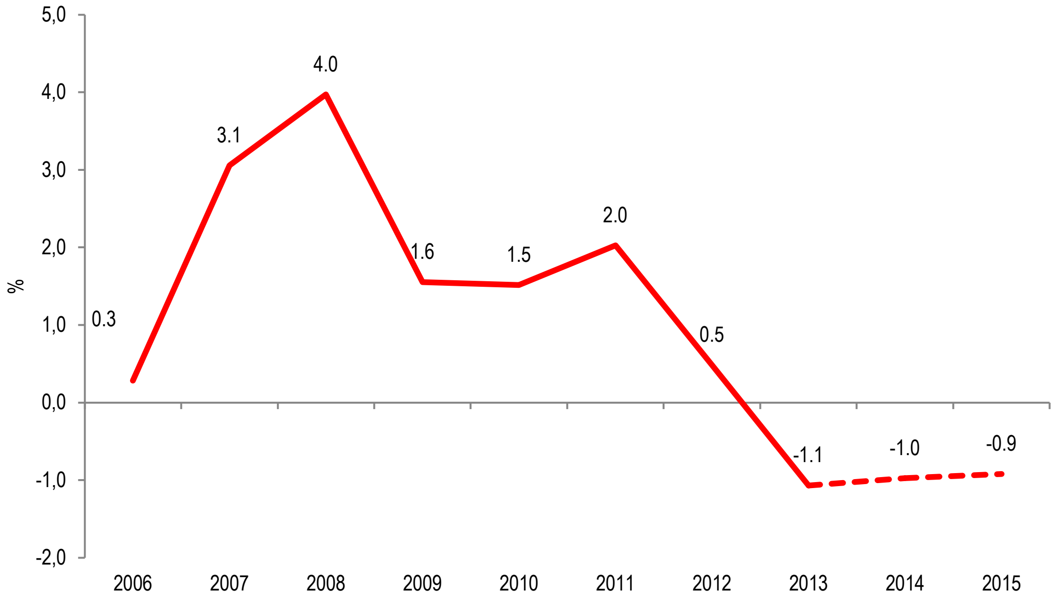
Current forecasts indicate that in 2014 GDP in Poland will grow by 3.3% in real terms, i.e. twice as fast as in the previous year. The major factor of economic activity intensification shall be the strong (by ca. 3.5. percentage points) acceleration of the domestic demand growth rate in connection with the observed dynamic increase in private investment and consumption. The recovery of the domestic private sector demand will be accompanied by the maintaining positive contribution of the public sector to the GDP growth. On the other hand, the forecast contribution of net export to the GDP growth will be negative (minus 0.2 percentage points). The improvement in the economic growth simultaneously fosters the favourable changes in the labour market. It is estimated that in 2014 the unemployment rate (LFS) will decrease to 9.7% against its level of 10.3% in 2013. The decline in unemployment rate will occur under growing occupational activity of the Poles and the strong growth in the demand for work. It is projected that in the current year the number of working people will increase by 1.5%.

In 2015, further acceleration of domestic demand is expected, up to 3.8% in real terms, among others, due to the foreseen improvement in the labour market, continued recovery of private sector investment activity and the measures announced by the government, associated i.a. with the increase in indexation of pensions and old age pensions as well as further increase of state aid for families with children (within a tax credit and care benefits), which will foster the growth of real income available to households. The positive contribution of the public sector to the economic growth will be also maintained. Enhanced increase of domestic demand will allow for acceleration of the real GDP growth rate in Poland in 2015 to 3.4%, under the negative contribution of net export (-0.4 percentage points). In 2015 further decline in the unemployment rate is expected to 9.1%, under the projected increase in the number of working people by 0.8%.

Despite the expected significant acceleration of the real economic growth rate in the years 2014-2015 in relation to the growth rates recorded in the period 2012-2013, the output gap – measured as a difference between the potential and the observed economic growth level – will basically not change and it will stay negative 0.9-0.8%. This is associated with the fact that during the entire period of the global financial crisis, the potential GDP growth in Poland stayed at a relatively high (the highest in the EU) and stable level. The slowdown of the economic growth in 2012-2013 meant a significant deterioration of cyclical conditions for economic activities and economic policy. At present, the growth rate is recovering at a level around the potential growth rate, which does not deteriorate the output gap, nevertheless, it shall also not allow for its fast closing.

The maintaining negative output gap and the strong decline of food prices resulting from the high supply of agricultural products due to favourable agrometeorological conditions (short and warm winter), and the embargo on import of food from the EU countries, including Poland, imposed by Russia, as well as good perspectives of this year's crops, resulted in record low level of inflation in Poland. It is forecast that the average annual growth of consumer prices in 2014 will reach 0.1%. Assuming the lack of supply shock in the global markets and in the domestic market, and stabilisation of raw material prices, the average annual growth of CPI in 2015 is projected at a level of 1.2%, i.e. significantly below the MPC (Monetary Policy Council) inflation target.

Chart 1. Output gap



Source: Ministry of Finance

► *Expenditures*

Effects of the stabilising expenditure rule

The key factor influencing the expenditure level planned for 2015, thus, also the shape of the fiscal policy, is the stabilising expenditure rule, introduced to the Polish legal system in 2013 (through the amendment to the *Public Finance Act*).

In accordance with the formula of the rule, the expenditure level for each year is obtained recurrently, based on the planned expenditure level for the current year. The dynamics of the expenditure level is limited to the medium-term real GDP growth rate, taking into account the CPI inflation forecast for the following year. The indicator of the medium-term real GDP growth rate is obtained based on six historic results, the planned execution of the current year and the forecast of the real GDP growth rate in the following year. Owing to such a formula of arithmetic mean, the impact of GDP dynamics forecasts and potential errors of such forecasts on the obtained expenditure level is minor. Potential errors in CPI inflation forecasts are, on the other hand, adjusted automatically during the calculation of the expenditure level for the next year. Consequently, the risk of overestimating or underestimating the expenditure level due to potential significant error made at the level of development of macroeconomic indicators forecasts for the needs of the state budget, has been minimised.

The rule has been designed so that it contributes to the compliance with both Polish and the EU requirements concerning the fiscal policy. It contains the automatic correction mechanism which corrects the expenditure growth rate by -2 percentage points or -1.5 percentage points, provided that public finance imbalance occurred in the previous year (or, potentially, +1.5 percentage points in case of positive deviations against the target). In 2015 as well as in 2016 the correction will amount to -2 percentage points (i.e. approximately 0.8% of GDP), which results from the general government deficit above 3% of GDP in 2013-14. In the years 2017-18 the correction is projected at a level of -1.5 percentage points in connection with the net public debt to exceed the level of 43% GDP.

The rule is binding for the first time in planning the general government expenditure for 2015. In accordance with the rule, the maximum expenditure level of almost entire general government[3] was defined at the first stage of the

[3] Over 95% of expenditures according to ESA'2010, which do not include expenses funded from the European Union budget and non-refundable resources from the aid granted by EFTA member states – the exclusions concern the expenses of entities that do not have a capacity to generate high deficits.

budgetary process. It means that the rule has determined the aggregated expenditure level and the expenditure limit which was subsequently distributed among entities covered by the scope of the rule. With the implementation of the rule, the approach to the budgetary process has changed through the full transfer to the *top-down* method.

The aggregated consolidated expenditure level for 2015 was defined on the basis of the entry level in accordance with the provisions of Art. 14 *of the Act of 8 November 2013 on the amendment to the Public Finance Act and some other acts*. For this purpose, the following items were calculated:

1) the planned consolidated expenditure level in 2013 covered by the scope of the stabilising expenditure rule, which amounted to PLN 657 582 426 thousand (i.e. 39.6% of GDP);
2) the consolidated entry level of expenditures for 2014, which amounted to PLN 690 629 525 thousand, based on the planned consolidated level of expenditures in 2013, using the indicators and correction defined in Art. 14 *of the Act of 8 November 2013 on the amendment to the Public Finance Act and some other acts*, as well as the total forecasted for 2014 value of discretionary measures concerning taxes and contributions.

At the stage of defining the expenditure level for 2014, constituting the entry level for the rule, the following discretionary measures exceeding the threshold value of 0.03% GDP were taken into account[4]:

1) increasing pension contributions transferred to FUS (Social insurance Fund) as a result of entry into force of the Act of 6 December 2013 on *the amendment of certain acts in connection with the determination of the rules for payment of pension from resources collected in the open pension funds* (Journal of Laws of 2013, item 1717) – estimated at PLN 4 900 000 thousand,
2) increasing tax rate on ethyl alcohol as a result of entry into force of the Act of 8 November 2013 *on the amendment of certain acts in connection with the execution of the budget act* (Journal of Laws of 2013, item 1645) – estimated at PLN 780 000 thousand,
3) liquidation of the VAT return in construction as a result of entry into force of the Act of 27 September 2013 *on the state aid for purchasing the first flat by young people* (Journal of Laws of 2013, item 1304) – estimated at PLN 912 000 thousand,
4) changes in the conditions for deducting tax charged when purchasing cars with a mesh partition and their fuel, as a result of entry into force of the Act of 7 February 2014 *on the amendment to the Act on value added tax and certain other acts* (Journal of Laws of 2014, item 312) – estimated at PLN 842 000 thousand,

The level of the planned expenditure, referred to in Art. 112aa paragraph 1 of the *Public Finance Act* for 2015 equals PLN 696 735 739 thousand (i.e. 39.7% of GDP). This amount has been defined on the basis of:

1) entry level of expenditure for 2014;
2) macroeconomic data and forecasts, including the correction due to errors in inflation forecasts included in the formula of the stabilising expenditure rule. The forecast CPI for 2014 was accepted at a level defined in Art. 14 item 5(1) of the *Act on the amendment of the Public Finance Act and some other acts*, i.e. 1.024. Currently, it is foreseen that the average annual CPI in 2014 shall reach a significantly lower level, i.e. 1.001 (c.f. Table 1);
3) the value of the correction referred to in Art. 112aa item 4 of the *Public Finance Act*, amounting in 2015 (as in 2014) to -2 percentage points due to the fact that general government balance to GDP in 2013, increased by the costs of the pension reform, exceeded the reference value of 3% GDP;
4) the general forecast value of discretionary measures (cf. Table 1).

The planned expenditure level for 2015 includes the following discretionary measures exceeding the threshold value of 0.03% GDP:

1) increasing contributions transferred to FUS (Social insurance Fund) as a result of entry into force of the Act of 6 December 2013 on *the amendment of certain acts in connection with the determination of the*

[4] In accordance with Art. 112aa paragraph 1 *of the Public Finance Act,* the discretionary measures concerning taxes and social insurance contributions are included in the formula of the stabilising expenditure rule provided that the value of each of such measures exceeds 0.03% of the gross domestic product value forecast in the draft budgetary act for the consecutive year submitted to the Parliament.

rules for payment of pension from resources collected in the open pension funds (Journal of Laws of 2013, item 1717) – estimated at PLN 6 000 000 thousand,

2) increasing pension insurance contributions due to changes in the scope of the aforementioned contributions of supervisory board members and persons employed under contracts for mandate, stipulated in the governmental draft of the *Act on the amendment of the act on the social security system and certain other acts*, estimated at PLN 623 333 thousand,
3) reducing the tax revenue through introducing the child tax credit, with the effects estimated at -1,100,000 thousand.

Due to including the discretionary measures related to taxes and contributions in the rule, the negative impact of the child tax credit on revenue is neutral for the general government balance. Consequently, it changes the context of the analysis of structural measures in the area of taxes and contributions which currently automatically provide for the stability of public finance by decreasing or increasing the maximum amount of expenditure, under the assumption of planning the expenditure at the maximum level permitted by the rule (otherwise, i.e. in case of planning the expenditure level lower than permitted, the general government balance will improve *ceteris paribus*).

Table 1. Data used for calculation of the expenditure amount and the limit for 2014-15

	2014	2015
Indicator of medium-term real GDP growth rate	1.0346*	1.0317
CPI inflation	1.024*	1.012
Correction due to forecast errors	1**	0.9795**
Correction***	-2 percentage points	-2 percentage points
Aggregated discretionary measures (thousand PLN)	7 434 000	5 523 333
Expenditure level	**690 629 525**	**696 735 739**

*indicators defined in Art. 14 of *Act on the amendment of the Public Finance Act and some other acts of 8 November 2013*

**according to Art. 14 of *Act on the amendment of the Public Finance Act and some other acts of 8 November 2013*

***according to Art. 112 aa of *Public Finance Act* of 27 August 2009

Source: Ministry of Finance

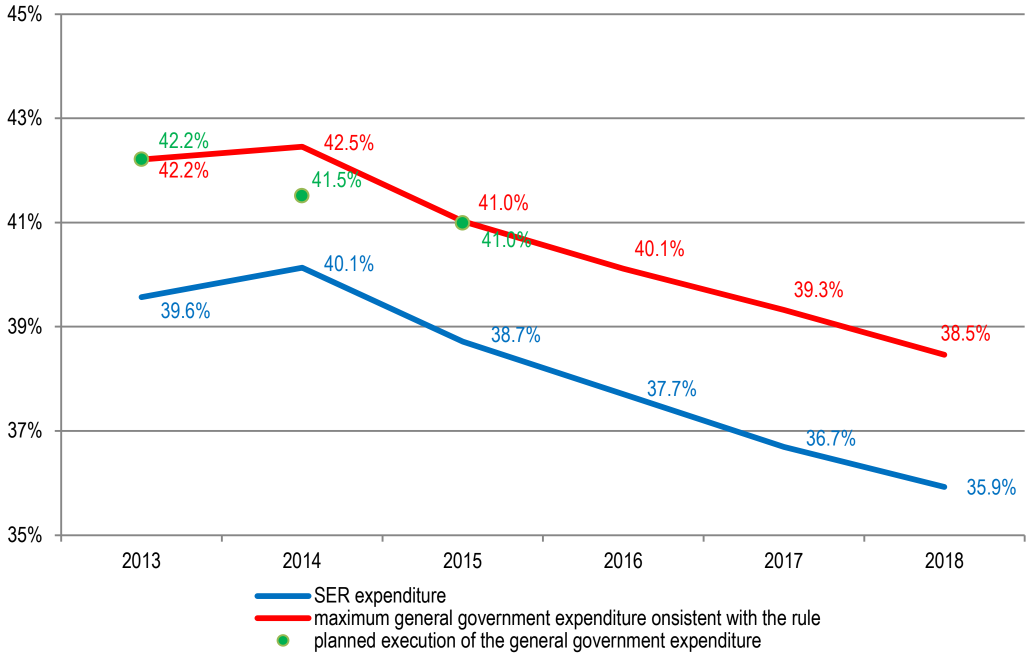
As indicated above, for operating reasons the rule does not cover the whole general government expenditure and the definition of expenditure according to ESA'2010. Accordingly, controlling for:

1) expenditure financed by the European funds and funds referred to in Art. 5 item 1(2) of the *Public Finance Act* of 27 August 2009 which are not affected by the rule (3.1% of the general government expenditure),
2) forecast expenditure of entities which have no capacity to generate high deficits (spending of those entities is, to a large extent, indirectly included, through taking into account in the expenditure level transfers from the state budget to those entities) and the transition between cash accounting to accrual-based accounting, making in total 4.8% of the general government expenditures, excluding the expenditures specified in item 1. (i.e. 1.9% of GDP),
3) expected indicator of expenditure execution covered by the scope of the stabilising expenditure rule, projected at a level of 97.75%, consistent with the relation of the executed expenditure covered by the scope of the rule to the entry level, i.e. the planned expenditure of those entities in 2013 (which means failure to implement the expenditure plan of entities covered by the scope of the stabilising expenditure rule at a level of 0.9% GDP),

it is forecast that the expenditure level of the general government consistent with the expenditure rule must not exceed 41% of GDP in 2015. Therefore, it will be 1.2 percentage points of GDP lower than in 2013, when the Council issued its recommendation calling Poland to eliminate the excessive deficit

In the forecast it is assumed that the correction mechanism of the rule will enforce further fiscal consolidation on the expenditure side. The correction will result in successive reduction of the expenditure covered by the rule to GDP – by 1 percentage point of GDP in 2016-17 and 0.8 percentage points of GDP in 2018.

Chart 2. Maximum general government expenditure consistent with the rule (SER), planned execution of the general government expenditure and the SER expenditure to GDP (ESA'2010)



Source: Ministry of Finance

As a result of the change in the approach to the budgetary planning, imposed by the introduction of the stabilising expenditure rule, the Ministry of Finance have taken measures to strengthen the monitoring process of fiscal rules and the relevant adjustment of the budgetary process. In particular, analytical works have been conducted in order to define the scope of adjustments required for the implementation of Council recommendation concerning the monitoring of fiscal rules and the budgetary process by independent bodies. The analysis of the adequacy of provisions of the *Act on the Supreme Audit Office* was performed in the context of the role of a fiscal council to be fulfilled by this institution, and the review of fiscal bodies in other Member States was performed. The review focused, i.a. on the level of independence of the operating fiscal councils, their tasks and requirements set as well as on the opinion of the European Commission. As a result of the above-mentioned analyses it has been found that some of the required elements are already present in the Polish legal system, in particular, the necessity of *ex post* assessment of state budget implementation, taking into account the compliance with the fiscal rules, including the introduced stabilising expenditure rule. At the same time, it has been found that the *ex-ante* monitoring of compliance with the fiscal rules and the opinion-making process related to macroeconomic forecasts used for the preparation of the Budget Act and the *Convergence Programme (Multiannual Financial Plan of the State)* require some amendments. At present, the conceptual works are on-going concerning the solutions which would supplement the Polish fiscal framework with the aforementioned elements, taking into account good practices and conclusions arising from the review of experience gathered by other Member States.

At the same time, pursuant to the Minister of Finance decree, the *Task force for the budgetary process reform* has been established, whose objective is, in particular, to develop procedures ensuring safe execution of the state budget, so that the consistence of the budget act execution with the limit of expenditure arising from the rule is provided. The Task force is chaired by the Minister of Finance. Preparation of the final report on the activities of the Task force is planned still this year.

The application of the *top-down* method for the budgetary planning, where the expenditure of entities covered by the scope of the rule are defined at the very beginning of the process, required the change in the approach to public expenditure through focusing on their quality / effectiveness and structure, instead of their level defined by the rule. Accordingly, within the organisational changes at the Ministry of Finance, the Expenditure Policy Department has been established whose tasks include, i.a. the review of public expenditure in cooperation with the World Bank and the OECD. The aim of the review is to achieve the best possible and the most effective use of public funds. The official kick-off of the joint project was the conference on *Public Spending Reviews: Theory and Practice* on 17-18 June this year, held at the Ministry of Finance. Since then, intensive work is in progress, aimed at launching pilot reviews as soon as possible. It is assumed that the first results of the review will be known in the first half of 2015, and the results of effectiveness analyses of state expenditure will be taken into account already during the works on the draft budget act for 2016.

Moreover, planning of the general government expenditures based on the stabilising expenditure rule is also supported by the amendments to the *Public Finance Act* introduced in 2009, which defined new fiscal rules for local governments. Due to the gradual implementation of those regulations, extended over time, it was possible to implement them fully without major problems. The first rule on at least balanced current part of the budget (Art. 242 *of the Public Finance Act*) became effective in 2011, the next rule introducing individual debt limits has been binding since 2014.

Other measures on the expenditure side

Besides measures aimed at strengthening of the fiscal policy framework, a number of measures of structural nature and those aimed at rationalising public spending are implemented.

Consolidation of public finance in 2014-15 will be implemented as in the previous years, through limiting the relation of expenditure to GDP (decline by 1.2 percentage points), although the rate of decline in the relation to the GDP will be slower and it will occur under much faster economic growth than in 2010. The main areas where expenditure growth rate is slower than the GDP growth rate will include debt servicing costs (decrease by 0.5 percentage points), public consumption (decline by 0.3 percentage points, including labour costs (decline by 0.1 percentage points), social security benefits (decline by 0.1 percentage points). Public investment which, in accordance with the Council recommendation, should not be subject to consolidation, will reach the level by 0.1 percentage points higher than forecast in 2014 (4.0% of GDP).

One of the main measure limiting the growth of general government expenditure is implementation of the general policy on freezing the remuneration fund in the central government sub-sector, which shall generate the total effect in 2014-15 at a level of ca. 0.2% of GDP. This policy, through the so-called demonstration effect has already indirectly influenced the growth of wages in local government units (in 2013 costs of labour in the local government sub-sector decreased by 0.1 percentage points in relation to GDP).

Additionally, the general government expenditures are still limited by the effects of reforms undertaken in the previous years. The most important reforms include abolition of early retirement scheme and gradual increasing and equalising the retirement age for women and men. The effectiveness of the measures undertaken is confirmed, for example, by the 30% decline in sick leaves among uniformed services as a result of entry into force in spring this year of the act restricting the level of benefits for such services for a period of sickness to 80% of the remuneration.

At the same time, measures aimed at rationalising of public expenditure are undertaken. Examples include the activities of the Social Insurance Institution (ZUS) comprising[5], in particular, the implementation and development of IT tools supporting both the communication with external client (Electronic Service Platform – PUE), and the internal governance procedures (i.a. *workflow* enabling broader use of electronic documents in internal document flow), introduction of the eWUŚ system (Electronic Verification of Benefit Recipients' Entitlements) reducing the scale of abuse in using the health care benefits by unauthorised persons, centralising the services provided by ZUS to institutional clients and the consequent introduction and application of the competitive procedure towards customers (suppliers of goods and services). The savings arising from those measures in the years 2013-15 are estimated at approximately PLN 500 million.

Among others, due to the aforementioned limitations of expenditure it is possible to allocate resources for the priority tasks of the government, such as pro-family policy and - in connection with the situation in Ukraine - the defence, within the limit of expenditure determined by the stabilising expenditure rule. The decisive intensification of measures within the pro-family policy shall enable to counteract the negative demographic trends more effectively. This goal is achieved through the increased duration of additional maternity leave and introduction of the so-called parental leave, already implemented in 2013 (the total duration of maternity leave and parental leave amounts to 52 weeks, for a single birth, and in case of multiple births from 65 to 71 weeks). In parallel,

[5] More information may be found in the ZUS communication: http://www.zus.pl/default.asp?p=1&id=1&idk=2349.

measures have been undertaken with the purpose of popularising the pre-school education (resources for this goal have been allocated in the Budget Act for 2014 and in the draft Budget Act for the next year). In addition, starting from the next year, changes in the child tax credit in PIT will apply. These changes will, on the one hand, increase support for families with many children – through raising by 20% value of the tax credit for the third child and the next children, on the other hand, enabling practically all entitled persons to deduct the maximum level of the relief through introducing the mechanism of unused relief refund (where the refund must not exceed the total amount of deductible social security and health insurance contributions paid by the tax payer/parents). A totally new proposal, included in the *exposé* of Prime Minister Ewa Kopacz, of 1 October 2014, is to apply the right to extended maternity leave to persons who are not subject to social security (the unemployed, students, persons employed under contracts for a specific job and farmers) starting from 2016. Moreover, changes in the scope and level of care benefit and the allowance to this benefit are under implementation, increasing the state support for persons entitled to receive this type of benefits.

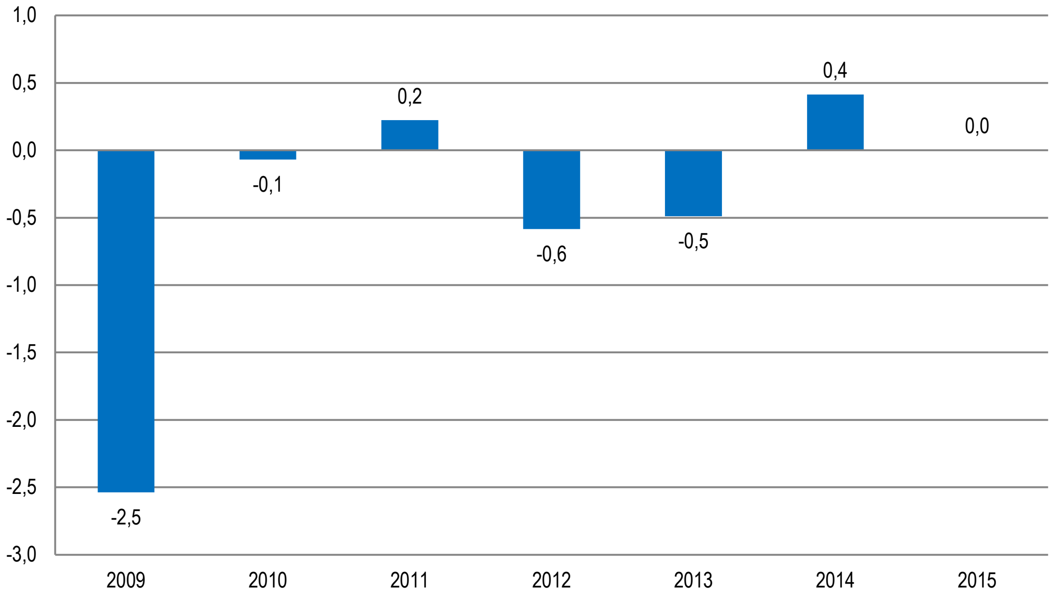
Under the current geopolitical situation a very important issue, already announced before and confirmed in the *exposé*, seems to be the increase of defence expenditure up to 2% of GDP per annum, starting from 2016. Under the assumption that funds spent for the modernisation of the Polish army will be mostly transferred to Polish arms enterprises, it will provide an additional stimulus to maintain the recovery in Poland.

It is worth stressing that all the new goals indicated in the *exposé* of Prime Minister Ewa Kopacz are within the limit of expenditure foreseen by the stabilising expenditure rule. Funds for tasks foreseen for implementation in 2015 have been already allocated in the draft Budget Act for 2015. In the expenditure limit, tasks planned for implementation in 2016 have also been included, with their cost estimated at approximately 0.2% of GDP. Such approach ensures the security of the on-going fiscal consolidation and reaching the medium-term budgetary objective in the forthcoming years.

► ***Revenues***

Owing to the effects of structural measures and the improvement of the economic cycle, 2014 is the year of significant growth of tax revenue, the highest recorded since the times of crisis (cf. Chart 3) (by 0.4% GDP in relation to 2013). The contribution of measures on the revenue side to the consolidation of public finance will, however, be significantly lower than on the expenditure side.

Chart 3. Change in the general government expenditures in the years 2009-15 (% of GDP)



Source: Ministry of Finance

Positive conditions for collecting revenues are reflected in the exceptionally good current situation of the budget. In the first nine months of 2014 the inflows to the state budget due to tax revenues were higher than in the corresponding period of 2013 by as much as 8.6%, including revenues from indirect taxes which recorded growth by 9.4% on an annual basis (including VAT by 11.4%). Better performance of the revenue side as compared to the forecast included in the Budget Act for 2014 as well as to the forecast included in this year's update of the *Convergence Programme*, will constitute, through the effect of base, an additional factor improving the general government balance in the following years.

The continuing upward trend of private consumption, due to the recovery of the labour market situation, also allows to assume the continuation of the upward trend in tax revenues in the current year and the following years. Such a significant acceleration of tax revenue growth which currently occurs, under still negative output gap and the deflation continuing in the last months, however, confirms much higher importance of structural measures effects than was originally estimated (partly due to the difficulties in their estimation, e.g. the improvement of effectiveness of the tax administration and effects of counteracting tax fraud). It should be noted that without a number of significant structural changes that have been introduced in the recent years in the area of taxes and social security contributions, the general government revenue would face a deep cyclical decline in relation to GDP. The most important measures on the revenue side which should be mentioned include:

- increasing social security contributions (through limiting the part transferred to OFE (Open Pension Funds) in favour of the part transferred to FUS (Social Insurance Fund) – 2011 as well as owing to the increase of the pension insurance contribution in 2012, (formerly reduced in 2007 and 2008);
- increasing VAT rates from 22% to 23% and from 7% to 8% in 2011, simultaneously decreasing the rates for basic food products from 7% to 5%;
- temporary limitation – since 2011 – of the possibility to deduct VAT paid on purchasing personal vehicles with LCV homologation, and fuel used to propel them;
- freezing of the PIT parameters at a nominal level for 2009: tax thresholds, tax free amount and flat tax deductible costs;
- introducing a fee for exploiting certain natural deposits of copper and silver – from 2012.

In addition, during the last year a number of measures were undertaken aimed at limiting the VAT fraud: reducing the limit authorising tax payers to the exemption from the obligation to keep cash register, extension of the *reverse charge* mechanism and the joint and several liability of the purchaser for tax liabilities of the supplier of steel products, fuel and non-processed gold. All these changes, excluding the limitation of the possibility to deduct VAT paid on purchasing personal vehicles with LCV homologation, and fuel used to propel them, shall remain in force in the following years (2015-16).

Additionally, the Ministry of Finance prepared the programme on *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-2017*, which was announced in April 2014. The implementation of this programme will facilitate the fulfilment of liabilities towards the state by tax payers and enhance the effectiveness of tax administration[6]. The Ecofin Council recommended Poland to undertake steps in this area in the recommendation concerning the elimination of excessive deficit. Among 43 projects, measures improving tax collection represent a significant group. It is expected that the implementation of all the foreseen measures would result in the growth of the general government revenues even in 2014 by a minimum of PLN 1.9 billion (in the maximum variant, by PLN 2.1 billion), and in 2015 – minimum by further PLN 2.0 billion (in the maximum variant, by PLN 3.3 billion). According to the state of implementation at the end of September this year, 33 measures has been implemented according to the schedule (i.e. ¾ of all tasks, more information is included in Annex 2). At the same time, in accordance with the *exposé* of Prime Minister Ewa Kopacz, of 1 October 2014, works associated with the preparation of a new *Tax Code Act* are to be accelerated – the project assumptions should be ready at the beginning of 2015. In order to eliminate the dualism in the labour market, existing due to possibility of tax optimisation (mainly as the possibility to reduce social contributions from labour), the government undertakes measures aimed at compensating disproportions in burdens on various forms of work contracts. One of such measures is the change in the rules of calculating social security contributions in case of contracts for mandate and contracts for specific work (in case of contracts for mandate the provision shall apply on combining the titles for insurance in case of the resulting lower contribution base than the amount of the minimum salary for

[6] *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-2017* – a package announced by the Ministry of Finance on 15 April this year and published at http://www.mf.gov.pl/documents/764034/1161625/pakiet_dzialan_podatkowych.doc

work), and salaries for supervisory board members (covering them by the obligatory pension and old age pension insurance).

The change in the tax credit for bringing up children, discussed above, will also foster the compensation of differences in effective charging of revenues generated under the employment contracts and the so-called junk contracts. The proposed solutions will have a positive impact on the labour market through the reduction of the tax wedge for families with children and large families with relatively lower income. It will positively influence the economic growth through the increase in household revenue, private consumption and through creating the incentives for official hiring of employees, and for undertaking work by the unemployed. It is expected that the solution will contribute to the limitation of the grey economy. The proposed changes should simultaneously contribute to the improvement of the fertility rates, as an element of the poverty reduction.

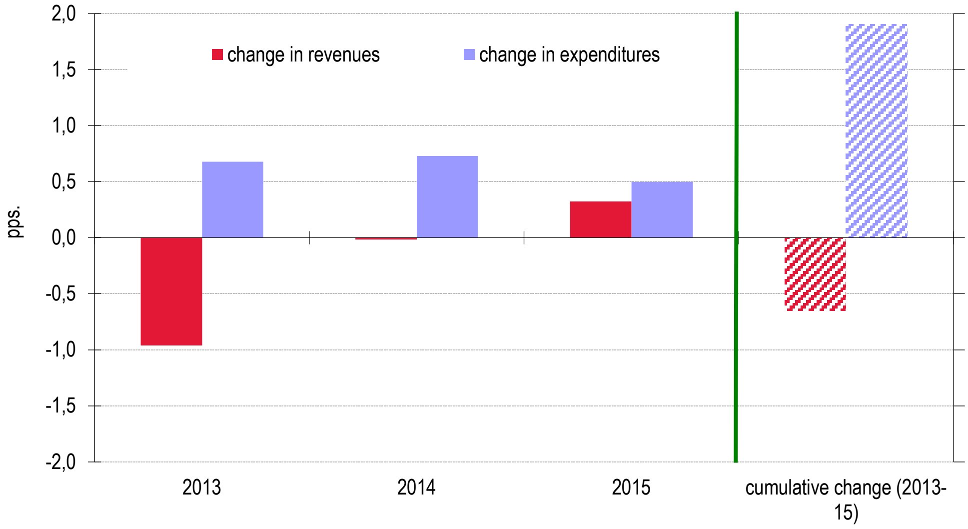
In 2015, owing to the visible recovery in the current year and the increased profits generated also by the companies fully owned by State Treasury and enterprises where State Treasury is the co-owner, it will be possible to increase slightly the stream of dividends transferred to the central budget. The sale of frequency reservation through the electronic auction system (digital dividend) will also have positive effects on the revenues in 2015.

Based on the aforementioned expected effects of systemic changes (structural measures) and macroeconomic conditions, under the conservative assumption on VAT tax elasticity against the base (equal to 1), a slight improvement of the general government revenue-to-GDP ratio in 2015 is forecast, comparing to the current year. In 2016 this ratio will return to the ratio observed in 2014.

2. General government balance 2014-15

In 2013, the general government deficit (according to ESA'2010) reached 4.0% of GDP, and it decreased by 0.3 percentage points of GDP in relation to the level estimated in the April 2014 notification. Simultaneously this result is better by 0.8 percentage points of GDP, as compared to the level projected by the European Commission in 2013, which was the basis for the Council recommendation.

Chart 4. 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

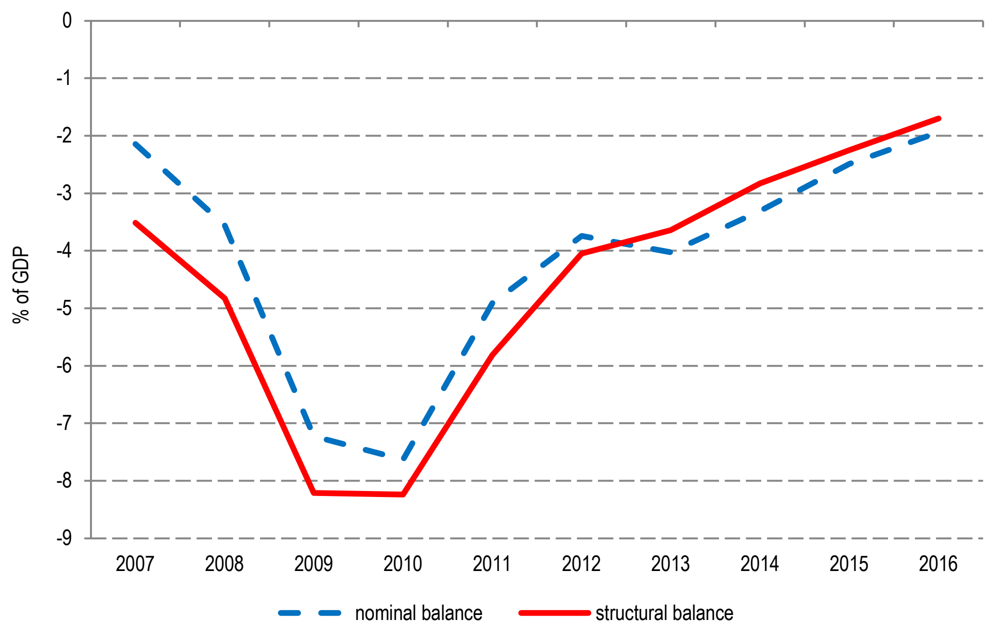
The lower general government deficit and, at the same time, the revision of the revenue and expenditure, was i.a. a result of implementation of the European System of National and Regional Accounts (ESA'2010). Due to the reclassification of the Bank Guarantee Fund to the central government sub-sector, the general government balance improved by approximately PLN 1.4 billion. However, the inflows to the state budget due to the reduction of the statutory fund of Bank Gospodarstwa Krajowego were not recognised as the central government revenue and deteriorated the general government balance by PLN 1 billion. On the other hand, the change in the GDP calculation method resulted in improvement of the relation of the general government balance to GDP by 0.1 percentage points.

The revision of the methodology, i.e. shift from ESA'95 to ESA'2010 and update of the data also influenced the general government deficit forecasts for 2014-15. According to the latest estimates, the nominal deficit will amount to 3.3% of GDP in 2014 and 2.5% in 2015. In the forthcoming years, further consolidation of public finance is expected, until reaching the medium-term budgetary objective (-1% of GDP) in 2018 at the latest.

The fiscal consolidation arising from the stabilising expenditure rule is reflected not only in the reduction of public expenditure to GDP, but also in the gradual reduction of the structural deficit (cf. Chart 5). It is estimated that the structural deficit in 2013 amounted to 3.6% of GDP, whereas in 2014 it will reach 2.8% of GDP and in 2015 2.3% of GDP.

Consequently, in 2014 the forecast fiscal effort, i.e. the change in the structural balance, will amount to 0.8 percentage points of GDP, which will arise from: improvement of the nominal balance by 0.7 percentage points and the growth in the value of one-off measures by 0.1 percentage points. On the other hand, in 2015 the forecast fiscal effort will amount to 0.6 percentage points of GDP, which will arise from: improvement of the nominal balance by 0.8 percentage points and decrease of one-off measures value by 0.2 percentage points. Both in 2014 and 2015, the impact of changes of the cyclical component of the nominal balance will not differ significantly from zero, which results from the stabilisation of the output gap around -0.8% of GDP in the years 2013-15. In the following years, the fiscal effort will be consistent with the minimum benchmark indicated in the Council Country-specific recommendations (July 2014), i.e. it will amount to about 0.5 percentage points per year.

Chart 5. Structural and nominal general government balance in the years 2007-16



Source: Ministry of Finance

Summary

Information and forecasts presented in this report imply that the nominal deficit will be reduced to 2.5% of GDP in 2015, i.e. below 2.8% of GDP recommended by the Council. Also in the current year the general government deficit at the level of 3.3% of GDP is by 0.6 percentage points of GDP lower than recommended by the Council. As regards 2013, the deficit was by 0.8 percentage points of GDP lower than the budgetary target determined in the Council recommendation, and it reached 4.0% of GDP.

The government is committed to reducing the imbalance in public finances in the manner which would not pose any threat to the medium-term development perspectives of the country. Therefore, the next years will be oriented towards Poland's meeting the medium-term budgetary objective (MTO) in 2018, i.e. the structural deficit equal to 1% of GDP. Achieving the MTO and maintaining the general government debt significantly below the reference value of 60% of GDP will, in particular, be ensured by compliance with the stabilising expenditure rule introduced in 2013, and supported by measures increasing effectiveness of spending.

Annex 1. Impact of the main measures taken by the government on the general government balance in the years 2014-15

	cumulative effect 2014-15 bln PLN	cumulative effect 2014-15 % of GDP
DISCRETIONARY MEASURES TAKEN TO IMPLEMENT COUNCIL EDP RECOMMENDATION	**46.058**	**2.66**
REVENUE	**24.649**	**1.42**
Tax revenue	**5.578**	**0.33**
Increase the tax rate on ethyl alcohol	0.780	0.05
Repeal of act concerning VAT returns on housing expenditures	1.314	0.08
Changes in the conditions for deducting tax charged when purchasing cars with a mesh partition and their fuel, impact on VAT	0.914	0.05
Tax revenue decrease, as a result of child tax credit	-1.100	-0.06
Other tax revenue, including i.a.:	3.670	0.21
- changes in the conditions for deducting tax charged when purchasing cars with a mesh partition and their fuel, impact on PIT/CIT		
- the abolition of the exemption from the purchase of a farm or part of it, as well as the abolition of the exemption for contracts for the sale in enforcement proceedings or bankruptcy, as well as the abolition of the lower rate of forest tax		
- freeze of PIT thresholds		
- abolition of tax relief for internet expenditure		
- limitation of 50% tax deductible costs		
- changes in CIT for some companies		
Non-tax revenue	**14.976**	**0.86**
Higher social contributions to FUS (lower to OFE)	10.900	0.63
Introduction of pension and disability contributions on contracts for mandate and on salaries of supervisory boards members	0.623	0.04
Other non-tax revenue, including i.a.:	3.453	0.20
- sale of frequency reservations through the electronic auction system (digital dividend)		
- averaging the contribution base and, consequently, allowance base, in the case of less than 12 months subject to sickness insurance of persons engaged in non-agricultural activities and other groups of people for whom the contribution basis is the amount declared in excess of the lowest basis of the contribution		
- receipts from fare charged in ETC system (VIAtoll)		
- net revenue from the National Forest Holding		
- revenues from the CO2 emission rights auction		
- increasing the fees for paid services provided by agricultural producers inspections and executive agencies		
Increased efficiency of tax system	**4.095**	**0.24**
Measures improving tax compliance and increasing the efficiency of tax administration	3.870	0.22
Measures improving i.a. cost effectiveness of ZUS	0.165	0.01
EXPENDITURE	**21.410**	**1.24**
Social benefits	**10.875**	**0.63**
Abolition of early retirement scheme	7.287	0.42
Extension of maternity leave	-1.573	-0.09
Increase of retirement age	4.900	0.28
Other measures in the area of social benefits, including i.a.:	0.261	0.02
- family benefits and alimony		
- abolition and limitation of allowance for childbirth		
- the introduction of paid sick leave only in 80% (soldiers, justice)		
Streamlining of administration costs	**10,535**	**0.61**
Payments for farmers from the second pillar, instead direct budget payments	2.369	0.14
Effect of the nominal freezing of the wage fund in the central and social security sub-sector	3.131	0.18
Increased availability of pre-school education for children aged 3–5	-1.153	-0.07
Reduction of debt servicing costs, as a result of changes in the pension system	5.200	0.31
Other measures in the area of streamlining of administration costs, including i.a.:	0.988	0.06
- increased revenue from selling properties from Agricultural Reserves of State Treasury		
- introduction of regulations allowing for the joint service of local government units		
- introduction of e-forms for sick leaves		
- e-declarations 2		
- further consolidation of liquidity management		

Annex 2. Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-17. Status of implementation as at 30 September 2014