EUROPEAN COMMISSION

Brussels, 11.1.2012
SEC(2012) 50 final

COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Poland in response to the Council Recommendation of 7 July 2009 with a view to bringing an end to the situation of excessive deficit

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Assessment of budgetary implementation in the context of the ongoing Excessive Deficit Procedures after the Commission services' 2011 Autumn Forecast

{COM(2012) 4 final}
{SEC(2012) 49 final}
{SEC(2012) 51 final}
{SEC(2012) 52 final}
{SEC(2012) 53 final}

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1. INTRODUCTION

In 2009, as part of the European Economic Recovery Plan (EERP), the Polish authorities implemented a fiscal stimulus programme to cushion the impact of the global economic slowdown on the Polish economy. As a consequence, the general government deficit widened sharply from 3.7% in 2008 to 7.3% of GDP in 2009. Against this background, on 7 July 2009, the Council decided in accordance with Article 104(6) of the Treaty establishing the European Community (TEC)[1] that an excessive deficit existed and addressed recommendations to Poland, in accordance with Article 104(7) TEC with a view to bringing an end to the situation of an excessive government deficit by 2012. In particular, the Council recommended that the Polish authorities should: (a) implement the fiscal stimulus measures in 2009 as planned, in particular the public investment plan, while structuring a supplementary budget in such a way that any further deterioration in public finances is avoided; (b) ensure an average annual fiscal effort of at least 1¼% of GDP starting in 2010; (c) spell out the detailed measures that are necessary to bring the deficit below the reference value by 2012, and reforms to contain primary current expenditure over the coming years. The macroeconomic and budgetary projections underlying the recommendation were those of the Commission services' 2009 Spring Forecast.

On 3 February 2010, the Commission concluded that Poland had taken action towards the correction of the excessive deficit within the time limits set by the Council. The conclusion was based on an assessment of the 2010 budget and the letter of 7 January 2010 from Polish Finance Minister Jacek Rostowski to the Commissioner for Economic and Monetary Affairs Joaquin Almunia, in which the fiscal consolidation plan for 2010-2012 was presented. While the Commission recognised that Poland introduced a 2010 budget with measures to contain the deficit, announcing first elements of a fiscal consolidation programme for the period 2010-2012 and initiating the work to facilitate consolidation in the years ahead, it also emphasised the "considerable risks attached to the fiscal strategy of the Polish authorities" and noted that "further sizeable consolidation measures will be needed to bring the deficit below 3% in 2012".

[1] The corresponding article in the Treaty on the Functioning of the European Union, which entered into force on 1 December 2009, is Article 126(7).

According to the Commission services' 2010 Autumn Forecast, the general government deficit in Poland was expected to increase from 7.2% in 2009 to 7.9% in 2010 despite a considerable acceleration in real GDP growth from 1.7% to 3.5% over the same period. Against this background, on 14 January 2011, Commissioner for Economic and Monetary Affairs Olli Rehn sent a letter to Finance Minister Jacek Rostowski asking him to present measures allowing Poland to comply with the Council recommendations and reducing the general government deficit below a 3% of GDP reference value in the Treaty by 2012. In his response of 2 March 2011, the Minister presented consolidation measures to be implemented in 2011 and 2012. The Commission considered these measures to be sufficient to ensure a correction of the excessive deficit by 2012 and decided to maintain the excessive deficit procedure (EDP) in abeyance.

The Commission services' 2011 Autumn Forecast projects the deficit in Poland at 4% of GDP in 2012, which is 1 pp. above the 3% of GDP reference value in the Treaty. Against this background, on 11 November 2011 Vice-President Rehn sent a letter to Minister Rostowski urging him to adopt with no delay a 2012 budget that would ensure a timely and lasting correction of the excessive deficit, and informing him that in the absence of corrective measures spelled out in detail and adopted by mid-December 2011, a Commission recommendation for a Council decision under Article 126(8) followed by new recommendations under Article 126(7) of the Treaty would become unavoidable. On 8 December 2011, the Polish government revised the 2012 draft Budget Law and supplemented it with additional measures. The Polish Minister of Finance, Mr Rostowski, replied to Vice-President Rehn's letter on 21 December 2011 and provided additional information on actions taken or planned in order to reduce the general government deficit.

This paper examines progress made by Poland towards a timely and sustainable correction of the excessive deficit. In particular, it analyses the budgetary developments since the Commission communication to the Council on action taken of 3 February 2010 and takes into account all budgetary decisions of the Polish government that were announced publically, including the additional measures contained in the 2012 draft Budget Law and the explanations provided by Minister Rostowski in writing on 21 December 2011.

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

The macroeconomic situation in Poland over the period 2009-2012 turned out better-than-expected at the time when the Council recommendations were issued, i.e. in the Commission services' 2009 Spring Forecast. With real GDP growth at 1.6%, Poland was the only EU member state with positive growth in 2009. Economic activity continued to be stronger than projected by the Commission services' 2009 Spring Forecast, with real GDP growth in 2010 reaching 3.9% compared to 0.8% in the 2009 Spring Forecast. According to the Commission services’ 2011 Autumn Forecast, the recovery is on course to strengthen further in 2011, with real GDP expected to increase by 4% (for details see Table 1). The main drivers of the recovery in 2010 and 2011 were a gradually improving labour market, rebounding consumer and business confidence and increased foreign capital inflows. However, the growth is expected to slow down to 2.5% in 2012 on the back of faltering external demand and weakening confidence. These developments are set to result in moderate investment (including public investment slowing down towards the end of the EU financial perspective 2007-2013) and weaker private consumption growth.

Table 1: Comparison of macroeconomic developments and forecasts

	2009	2010	2011		2012		2013	
	Outturn	Outturn	COM AF 2011	National projections	COM AF 2011	National projections	COM AF 2011	National projections
Real GDP (% change)	1.6	3.9	4.0	4.0	2.5	2.5	2.8	3.4
Contributions to real GDP growth								
Final domestic demand	1.3	2.7	3.7	n.a.	2.2	n.a.	2.6	n.a.
Changes in inventories	-2.5	1.9	0.3	n.a.	-0.3	n.a.	0.0	n.a.
Net exports	2.7	-0.7	0.0	n.a.	0.6	n.a.	0.2	n.a.
Employment (% change)	0.4	0.5	1.0	1.9	0.2	0.8	0.4	0.8
GDP deflator (% change)	3.7	1.4	3.4	2.8	2.0	2.5	2.0	2.5

Note: COM AF 2011 – Commission services' 2011 Autumn Forecast; National projections – draft 2012 Budget Law
Sources: National authorities and Commission services

The Commission services' 2011 Autumn Forecast assessment of the economic developments for 2011 is in line with that of the Polish authorities presented in the 2011 update of the Convergence Programme (CP) and the draft 2012 Budget Law. The estimate of 2.5% real GDP growth for 2012 made in the 2011 Autumn Forecast is much lower than the 4% expected in the CP, as the latter could not take into account the adverse developments in the euro area. However, in its 2012 draft budget the Polish government has revised its projections for 2012 to 2.5%, in line with the Commission services' 2011 Autumn Forecast.

3. BUDGETARY SITUATION AND PROJECTIONS FOR THE PERIOD 2011-2013

3.1. Estimated outturn for 2011

Following a significant deterioration in the general government deficit, from 3.7% of GDP in 2008 to 7.8% of GDP in 2010, the Polish government embarked on an ambitious consolidation programme. This programme covered not only measures included in the 2011 Budget Law, but also supplementary ones, which were implemented outside the central government budget. Of particular importance was the reduction in the contribution rate to second pillar pension funds (from 7.2% to 2.2% of gross wages). According to the 2011 Autumn Forecast, these measures, in combination with a sharp economic rebound in 2011, are projected to bring the general government deficit down to 5.6% of GDP in 2011.

Table 2: Comparison of budgetary projections

	2011				2012				2013			
	CP 2011		COM AF		CP 2011		COM AF		CP 2011		COM AF	
	% of GDP	*nominal rate of growth*	% of GDP	*nominal rate of growth*	% of GDP	*nominal rate of growth*	% of GDP	*nominal rate of growth*	% of GDP	*nominal rate of growth*	% of GDP	*nominal rate of growth*
Total government revenue	**40,1**	***13,6***	**39,6**	***13,6***	**40,7**	***8,3***	**40.8**	***7.5***	**39,7**	***3,6***	**41,0**	***5,4***
Taxes on production and imports	13,9	*10,4*	14,2	*12,0*	14,1	*8,2*	14.3	*5.8*	13,9	*4,7*	14,4	*5,3*
Taxes on income and wealth	7,3	*12,8*	7,3	*12,3*	7,6	*11,1*	7.5	*8.2*	8,0	*11,8*	7,7	*7,0*
Social contributions	11,9	*14,6*	11,6	*12,9*	12,5	*12,1*	12.2	*9.7*	12,5	*6,2*	12,5	*7,1*
Total government expenditure	**45,7**	***7,2***	**45,2**	***7,2***	**43,7**	***2,0***	**44.8**	***3.5***	**42,2**	***2,6***	**44,0**	***3,1***
Compensation of employees	9,8	*4,5*	9,8	*4,5*	9,4	*2,3*	9.7	*2.5*	9,2	*3,9*	9,7	*4,8*
Intermediate consumption	6,1	*5,9*	6,1	*6,2*	5,9	*3,2*	6.1	*4.7*	5,8	*4,4*	6,1	*5,1*
Social transfers other than in kind	14,3	*3,2*	14,3	*3,3*	13,9	*3,7*	14.2	*4.0*	13,7	*4,7*	14,1	*4,3*
Interest expenditure	2,8	*11,8*	2,8	*13,5*	2,8	*6,7*	3.0	*9.2*	2,7	*2,4*	3,0	*6,0*
Subsidies	0,5	*6,9*	0,6	*12,7*	0,5	*6,7*	0.5	*2.3*	0,5	*6,2*	0,5	*3,1*
Gross fixed capital formation	6,6	*27,1*	6,4	*22,0*	5,8	*-6,2*	6.1	*0.5*	4,7	*-14,1*	5,4	*-7,0*
GG balance (% of GDP)	**-5,6**		**-5,6**		**-2,9**		**-4,0**		**-2,5**		**-3,1**	
Structural balance (% of GDP)	**-5,5**		**-5,4**		**-2,9**		**-3,6**		**-2,4**		**-2,5**	
GG gross debt (% of GDP)	**-54,9**		**-56,7**		**-54,1**		**-57,1**		**-52,4**		**57,5**	
Real GDP growth (%)	4,0		4,0		4,0		2,5		3,7		2,8	
Nominal GDP growth (%)	7,4		7,5		6,7		4,5		6,2		4,8	
GDP deflator (%)	3,3		3,4		2,6		1,8		2,5		2,5	

Note: COM AF 2011 – Commission services' 2011 Autumn Forecast; CP 2011 – April 2011 update of the Convergence Programme
Sources: National authorities and Commission services

Since the macroeconomic assumptions underlying the budgetary projections for 2011 are similar in the 2011 Autumn Forecast and in the 2011 update of the CP, both expected revenues and expenditures are forecast to grow at the same nominal rate in both projections, resulting in a headline deficit of the same magnitude. However, small differences in the composition of expenditure can be observed (see Table 2), as the Commission services expect a slightly higher nominal rate of growth for intermediate consumption, offset by a lower growth rate of public investment expenditure, because the profile of inflowing EU funds becomes flatter over the current EU multiannual financial framework.

3.2. Deficit projections for 2012-13

Since the Polish government did not announce any significant new reforms prior to the 2011 Autumn Forecast, the Commission services projected under the customary no-policy-change assumption that the general government deficit would fall to 4.0% of GDP in 2012, i.e. 1 pp. above the 3% of GDP reference value in the Treaty. Furthermore, it was projected that Poland's average annual fiscal effort would not comply with the respective Council recommendation (see Table 3 for details). Taking into account the change in the macroeconomic scenario between the projections underlying the EDP recommendations and the 2011 Autumn Forecast, it appears that the current estimate of the fiscal effort (1.2% of GDP) has benefited from an upward revision of underlying growth prospects; when correcting for this upward revision, the average annual fiscal effort over the period 2010-2012[2] was, at 0.9% of GDP, below the value of "at least 1¼% of GDP" recommended by the Council.

Table 3: Comparison of fiscal efforts, change in the structural balance (% of GDP) based on the Commission services' 2011 Autumn Forecast

Average annual change of structural balance 2010-2011		Average annual change of structural balance 2010-2012		Additional average annual effort needed to correct the excessive deficit	Average annual fiscal effort recommended by the Council	Deadline for correction
Uncorrected	Corrected	Uncorrected	Corrected			
1.0	0.7	1.2	0.9	1.0	at least 1¼% in 2010-2012	2012

Notes:
- The additional average annual effort (i.e. on top of measures already included in the 2011 Autumn Forecast) is calculated for the period from 2011 until the deadline for correction (2012).
- The uncorrected average annual change in the structural balance is the estimated change in the structural balance from the Commission services' 2011 Autumn Forecast. The corrected average annual change in the structural balance is the uncorrected average annual change in the structural balance plus a correction factor capturing the effect of revisions to potential output growth between the projections at the time of the EDP recommendations and the Commission services' 2011 Autumn Forecast (see European Commission (2004) Public Finances in EMU – 2004, European Economy, Brussels; and European Commission (2006) Public Finances in EMU – 2006, European Economy, Brussels).
Source: Commission services

Subsequently, on 8 December 2011, the Polish government adopted the updated 2012 draft Budget Law and revised its forecast for economic growth considerably downwards, from 4% still expected in the CP, to 2.5%. The draft Budget includes additional consolidation measures (see Table 4), which according to the Commission services' estimates (including second round effects on growth) would bring down the general government deficit to 3.3% of GDP in 2012, still above the 3% of GDP reference value in the Treaty[3]. However, the deficit of 3.3% of

[2] According to Item 4 of the Council recommendation, "the assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' Spring 2009 forecast". In the case of Poland, the positive potential growth surprise has been quite significant, i.e. it amounted to an average annual upward revision of 0.7 pps. Hence, the average annual change in the structural budget balance in the Commission services' 2011 Autumn Forecast includes a component that is not imputable to discretionary fiscal policy making. When correcting for the upward revision of the underlying growth prospects, the estimated average annual fiscal effort would be lower by 0.4 pps. amounting to 0.9% of GDP and falling short of what was recommended by the Council. Detailed information for the underlying methodology can be found at: European Commission (2004) Public Finances in EMU – 2004, European Economy, Brussels, available at: http://ec.europa.eu/economy_finance/publications/publication469_en.pdf and European Commission (2006) Public Finances in EMU – 2006, European Economy, Brussels, available at: http://ec.europa.eu/economy_finance/publications/publication423_en.pdf.

[3] In his response to Vice-President Rehn's letter, Minister Rostowski estimated the general government deficit to be at 2.97% of GDP in 2012. However, this estimate does not take into account second round effects. In addition to the main measures (listed in Table 4 of this assessment), the response referred to new regulations limiting the local government subsector's deficit (local government deficit rule) as well as to a newly introduced road speed limit enforcement system. According to Minister Rostowski, these two measures would have an impact of 0.34% and 0.08% of GDP respectively. However, the Commission services note that the local government deficit rule has not been yet formally adopted by the government and can therefore not be taken into account. Moreover, even if it were adopted, the information provided does not allow assessing of the likely effect on the budget. The same applies to

GDP expected by the Commission service taking into account measures announced/adopted after the 2011 Autumn Forecast can be considered to be close to the reference value" and the debt-to-GDP ratio is below the 60% of GDP reference value in a sustained manner (on debt developments, see Section 3.3). This, according to the Council Regulation (EU) No 1177/2011[4], allows to take into account the cost of a systemic pension reform. National authorities estimate the cost (measured as the amount of contributions transferred to the second pillar private pension funds)[5] at around 0.6% of GDP in 2012, which is higher than the gap between the expected deficit and the reference value.

As a consequence of the additional consolidation measures, the average annual fiscal effort over the period 2010-2012 has increased from 0.9% of GDP according to the 2011 Autumn Forecast to 1.1% of GDP, approaching the level recommended by the Council.

Table 4: Main budgetary measures for 2012

Revenue	Expenditure
• An increase in the social security contribution rate by 2 pp. (from 6% to 8% of gross wages) to be implemented as of 1 February 2012 (0.3% of GDP) • A royalty levy on minerals to be implemented as of 1 April 2012 (0.1% of GDP) • Additional dividends due to good results of entirely or partially state-owned companies (0.2% of GDP) • Adjustment to the law on the capital revenue tax, preventing tax avoidance on one-day deposits (0.02% of GDP)	Decrease in complementary national direct payments to landowners (-0.1% of GDP)

Note: Budgetary impact estimated by the Commission services. A positive sign implies that revenue / expenditure increases as a consequence of this measure.
Sources: Draft 2012 Budget Law, government announcements

The headline deficit is projected to keep falling in 2013 according to both national projections (2.5% of GDP) and the Commission services' 2011 Autumn Forecast (3.1% of GDP). Moreover, the structural measures announced in the draft 2012 Budget Law and in Minister Rostowski's letter (increase in social security contribution rate, royalty levy on minerals, amended law on the capital revenue tax and decrease in complementary national direct

the case of the road speed limit enforcement system. Therefore, the Commission services decided to take a prudent approach and assessed the government deficit without these two measures.

4 See Article 1(2c). The regulation has amended the modalities according to which budgetary costs related to the introduction of a mandatory, fully-funded pillar in the national pension system can be taken into account when assessing adequate progress towards a timely and sustainable correction of an excessive deficit. In the case of Member States in the EDP where the excess of the deficit over the reference value of 3% includes the effects of such a pension reform, the full net direct cost of the reform to the public budget will be taken into account provided (i) the deficit declines substantially and continuously and comes close to the 3% of GDP reference value, (ii) the gross government debt ratio does not exceed 60% of GDP and (iii) overall fiscal sustainability is maintained.

5 Pensions which would have been paid out from the state budget to people who have moved to the private pension funds should be subtracted from the cost estimate, but for the moment the number of those people is negligible.

payments to landowners) are expected to reduce it further. Adjusting the Commission services' 2011 Autumn Forecast for these additional structural measures (excluding dividends), and assuming that no further measures are taken, the 2013 deficit would further decline to 2.6% of GDP (from 3.1% in the 2011 Autumn Forecast), and if the dividend-related revenues were to remain constant in 2013, it would reach 2.4% of GDP[6].

A comparison of the general government balance projections for period 2010-2013 is presented in Table 5 below.

Table 5: Comparison of budgetary projections, including impact of measures announced/taken post-Commission services' 2011 Autumn Forecast, general government balance (% of GDP)

	2010	2011	2012	2013
COM AF 2011	-7.8	-5.6	-4.0	-3.1
CP 2011	-7.9	-5.6	-2.9	-2.5
Draft 2012 Budget Law	*n.a.*	*n.a.*	-2.9*	*n.a.*
COM Jan 2012	-7.8	-5.6	-3.3	-2.6

Notes: COM AF 2011 – Commission services' 2011 Autumn Forecast; CP 2011 – April 2011 update of the Convergence Programme, COM Jan 2012 – Commission services' assessment taking into account measures taken/announced after COM AF 2011.

* The budget balance presented in the draft 2012 Budget Law is calculated according to the national method based on cash accounting, which is not directly comparable to the ESA95 accrual accounting method.

3.3. Debt developments

The general government gross debt in Poland is projected to remain below the 60% threshold over the entire period under consideration, both in the Commission services' 2011 Autumn Forecast and the national projections in the 2011 update of the CP. While the national authorities forecast a gradual improvement in the debt position (reduction from 55.1% of GDP in 2010 to 54.9% in 2011, 54.1% in 2012 and 52.4% in 2013, according to the 2011 update of the CP), the Commission services expect a slight increase until 2013 (from 54.9% of GDP in 2010 to 56.7% in 2011, 57.1% in 2012 and 57.5% in 2013). However, the additional measures contained in the 2012 draft Budget Law are expected to slow down this trend.

Beyond 2013 and under the assumption of no further policy changes on top of the Commission services' 2011 Autumn Forecast, the debt ratio would be fairly stable and reach 56% of GDP by 2020. An additional annual structural fiscal consolidation of 0.5% of GDP from 2014 onwards in order to reach the Medium-Term Budgetary Objective (MTO) – in the case of Poland a deficit of 1% of GDP in structural terms – would set the debt ratio on a declining path, reaching 49% of GDP in 2020 in Poland[7].

6 Second round effects through the impact of the additional consolidation on the budget deficit are estimated to be very limited.

7 The underlying assumptions for economic growth and interest rates are those of the Joint Commission-EPC 2012 ageing report.