INFORMATION ON MEASURES TAKEN BY POLAND TO IMPLEMENT THE RECOMMENDATION OF THE COUNCIL ON ARTICLE 126.7 OF THE TREATY ON THE FUNCTIONING OF THE EUROPEAN UNION OF 21 JUNE 2013

I. MEASURES TAKEN IN 2013 AND PLANNED FOR 2014, IN ORDER TO INCREASE THE STABILITY OF PUBLIC FINANCES AND REDUCE THE EXCESSIVE DEFICIT

In order to implement the recommendation of the Ecofin Council on reduction of the excessive deficit by 2014, Poland has taken a number of the following measures, involving continuation of previous activities, the measures announced in the *Convergence Programme. Update 2013* (CP 2013) and earlier updates, as well as additional actions implemented on the occasion of the amendment of the Budget Act for 2013 and in the preparation of the Budget Act for 2014.

1. Measures undertaken in the pension system

Measures undertaken to improve the pension system in Poland are the Government's response to the challenges for public finances resulting from the aging of the population. The greatest positive effects of these measures, related, among others, to the reduction of the negative effects of aging on the rate of potential GDP growth, are expected in the long term.

a) **reducing the number of people entitled to early retirement and the introduction of bridging pensions –** entry into force of *the Act on early retirement* in 2009.

b) **change in the conditions of acquisition of pension rights by the officers and soldiers -** in force from 1 January 2013, provides that the representatives of the uniformed services will acquire the right to a pension after joint fulfilment of two conditions: age and length of service. The amendments set the minimum retirement age of "uniforms" to 55 years (previously 35 years), and the minimum length of service to 25 years – until now it was 15 years (*Act amending the Act on pensions for retired professional soldiers and their families, the Act on pensions for retired officers of the police, the Internal Security Agency, the Intelligence Agency, the Military Counterintelligence Service, the Military Intelligence Service, the Central Anticorruption Bureau, the Border Guard, the Government Protection Bureau, the State Fire Service and the Prison Service and their families and certain other acts*).

c) **increase in the retirement age** – on 1 January 2013, the provisions came into force amending the number of regulations with respect to *inter alia, a* pension provision, whose main objective is to gradually raise the retirement age for women and men to achieve the same level of 67 years (*Act of 11 May 2012 amending the Act on pensions from the Social Insurance Fund and certain other acts*).

d) **changes in the pension system** – based on the *Review of the pension system* published in June 2013, after a broad public debate, changes to the pension system have been proposed, to be introduced in 2014. Currently, a draft act introducing changes in the pension system is being developed and will be forwarded for public consultation in the first half of October. Its key assumptions include:

- **transfer of part of the pension rights of the insured, expressed by The State Treasury bonds, from the Open Pension Funds (OFE) to the Social Insurance Institution (ZUS)**
    - transfer of assets for a total amount equal to 51.5% of the assets of each pension fund (as of 31 December 2012) and saving pension rights resulting from the transferred assets on a sub-account maintained by the Social Insurance Institution,
    - redemption of Treasury bonds transferred to the Social Security Institution;
- **establishing the rules for pension payments from funds collected in OFE and for transfer the pension rights of the insured from OFE to ZUS:**
    - launching of the so-called "security slider", i.e. a mechanism of gradual, starting 10 years before retirement, transfer of capital accumulated in OFE to the pension fund of the Social Security Fund, and accounting for the sub-account maintained in ZUS,
    - calculation by ZUS of the pension, based on the measures recorded on the account of the insured (first pillar) and the sub-account (second pillar);
- **establishing a new amount of compulsory contribution transferred to the OFE equal to 2.92%,** which corresponds to the 40% limit of OFE investments in shares, with the original amount of contribution transferred to open pension funds (7.3%). **The proposed change in the functioning of OFE** which allows the insured and those entering the labour market to choose the fund, to which the social contribution goes, **does not change the mandatory nature of this part of the pension system (as opposed to voluntary forms of retirement savings in Individual Retirement Accounts – IKE, Individual Retirement Security Accounts – IKZE or the Occupational Pension Schemes – PPE).** After the entry into force of the amendments, the insured will still not be able to opt out of paying the mandatory pension contribution as required, and they may only decide whether future pension contributions will be forwarded to ZUS or OFE. Currently, the insured choose one of the open pension funds operating in Poland. Now, the alternative will include a sub-account in ZUS;
- **stimulation of the third pillar - through changes in the functioning of IKZE:**
    - adoption of tax solutions providing real incentives to save in IKZE – i.e. the introduction of taxation of payments from IKZE and payments to persons entitled by flat-rate income tax, instead of the current taxation of payments from IKZE according to the PIT scale,

- introduction of a limit on payments to IKZE, common to all, in the amount similar to the current maximum annual contribution limit for IKZE account, i.e. about PLN 4000.

The effect of the changes in the pension system will be an abrupt reduction of public debt in 2014, resulting mainly from the one-off effect of the redemption of the State Treasury securities purchased by the Ministry of Finance. According to preliminary estimates, assuming that half of the insured goes to ZUS, the public debt-to-GDP ratio will decrease as a result of changes in pensions by about 7 percentage points, and the ratio of the general government debt by about 8 percentage points. Therefore, after the entry into force of the **changes to the pension system, it is planned to adequately (by 7 percentage points) reduce the public debt thresholds on which the Stabilizing Expenditure Rule correction mechanism is based.**

According to ESA95 rules, the general government revenues will register a value equal to the amount of assumed pension liabilities, which is equal to the value of the assets acquired and redeemed. According to the ESA2010 rules, this transaction, as a rule, will be reflected in the financial accounts, without impact on the outcome of the sector.

e) **reduction of debt servicing costs** – decrease in spending on the State Treasury debt is the result of a 24.9% reduction in operating costs of treasury securities and other financial instruments in the domestic market, not planned for 2014 the settlements of foreign warranties and guarantees granted by the Treasury and an increase of 14.2% of the foreign debt service costs and other foreign operations. The expenditure level from the draft Budget Act for 2014 also includes changes to the pension system, in particular the redemption of the bonds transferred to ZUS and savings, which are a result of the transfer of the insured from OFE to ZUS.

2. Disciplinary measures

a) **temporary expenditure rule** – limiting the growth of discretionary and new legally mandated spending, which will also include current legally mandated expenditures, when the determining act is modified a possible bill entailing an increase in the above expenditure requires including it in the total pool of discretionary spending and new legally mandated expenditure that cannot grow by more than 1% in real terms per year. In the draft Budget Act for 2014, this rule has been replaced with permanent, stabilizing expenditure rule (see point h), which is coherent with *Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States*.

b) **new rules for revenue and expenditure of general government, when Poland is subject to an excessive deficit procedure**. In line with those rules the Council of Ministers may not adopt bills, which could result in:

- decrease in revenue of the public sector units in relation to their level under the current binding regulations,
- increase in some categories of expenditure of public sector units in relation to their level under the current provisions of law.

c) **requirement to determine for new expenditures,** resulting from draft laws adopted by the Council of Ministers, **the binding cash limits over a 10-year horizon after the entry into force of the Act.**

d) **principle of a balanced current budget of the local government units**, in force since 2011.

e) **system of individual debt limits for local government units** (LGUs) – existing regulations protecting against excessive indebtedness of LGUs (safeguards against excessive indebtedness under Article 242 and 243 of *the Public Finance Act* and a mechanism strengthened in 2013 to monitor the situation of LGUs and to provide a wider range of information about projected financial position of LGUs) will be enhanced, starting from 2014, by a system of individual debt limits for LGUs. Debt limits will depend on the ability to repay the debt by the various local governments and will be calculated based on the average of the current surpluses (plus the proceeds from the sale of assets) for the last three years. In accordance with the draft act adopted on 1 October by the Council of Ministers amending *the Public Finance Act*, it is assumed that interest on liabilities incurred to finance projects involving at least 60% of the EU funds is excluded, net of income generated by them, from the limit of liabilities. This measure is aimed at increasing the capacity of absorption of EU funds by LGUs.

f) **corrective actions** – *a draft act to amend the Public Finance Act*, adopted by the Council of Ministers on 1 October, introduces the provisions for the corrective actions for local governments, which provide, among others, for:

  - limiting new investments to investments that do not generate growth of the debt;
  - ban on financial assistance to other LGUs and non-provision of sureties, guarantees and loans;
  - non-disbursement of funds for the promotion of the unit;
  - ban on creating village fund, regulated in separate regulations;
  - limiting tasks other than mandatory, funded from own resources.

  Regulations also introduce a limitation of expenditure on salaries of board members and allowances of local government councillors, which should help to protect the budget against actual increase in spending on the above goals.

g) **tightening up the rules regarding the financial management of certain organizational types of the public finance sector:** in the plan of revenue and expenditure of the executive agency, the expenditure should not be higher than projected revenue (exceeding requires a consent of the Minister supervising the executive agency, issued in consultation with the Minister of Finance):

  - public university, in which the sum of net loss in the period not longer than last five years is exceeding 25% of the state budget grants received in the year preceding the current budget year for the tasks related to the education of full-time studies, the education of students of full-time PhD studies and academic staff as well as maintaining university, is obliged to prepare a recovery programme aimed at recovery of financial balance by offsetting the planned operational costs with income in the period not exceeding three years since the date of adoption of the recovery programme (the recovery programme must be adopted no later than three months since the event identification);

- if the entity that creates an independent public health care institution, within 3 months from the deadline for approval of the financial statement thereof, does not cover the negative value of the financial result increased by depreciation costs, must within one year make a decision on the change of the organisational and legal form of independent public health care institution or on its liquidation;
- in order to get liabilities exceeding 30% of annual income, a budgetary institution must obtain the approval of the authority executing the functions of the founding body.

h) **introduction of the stabilizing expenditure rule (SER) –** draft act amending the Public Finance Act was adopted by the Council of Ministers on 1st October 2013. However, the rule was already used supplementary in the planning of expenditure in the draft Budget Act for 2014, and according to the draft act amending the Public Finance Act, SER will be binding in the budget process for 2015.

The main goal of the rule is to reduce and stabilize the general government deficit, and consequently – the public debt. For this purpose, the level of expenditure resulting from the rule will cover the general government expenditure with two exceptions. First, the calculation of the level of expenditure will exclude budget spending of EU funds and that part of the expenditure which is financed by means of a non-refundable grant from the EU and EFTA countries. Secondly, the costs of units which do not have the ability to generate high deficits will be also excluded. In line with the rule, the public expenditures will grow substantially in the medium-term real GDP growth rate multiplied by the projected CPI. This rate will be adjusted accordingly with the inflation forecast errors and forecasted significant discretionary measures on the revenue side. In case of imbalance in public finances, growth in expenditure will be further revised either by 1.5 or 2.0 percentage points. The use of the rule will provide a coherent framework for fiscal policy in a manner that guarantees implementation of the objectives under both the national law (prudential limits) and European Union law: up to 3% of the general government deficit and stabilization of the general government balance at the level of the medium-term budgetary objective (MTO).

3. Other measures to limit expenditure growth

a) **reduction** (from 2010, continued in 2013-2014) **of the wage fund in the state budget entities** by adopting general rules for freezing it at the nominal level of the previous year, with the exception *inter alia,* of the remuneration of judges delegated to the Ministry of Justice or other organizational unit subordinate to the Minister of Justice or supervised by him, whose salaries are funded from the resources at the disposal of the Minister of Justice, prosecutors and assessors of the prosecutor's office and without employees of state higher education schools (the next stage of remuneration growth results from *the Ordinance of the Minister of Science and Higher Education of 5 October 2011 on the conditions of remuneration for work and granting other work-related benefits for employees in public schools*).

b) **reduction** (in 2011, continued in 2013-2014) **of the funeral benefits** up to PLN 4 000 and cancel the automatic indexation.

c) **consolidation of the liquidity management of the public finance sector** – in the first stage of consolidation, introduced in May 2011, not all of the available funds of the general government units were consolidated, i.e. covered by the obligation to pay onto the Ministry of Finance account. Due to the use of available funds remaining after changes already made in order to "*consolidate liquidity*", held by the general government to manage liquidity of the budget and to finance transitory borrowing requirements, it will be possible to further reduce the level of the public debt and its servicing costs. The draft act *amending the Public Finance Act* and expanding the group of units subject to consolidated liquidity management is currently at the stage of external consultation;

d) **reduction of expenditures on the implementation of the Common Agricultural Policy**, resulting from the financing of complementary national direct payments (CNDP) from the national budget. In connection with the termination of the payment of domestic support CNDP in 2013, the European Commission with *Regulation (EU) No 671/2012 of the European Parliament and of the Council of 11 July 2012 amending Council Regulation (EC) No 73/2009 as regards the application of direct payments to farmers in respect of the year 2013*, allows for single use of the interim national support entirely financed from the state budget. The amount of the planned national support in 2014 will be lower than complementary national direct payments in 2013.

4. Revenue measures

4.1. *Systemic changes in 2013:*

a) **changes in VAT:**

- extended use of the reverse charge mechanism – the extended catalogue of goods, to which the reverse charge mechanism applies (*Act of 26 July 2013 amending the Act on VAT and certain other acts*);
- introduction of joint and several liability in the customer's VAT for tax liabilities of the seller of steel products and fuels (which does not apply the reverse charge mechanism) and rough gold, as well as for the sellers of these goods - obligation only for monthly settlements (*Act of 26 July 2013 amending the Act on tax on goods and services and certain other acts*);
- increase from 1 April 2013 the VAT rate from 8% to 23% on folk art goods and folk arts and crafts registered by the Artistic and Ethnographic Commission (*Act of 7 December 2012 amending the Act on VAT and certain other acts*);
- changing VAT on non-universal postal services provided by the public operator to 23% from 1 April 2013. This is caused by the requirement to adapt national provisions to the ruling of the Court of Justice of the European Union C-357/07 (*Act of 7 December 2012 amending the Act on VAT and certain other acts*).

b) **changes in PIT:**

- the current tax thresholds and the statutory flat income tax rates and the allowances exempt from tax will not be indexed, which means that the effective burden of the PIT tax will increase;
- in 2013-2014 reduction of 50% of the cost of revenues of copyright and related rights, through the introduction of an annual limit, which will be ½ the amount of the tax base determined in the first tax scale, i.e. PLN 42,764 (*Act of 24 October 2012 amending the Act on income tax from natural persons*).

c) **changes in excise duty:**

- increase in excise duty for cigarettes (*Act of 7 December 2012 on the amendment of certain acts in connection with the implementation of the budget act*);
- introduction of the excise duty on dried tobacco leafs, which were illegally used as a tobacco product not covered by excise duty (*Act of 7 December 2012 on the amendment of certain acts in connection with the implementation of the budget act*);
- introduction, from 1 November 2013, of the excise duty on natural gas for heating purposes, with the exception of households (*Act of 27 September 2013 amending the Act on excise duty* (transferred for the President's signature)).

d) **increase in a disability pension contribution and deductions of payments to IKZE** – passing effect of the amendment from 2012 (*Act of 25 March 2011 on the amendment of certain acts relating to the operation of the social security system*).

e) **introduction, from 2013, auction system for selling CO2 emission rights.**

4.2. *New systemic changes affecting revenue in 2014:*

a) **changes in VAT:**

- keeping unchanged current VAT rates in the coming years – originally, it was planned to reduce all VAT rates since the beginning of 2014, by 1 percentage point (draft *Act amending the Act on VAT and the Act on reimbursement to natural persons of some expenses related to housing*);
- removal of the possibility to recover some of the expenses for housing purposes (*Act on state aid in the purchase of a first home for young people*).

b) **changes in CIT:**

- introduction of taxation for limited joint-stock partnerships and for limited partnerships (*draft act amending the Act on CIT, the Act on PIT* and *the Act on tonnage tax*).

c) **changes in PIT:**

- the current tax thresholds and the statutory flat income tax rates and the allowances exempt from tax will not be indexed, which means that the effective burden of the PIT tax will be further increase;
- reduction of the Internet tax relief – change of the rules in 2013 (*Act of 24 October 2012 amending the Act on PIT*);

- modification of the tax relief for raising children – change of the rules in 2013 (*Act of 24 October 2012 amending the Act on PIT*).

d) **changes in excise duty:**

- further increase in excise duty on cigarettes (*draft law on amendment of certain acts in connection with the budget law*);
- excise duty from 1 November 2013 on natural gas for heating purposes – passing effect;
- increase in excise duty on spirits (*draft law on amendment of certain acts in connection with the budget law*).

e) **revenue from the sale of rights to use frequencies** (so-called digital dividend – revenue from fees for reservation of frequencies and for the right of use of frequencies and use reserved frequencies, as well as fees for licenses granted in telecommunications).

4.3. *Other measures affecting revenue*

a) **measures against the *"shadow economy"*** – in addition to the above-mentioned measures against tax avoidance/evasion, such as: extending the application of the reverse charge mechanism, introduction of joint and several liability in the customer's VAT for tax liabilities of the seller of steel and fuel, excise duty on natural gas for heating purposes and dried tobacco, introduction of taxation for limited joint-stock partnerships and for limited partnerships and the end of derogation for the reduction of VAT deduction on the purchase price of company cars (so-called cars with grid); the fight against the "shadow economy" puts special emphasis on measures to reduce the phenomenon of formation of "chains" of fictitious companies. Also fiscal controls of e-commerce operators has been increased , action *"Take your receipt"* has been introduced and there are ongoing works on changes, aimed to improve the functioning of the tax administration.

   Furthermore, in order to improve tax administration tasks, with regard to property taxes, it is planned to implement in 2014 the electronic handling of declarations and tax information in a new computer system Gentax. The new centralized system will enable faster and more complete access to tax information and facilitate the exchange of information between the taxpayer and the tax administration. Work is also underway on a new review of tax preferences in taxes constituting the state budget revenue (VAT, excise duty, PIT, CIT), as well as in local taxes for the budgets of the local government units.

b) **expanding the scope of the electronic toll collection system** – on 1 July 2011, Poland introduced the Electronic Toll Collection System (ETC) which covers motor vehicles with a maximum mass exceeding 3.5 tonnes and buses, regardless of their weight. ETC replaced the existing vignette system was introduced by the *ordinance of the Council of Ministers of 22 March 2011 on national roads or sections thereof, where fees are collected electronically, and on electronic fee rates.* The ordinance determined the basis network of national roads with a length of around 1565 km, where fees are collected electronically. On 30 March 2013, the second extension of the ETC took place; it covered about 300 km of roads.

   The third extension of the road network subject to an electronic payment will be made in two stages, between 31 October 2013 and 1 December 2013. The total expansion will include approximately 463 km of national roads and highways. At the end of 2013, electronic payments will be available for approximately 2653 km of roads in Poland. Extension of the scope of the Electronic Road Toll System results in an increase of the National Road Fund revenues on this account. In 2013, proceeds from the ETC will increase by approximately 51.4% y/y, reaching PLN 1.3 billion, while in 2014, it is projected to further increase revenues by approximately 43.9% y/y.

II. OTHER MEASURES AFFECTING THE RESULT OF THE SECTOR

As shown by the latest research on the so-called fiscal multipliers, the so-called non-Keynesian multiplier effects occur very rarely, and if, it is usually in the medium and long term. In the short term, the reduction of fiscal imbalances usually leads to a reduction in domestic demand and lower economic growth. In order to prevent unwanted non-Keynesian multiplier effects of fiscal consolidation, the Government has also introduced a number of solutions, whose primary purpose is to support domestic demand with financial commitment from the public sector limited to the minimum, which would result in a strong increase in the deficit of public finances. These considerations also include measures to counteract negative demographic trends in order to limit the decline in the growth rate of potential GDP.

1. Growth-enhancing activities and measures taken to limit the negative effects of consolidation

a) **continuation of the current multi-annual programmes** – spending on public investment is due to the investment cycle of implemented long-term programmes and schedule of absorption of EU funds. The Government will continue the *National Road Construction Programme for 2011-2015*, which includes investment projects related to the construction and reconstruction of roads and highways, financed from the National Road Fund.

b) **new programmes** – the Government has decided on the introduction of supporting instruments aimed at increasing the availability of flats on the market for young people, buying first flat and not having the ability to handle credit obligations, which without financial support would be higher. The proposed aid instruments combine three priorities: objective of the housing policy, the priority of the government for increasing the volume of investments, with the objectives of pro-family policy. The new instrument is a natural continuation of the *"Family on its own"* programme, as it is aimed at a similar target group.

   The source of funding of the programme *"Flat for young"* will be savings from extinction, with effect from 1 January 2014, of the system of reimbursement of part of expenses related to housing. This system has been operating since 2006 and its purpose is to compensate for the impact of the higher VAT rate on building materials after the Polish accession to the European Union.

c) **Polish Investments Programme** – in order to maintain the current growth rate of investments in infrastructure project, investments directly financed by the general government it is to be supported by investments being carried out in the Polish Investment Programme. This programme is based on two pillars: BGK and specially appointed Polskie Inwestycje Rozwojowe S.A. The aim of the first pillar is to increase lending and guarantees related to the needs of long-term financing of investments carried out by the private sector in a state strategic areas. In particular, a new instrument supported by BGK is the portfolio guarantee facility *de minimis* (described below) that provides small and medium-sized enterprises (SMEs) with easier and less expensive access to finance current operations during the economic downturn. This instrument at the same time will reduce the credit risk for banks. The task of the Polskie Inwestycje Rozwojowe S.A. is, in turn, to invest in special purpose vehicles, responsible for the design and conducting of infrastructure projects.

This programme is designed to be budget-neutral, and through new support instruments for investments is to replace budgetary expenditure, as investment in infrastructure from public funds will be taken up and replaced by private investment from market resources.

d) ***de minimis* guarantee programme** – implemented with great success by the Bank Gospodarstw Krajowego (BGK), the *de minimis* guarantee programme is one of the Government's response to the economic slowdown. As part of the programme, micro, small and medium-sized enterprises will be able to get a guarantee on the loan for the financing of current operations. It is the first programme of the Government, in which the risks associated with the guarantees is taken over by the Treasury. It is also an unprecedented programme during the transformation of the Polish economy after 1989. *De minimis* guarantees are state aid for entrepreneurs allowed by Polish law and EU regulations. They are offered by BGK through the lending banks.

By the end of September, 20,000 companies benefited from *de minimis* guarantees. Under this programme, BGK provided PLN 4.2 billion guarantees, which translates into about PLN 7.2 billion of loans provided by the lending banks.

This program is designed to be budget-neutral, and through new support instruments for investments is to replace budgetary expenditure.

e) **measures to counteract demographic trends:**

- **extension of maternity leave** (and additional leave under the terms of maternity leave) **and the introduction of the so-called parental leave** (26 weeks);
- **popularisation of pre-school education** - changes in the *Act on education system* of 13 June 2013 are designed to increase (from September 2013) the availability of pre-school education for children aged 3 to 5 years in kindergartens and other forms of pre-school education and as a result to increase preschool children dissemination rate to a level comparable to other EU countries;
- **increase since July 2013 of attendance allowance** (amendment of the *Act on family benefits and certain other acts* of 26 July 2013) – in accordance with the provisions of the act on family benefits – from 1 January 2013 until the end of June 2013, the persons entitled to attendance allowance in the amount of PLN 520 received additional PLN 100. From 1 July 2013, the amount of attendance allowance is PLN 620. Entitled persons will no longer receive the additional amount. At the same time, it is expected that from 2014 the amount of attendance allowance will increase gradually until it reaches the minimum wage. Such a gradual increase is due to the situation of public finances.

2. **One-off factors associated with Constitutional Court's judgments affecting the balance of the sector:**
   - implementation of the Constitutional Court's judgment of 13 November 2012 (file no. K 2/12) on non-compliance with Art 2 of the Constitution of Article 28 of the Act of 16 December 2010 amending the Public Finance Act and certain other acts (Dz.U. No. 257, item 1726, as amended), in connection with Article 103a of the Act of 17 December 1998 on pensions from the Social Insurance Fund (Dz.U. of 2009, No. 153, item 1227, as amended), in so far as it applies to persons who have acquired the right to a pension before 1 January 2011, without the need to terminate employment;
   - the judgment of the Constitutional Court of 9 July 2012, Ref. No. P 59/11 ruling that Article 2(3) of the Act of 12 December 1997 *on the supplementary annual salary for employees of the public sector* (Dz.U. No. 160, item 1080, as amended), in the extent to which it ignores the period of maternity leave as allowing acquisition of the right to additional annual salary in proportion to the length of time worked, in a situation of not working throughout the calendar year for six months, is incompatible with Article 32(1) in conjunction with Article 71(2) of the Constitution of the Republic of Poland;
   - implementation of the "*Bierut Decree*"[1] – in 2013-2015, the Restitution Fund will allocate up to PLN 200 million per year for compensation to former owners of properties acquired by Bierut Decree.

3. **Revenue measures**
   a) **end of the derogation for the reduction of VAT deduction from the purchase price of company cars (so-called cars with grid) –** abolition on 1 January 2014 of restrictions on the deduction of input tax on the purchase of cars with so-called grid and fuel to propel them; this is related to the expiry on 31 December 2013 of the executive decision of the Council (2010/581/UE) of 27 September 2010 authorizing Poland to introduce a special measure derogating from Article 26(1) point a) and Article 168 of Directive 2006/112/EC on the common system of value added tax (OJ L 256, 30.09.2010).

III. ECONOMIC SITUATION IN 2013-2014 AND ITS IMPACT ON THE STATE BUDGET

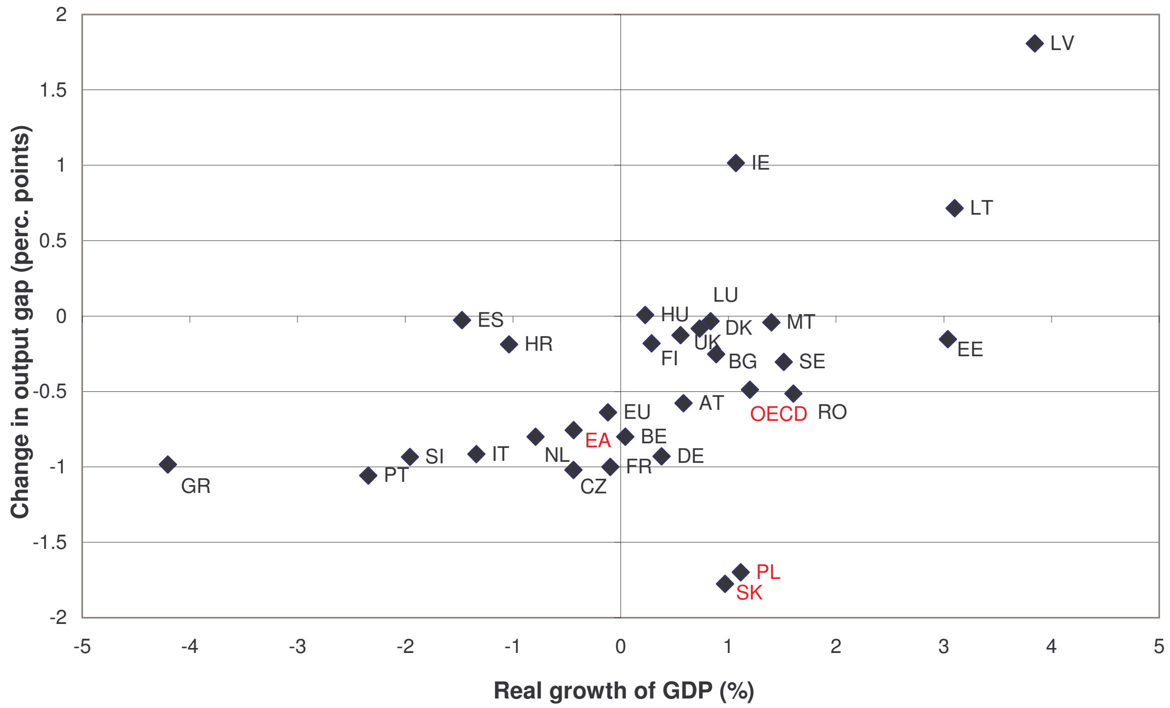
Strong macroeconomic foundations and the action taken to stabilize economic activity allowed Poland to avoid recession during the first wave of the financial crisis at the turn of 2008/2009. In the last two years, however, we can observe a significant deterioration in the economic situation[2]. Real GDP growth rate in Poland in 2012 fell to 1.9% from 4.5% in the last year. It is expected that in 2013, GDP growth will be even lower, reaching 1.5%. Maintaining a relatively high rate of potential GDP growth with a sharp decline in real GDP

[1] *Decree on the ownership and use of land within the City of Warsaw*, issued on 26 October 1945, by the National Council whose president was Bolesław Bierut. All property within the pre-war city limits passed to the City of Warsaw.

[2] It is also a period of significant, the highest in Europe, consolidation of public finances.

growth rate indicates that the observed slowdown in Poland is predominantly cyclical. It is estimated that in 2013 the scale of the economic slowdown will be one of the largest in the EU (Figure 1).

Figure 1. Scale of the cyclical deterioration in 2013

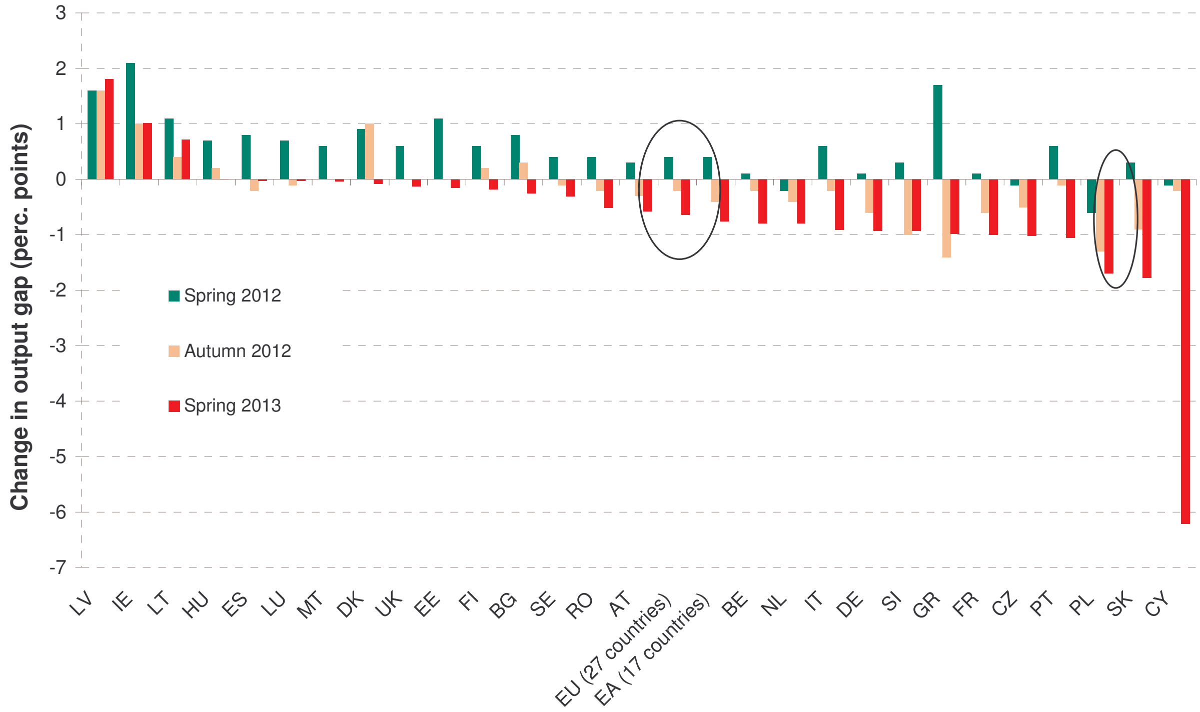


Source: AMECO, European Commission

The main factor of economic growth is net exports, while the domestic demand declines. This structure of growth is a result of the following: actions taken in the course of fiscal consolidation, reductions in public investment due to phasing out the 2007-2013 EU financial perspective and a significant slowdown in credit growth, especially in investment credit as a result of the uncertainty regarding the macroeconomic situation in the euro area. In addition, domestic demand is still negatively affected by relatively restrictive monetary policy pursued until the end of 2012. The positive effects of easing it in the last three quarters, owning to the typical delays, should be seen in the second half of the year.

Reduction in domestic demand in Poland is also a result of significant deterioration in the performance of Polish export with major export markets. According to the European Commission's estimates, the cyclical slowdown of the EU economy in 2013, which receives about 75% of Polish exports, is likely to be about two times higher than estimated in the fall of last year (Figure 2).

Figure 2. Cyclical deterioration expected in 2013 - comparison of the forecasts history

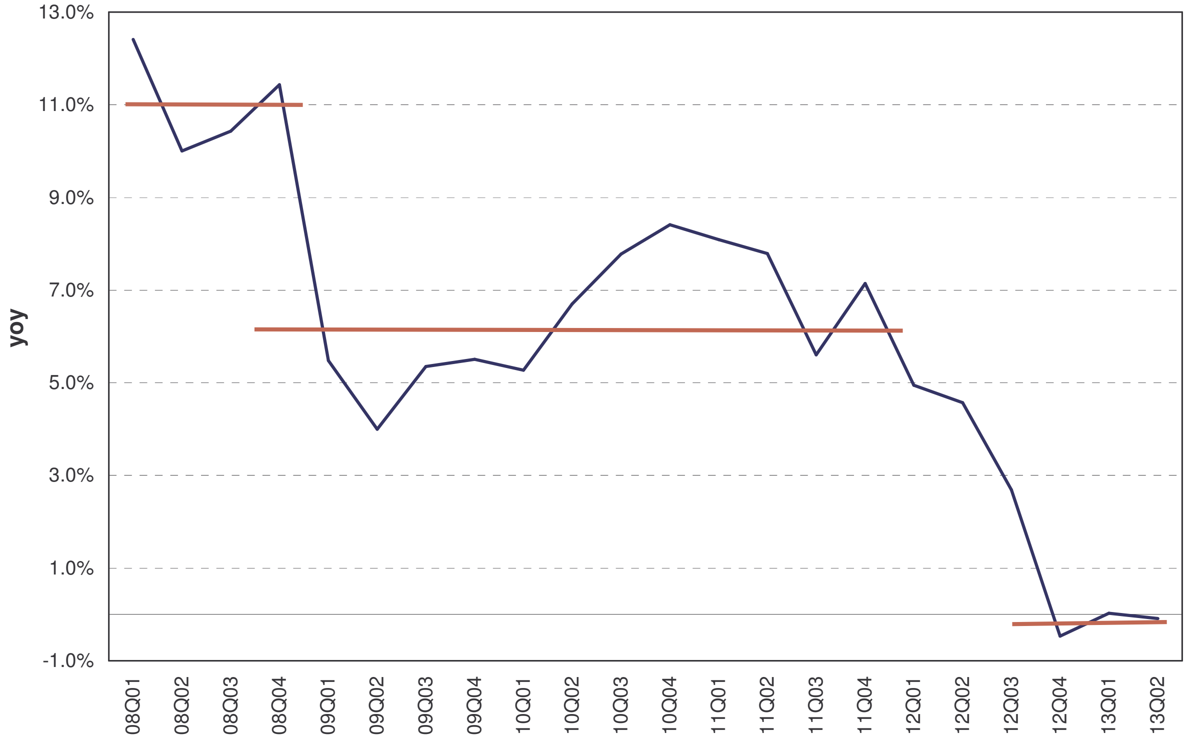


Source: European Commission – Spring and Autumn Economic Forecasts from 2012 and 2013

Negative effects for Polish export connected with a reduction in external demand by the EU were mitigated, thanks to the growing competitiveness of the Polish economy, with the increase in the share of Polish products on the markets of Central and Eastern Europe which are not members of the euro area. The main reason for this was a growning competitiveness of Polish exporters due to maintaining, since the beginning of the crisis, a high discipline in terms of wage growth. On the other hand, this policy has a limited impact on the increase in disposable income of households. This combined with limited growth in public consumption as a consequence of consolidation of public finances, leads to a significant reduction in consumption growth. At the same time we observe a significant reduction in the share of investment in gross fixed capital formation of the public sector. Consequently, since the second half of 2012, net exports has become a key factor of the growth of the Polish economy. Contribution to GDP growth from domestic demand is negative at near-zero contribution of consumption and strong negative contribution of investment and growth in stocks.

The structure of economic growth based on net exports allows for a significant reduction in the external and internal imbalance of the Polish economy. The deficit in the current account balance in 2012 decreased to 3.5% of GDP, and in mid-2013 reached 1.6% of GDP, compared to 4.9% of GDP in 2011. At the same time, the inflation rate is strongly declining, in 2013 it was below the lower range of the fluctuation of the index, as allowed by the monetary policy conducted by the Monetary Policy Council (MPC). Such a structure of growth is very unfavourable from the government revenue point of view. GDP growth generated by net exports does contribute to increase tax revenue. From this point of view boosting private consumption, public investment and net purchases of public sector is of utmost importance[3]. Tax base indicator defined this way registers nominal decreases since the last quarter of last year, and its share in GDP is falling steadily. At the stage of formulating macroeconomic forecast for CP2013, it was assumed that the situation in this area will improve in the subsequent quarters of 2013. It turned out, however, that in the second quarter, nominal decrease in this indicator worsened (Figure 3). As a result, despite a great possibility to achieve GDP growth at 1.5% in the current year, GDP structure may be different than expected, with a higher proportion of net exports and lower domestic demand.

Figure 3. Nominal rate of VAT base indicator



Source: Ministry of Finance

Under these conditions, fiscal policy should prevent further economic slowdown, i.a. by allowing for the full operation of automatic stabilizers, while maintaining the sustainability of public finances in the medium and long-term. Further substantial reduction of public demand in the scale observed in 2011-2012 will not only deepen the slowdown in economic activity, but – with the additional loss of income – may lead to the deterioration of public finances. The European Commission estimates[4] that the reduction in the nominal deficit in Poland in 2013 by 0.3% of GDP will lead to a decline in real GDP growth by 0.3 percentage point and will reduce the potential growth of GDP by 0.1 percentage point. Recent research

[3] From the VAT receipts point of view, the greatest impact on their amount is by private consumption, which is estimated to account for about 80% of VAT receipts.

[4] Commission Staff Working Document (2013) 393 – *"Analysis by the Commission services of the budgetary situation in Poland following the adoption of the COUNCIL RECOMMENDATION to Poland of 7 July 2009 with a view to bringing an end to the situation of an excessive government deficit"*.

on the fiscal multipliers suggests that their scale may be higher now than it was typically regarded (Blanchard and Leigh, 2013[5]).

Although there have been significant systemic changes, as well as measures taken to strengthen the revenue side, the process of collecting revenue in 2013 is worse than expected in the CP 2013.

Weaker-than-expected collection of revenue stems directly from the fact that the structure of economic growth seen in 2013 is significantly worse than originally expected. In particular, the nominal growth in private consumption, which is the main component of the tax base for indirect taxes, in the first half of this year was the lowest since 1995 and grew by only 0.8% year on year. Additionally, other elements of the tax base are also of key importance for VAT revenues – i.e. public sector investment and net consumption of the public finance sector. The development of these elements determined the decline in nominal terms of the total VAT base in the first half of 2013.

Unfavourable, from the tax point of view, the structure of GDP growth, and observed significant slowing down in the first half of this year, were reflected in the level of tax revenues. In the period of January-August 2013, budget revenues from VAT decreased by 7.1% compared to the same period of 2012. In comparable conditions – that is, taking into account the change in the accounting of VAT refunds in the so-called transition period (change has decreased VAT revenues in January 2013 and increased in December 2012), VAT revenues were lower than in the corresponding period of 2012 by approximately 4.2%. Also excise duty revenues were unfavourable; in the first eight months were lower compared to the same period of 2012 by 2.5%.

It should be noted that the observed decline in indirect tax revenues was much deeper than it would result from the macroeconomic situation. In the case of VAT, according to estimates, the indicator of VAT (elements of tax base weighted by rates) felt in the first half of 2013 only by 0.3% year on year, which is significantly less deep than it did in the case of completed VAT revenues. A similar situation occurred in the case of excise duty. Due to the fact that the rate of excise duty in the vast majority is quota based (paid on the amount of the product) and because of the nature of the goods liable to duty, the best indicator for the macroeconomic dynamics of the tax is private consumption in real terms. In the first half of this year there was stagnation in this economic category (an increase of only 0.1% y/y), while revenues from excise duty declined compared to the same period of 2012.

The above-mentioned examples are a direct confirmation of the thesis of strong pro-cyclical tax elasticities in the short term, observed in recent years. This means that if GDP is above potential, tax revenues grow faster than is expected from the increase of the tax base. This was the case in 2005-2007, when the growth of tax revenue was higher than the increase of the tax base. Strong pro-cyclical tax elasticities also means that when the economy is below potential, flexibility is reduced. In case of significant deviation of GDP from its potential level, they can take negative values, which are difficult to estimate and forecast. The risk of error in forecasting under strong negative output gap is larger. It should be recalled that in 2013, it is estimated that the output gap will approach 3% of GDP. Since 1995 such negative result occurred only in 2002.

In the event of a significant economic downturn also further cyclical effects associated with the operation of automatic stabilizers are visible. The most obvious example is the CIT. In the period January-August 2013, the execution of the state budget revenues

[5] O. Blanchard and D. Leigh (2013), *"Growth Forecast Errors and Fiscal Multipliers"*, International Monetary Fund Working Paper 13/1

from CIT, compared to the same period of 2012, was lower by 13.1% (on a comparable basis, i.e. after taking into account a systemic change consisting in the liquidation of the so-called double deposit paid by the taxpayers in December, revenues were lower by 21.9%). This low growth rate of CIT revenues is partly due to the significant deterioration in the current results of the industries. In addition, the low performance of the revenues of this tax is also affected, through the mechanism of the annual accounts, by lagged impact of economic downturn in 2012. The available data show that the balance of the annual accounts for 2012 (payments of tax payers minus refunds to taxpayers) was much less beneficial to the state budget than planned – for the annual accounts for 2012, the revenue from CIT will be lower by about PLN 3.7 billion.

Another example of a cyclical effect, which negatively affects the level of tax revenue in 2013, is the increase in tax arrears observed especially in VAT. Tax arrears are tax not paid by the operators, which for various reasons cannot be paid on time. The share of these arrears is growing, despite the increase in the intensity of tax inspections (see I.4.3.a).

The above-described significant decline in tax revenues of the state budget (by 1.5% of GDP), which may not be covered by non-tax revenues, with a low share of domestic demand in the growth, forced Poland to revise the budget for 2013. According to the amendment to the Budget Act for 2013 adopted by the Sejm on 13 September 2013, the budgetary expenditure has been reduced by PLN 7.7 billion (0.5% of GDP) and the budgetary deficit rose by PLN 16 billion (1% of GDP). This amendment to the Budget Act for 2013 due to its measures is to support the economic recovery.

Therefore, the substantial cuts were applied to expenditures on national defence – PLN 3.1 billion, transport – PLN 1 billion, foreign debt servicing costs – PLN 1.05 billion and specific provisions – PLN 1 billion. It is worth noting that according to the *draft act amending the Public Finance Act*, adopted by the Council of Ministers on 1 October and introducing the SER, the expenditure of 2013 (after amendment) will form a permanent basis for calculating the expenditure limits (rule description in Annex 1). Measures taken in line with the revised budget will reduce in a sustainable manner spending limit in the coming years. So even if, any of the expenditures (e.g. costs of the Ministry of National Defence) increases in the coming years, it will have to be offset by a decrease in other expenditures, within the overall permanently reduced ceiling. Therefore, the cuts planned in the amendment to the Budget Act for 2013 should be considered permanent.

Also in 2014, the level of tax revenues will be influenced primarily by the macroeconomic situation. It is expected that, in comparison to the situation in 2013, economic growth in 2014 will accelerate, reaching 2.5% in real terms. One should pay particular attention to the predicted structure of growth in 2014, which will be significantly more beneficial for tax revenue than in 2013. Growth in 2014 will be based mainly on domestic demand, which will have positive impact on revenues from indirect taxes. The projected improvement in macroeconomic conditions also allows us to expect the reversal of the negative trend in tax elasticities in 2014. However, using the principle of careful planning of tax revenue, it is assumed that the elasticities of indirect taxes in 2014 will coincide with their long-term values. It is worth mentioning that despite the significant acceleration of economic growth, additional revenue resulting from the pro-cyclicality of tax elasticities was not assumed. In the event of an increase in GDP growth combined with significantly better, in fiscal terms, a structure of the growth, one can expect higher values of tax elasticities above those assumed in the forecast.

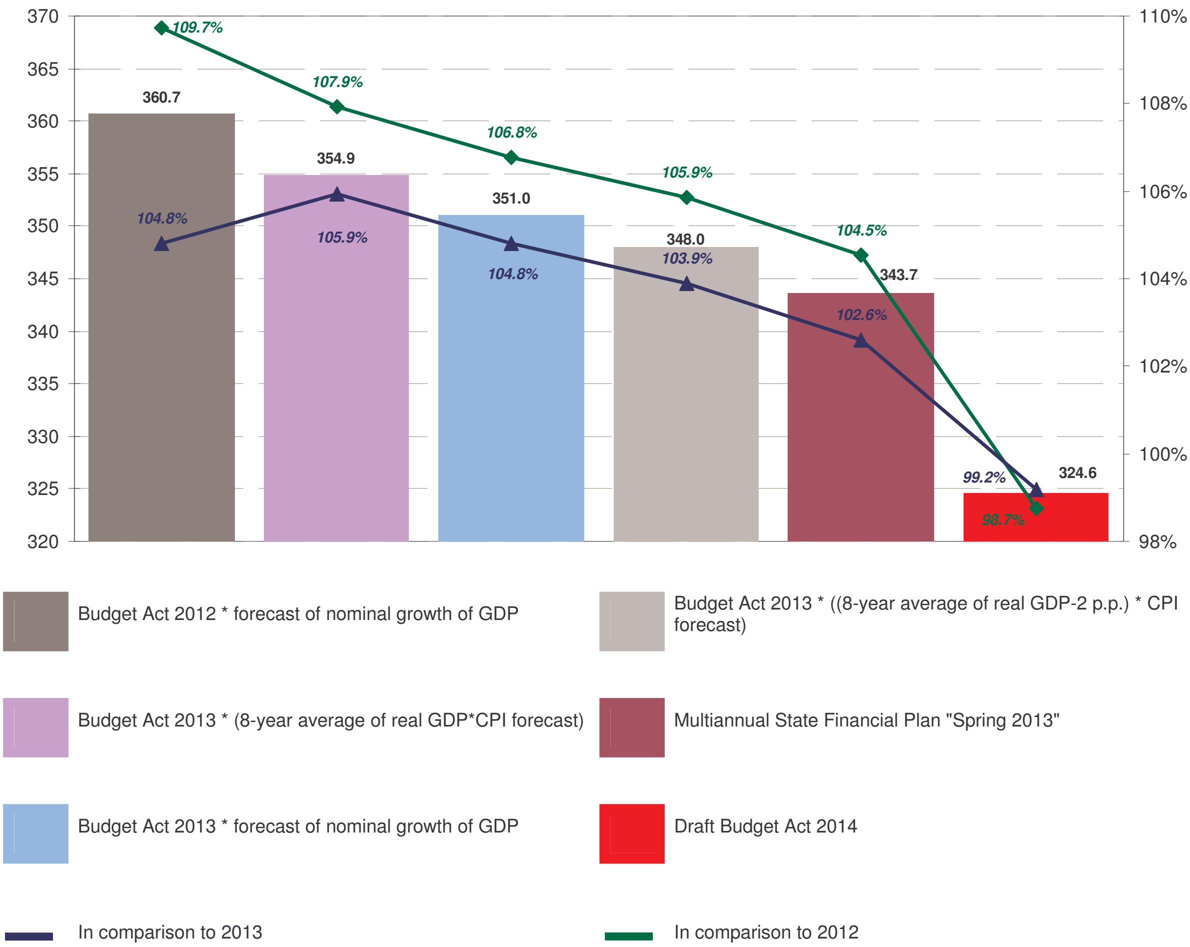
Improving economic performance of enterprises give rise to a more optimistic expectations concerning the issues of tax arrears. Using the above precautionary principle, at this stage, no additional revenue was assumed in 2014 due to a change in lowering tax arrears to current tax revenues.

The current revenue forecast for 2014 was based on revenue projected in the amendment to the Budget Act for 2013. It should be noted that this projection is a conservative one, which ensures fiscal sustainability in the event of lower economic recovery in the second half of 2013. This means that there is a possibility of meeting higher-than-assumed tax revenues in 2013, which at the same time would improve the forecast for 2014.

The above-mentioned factors associated with pro-cyclical tax elasticities, the conservative base of the forecast and possible improvement in the tax arrears, constitute a positive safety margin for revenue projections in 2014.

According to the draft Budget Act for 2014, expenses will be reduced by PLN 14 billion in comparison to *the Multiannual State Financial Plan* – planned spending cuts will be about PLN 6.3 billion higher than in the amendment to the Budget Act for 2013. The chart below shows the scale of spending cuts presented in the draft budget for 2014, compared with the amount of potential spending. Expenditure projected in the draft budget for 2014 are also considerably lower than it would be as a result of applying the SER. The scale of adjustment varies from PLN 9 to 36 billion, depending on the selected baseline scenario (columns 1-5).

Figure 4. Planned state budget expenditures in 2014



IV. SUMMARY

In comparison to the projected path of fiscal adjustment presented in CP 2013, the impact of automatic stabilizers and the pro-cyclical income elasticity was much stronger. These and unfavourable income structure of GDP growth and observed a significant slowdown in the first half of this year reflected in lower projected the general government revenues. As a result, it is forecasted that in 2013 the general government revenues will reach 36.6% of GDP, i.e. 1,3 percentage point of GDP less than projected in CP 2013. Tax revenues will be lower by 0.6 percentage point of GDP and EU funds, where the general government is the ultimate beneficiary, will decrease by 0.4 percentage points of GDP. The general government expenditures to GDP in 2013 are expected to be higher by 0.1 percentage point of GDP than in CP 2013, which is influenced on the one hand by a higher than expected increase in social spending by 0.3 percentage point of GDP (impact of cyclical expenditure – unemployment benefits, along with derivative transfers – and one-off expenditures – sentences of the Constitutional Court, on the other, by a deeper-than-expected decline in investments by 0.2 percentage point of GDP (due to a lower absorption of EU funds).

As a result, despite taken consolidation measures, it is anticipated that the general government deficit increased compared to 2012 by 0.9 percentage point, with the decline in revenues by 1.8 percentage point and expenditures consolidation by 0.9 percentage point of GDP (impact of the systemic changes on the general government revenues and expenditures is presented in Table 1). As a result, the nominal deficit will reach this year about 4.8% of GDP. As indicated above, the increase in the deficit compared to that assumed in the CP 2013 is almost entirely due to cyclical factors, in particular the decline in tax revenues due to the strong pro-cyclical deterioration in tax elasticities with respect to the tax base and decrease of this base share in GDP. It should be noted that the European Commission – even with a lower GDP growth forecast for the current year (i.e. 1.1% vs. 1.5% forecasted by the Polish Government) – forecasted revenues of the sector at 37.6% of GDP, i.e. one percentage point higher than in the forecast for 2013 presented here.

In view of the impact of fiscal consolidation on economic growth, also indicated in the above mentioned publications, including by the European Commission, it was considered that the implementation of deeper consolidation (i.e. nominal deficit reduction to the level of 3.6% of GDP) would jeopardize the growth recovery in 2013, with a significant risk of recession. This would probably lead to an even deeper slump in tax revenues and rise the general government deficit well above 5% of GDP.

It should be borne in mind that in the terms of strongly changing tax elasticities and the tax base share in GDP, in order to asses the structural measures one should apply a bottom-up approach, which presents a settlement of the financial consequences of various systemic changes. Calculation of the structural efforts by using estimates of unobservable categories, i.e. the output gap, may in fact lead to not fully reliable results.

The continuation of a fiscal policy, including taking additional measures to enhance the revenue side permanently and limit expenditure growth[6], will allow Poland to fulfill the Council recommendations in 2014. It is predicted that – taking into account the effects of changes in the pension system – in 2014, the general government will reach a 4.5% of GDP surplus, which will be largely the result of one-off effects of changes in the pension system. It

[6] It is estimated that the general government revenues will reach 44.9% of GDP and expenditures will reach 40.4% of GDP.

is also assumed that the structure of fiscal consolidation will sustainable reduce the excessive deficit in Poland and in 2015 the general government deficit will reach 3% of GDP.

Table 1. Impact of the measures taken to reduce the excessive deficit on the general government balance (yoy)

	2013 PLN billion	2014 PLN billion	2013 % of GDP	2014 % of GDP
MEASURES ON THE REVENUE SIDE				
Changes in the pension system	-1.94	151.95	-0.12	8.83
Increase in disability pension contribution paid by employers (increase by 2 percentage points), effectively from March 2012	1.42	-	0.09	-
PIT	1.00	1.17	0.06	0.07
Excise duty	0.09	1.44	0.01	0.08
VAT (incl. maintaining the current VAT rates at the current level)	-0.34	5.00	-0.02	0.29
CIT	0.27	0.29	0.02	0.02
Revenues from auction system for selling CO2 emission rights	0.94	0.08	0.06	0.00
Introduction of royalties on certain mineral resources	0.77	-	0.05	-
Sale of rights to use frequencies (digital dividend)	-	1.80	-	0.10
Revenues from the electronic toll collection system (ETC)	0.44	0.57	0.03	0.03
MEASURES ON THE EXPENDITURE SIDE				
Introduction of the stabilizing expenditure rule (incl. limits on new expenditures)	-0.37	-	-0.02	-
Effect of the nominal freezing of the wage fund in the central and social security sub-sector (except for the remunerations of those employees of state higher education schools)	-0.11	-2.24	-0.01	-0.13
Popularisation of pre-school education	0.50	1.06	0.03	0.06
Increase in the duration of additional maternity leave	0.98	2.11	0.06	0.12
Abolition of early retirement scheme	-8.67	-3.67	-0.53	-0.21
Reduction of debt servicing costs, as a result of changes in the pension system	-	-4.80	-	-0.28
Budget Act 2013 – Amendment*	-7.66	-	-0.47	-
Increase of retirement age	-0.60	-1.90	-0.04	-0.11
Others	0.14	-0.57	0.01	-0.03

** - in comparison to Budget Act for 2013*