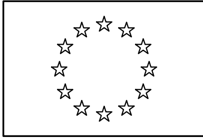

EUROPEAN COMMISSION

Brussels, 24 June 2009

Commission assessment in relation to the Commission recommendation for a Council Decision and recommendation under Articles 104(6) and 104(7) of the Treaty

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States, with more room for manoeuvre for those Member States that have achieved sustainable public finance positions and improved their competitive positions. It also called for structural reforms that support demand and promote resilience in the short term, while paying special attention to actions in the four priority areas of the Lisbon strategy. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up

and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the data notified by the Polish authorities in April 2009[2] and subsequently validated by Eurostat[3] and taking into account the Commission services' spring 2009 forecast, the Commission adopted a report under Article 104(3) for Poland on 13 May 2009[4].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 28 May 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to the April 2009 EDP notification by the Polish authorities, subsequently validated by Eurostat, the general government deficit in Poland reached 3.9% of GDP in 2008, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the deficit was not close to the 3% of GDP reference value and that the excess over the reference value cannot be qualified as exceptional within the

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1 OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm

2 According to Council Regulation (EC) No 3605/93, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Poland can be found at:

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

3 Eurostat news release No 56/2009 of 22 April 2009.

4 All EDP-related documents for Poland can be found at the following website:

http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

meaning of the Treaty and the Stability and Growth Pact. In particular, it does not result from an unusual event in the sense of the Treaty and the Stability and Growth Pact. Moreover, it does not result from a severe economic downturn in 2008 in the sense of the Treaty and the Stability and Growth Pact. Despite growth slowing down to 3.3% year-on-year in the last quarter of 2008, which affected revenue collection in the last quarter of the year and added to the worse-than-expected deficit outcome, overall GDP growth was still relatively robust at 4.9% in 2008. Potential GDP growth is estimated to be of the order of 4½% and the output gap to have reached about 3½% of potential GDP, indicating favourable cyclical conditions. Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' spring 2009 forecast, the general government deficit is expected to reach 6.6% of GDP in 2009 and 7.3% in 2010 against a GDP contraction of 1.4% in 2009 and GDP growth of 0.8% in 2010. The deficit will increase in 2009 (to 4.6% of GDP) also according to the most recent fiscal notification by the Polish authorities. The deficit criterion in the Treaty is therefore not fulfilled.

General government gross debt remains below the 60% of GDP reference value and stood at 47.1% of GDP in 2008. However, due to high expected deficits, the general government debt is likely to reach almost 60% in 2010 according to the Commission services' spring 2009 forecast.

In line with the provisions in the Stability and Growth Pact, the Commission in its report gave due consideration to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on the estimates of the Polish authorities, the net cost of this reform amounted to 2.9% of GDP in 2008, rising to 3.2% of GDP in 2009. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value. Since the deficit does not remain close to the reference value in 2008-2010, the cost of the pension reform cannot be taken into account.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Poland, the double condition is not met. Considered on their own merit, the relevant factors in the case of Poland, on balance, present a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Poland. This opinion, adopted by the Commission on [24 June 2009], is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Poland with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Poland, special circumstances are considered to exist. In particular, the deficit is expected to reach 6.6% of GDP also because of an unfavourable global environment. The collapse of exports, the tightening of credit conditions for mortgage loans and corporate loans and a correction in the domestic housing market all entail the likelihood of a recession this year. In addition, the ongoing structural shift in the economy, which will have to be speeded up because of the global crisis, contributes to quickly rising unemployment rates. The Commission Spring forecast expects real GDP to contract by 1.4% in 2009, recovering to positive growth of 0.8% in 2010. The Polish authorities have revised downwards substantially their convergence programme update growth forecast of 3.7% in 2009 on two occasions; the first time in January, to 1.7% for 2009, and more recently on 22 June to "close to zero, but positive" in 2009 and 0.5% in 2010[5]. On 22 June the Minister of Finance also announced that "the general government deficit may significantly exceed the 4.6% of GDP planned for the current year" in the Spring 2009 EDP notification.[6] Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework. Considering the Commission services' spring 2009 forecast which projects the structural balance to reach 6% of GDP in 2009 and, on a no-policy-change assumption, 5.5% in 2010, and given the special circumstances, Poland is recommended to 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, and start consolidation in 2010 in order to bring the deficit below the reference value by 2012. This would imply a structural fiscal effort of around 1¼-1½ percentage points of GDP annually starting in 2010.

The excess over the 3% of GDP threshold from 2008 also reflects the fact that the recent good times were not fully used as an opportunity to consolidate public finances and undertake deep reforms on the expenditure side. In particular, the farmers' social fund (KRUS) is only marginally financed by contributions and is almost fully subsidised by the central budget (about 1¼% of GDP annually). This is not changed by the currently planned reform of KRUS which will have a negligible budgetary impact. The disability benefits system should also be reformed, in order to avoid that disability benefits may be higher than pensions. Moreover, a review of entitlements of a large number of disability

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[5] Letter from Finance Minister Mr Rostowski to Commissioner Almunia.

[6] See footnote 5.

benefit recipients with permanent eligibility (rather than eligibility subject to periodical review), accumulated under old lenient eligibility criteria, would also be needed. The reform of the costly early pensions, with a noticeable positive budgetary impact materialising however only in the long term, does not apply to some professional groups and it does not fully address the issue of financing the early pensions.

The negative deficit surprise in 2008 appears to be related to problems with expenditure planning and budget implementation controls. Higher than planned public consumption was the main reason for the general government deficit slippage. Significant overspending on intermediate consumption (including administrative and military expenditure) by 0.8 percentage point compared to the estimate in the December 2008 convergence programme points to some problems in planning and execution of the budget. There was a high discrepancy between the outturn of the cash budget and the ESA95 accounts: the provisional outturn for the cash central state budget deficit (non ESA95) was 1.9% of GDP, better than planned in the 2008 budget (by 0.2 percentage point), whereas the ESA95 central government deficit was 4.2% of GDP (0.6 percentage point higher than estimated in the December 2008 convergence programme). Absence of appropriate rules and enforcement mechanisms to impose spending discipline appears to be at the origin of this discrepancy, since the cash spending limits did not prevent general government entities from incurring liabilities on an accrual basis. In addition, a lack of up-to-date information from different spending entities played a role.

Enhanced surveillance under the EDP, which seems necessary in view also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Polish convergence programme which will be prepared between 2009 and 2011 could usefully be devoted to this issue.

Key macroeconomic and budgetary projections

	2007	2008	2009	2010
Real GDP (% change)	6.6	4.8[3]	−1.4	0.8
Output gap[1] (% of potential GDP)	3.4	3.5	−1.5	−3.8
General government balance (% of GDP)	−1.9	−3.9	−6.6	−7.3
Primary balance (% of GDP)	0.4	−1.7	−3.7	−4.4
Cyclically-adjusted balance[1] (% of GDP)	−3.2	−5.3	−6.0	−5.8
Structural balance[2] (% of GDP)	−3.2	−5.3	−6.0	− 5.6
Government gross debt (% of GDP)	44.9	47.1	53.6	59.7

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.2% of GDP in 2010 (deficit-increasing) according to the most recent programme and the Commission services' spring 2009 forecast.
[3] Following the spring 2009 Commission services’ forecast, the Polish statistical office revised the 2008 real GDP growth to 4.9%. The year-on-year growth in 2008Q4 was revised from 3.1% to 3.3%.

Source:
Commission services’ spring 2009 forecasts (COM); Commission services’ calculations.