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CONVERGENCE PROGRAMME OF POLAND
(2004-2007)
AN ASSESSMENT

Table of contents

SUMMARY AND CONCLUSIONS	3
1. INTRODUCTION	5
2. MACROECONOMIC DEVELOPMENTS	6
2.1. Macroeconomic scenario	6
2.2. External accounts	8
3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY	8
4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES	9
4.1. Budgetary developments until 2003	9
4.2. Programme overview	11
4.3. Targets and adjustment in 2004	13
4.4. Targets and adjustment in 2005 and beyond	14
4.5. Debt ratio	15
5. THE QUALITY OF THE PUBLIC FINANCES	17
6. THE SUSTAINABILITY OF THE PUBLIC FINANCES	18
ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME	20

SUMMARY AND CONCLUSIONS¹

Poland's first convergence programme covering the period 2004-2007 was submitted on 17 May 2004. The programme does not specify the Polish authorities' intentions as regards the envisaged timing of ERM II entry or euro adoption.

The programme only partly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"² and adheres to ESA95 standards. In particular, the quality of ESA95 data on the composition of the general government revenue and expenditure needs to be further improved.

The general government deficit increased to 4.1% of GDP in 2003, above the 3% of GDP Treaty reference value. The Commission initiated the excessive deficit procedure for Poland on 12 May 2004, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on this report on 25 May. On [5 July 2004], the Council is expected, on the basis of two Commission recommendations, to decide that an excessive deficit exists in Poland and to make recommendations to Poland to bring this situation to an end. The deficit figures will have to be adjusted upward if the open pension funds are excluded from the general government sector following the EUROSTAT decision on the classification of funded pension schemes.

The macroeconomic framework presented in the programme predicts a gradual acceleration of GDP growth from 3.7% in 2003 to 5.0% in 2004 and 2005 and to 5.6% in 2006 and 2007. Net exports will continue to support economic growth this year, while domestic demand is expected to take over this role from 2005 onwards. The scenario up to 2005 is very close to the Commission Spring 2004 forecasts. And recent information points to even higher GDP growth in 2004 than projected in the programme. In the outer years of the programme period, the projected acceleration in GDP growth reflects strong expansion of domestic demand. This projection rests on perhaps optimistic assumptions about both investment and private consumption. Nevertheless, the dissipation of uncertainties surrounding fiscal policy, through the full implementation of the *Hausner plan*, would be instrumental in achieving the projected double-digit investment growth rates as well as the expected strong acceleration of private consumption growth. The programme includes estimates of potential output growth and projects that actual GDP growth will exceed potential over the whole programme period.

HICP inflation dropped from 10.1% in 2000 to 0.7% in 2003. The fall in inflation largely reflected tight monetary policy, the widening of the output gap and declining food and oil prices. Although inflation has picked up since mid-2003, it remains low. Much of the increase in headline inflation observed recently has been due to rising oil prices and an end to the fall in food prices, while limited price pressures have emerged so far from the demand side. The real effective exchange rate of the zloty has depreciated sharply since mid-2001. This decline is to a large extent the consequence of the continuous disinflation

¹ This assessment has been carried out on the basis of information available as of 16 June 2004.

² *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

path and the nominal depreciation of the zloty against the euro. Yield spreads between Polish and euro area benchmark bonds narrowed between 2001 and mid-2003, but widened again in the second half of 2003 and early 2004. No change to the existing monetary and exchange rate arrangements, i.e. a direct inflation-targeting framework combined with a floating exchange rate regime, is foreseen before entry into ERM II.

The budgetary strategy underlying the programme aims at reducing the general government deficit to below 3% of GDP by 2007 and maintaining the debt ratio below 60% of GDP. The general government deficit is expected to increase in 2004 from 4.1% of GDP in 2003 to 5.7% and to decrease steadily thereafter. For 2005, 2006 and 2007, the projections are for headline deficits of 4.2%, 3.3% and 1.5% respectively. The programme incorporates a comprehensive set of measures (the so-called *Hausner plan*), which, if fully implemented, would result in a cumulative correction of the deficit over the period 2005-2007 by 5.3% of GDP of additional revenues and savings (3.3% of GDP in the social area and 2% of GDP in public administration and state-owned enterprises). The achievement of the deficit targets is also conditional on projected high GDP growth throughout the programme period. In comparison to the August 2003 pre-accession economic programme the most significant difference is the upward revision of the general government deficit in 2004 by 0.7 percentage points of GDP, despite the confirmed economic recovery, ascribed in the programme inter alia to EU-accession-related expenditure.

The reduction of the deficit between 2004 and 2007 is ambitious amounting to more than 4 percentage points of GDP. Many risks surround the planned consolidation strategy. Besides the downside macroeconomic risk highlighted above, a delayed or incomplete implementation of the envisaged measures seems a distinct possibility in view of the uncertain political situation. The planned adjustment is not only heavily back-loaded but also appears only in part consistent with the sequence announced in the *Hausner plan*. In particular, in the run-up to the elections, savings stemming from the measures already voted by Parliament could be used for consumption and the fulfilment of some pre-election promises rather than for deficit reduction, all the more so as the *Hausner plan* is socially sensitive as most of the savings are expected in the social area. In turn, the monetary authorities may respond to a lax fiscal policy with a more cautious stance keeping interest rates at a relatively high level in order to maintain a stable macroeconomic environment. In the medium-term, a combination of large deficits and high real interest rates can be damaging for growth by hampering investment and backfire on the attainment of the budgetary targets. Finally, as a consequence of a recent Eurostat decision on the classification of the funded pension scheme, the planned figures for the deficit may have to be revised upwards by 1.6 percentage points of GDP.

The government debt ratio increased from 36.7% of GDP in 2001 to 45.4% in 2003. The debt ratio is projected to increase further up to 2006, reaching 52.7% of GDP at the end of 2006, before declining to 52.3% of GDP in 2007. The Commission Spring 2004 forecasts show a similar steady increase in the debt ratio up to 2005. The classification of the open pension funds outside the general government sector would lead to a further increase in the debt figures by approximately 4.5 percentage points. Even under this scenario, the debt ratio would remain below the 60% of GDP reference value over the programme period. The planned slowdown and eventual reversal of the increase in the debt ratio would reflect the combined effect of improving primary balances and an increasing nominal growth dividend, partially offsetting the persistent net debt-increasing impact of the stock-flow adjustment. It is also conditional on sizeable privatisation proceeds. The programme assumes that privatisation receipts in the period 2004-06

would amount to about 0.8% of GDP on average each year, i.e. twice the level reached in 2003. This assumption appears optimistic given the experience of the past three years, when actual privatisation receipts turned out to be significantly lower than planned.

The programme presents the measures envisaged in the *Hausner plan* to curb social spending and improve public expenditure management. The proposed reforms are ambitious and, if fully implemented, would constitute a major step towards addressing Poland's fiscal problems. The adjustment path described in the programme hinges critically on the implementation of the planned reform of social protection. In particular, important savings would result from the reform of the two most important social benefit systems in Poland, the disability pension system and the special farmers' social security system. Also, the envisaged revision or suppression of automatic indexation mechanisms of social benefits would contribute to easing expenditure pressures. Besides their budgetary impact, these reforms would pave the way for reducing the high labour tax wedge, which is a major impediment to job creation and discourages labour market participation.

Poland faces a risk of budgetary imbalances in meeting the projected costs of an ageing population. Securing an adequate primary surplus in the medium term together with the implementation of measures to stem the pension system deficit and to limit the assumption of liabilities of the state-enterprises and the health care system is essential to place public finances on a sustainable footing.

Table 1: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP (% change)	CP	3.7	5.0	5.0	5.6	5.6
	COM	3.7	4.6	4.8	n.a	n.a
	PEP	3.0	5.0	5.0	5.6	n.a
HICP/CPI (% change) 1/	CP	0.8	2.2	2.8	< 3	< 3
	COM	0.7	2.3	3.0	n.a	n.a
	PEP	0.8	2.2	2.8	2.9	n.a
General government balance (% of GDP) 2/	CP	-4.1	-5.7	-4.2	-3.3	-1.5
	COM	-4.1	-6.0	-4.5	n.a	n.a
	PEP	-4.1	-5.0	-4.0	-3.4	n.a
Primary balance (% of GDP) 2/	CP	-1.0	-2.8	-1.1	-0.3	1.3
	COM	-1.0	-2.8	-1.2	n.a	n.a
	PEP	-1.1	-2.3	-1.5	-0.8	n.a
Government gross debt (% of GDP) 2/	CP	45.3	49.0	51.9	52.7	52.3
	COM	45.4	49.1	50.3	n.a	n.a
	PEP	44.3	46.9	49.2	49.1	n.a
1/ CPI for PEP and CP, HICP for COM						
2/ Open pension funds are considered part of the general government sector.						
<i>Sources:</i>						
<i>Convergence programme (CP), August 2003 pre-accession economic programme (PEP), Commission services Spring 2004 forecasts (COM)</i>						

1. INTRODUCTION

Poland's first convergence programme covering the period 2004-2007 was submitted to the European Commission on 17 May 2004, following the approval by the Council of Ministers on 30 April 2004. The document incorporates the measures taken in the 2004 budget and draws upon the government's "*Medium-term fiscal strategy*" adopted in

October 2003 and the “*Programme of Rationalisation and Reduction of Public Expenditure*” (the so-called *Hausner plan*) endorsed in January 2004.

The programme only partly complies with the data requirements of the revised “code of conduct on the content and format of stability and convergence programmes” and adheres to ESA95 standards. However, the quality of ESA95 data on the composition of the general government revenue and expenditure needs to be further improved³. The convergence programme compares favourably with the 2003 pre-accession economic programme (PEP) in terms of the information provided.

The main goals of Poland’s fiscal policy strategy, as articulated in the programme, are: (i) a reduction of the general government deficit from 5.7% of GDP in 2004 to 1.5% in 2007 (the open pension funds are classified within the general government sector)⁴, and (ii) a containment of the debt dynamics in order to maintain the debt ratio below 60% of GDP. These objectives are said to be achieved thanks to the implementation of the government’s *Medium-term Fiscal Strategy* and the *Hausner plan* based on a combination of expenditure and revenue measures for the period 2005-2007. The gross debt ratio is expected to increase from 45.3% of GDP in 2003 to 52.7% in 2006. It would then slightly decrease to 52.3% in 2007. The deficit targets are broadly in line with the 2003 PEP although the figure for 2004 in the programme has been revised upwards from 5.0% to 5.7% of GDP. Consequently, the debt ratios have also been revised upwards.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

Real GDP growth is projected to accelerate from 3.7% in 2003 to 5.0% in 2004 and 2005 and to 5.6% in 2006 and 2007. The driving force behind growth this year will continue to be net exports, boosted by economic recovery in the EU and the (albeit diminishing) effects of the depreciation of the exchange rate. Domestic demand is expected to strengthen over the programme period, becoming the main engine of growth from 2005 onwards. Investment activity is projected to pick up in 2004 and reach double-digit growth over the rest of the programme period, helped by diminishing excess capacity, improving corporate profitability and accession-related business opportunities. Consumer demand will remain weak this year but is expected to grow more strongly in the following years in a context of rising employment and faster wage growth.

³ The programme deviates from data requirements in the area of the long-term sustainability of public finances; information needed to fill table 6 of Annex 1 of the code of conduct has not been regrouped and is not complete. Line 22 (“other expenditure”) of table 2/Annex 1 on the general government budgetary developments points to a misclassification by the authorities and gives a misleading picture of the composition of expenditure. In addition, inflation is still reported on the basis on the consumer price index (CPI) although table 1 of Annex 1 requires projections for the harmonised index of consumer prices (HICP).

⁴ The Eurostat decision on the classification of funded pension schemes (2 March 2004, EUROSTAT News Release 30/2004) is of a generic nature with the individual cases to be assessed in time for the reporting due by 1 September 2004. If the open pension funds are classified outside the general government sector, the deficit figures will be adjusted upwards by 1.6 percentage point of GDP for the years after 1999 (introduction of the three-pillar pension system).

The macroeconomic scenario up to 2005 appears broadly plausible and is very close to the Commission Spring 2004 forecasts, although the Commission predicts a somewhat lower GDP growth for 2004 and 2005. However, recent economic data point to higher GDP growth this year than projected in the programme.

Looking further ahead, the projected acceleration in GDP growth in 2006 and 2007 reflects strong investment growth and a strengthening of consumer spending. This projection is perhaps optimistic and rests crucially on a successful implementation of the public finance reform. Indeed, as uncertainties surrounding fiscal policy weigh heavily on investment decisions, credible fiscal consolidation is crucial to achieve vigorous investment spending. Similarly, a reduction in political and fiscal uncertainties should strengthen confidence and support consumption. However, the tightening of fiscal policy could hold back consumption growth, especially if interest rates are raised in response to the pick-up in inflation. A further risk surrounding the projected acceleration of private consumption relates to the expected fall in unemployment.

The programme includes estimates of potential output (based on a Hodrick-Prescott methodology), pointing to an acceleration in the growth rate of potential from 3.6% in 2003 to 5.1% in 2007. This would reflect rising employment levels and the return to high investment rates, similar to those recorded in the second half of the 90s. As real GDP growth is projected to exceed potential over 2004-2007, the large negative output gap observed in 2003 would gradually narrow and turn positive in 2006 and 2007.

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	CP	COM	CP	COM	CP	COM	CP	COM	CP
Real GDP (% change)	3.7	3.7	4.6	5.0	4.8	5.0	n.a.	5.6	n.a.	5.6
<i>Contributions:</i>										
- Final domestic demand	1.8	2.0	3.7	4.0	4.8	4.9	n.a.	5.5	n.a.	5.8
- Change in inventories	0.2	0.5	0.0	0.0	0.1	0.0	n.a.	0.0	n.a.	0.0
- External balance on g&s	1.7	1.3	0.8	1.0	-0.1	0.1	n.a.	0.1	n.a.	-0.2
Employment (% change)	-1.1	-2.3	0.4	-0.2	1.1	1.0	n.a.	1.8	n.a.	2.5
Unemployment rate (%)	19.8	20.0	19.6	19.5	19.3	18.8	n.a.	n.a.	n.a.	16.1
HICP inflation (% change)	0.7	0.8	2.3	2.2	3.0	2.8	n.a.	< 3	n.a.	< 3
GDP deflator (% change)	0.7	0.7	2.1	1.7	2.6	2.0	n.a.	2.1	n.a.	1.9
Current account (% of GDP)	-2.0	n.a.	-2.3	n.a.	-3.0	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Sources:</i>										
<i>Convergence programme (CP); Commission services Spring 2004 forecasts (COM)</i>										

The macroeconomic scenario is based on external assumptions largely consistent with those underlying the Commission Spring 2004 forecasts. The programme expects an acceleration of world GDP growth in 2004, followed by a stabilisation in 2005, and an economic recovery in the EU-15 in 2004-05. The main differences with the Commission's forecasts concern the assumptions on interest and exchange rates. In particular, the programme assumes a moderate appreciation of the zloty vis-à-vis the euro in 2005 compared with the technical assumption of a stabilisation of the exchange rate in the Commission's forecasts.

After dropping to about 10% in 1998, the unemployment rate rose to a peak of some 20% in 2002. This surge in unemployment reflected both the acceleration of enterprise restructuring following the Russian crisis of August 1998 and the slowdown in activity in 2001-02. Despite stronger growth, the unemployment rate stabilised at a high level in

2003, suggesting that deep-seated structural problems hamper the smooth functioning of the labour market. The programme projects a gradual improvement in the labour market situation over 2004-07. Employment growth is projected to rebound in 2005 and accelerate in the following years up to 2.5% in 2007, leading to a reduction in the unemployment rate to 16.1% in 2007. The Commission forecast points also to an improving labour market outlook, although with a much less rapid decline in unemployment.

Consumer price inflation is projected to rise from 0.8% in 2003 to 2.2% in 2004 and 2.8% in 2005 and to remain below 3% in the subsequent two years. The inflationary push is expected to come from the economic upswing, the acceleration of domestic demand, and accession-related price and tax adjustments. However, the increase in inflation will be limited by the expected appreciation of the zloty and subdued wage growth in a context of still high unemployment. The inflation forecast of the programme is very close to that of the Commission.

2.2. External accounts

Over the past three years, weak domestic demand coupled with the strong export performance resulted in a marked reduction in the current account deficit which dropped to 2% of GDP in 2003, compared with a peak of 6% of GDP in 2000. During this period, the increase in the private savings-investment surplus mitigated pressures on the current account stemming from the deterioration in the general government accounts.

Information provided in the programme makes possible an approximate analysis of sectoral balances, which confirms the overall consistency of the macroeconomic scenario. Against the backdrop of a widening government deficit and weak consumer demand, a further increase in net private savings is expected in 2004. However, over the rest of the programme period, the savings-investment surplus of the private sector is likely to diminish sharply, as a result of the acceleration of business investment and of private consumption growth. This in turn would lead to a widening of the current account deficit, as the reduction in general government net borrowing will likely be insufficient to offset the deterioration of the private sector savings-investment balance.

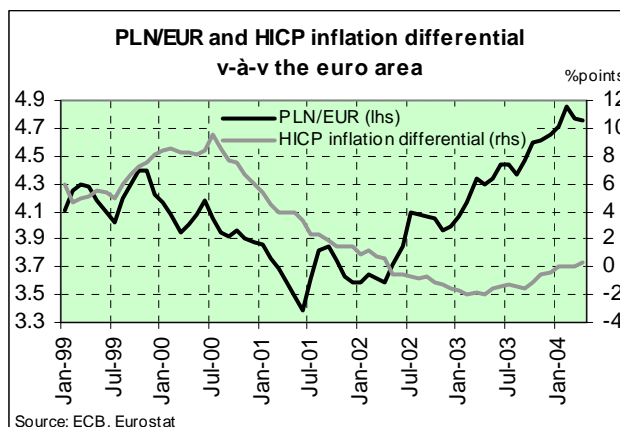
The programme could have provided more information on the current account projections, the underlying domestic savings-investment balances and the composition of capital flows. In this context, it would also be useful to examine developments in domestic credit growth, foreign debt dynamics and associated macroeconomic and financial stability issues.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

The National Bank of Poland conducts its monetary policy within a direct inflation targeting framework (since 1998) and operates a floating exchange rate regime (changed from a crawling peg in April 2000). Originally, the framework was based on annual target bands for consumer price inflation, aiming towards a medium-term consumer price inflation target of 3 percent (+/- 1 percent) to be achieved by the end of 2003. Reflecting a shift in the main policy focus from disinflation to maintaining a low-inflation environment, the central bank from 2004 onwards focuses on a medium-term inflation target of 2.5 percent with a range of +/- 1 percentage point.

Poland's impressive disinflation process continued up to mid-2003. HICP inflation dropped from 10.1 percent in 2000 to 0.7 percent in 2003. The fall in inflation largely reflected tight monetary policy, the widening of the output gap and declining food and oil prices. Although inflation has picked up since mid-2003, it remains low. Inflation stood at 2.2 percent (year-on-year) in April 2004 compared to a low of 0.1 percent in April 2003. Much of the increase in headline inflation observed in recent months has been due to rising oil prices and an end to the fall in food prices. Core inflation, excluding food and energy prices, has remained steady at about 1.1 percent (year-on-year), suggesting that limited price pressures have emerged so far from the demand side. Also, the substantial depreciation of the zloty has not yet had a significant effect on prices.

The sharp fall in inflation allowed the central bank to lower interest rates substantially until mid-2003. Policy rates came down from 19 percent to the current level of 5.25 percent in 20 steps between February 2001 and June 2003. Given the subsequent shift in the balance of risks, the easing cycle was halted, and since early 2004, the central bank has maintained a "tightening bias" to signal the re-emergence of inflationary risks, while keeping rates on hold for the time being. Yield spreads between Polish and euro area benchmark bonds narrowed between 2001 and mid-2003, but widened again in the second half of 2003 and early 2004.



Yield spreads between Polish and euro area benchmark bonds narrowed between 2001 and mid-2003, but widened again in the second half of 2003 and early 2004.

The exchange rate of the zloty has been depreciating against the euro since mid-2001, and its fall has accelerated in the second half of 2003 as market uncertainty regarding fiscal consolidation increased, bringing the year-on-year depreciation to some 15 percent. As the zloty has been relatively stable against the dollar, the depreciation has been less pronounced in effective terms at around 10 percent in 2003. Against a background of low inflation and nominal depreciation, Poland has recently gained in competitiveness. The real effective exchange rate based on the GDP price deflator and unit labour costs decreased by some 20 percent since January 2001.

The programme does not spell out explicit government intentions on the envisaged timing of euro adoption or ERM II entry. It recalls the conclusions of the inter-institutional working group on EMU of January 2004, which highlighted that *“the euro zone accession process should take place while taking into consideration the macroeconomic conditions, including the ability to fulfil the Maastricht criteria”* and called for restricting ERM II participation to the minimum two-year period, so as to minimize the risk of currency market tensions. The programme also reports the central bank's indication that the floating exchange rate regime would not be changed before entry into ERM II.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

The general government deficit increased from 1.9% of GDP in 1999 to 3.6% in 2002 (see table 3). The deterioration in Poland's budgetary position over this period reflects a

combination of cyclical factors and some discretionary relaxation of fiscal policy stemming mainly from an increase in social spending. The high costs of three major reforms implemented at the beginning of 1999, namely in public administration, health care and social security, weighed heavily on the central government's budget. On the revenue side, a drop in tax receipts resulted among other things from changes in direct taxation and from an extensive use of tax exemptions and rebates.

Looking at the sectoral breakdown, the deterioration of the overall deficit is attributable to the deficit of the central government and the growing financing needs of local governments. By contrast, the social security sub-sector has been improving its net lending position since 2000.

Since 2001, there have been many attempts by the Polish authorities to tackle the increasing deficit but none of the reform plans was implemented and the deficit continued to deteriorate. In 2002, for instance, the government adopted a spending rule, according to which the growth rate of central government expenditures had to be limited to one percentage point above the inflation rate (the so-called Belka anchor). This spending rule was never applied.

Table 3: General government balance and debt, 1998-2003 (% of GDP)

	1998	1999	2000	2001	2002	2003
General government balance	-2.1	-1.9	-1.8	-3.5	-3.6 ^a	-4.1
General government gross debt	39.1	40.3	36.6	36.7	41.2	45.4

^a The deficit figure for 2002 has been revised in the convergence programme to 4.0% of GDP.

Source:
Commission services

Budgetary targets are often missed and frequently revised. While each of the last three PEPs elaborated on the authorities' intention at that time to pursue significant reductions in government spending levels, these objectives were never met. The August 2002 PEP projected a deficit of 3.6% of GDP in 2003. While the growth forecast underlying the 2003 PEP remained comparable to the one underlying the 2002 PEP, the 2003 PEP contained an upward revision of the 2003 deficit to 4.1% of GDP. The actual general government deficit as presented in the Commission 2004 forecasts and reported by the Polish authorities in the fiscal notification in March 2004 deteriorated from 3.6% of GDP in 2002 to 4.1% of GDP in 2003. However, in the convergence programme the deficit for 2002 has been revised upward to 4.0% of GDP, implying that a stabilisation took place between 2002 and 2003.

The overshoot in the general government deficit in 2002 and 2003 (tax undershoot and expenditures overruns) reflected lax implementation of the fiscal measures, but also a different growth composition from that forecast. In 2003, higher-than-expected expenditure resulted from additional outlays for various social allowances (e.g. child and family allowances) and foreign debt servicing. In spite of higher growth and various measures to improve tax administration, revenues in 2003 were lower than initially foreseen. Personal income tax revenues were over-estimated reflecting an optimistic wages and employment forecast. Indirect taxes revenues were lower than expected.

The widening of the deficit combined with the slowdown in privatisation resulted in an increase in the debt ratio by 8.7 percentage points between 2001 and 2003. In 2003, the debt ratio increased above expectations mainly because of lower privatisation receipts with only 40% of the initial expectations met.

4.2. Programme overview

The convergence programme revises the budgetary objectives for all the years that overlap with the PEP period, namely 2003-2006. The open pension funds are still classified within the general government sector. Spending and revenue data have again been adjusted complicating the analysis. Revenue and expenditure shares in GDP over 2004-2006 are about 8 percentage points higher than projected in the 2003 PEP.

The Polish authorities assume that the high economic growth expected in the programme period, supported by the effects of EU accession, along with the expected implementation of the public finance reform (*Hausner plan*), will result in a reduction of the deficit and in a stabilisation of the debt-to-GDP ratio in order to fulfil the Maastricht fiscal criteria by 2007.

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
General government balance					
CP	-4.1	-5.7	-4.2	-3.3	-1.5
COM	-4.1	-6.0	-4.5	n.a.	n.a.
PEP	-4.1	-5.0	-4.0	-3.4	n.a.
General government expenditure					
CP	55.0	56.3	54.6	53.3	50.6
COM	45.1	46.8	45.7	n.a.	n.a.
PEP	47.2	47.9	46.2	45.5	n.a.
General government revenues					
CP	50.9	50.6	50.4	50.0	49.1
COM	41.0	40.8	41.2	n.a.	n.a.
PEP	43.1	42.9	42.2	42.1	n.a.
<i>Sources:</i>					
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services Spring 2004 forecasts (COM)					

The general government deficit is expected to increase from 4.1% of GDP in 2003 to 5.7% in 2004, but to decrease thereafter. The reduction of the deficit between 2004 and 2007 represents an ambitious 4.2% of GDP. The largest annual reduction is expected for 2007 (1.8% of GDP). If fully implemented, the *Hausner plan*, as described in the convergence programme, would deliver 5.3% of GDP of additional revenues and expenditure savings over the period 2005-2007⁵.

Box: The “Programme of Rationalisation and Reduction of Public Expenditure” (*Hausner plan*) as approved by the government on the 27th January 2004

The “Programme of Rationalisation and Reduction of Public Spending” (so-called *Hausner plan*) touches upon a rationalisation and savings of public expenditure in the fields of (i) functioning of the State and its administration; (ii) functioning of some inefficient sectors in the economy –

⁵ The convergence programme is based on the *Hausner plan* that calls cumulative expenditure savings and additional revenues of 5.3% of GDP (53.6bn PLN) compared to 5.2% (49.4bn) as announced in the document approved by the government on the 27 January after consultations with social partners (see Box).

resulting from the consequences of the on-going restructuring in the mining, railways and health sectors; (iii) social policy– among which entitlement programs including de-indexation, raising the pension age, reforming the disability pensions schemes and the farmers’ social security system (KRUS). The *Hausner plan* is meant to contribute also to broader discussions on future economic policy and structural reforms in Poland.

The total amount of savings in these three areas corresponds to 5.2% of GDP (49.4bn PLN) over the period 2004-2007 (table A). The budget savings in the social area represent 3.1% of GDP (29.4bn PLN). Around 2.1% of GDP (20bn PLN) stands for budget savings in the administration and economy section (table B).

Table A: Fiscal reform package - savings in social spending (PLN billion)

	2004	2005	2006	2007	2004-2007
Indexation of pensions and health subsidies	0	2.2	5.1	2.4	9.6
System of early retirement benefits	0	0.6	1.2	1.9	3.6
System of disability benefits	0	1.2	1.8	2.4	5.5
Support for disabled - employer subsidies	0.8	1.2	1.6	1.7	5.3
Subsidies for the rural pension system	0	1.7	1.8	1.8	5.3
Total savings	0.8	7	11.4	10.2	29.4
% of GDP	0.1	0.8	1.2	1	3.1

Source: "Programme of Public Spending Rationalisation and Reduction" (January 2004), Ministry of Economy and Social Affairs, based on Commission services calculations

Major cuts have been planned for 2006 (1.8% of GDP) and 2007 (1.6% of GDP), but also for 2005 (1.4% of GDP). Savings in social spending are planned to be higher in 2006 than in 2007 because of the indexation payments expected for 2007. The *Hausner plan* foresees expenditure cuts in the area of public administration already in 2004 (0.3% of GDP), from 2005 on, at least 0.6% of GDP is planned to be saved per year. No details were given about the specific measures except that they will cover current expenditure, investments and employment in public administration.

Table B: Fiscal reform package - savings in administration and economy (PLN billion)

<i>Projected annual savings (over 2005-2007)</i>	
TOTAL, of which:	5.9 (ca. 0.6% of GDP)
Change in financing the defense sector	1.3-1.6
Broadening the taxation base	2-3
Restructuring the mining sector	0.38
Restructuring railways	0.4
Restructuring the healthcare system	0.25

Source: "Programme of Public Spending Rationalisation and Reduction" (October 2003), Ministry of Economy, Labour and Social Affairs

The programme does not indicate the state of implementation of the measures. Moreover, the link between the savings expected from the implementation of the *Hausner plan* and the consolidation path in the convergence programme is difficult to make especially as regards their distribution over time. The planned adjustment is only in part consistent with the sequence announced in the *Hausner plan* (see also section 4.4 below). For instance, the planned measures are designed to bring the highest savings of 2.0% of GDP in 2006, while the programme envisages the deficit to decrease only by 0.9 percentage points despite a high growth rate above potential.

In addition, the developments in the expenditure and revenue ratios in the convergence programme do not correspond to the measures foreseen in the *Hausner plan*. The estimation of the impact of EU accession is also not clearly spelled out; although the programme articulates that “a fall in nominal expenditures shall not be expected in the next years as a consequence of the accession-related expenditure”; the assumptions behind this statement are not made explicit and the budgetary implications are open to question.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003	2004	2005	2006	2007	Change: 2007-2003
Revenues	50.9	50.6	50.4	50.0	49.1	-1.8
<i>of which:</i>						
- Taxes & social security contributions	35.6	34.7	34.1	33.7	33.8	-1.8
- Other (residual)	15.3	15.9	16.3	16.3	15.3	0.0
Expenditure	55.0	56.3	54.6	53.3	50.6	-4.4
<i>of which:</i>						
- Primary expenditure	51.9	53.4	51.5	50.3	47.8	-4.1
<i>of which:</i>						
Gross fixed capital formation	3.5	3.7	3.8	3.7	3.6	+0.1
Consumption	17.0	17.1	16.4	15.8	15.2	-1.8
Transfers	17.8	17.4	15.3	15.0	14.3	-3.5
Subsidies	0.1	0.1	0.4	0.4	0.4	+0.3
Other (residual)	13.5	15.1	15.6	15.4	14.3	+0.8
- Interest payments	3.1	2.9	3.1	3.0	2.8	-0.3
Budget balance	-4.1	-5.7	-4.2	-3.3	-1.5	2.6
Primary balance	-1.0	-2.8	-1.1	-0.3	1.3	2.3
<i>Sources:</i>						
<i>Convergence programme; ECFIN calculations</i>						

4.3. Targets and adjustment in 2004

The Polish authorities expect a significant widening of the general government deficit from 4.1% of GDP in 2003 to 5.7% in 2004 mainly due to increased expenditure, despite a considerable strengthening of economic growth. The 2004 deficit target in the programme confirms the one set in the 2004 budget. The programme does not refer to savings foreseen for 2004 in the original *Hausner plan* (see the box in section 4.2). Comparing with the 2003 PEP, the programme made an upward revision for the deficit in 2004 by 0.7 percentage points stemming from an increase in the central government deficit and a decrease in the surplus of the social security sub-sector. The Commission Spring 2004 forecasts project a somewhat higher deficit (6.0% of GDP) because of the inclusion of additional expenditure related to old-age and disability pensions and because of a higher contribution to the EU budget (due to different exchange rate assumptions).

In 2004 the revenue ratio is expected to decline slightly by 0.3 percentage points compared to 2003, which is the combined effect of the reduction of the corporate tax rate and an increase of indirect taxation (table 5). In particular, a decline in corporate tax revenues is expected from an additional reduction of the corporate tax rate from 27% to 19%, after a cut from 28% to 27% in 2003, representing overall a decrease of the tax rate by 9 percentage points over two years. The alignment of the VAT regime to EU legislation has led to an increase of the tax rate on various products to 22% (e.g. construction materials) from May 2004.

The 2004 budget foresees an important increase in the expenditure-to-GDP ratio from 55.0% of GDP in 2003 to 56.3% in 2004 due to co-financing of EU projects and the contribution to the EU budget⁶. However, only part of the relaxation in 2004 should be connected with EU accession. Poland is expected to be a net recipient of funds from the EU. Taking into account the additionality requirement, associated with rural development and structural actions, accession would be broadly neutral for the budget. If co-financing costs associated with structural and cohesion funds represent net additions to spending and taking into account the loss in tax revenues (change in VAT settlement regime), the overall impact on the public finances could be negative. However, the attribution in the programme of the deficit increase in 2004 by 1.6 percentage points of GDP to EU accession seems exaggerated and moreover neglects pre-accession aid that is still to be paid from the EU budget after accession.

4.4. Targets and adjustment in 2005 and beyond

The headline adjustment of the general government deficit between 2004 and 2007 represents an ambitious 4.2% of GDP. As mentioned above, the convergence programme builds its projections for 2005 and beyond upon the *Hausner plan*, which aims at structural reforms on the expenditure and revenue sides enhancing the sustainability of the consolidation and the quality of public finances. Its implementation, as described in the convergence programme, would bring additional revenues of 2.2% of GDP and expenditure savings representing 3.1% of GDP over 2005-2007, i.e. a total of 5.3% of GDP⁷. On the revenue side, changes mainly consist of a widening of the tax base (eliminating special rights of some economic groups, including farmers). On the expenditure side, the programme calls for the rationalisation of public administration and for the restructuring of state-owned enterprises. The measures in the social area aim among other things at diminishing the indexation of various social expenditures (disability pensions and retirements benefits), reforming the highly inefficient and costly social security system for farmers and addressing the relatively high increase in the old age-dependency ratio.

Looking at the sectoral distribution of the 5.3% of GDP additional revenues and savings in the *Hausner plan*, the social area would account for 3.3% of GDP. Reforms in the administration and state-owned enterprises would contribute to savings representing 2.0% of GDP over the period.

The sensitivity analysis presented in the programme discusses the impact of various shocks on the general government deficit targets for 2005-2007: (i) the impact of higher than expected inflation on the balance of the social security sub-sector through the indexation mechanism; (ii) the impact of higher interest rates pushing up debt servicing costs and the deficit; (iii) implications for debt servicing costs of exchange rate fluctuations (such costs are not considered to be particularly exchange rate sensitive); (iv) the current political situation, raising some doubts about the effective implementation of the *Hausner plan*. In case of its rejection, the deficit would increase

⁶ The EU-accession-related expenditure seems to have been misclassified under “other (residual) expenditure” in table 5 (section 4.2).

⁷ The difference between the expected expenditure cuts and additional revenues foreseen in the convergence programme (53.6bn PLN or 5.3% of GDP) and the measures included in the Programme of Rationalisation and Reduction of Public Expenditure approved in January 2004 by the government (49.4bn or 5.2% of GDP) should be noted.

again in 2005 and decrease steadily in 2006 and 2007 due to cyclical factors. It would remain above 3% in 2007.

The plausibility of the budgetary consolidation envisaged in the programme is undermined by several risks surrounding its implementation:

- The achievement of the deficit target is conditional on projected high growth throughout the programme period;
- The reform measures are back-loaded. Parliamentary elections are foreseen for 2005, but could be scheduled already in 2004. In an uncertain political environment, a delay in the implementation of the *Hausner plan* seems a distinct possibility. Savings stemming from the measures already voted by Parliament could be used for consumption and the fulfilment of some pre-election promises rather than for deficit reduction or investment. Moreover, the *Hausner plan* is socially sensitive as most of the savings are expected in the social area;
- If the open pension funds are excluded from the general government sector, the deficit figures for each year will be adjusted upwards by 1.6 percentage points of GDP and, in the absence of additional savings measures, the deficit will still be above the 3% reference level in the end year of the programme.
- The monetary authorities may respond to a lax fiscal policy with a more cautious stance keeping interest rates at a relatively high level in order to maintain a stable macroeconomic environment. In the medium-term, a combination of large deficits and high real interest rates can be damaging for growth by hampering investment and backfire on the attainment of the budgetary targets.

4.5. Debt ratio

The deterioration of the fiscal accounts together with the slowdown in the privatisation process resulted in a sharp increase in the government debt ratio in the last two years. The debt ratio increased from 36.7% of GDP in 2001 to 45.4% in 2003.

In the coming years, the debt ratio is expected to stay on an increasing path up to 2006. The debt ratio is projected to increase by a cumulative 7.4 percentage points between 2004 and 2006 to reach 52.7% of GDP at the end of 2006, before declining by 0.4 percentage points in 2007. The Commission Spring 2004 forecasts show a similar steady increase in the debt ratio up to 2005. The classification of the open pension funds outside the general government sector would lead to an increase in the debt figures by approximately 4.5 percentage points. Even under this scenario, the debt ratio would remain below the 60% of GDP reference value over the programme period.

The programme does not discuss the developments of the public debt-to-GDP ratio (national definition) and its implications under Polish fiscal rules⁸. Assuming that it will

⁸ At 51% of GDP in 2003 (national definition), the debt ratio is approaching the thresholds that trigger corrective mechanisms under the fiscal rules laid down in the Constitution and the Public Finance Act. The government must undertake specific actions if the public debt breaches the thresholds of 50%, 55% and 60% of GDP. While the consequences of breaching the 50% limit are relatively benign, those of breaching the 55% and 60% thresholds are more severe. In particular, breaching the 60% threshold constrains the government to vote a balanced State budget as well as balanced local

follow the same path as the debt ratio in ESA95 terms, the public debt ratio would breach the 55% of GDP threshold in 2005 and approach the constitutional limit of 60% of GDP by the end of the programme period⁹.

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	45.4	45.3	49.1	49.0	50.3	51.9	52.7	52.3
Change in debt ratio (1 = 2+3+6)	4.2	4.1	3.7	3.7	1.2	2.9	0.8	-0.4
<i>Contributions:</i>								
- primary deficit (2)	1.0	1.0	2.8	2.8	1.2	1.1	0.3	-1.3
- snow-ball effect (3 = 4+5)	1.3	1.4	0.3	0.1	-0.1	-0.1	-0.7	-0.9
- interest expenditure (4)	3.1	3.1	3.2	2.9	3.3	3.1	3.0	2.8
- nominal GDP growth (5)	-1.7	-1.7	-2.9	-2.9	-3.4	-3.3	-3.8	-3.7
- stock-flow adjustment (6)	1.8	1.7	0.6	0.9	0.1	2.0	1.3	1.8
Note:								
The change in the gross debt ratio can be decomposed as follows:								
$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$								
where t is a time subscript; D , PD , Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth.								
<i>Sources:</i>								
Convergence programme (CP); Commission services Spring 2004 forecasts (COM); ECFIN calculations								

Over the period 2004-2006, the programme foresees a deceleration in the pace of increase in the debt ratio. This would reflect the combined effect of improving primary balances and an increasing nominal growth dividend, partially offsetting the net debt-increasing impact of the stock-flow adjustment. Regrettably, the programme provides little information on the latter component. The planned improvement in the debt outlook is also conditional on sizeable privatisation proceeds. The programme assumes that privatisation receipts in the period 2004-06 would amount to about 0.8% of GDP on average each year, i.e. twice the level reached in 2003. This assumption appears optimistic given the experience of the past three years, when actual privatisation receipts turned out to be significantly lower than planned.

The debt remains vulnerable to exchange rate shocks despite the marked reduction in the share of foreign debt in total debt (33.1% of public debt was denominated in foreign currency in 2002 against 49.0% in 1999). The programme estimates that a depreciation of the zloty by 1% against the euro (and a proportional depreciation against the other currencies in which the foreign debt is denominated), would result, *ceteris paribus*, in an increase in the debt ratio by 0.15 percentage points.

Contingent liabilities represent another significant fiscal risk in Poland. State-owned companies in the sectors in need of restructuring are an important source of such

government budgets two years following the breach. Under such a scenario, a draconian fiscal tightening would be required.

⁹ However, given the uncertainties surrounding the implementation of the *Hausner plan*, there is a serious risk that the debt ratio according to the national definition will reach the 60% limit already in 2005 or 2006.

liabilities. According to the IMF, the stock of outstanding guarantees¹⁰ amounted to 4.2% of GDP at the end of 2002 and is rapidly increasing.

5. THE QUALITY OF THE PUBLIC FINANCES

The programme targets a reduction in the government expenditure-to-GDP ratio by 4.4 percentage points between 2003 and 2007 (see table 5). This adjustment would to a very large extent be driven by social transfers, which are projected to decline from 17.8% of GDP in 2003 to 14.3% by 2007. Additional savings would come from cuts in collective consumption. The other components of expenditures are projected to stay virtually stable in terms of GDP over the programme period. In particular, public spending on investment is expected to remain stable at 3.5% of GDP. The expected decrease in interest expenditures would be offset by an increase in subsidies. Subsidies would, however, remain low (at 0.4% of GDP in 2007), although public expenditure data may not reflect the true picture of state aid as Poland has an elaborate system of state guarantees and tax expenditures that provide support mainly to state-owned companies.

The revenue-to-GDP ratio is projected to decrease by 1.8 percentage points over 2003-07 (see table 5). Despite plans to improve the efficiency of tax collection and to broaden the tax base, tax revenues are expected to decrease by 1.3% of GDP. The programme forecasts also a drop in the share of social contributions in GDP, in spite of plans to increase social contribution rates for certain categories.

The programme outlines the reforms envisaged in the Hausner plan to reduce expenditure pressures. They concern especially two areas: public expenditure management and social protection. The proposed reforms are ambitious and, if fully implemented, would constitute a major step towards addressing Poland's fiscal problems.

Improvements in public expenditure management should result from the implementation of the following measures: (i) liquidating or consolidating a number of extra-budgetary funds and state agencies, (ii) improving the management of these funds and agencies by subjecting them to the same auditing standards as the rest of the government, and (iii) increasing the fiscal autonomy of local governments. The latter reform, linked to EU accession, should strengthen local accountability and provide incentives for better service delivery at the local level. Regrettably, the programme provides little information on these measures and their expected budgetary impact.

The adjustment strategy described in the programme hinges critically on planned expenditure cuts in social protection. The proposed reform of social protection would generate savings and additional revenues amounting to a total of 3.3% of GDP over the programme period (see section 4.4), with savings alone accounting for 2.4% of GDP. It will also contribute to reducing the rigidity of the budget as social transfers represent the largest share of general government expenditures; this share is projected to fall from 32.4% in 2003 to 28.3% in 2007. Moreover, the reform of the social benefit system will pave the way for reducing the high labour tax wedge, which is a major impediment to job creation and discourages labour market participation.

¹⁰ The public debt according to the Polish definition includes the risk-weighted stock of treasury guarantees which amounted to 1.6% of GDP in 2002.

The measures envisaged to curb social spending are wide-ranging and encompass a large number of changes. In particular, substantial savings would result from the reform of the two most important social benefit schemes in Poland, the disability pension system and the special farmers' social security system (KRUS). In addition, the cost of old age pensions would be reduced through the gradual equalisation of the retirement age for men and women and the phasing-out of early retirement benefits. Finally, the proposed revision or suppression of the automatic indexation mechanisms of social benefits would ease expenditure pressures. The programme would have benefited from a more thorough presentation of these reforms, with an indication of their budgetary impact and state of implementation, as some of them are currently being discussed in Parliament.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The section on the long-term sustainability of public finances includes demographic and macroeconomic assumptions as well as projections for public expenditures on pensions in the period 2002 - 2052.

According to the programme projections, the long-term demographic dynamics are characterised by a low fertility rate (1.25 in 2002) and an increasing life expectancy (total life expectancy to rise from 74.5 years in 2002 to 80 years in 2030). Although the former is to pick up by the end of this decade, its projected increase (from 1.1 in 2010 to 1.2 in 2030) does not seem to be sufficient to alter significantly a drastic increase of the old-age dependency ratio during the projection period (from 24% in 2002 to 43% in 2030 and 65% in 2050). According to the demographic assumptions in the programme, the situation is expected to become significantly unfavourable in the period 2020-2050.

In order to curtail the budgetary impact of ageing, the Polish authorities have been continuously adjusting the pension system to the ongoing demographic changes. Accordingly, numerous measures (e.g. equalisation of the retirement age for women and men, liquidation of the pre-retirement benefits, introduction of price indexation of retirement and disability pensions, reform of social security schemes – see the section above) included in the *Hausner plan* are aimed at reducing the relatively high level of social expenditure. Moreover, the programme foresees financial restructuring of public healthcare institutions to improve the system efficiency. Finally, the programme measures related to the labour market situation are expected to contribute to a rise in employment rate, hence indirectly improving the long-term sustainability of public finances.

On the basis of the available quantitative information in the programme, pension expenditures are foreseen to decrease substantially by 10% of GDP between 2002 and 2050 (from 12.7% of GDP to 2.7% of GDP). Given that in the programme, long-term projections are not available for other age-related expenditures such as health-care or education, it is impossible to estimate the overall pressure on the long-term sustainability of public finances resulting from population ageing. As far as the medium-term is concerned, the budgetary strategy based on a gradual budgetary consolidation over the programme period would allow the government debt ratio to stabilise and start decreasing before the full impact of ageing takes place. According to the long-term projections provided by the Polish authorities, this strategy would put Poland in a position to meet the budgetary cost of population ageing, as far as pension expenditure is concerned.

Risks to the long-term sustainability of public finances arise if the budgetary objectives set in the programme fail to be achieved. To this end, it is important that the measures included in the *Hausner plan* are implemented. Moreover, the pension system deficit which, according to the programme, is projected to be on a decreasing trend throughout the period 2005-2050, should be closely monitored. Additional risks stem from the outstanding stock of guarantees and the contingent liabilities related to the large loss-making state-owned enterprises. A significant increase in government debt could also result from the assumption of the outstanding debt in the healthcare system.

Summing up, the Polish high deficit and hitherto rising government debt/GDP ratio are a source of great concern for the long-term sustainability of public finances. The budgetary strategy is compatible with improving the sustainability of public finances. However, while the programme projects a significant fall in pension expenditures, major uncertainties remain regarding the long-term budgetary trends in Poland due to the lack of information on other age-related expenditures. Achieving and sustaining an adequate primary surplus together with a successful implementation of the planned measures and strict monitoring of the pension system deficit and of outstanding contingent liabilities seem crucial to avoid future budgetary imbalances. Failure to do so would imply a rising debt once the impact of ageing takes place.

* * *

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Table 1. Growth and associated factors

	2003	2004	2005	2006	2007
GDP growth at constant market prices (7+8+9)	3.7	5.0	5.0	5.6	5.6
GDP level at current market prices, PLN bn.	815.0	870.7	932.9	1005.8	1082.5
GDP deflator	0.7	1.7	2.0	2.1	1.9
CPI change	0.8	2.2	2.8		
Employment growth¹	-2.3	-0.2	1.0	1.8	2.5
Labour productivity growth					
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	3.1	3.8	4.0	4.7	5.0
2. Government consumption expenditure	0.4	1.6	1.2	0.8	0.8
3. Gross fixed capital formation	-0.9	7.1	11.0	12.0	12.0
4. Changes in inventories and net acquisition of valuables as a % of GDP	0.5	0.0	0.0	0.0	0.0
5. Exports of goods and services	13.0	12.6	12.0	12.0	10.5
6. Imports of goods and services	7.9	8.9	11.4	11.6	10.9
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	2.0	4.0	4.9	5.5	5.8
8. Change in inventories and net acquisition of valuables (=4)³	0.5	0.0	0.0	0.0	0.0
9. External balance of goods and services (5-6)	1.3	1.0	0.1	0.1	-0.2

(1) Employment means employees hired on the basis of an employment contract (labour contract, posting, appointment or election); fall in the number of employed persons amounted in 2003 (MF estimate) to 1.8%.

Table 2. General government budgetary developments

% of GDP	2003	2004	2005	2006	2007
Net lending by sub-sectors					
1. General government	-4.1	-5.7	-4.2	-3.3	-1.5
2. Central government	-5.6	-6.4	-5.5	-4.8	-3.4
3. State government	-	-	-	-	-
4. Local government	-0.2	-0.2	-0.4	-0.4	-0.1
5. Social security funds	1.7	0.9	1.8	1.9	2.0
General government					
6. Total receipts	50.9	50.6	50.4	50.0	49.1
7. Total expenditures	55.0	56.3	54.6	53.3	50.6
8. Budget balance	-4.1	-5.7	-4.2	-3.3	-1.5
9. Net interest payments	3.1	2.9	3.1	3.0	2.8
10. Primary balance	-1.0	-2.8	-1.1	-0.3	1.3
Components of revenues					
11. Taxes	21.2	20.5	19.9	19.6	19.9
12. Social contributions	14.4	14.2	14.2	14.1	13.9
13. Interest income	1.0	0.8	0.8	0.8	0.9
14. Other	14.3	15.1	15.5	15.5	14.4
15. Total receipts	50.9	50.6	50.4	50.0	49.1
Components of expenditures					
16. Collective consumption	8.9	9.0	8.6	8.3	8.0
17. Social transfers in kind	8.1	8.1	7.8	7.5	7.2
18. Social transfers other than in kind	17.8	17.4	15.3	15.0	14.3
19. Interest payments	3.1	2.9	3.1	3.0	2.8
20. Subsidies	0.1	0.1	0.4	0.4	0.4
21. Gross fixed capital formation	3.5	3.7	3.8	3.7	3.6
22. Other	13.5	15.1	15.6	15.5	14.5
23. Total expenditures	55.0	56.3	54.6	53.3	50.6

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	45.3	49.0	51.9	52.7	52.3
Change in gross debt	15.0	15.5	13.5	9.3	7.0
Contributions to change in gross debt					
Primary balance	-1.0	-2.8	-1.1	-0.3	1.3
Interest payments	3.1	2.9	3.1	3.0	2.8
Nominal GDP growth	-2.0	-3.4	-3.7	-4.1	-4.0
<i>Other factors influencing the debt ratio</i>					
<i>Of which: Privatisation receipts</i>	-0.4	-0.8	-0.8	-0.7	0.0
<i>p.m. implicit interest rate on debt</i>	6.8	6.0	6.0	5.7	5.3

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	3.7	5.0	5.0	5.6	5.6
2. Actual balance	-4.1	-5.7	-4.2	-3.3	-1.5
3. Interest payments	3.1	2.9	3.1	3.0	2.8
4. Potential GDP growth	3.6	4.2	4.7	5.0	5.1
5. Output gap	-1.4	-0.7	-0.3	0.3	0.7
6. Cyclical budgetary component	-0.4	-0.2	-0.1	0.1	0.2
7. Cyclically-adjusted balance (2-6)	-3.7	-5.5	-4.1	-3.4	-1.7
8. Cyclically-adjusted primary balance (7-3)	-0.6	-2.6	-1.0	-0.4	1.1

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	3.0	5.0	5.0	5.6	n.a.
Latest update	3.7	5.0	5.0	5.6	5.6
Difference	0.7	0.0	0.0	0.0	n.a.
Actual budget balance					
Previous update	-4.1	-5.0	-4.0	-3.4	n.a.
Latest update	-4.1	-5.7	-4.2	-3.3	-1.5
Difference	0.0	-0.7	-0.2	-0.1	n.a.
Gross debt levels					
Previous update	44.3	46.9	49.2	49.1	n.a.
Latest update	45.3	49.0	51.9	52.7	52.3
Difference	1.0	2.1	2.7	3.6	n.a.

Table 6. Long-term sustainability of public finances

% of GDP	2002	2005	2010	2020	2030	2050
Total expenditure	12.7		9.9	7.3	5.0	3.6
Old age pensions						
Health care (including care for the elderly)						
Interest payments						
Total revenues	9.2		8.2	6.0	4.1	3.1
<i>Of which:</i> from pension contributions	8.7		8.0	5.9	4.1	3.1
National pension fund assets (if any)						
Assumptions						
Labour productivity growth						
Real GDP growth	1.4		5.0	5.0	4.0	3.0
Participation rate males (aged 20-64)						
Participation rates females (aged 20-64)						
Total participation rates (aged 20-64)						
Unemployment rate	20.1		14.8	10.0	7.1	6.4

Table 7. Basic assumptions

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)	5.7	5.3	5.7	6.2	5.9
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
United States: short-term (three-month money market)	1.2	1.2	1.7	n.a.	n.a.
United States: long term (10-year government bonds)	4.0	4.2	4.6	n.a.	n.a.
USD/€exchange rate (annual average)	1.13	1.3	1.2	1.2	1.1
Nominal effective exchange rate (euro area)	11.8	4.2	0.2	n.a.	n.a.
Nominal effective exchange rate (EU)	12.8	6.9	-1.1	n.a.	n.a.
PLN/€exchange rate (annual average)	4.40	4.79	4.66	4.62	4.55
World GDP growth, excluding EU	4.4	5.1	4.7	n.a.	n.a.
United States, GDP growth	3.1	4.2	3.2	n.a.	n.a.
Japan, GDP growth	2.7	3.4	2.3	n.a.	n.a.
EU-15 GDP growth	0.8	2.0	2.4	n.a.	n.a.
Growth of relevant foreign markets					
World import volumes, excluding EU	7.3	9.7	8.5	n.a.	n.a.
World import prices (goods, in USD)	8.8	6.4	0.7	n.a.	n.a.
Oil prices (Brent, USD/barrel)	28.5	31.1	28.9	n.a.	n.a.
Non-oil commodity prices (in USD)	6.6	15.6	-2.6	n.a.	n.a.