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DECEMBER 2004 UPDATE OF THE CONVERGENCE PROGRAMME OF POLAND (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

Poland submitted to the European Commission its updated convergence programme covering the period 2004-2007 on 1 December 2004, following the approval by the Council of Ministers on 30 November 2004. The document incorporates the measures taken in the 2005 budget and draws upon the government's "*Programme of Rationalisation and Reduction of Public Expenditure*" (the so-called *Hausner plan*) endorsed in January 2004. The programme partly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes" and adheres to ESA95 standards. The quality of ESA95 data on the composition of the general government revenue and expenditure is not fully in line with ESA95 statistical standards. Accordingly, Poland is invited to achieve compliance with the data requirements.

The macroeconomic framework presented in the programme predicts a deceleration in real GDP growth from 5.7% in 2004 to 5.0% and 4.8% in 2005 and 2006, respectively, followed by a rebound to 5.6% in 2007. Throughout the forecast period, growth will be driven by domestic demand, while the contribution of net exports is expected to turn negative from 2005 onwards. The macroeconomic scenario up to 2006 is plausible and is close to the Commission services autumn 2004 forecasts, although the latter predict a somewhat lower GDP growth for 2006. By contrast, the growth forecast for the last year of the programme appears on the high side. The projected acceleration in GDP growth in 2007 reflects optimistic assumptions about the growth of both potential output and domestic demand. In particular, the programme assumes a strengthening of potential growth from 3.6% in 2004 to 4.7% in 2007 (according to Commission services calculations), resulting in an estimated output gap of over 2% at the end of the programme period. This suggests also that price pressures could be stronger than expected in the programme.

During 2004, inflation in Poland has been increasing from the very low levels recorded in 2003, but the pace has recently slowed. The surge in inflation observed between April and August 2004 was mostly due to temporary factors (food and oil prices, accession-related tax increases), while continued moderate wage growth and a stronger zloty help to underpin prospects for a slowing of inflation in 2005. The zloty appreciated strongly during most of 2004, gaining some 13% against the euro relative to December 2003. In effective terms, both nominal and real, the zloty also recorded an appreciation of more than 10% in the course of 2004 (year-end vs. year-end). Yield spreads between Polish and euro area benchmark bonds widened between mid-2003 and mid-2004 due to investor concerns about economic policy governance, but narrowed again in recent months, down to about 200 basis points at year-end. 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.

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[1] This technical analysis, which is based on information available up to 26 January 2004, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 2 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission.Comments should be sent to Agnieszka Skuratowicz [Agnieszka.Skuratowicz@cec.eu.int] and Nathalie Darnaut [Nathalie.Darnaut@cec.eu.int].

The budgetary strategy underlying the updated 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 update foresees a gradual reduction of the deficit to 2.2% of GDP in 2007 from 5.4% of GDP in 2004. The open pension funds (estimated annual impact of 1.5% of GDP) are classified within the general government sector as allowed by the transition period granted by Eurostat. Compared with the previous programme, the most significant difference is the upward revision of the general government deficit target in 2007 by 0.7 percentage points of GDP, despite the projected rebound in economic growth. The fiscal consolidation would result from the implementation of a comprehensive set of measures contained in the *Hausner plan*, which, if fully implemented, would have an estimated total budgetary impact of 4.7% of GDP over the period 2005-2007 (revised downwards by 0.6 percentage points compared with the previous programme).

The reduction of the headline deficit between 2004 and 2007 is less ambitious than in the May convergence programme and amounts to 3.2 instead of 4.2 percentage points. Many risks surround the planned consolidation strategy. The risk of a delayed or incomplete implementation of the envisaged measures of the *Hausner plan*, described in the assessment of the May 2004 programme, is already materialising. There is still uncertainty over the implementation of the remaining measures contained already in the budget for 2005, but requiring legislative action. Despite the rejection by Parliament of two important measures, the deficit targets remained unchanged. Almost half of the measures aiming at additional revenue and expenditure savings described in the update are unspecified. Contingent liabilities constitute an additional risk to the sustainability of public finances. The achievement of the deficit targets is also conditional on projected high GDP growth throughout the programme period. In addition, the funded pension scheme continues to be recorded inside the general government sector. With a change in classification in 2007, the deficit figures for each year will be adjusted upwards by 1.5 percentage points. In the absence of additional savings measures, the fulfilment of the Council recommendation to bring the deficit below 3% in the end year of the programme is not ensured, based on the new 2007 deficit target of 2.2% of GDP. Based on the risk assessment, the budgetary outcome could be worse than projected.

The government debt ratio is projected to increase by a cumulative 2.6 percentage points between 2004 and 2006 to peak at 48% of GDP at the end of 2006, before declining by 0.8 percentage points in 2007. The Commission services autumn 2004 forecasts show a less favourable debt development. The classification of the open pension funds outside the general government sector in accordance with the Eurostat ruling would lead to an increase in the debt figures by about 6 percentage points on average each year over the period 2005-2007. The debt ratio would thus remain below the 60% of GDP reference value even with this change in classification. The debt forecast for 2004 has been revised downwards by some 3 percentage points compared to the May programme, mainly due to stronger than expected nominal GDP growth and valuation effects following the appreciation of the zloty. Over the rest of the programme period, improving primary balances and a large nominal growth dividend would partly offset the net debt-increasing impact of the stock-flow adjustment, in part reflecting the pre-financing of EU funds. The planned slowdown and eventual reversal of the increase in the debt ratio is also conditional on sizeable privatisation proceeds. Contingent liabilities also represent a risk to the planned path of debt reduction. The stock of treasury guarantees amounted to 3.9% at the end of 2004 and is expected to increase in the coming years. In addition, the outstanding debt of the health-care system continues to grow and expectations for a bail-out by the government are rising.

The update outlines only briefly the measures envisaged in the *Hausner plan* to curb social spending and improve public expenditure management. The adjustment path described in the programme hinges critically on the implementation of the planned reform of social protection. The update complements the May convergence programme, where most of the measures were discussed, with the estimates of the budgetary impact of the measures. 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. They also address the challenge of decreasing the relatively high share of the legally determined expenditure. Due to the public finance reform and the rationalisation of expenditure, the share of mandatory (legally determined) expenditure is expected to decrease from 42.5% in 2003 to 39.3% in 2007.

The lack of budgetary projections beyond 2020 makes it very difficult to assess the long-term sustainability of the Polish public finances, as most of the budgetary impact of aging is likely to take place after 2020. However, on the basis of the available information, some risks cannot be ruled out. Major uncertainties regarding the budgetary impact of policies aimed at strengthening the long-term budgetary trends remain.

While the strategy outlined in the programme relies mainly on the impact of the pension reform and the necessary budgetary consolidation in the medium-term, additional reform measures need to be implemented in the future to improve the capacity to cope with an ageing population. Thus, a successful implementation of the planned measures, a strict monitoring of outstanding contingent liabilities and the resolute implementation of the planned budgetary consolidation in the medium-term should contribute to a sustainable position in the longer term.

Overall, the economic policies outlined in the update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. On the one hand, the programme is in line with the reduction of the general government deficit recommended by the Council and the reduction is based on the implementation of the *Hausner plan*. On the other hand, the programme does not present concrete steps to safeguard the long-term sustainability of public finances, and to address the issue of the rising stock of contingent liabilities.

In view of the above assessment and in the light of the recommendations made by the Council under Article 104(7), it would be appropriate that Poland strengthens the fiscal adjustment and lowers the deficit target for 2007. In order to bring the deficit below 3% of GDP in 2007 in a credible and sustainable manner, it should ensure a full implementation of the structural measures contained in the *Hausner plan* and take additional fiscal consolidation measures. If risks related to implementation materialized, additional effort should also be made to introduce alternative measures. Furthermore, Poland should be invited to undertake efforts to address the issue of the rising stock of contingent liabilities.

Table: Comparison of key macroeconomic and budgetary projections

		2004	**2005**	**2006**	**2007**
Real GDP (% change)	**CP Dec 2004**	**5.7**	**5.0**	**4.8**	**5.6**
	COM Oct 2004	5.8	4.9	4.5	n.a.
	CP May 2004	*5.0*	*5.0*	*5.6*	*5.6*
HICP inflation (%)	**CP Dec 2004**	**3.5**	**3.0**	**2.7**	**2.5**
	COM Oct 2004	3.5	3.3	3.0	n.a.
	CP May 2004	*2.2*	*2.8*	*<3*	*<3*
General government balance (% of GDP)	**CP Dec 2004**	**-5.4**	**-3.9**	**-3.2**	**-2.2**
	COM Oct 2004	-5.6	-4.1	-3.1	n.a.
	CP May 2004	*-5.7*	*-4.2*	*-3.3*	*-1.5*
Primary balance (% of GDP)	**CP Dec 2004**	**-2.6**	**-1.3**	**-0.5**	**0.4**
	COM Oct 2004	-2.5	-1.0	-0.0	n.a.
	CP May 2004	*-2.8*	*-1.1*	*-0.3*	*1.3*
Government gross debt (% of GDP)	**CP Dec 2004**	**45.9**	**47.6**	**48.0**	**47.3**
	COM Oct 2004	47.7	49.8	49.3	n.a.
	CP May 2004	*49.0*	*51.9*	*52.7*	*52.3*

Sources:
Convergence programme (CP); Commission services autumn 2004 forecasts (COM)

1. INTRODUCTION

Poland submitted to the European Commission its updated convergence programme covering the period 2004-2007 on 1 December 2004, following the approval by the Council of Ministers on 30 November. The document incorporates the measures taken in the 2005 budget and draws upon the government's "*Programme of Rationalisation and Reduction of Public Expenditure*" (the so-called *Hausner plan*) endorsed in January 2004.

The programme partly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes" and adheres to ESA95 standards. The quality of ESA95 data on the composition of the general government revenue and expenditure is not fully in line with ESA95 statistical standards[2]. Accordingly, Poland is invited to achieve compliance with the data requirements.

2. MACROECONOMIC DEVELOPMENTS

Real GDP growth is projected to peak at 5.7% in 2004 compared to 3.8% in 2003. As fiscal consolidation starts and monetary conditions become less supportive, growth is expected to decelerate to 5.0% and 4.8% in 2005 and 2006, respectively, before rebounding to 5.6% in 2007. Throughout the forecast period, growth will be driven by domestic demand, while the contribution of net exports is expected to turn negative from 2005 onwards. Investment activity is projected to pick up in 2004 and reach double-digit growth over the rest of the programme period, against the backdrop of emerging capacity constraints, strong corporate profitability and accession-related business opportunities. Private consumption is projected to grow moderately in 2004-2005, but should strengthen in 2006-2007, sustained by improving employment prospects and a slight acceleration in real wage growth.

The macroeconomic scenario up to 2006 appears plausible and is close to the Commission services autumn 2004 forecasts, although the Commission services predict a somewhat lower GDP growth for 2006. By contrast, the growth forecast for 2007 appears optimistic in view of the estimated potential growth rate of 4.7% (see Table 2). Several downside risks surround this projection which rests on the assumptions of strong investment dynamics and of an acceleration in private consumption growth. At any rate, the strength of economic activity in the medium term depends on a successful implementation of the public finance reform and the ensuing effect on business and consumer confidence.

[2] 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, gives a misleading picture of the composition of expenditure and objectively makes the assessment more difficult.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	5.8	5.7	4.9	5.0	4.5	4.8	5.6
Contributions:							
- Final domestic demand	4.1	4.1	4.8	5.1	5.4	5.3	6.3
- Change in inventories	0.9	0.7	0.1	0.0	-0.1	0.0	0.0
- External balance on g&s	0.8	0.8	-0.1	-0.1	-0.7	-0.5	-0.8
Employment (% change)	-0.2	-0.5	0.7	1.0	1.2	1.6	1.7
Unemployment rate (%)	19.0	19.3	18.7	18.2	18.1	17.4	n.a.
HICP inflation (%)	3.5	3.5	3.3	3.0	3.0	2.7	2.5
GDP deflator (% change)	2.8	2.7	2.9	2.7	3.3	2.5	2.4
Current account (% of GDP)	-2.3	-1.9	-2.5	-2.3	-2.7	-3.0	-3.6

Sources:
Commission services autumn 2004 forecasts (COM); convergence programme update (CP)

HICP inflation is projected to decrease gradually from 3.5% in 2004 to 2.5% in 2007. For 2005 and 2006, the Commission services forecast a less rapid decline in HICP inflation, mainly owing to different estimates of the output gap. Moreover, the Commission services project higher inflation for the GDP deflator than the programme; in contrast to the Commission services forecast, which sees inflation accelerating in 2005-2006, the programme projects disinflation gains extending into 2007.

The macroeconomic scenario is based on external assumptions largely consistent with those underlying the Commission services autumn 2004 forecasts. The programme projects an acceleration of world GDP growth (excluding the EU) this year, followed by a slowdown in 2005-2006; a similar growth profile is forecast for the EU, although a moderate rebound is projected in 2006. The main differences with the Commission services autumn 2004 forecasts concern the assumptions on interest and exchange rates. In particular, the programme assumes a moderate nominal appreciation of the zloty vis-à-vis the euro over 2004-2007 (2.3% on average) compared to the technical assumption of a constant real exchange rate in the Commission services autumn 2004 forecasts[3].

For the period 2004-2006, the estimates of potential output derived from the programme's projections (calculated by the Commission services using the commonly agreed methodology) are identical to those of the Commission services autumn 2004 forecasts (see Table 2). The estimates point to an acceleration of potential growth from 3.6% in 2004 to 4.2% in 2006. In both scenarios, real GDP growth is projected to exceed potential, with the negative output gap turning positive in 2005 and increasing further in 2006. However, the programme assumes a higher positive output gap in 2006 relative to the Commission services forecast, reflecting the difference in the forecasts for real GDP growth. For 2007, the programme expects real GDP growth to be substantially above potential, resulting in an estimated output gap of over 2%. This could lead to price

[3] The assumptions on short-term interest rates differ also slightly from the Commission services forecasts. The programme assumes an increase in policy interest rates in 2005, followed by a policy easing in the last year of the programme. Most importantly, the programme's assumptions on the implicit interest rate on government debt have been changed from the May programme. The current programme assumes a sharp reduction from 6 to 5½% in 2005 and broadly stable levels thereafter (compared to stable interest rates of 6% in 2004-2005 in the May programme). An explicit reference to the underlying reason for this change in the interest rate profile – which reduces the 2005 general government deficit by some 0.25% of GDP relative to the May assumptions – would have been helpful.

pressures and hence, may not be consistent with the decline in inflation projected in the programme. Therefore, while estimates of potential growth are still subject to a large degree of uncertainty, they tend to confirm the view that the projections for both growth and inflation for the last year of the programme are rather favourable.

Table 2: Sources of potential output growth

	2004		2005		2006		2007
	COM	**CP[3]**	**COM**	**CP[3]**	**COM**	**CP[3]**	**CP[3]**
Potential GDP growth[1]	3.6	3.6	4.0	4.0	4.2	4.2	4.7
Contributions:							
- Labour	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	0.0
- Capital accumulation	1.4	1.5	1.6	1.7	1.8	2.0	2.3
- TFP	2.3	2.3	2.4	2.3	2.4	2.4	2.4
Output gap[1,2]	-0.4	-0.3	0.4	0.7	0.7	1.2	2.1

Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme update

Sources:
Commission services autumn 2004 forecasts (COM); Commission services calculations

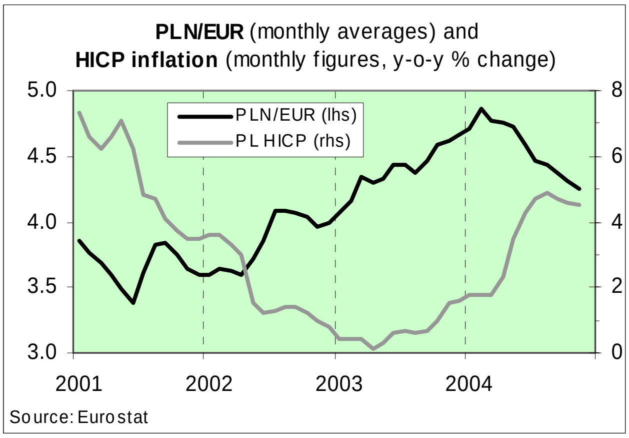
Following a marked reduction over 2000-2003, the programme expects the current account deficit to decrease further to 1.9% of GDP in 2004 from 2.2% in 2003, and to widen in the subsequent years to reach 3.6% of GDP in 2007. Information provided in the programme makes possible an approximate assessment of sectoral balances. Against the backdrop of an increasing government deficit and weak consumer demand, an increase in net private savings is expected in 2004. As both business investment and private consumption growth accelerate, the programme predicts a reduction in the private savings-investment surplus this year and next and the emergence of a net private borrowing position in 2007. This is consistent with the projection of a widening current account deficit as the reduction in the general government net borrowing will likely be insufficient to offset the deterioration of the private sector savings-investment balance. In addition, the programme assumes that the current account deficit will continue to be financed mainly by long-term capital inflows, thus mitigating concerns about external sustainability. Nevertheless, prospective developments in the sectoral balances of the private and external sectors underscore the need for ambitious fiscal consolidation.

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

During 2004, inflation in Poland has been increasing from the very low levels recorded in 2003, but the pace has recently slowed. HICP inflation accelerated in spring and peaked at 4.9% (year-on-year) in August. The surge in inflation was mostly due to temporary factors (food and fuel prices, accession-related tax increases), while continued moderate wage growth and a stronger zloty help to underpin prospects for a slowing of inflation in 2005.

The National Bank of Poland operates a direct inflation targeting regime combined with a free float of the zloty. The programme reiterates the central bank’s running target of CPI inflation close to 2.5% with a ±1% tolerance margin (as recently reaffirmed in the *2005 Monetary Policy Guidelines*). Reflecting progress in disinflation, monetary policy had been eased strongly between 2001 and mid-2003. In order to contain inflationary expectations and prevent second-round effects from temporary price hikes, the National

Bank of Poland introduced a tightening bias in April 2004 and subsequently raised the main reference rate by 125 basis points between June and August, to the current level of 6.5%.



Polish money market rates have generally stood moderately above policy rates, with fluctuations in the differential mainly reflecting market expectations of future monetary policy moves. After a pronounced increase during autumn, 3-month rates receded somewhat towards the end of the year, in line with a more upbeat market assessment of inflationary risks and the resulting path of policy rates. Government bond yields have been rather volatile, with a strongly increasing trend between mid-2003 and mid-2004 due to investor concerns about economic policy governance. 10-year benchmark yields peaked at 7.6% or 330 basis points above the euro area in July 2004. The spread has narrowed again in recent months and hovered slightly above 200 basis points at year-end.

Following a weak period early in the year, the zloty appreciated strongly during most of 2004, gaining some 13% against the euro relative to December 2003. This needs, however, to be seen against the background of a 30% depreciation of the zloty/euro rate between mid-2001 and end-2003. In effective terms, both nominal and real, the zloty also recorded an appreciation of more than 10% in the course of 2004 (year-end vs. year-end), while the annual averages for 2004 stood slightly below the 2003 levels, reflecting a strong depreciation trend during 2003. The upward trend of the zloty has helped to attenuate inflationary risks, while it has so far not impeded the economy's strong export performance. 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.

4. BUDGETARY IMPLEMENTATION IN 2004

The deficit target for 2004 has been revised downwards in the update to 5.4% of GDP from 5.7% in the May 2004 programme. According to the latest government estimates from January 2005, the general government deficit is expected to be subject of a further downward revision to 5% of GDP. The Commission services autumn 2004 forecast projected a somewhat higher deficit of 5.6% of GDP.

The revisions reflect a better-than-expected implementation of the State budget. In cash terms, the State budget would outperform the 45.3bn PLN (5.1% of GDP) of the planned deficit by approximately 4bn PLN (0.4% of GDP) due to higher revenue. At the end of November, the receipts from the corporate income tax were by 18% higher than initially planned for the entire year. The revenue from indirect taxes as well as from the personal income tax is meeting the planned targets.

The downward revision of the deficit-to-GDP ratio results also from an upward revision of the real growth rate forecast for 2004 to 5.7% in the update from 5% in the May 2004 convergence programme. Higher-than-expected inflation contributed to higher receipts from indirect taxes, which are proportional to the price level.

The allocation of extra revenues to decrease the general government deficit is in line with the recommendations made by the Council under Article 104 (7). This is also consistent with the country-specific broad economic policy guidelines in the area of public finances for Poland.

Better-than-expected performance of the social security sub-sector and local governments at the end of the third quarter of 2004 is expected to contribute to undershooting the deficit target in 2004.

5. Budgetary targets and the medium-term path of the public finances

5.1. Evolution of budgetary targets in successive programmes

The updated convergence programme foresees a gradual reduction of the general government deficit from 5.4% of GDP in 2004 to 2.2% in 2007. For the 2005 and 2006 deficits, the projections are of 3.9% and 3.2% respectively. The headline adjustment planned for the period 2004-2007 is less ambitious compared to the May programme. It declined to 3.2 percentage points in the update from 4.2 percentage points. The open pension funds (estimated annual impact of about 1.5% of GDP) are classified within the general government sector.

Box 1: The excessive deficit procedure for Poland

On the basis of a general government deficit of 4.1% of GDP in 2003, above the 3% of GDP reference value, the Council decided on 5 July 2004 that Poland had an excessive deficit and recommended that this be corrected by 2007 at the latest. In particular, Poland was recommended to implement with vigour the measures envisaged in the May convergence programme, in particular those contained in the so-called "*Hausner plan*". It was recommended to take effective action regarding the measures envisaged to achieve the 2005 deficit target by the deadline of 5 November 2004, i.e. four months after the recommendation, in line with the Stability and Growth Pact (SGP). In addition, Polish authorities were invited to allocate possible extra revenues to decrease the general government deficit and to ensure the rise in the debt ratio is brought to a halt.

On current information and on the basis of the measures detailed in the 2005 budget, the Commission concluded in its Communication of 22 December 2004 that the Polish government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target, by the deadline of 5 November, in response to the recommendation under Article 104(7) to correct the excessive deficit by 2007 at the latest.

The fiscal consolidation would result from the implementation of the *Hausner plan*. The estimation of the total budgetary impact of the envisaged measures was revised downwards to 4.7% of GDP in the update from 5.3% of GDP in the May programme.

The deficit targets (as % of GDP) are more optimistic in the update compared to the May 2004 programme except for 2007. A slight downward revision of the deficit target was made for 2006 despite a considerable downward revision of the GDP growth by 0.8 percentage points and an estimated lower budgetary impact of the consolidation measures compared to the May programme. For 2007, an upward revision of the deficit target was made to 2.2% of GDP from 1.5% of GDP in May notwithstanding the projected rebound in economic growth. The authorities motivated the revision of the 2007 deficit target with an unexpected improvement in the debt outlook (see section 6) that eliminated the need to introduce drastic fiscal measures that would have to be implemented if the debt-to-GDP ratio (based on the Polish conservative definition) was to exceed the 55% safety threshold in 2005[4].

Expenditure and revenue data were once again revised complicating the analysis. Revenue and expenditure shares in GDP over 2004-2006 are about 8 percentage points lower than projected in the May programme and correspond to levels reported in the 2003 pre-accession economic programme.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007
General government balance (% of GDP)	**CP December 2004**	**-3.9**	**-5.4**	**-3.9**	**-3.2**	**-2.2**
	CP May 2004	-4.1	-5.7	-4.2	-3.3	-1.5
	PEP August 2003	*-4.1*	*-5.0*	*-4.0*	*-3.4*	*n.a.*
General government expenditure (% of GDP)	**CP December 2004**	**47.6**	**48.6**	**48.4**	**48.0**	**46.2**
	CP May 2004	55.0	56.3	54.6	53.3	50.6
	PEP August 2003	*47.2*	*47.9*	*46.2*	*45.5*	*n.a.*
General government revenues (% of GDP)	**CP December 2004**	**43.7**	**43.2**	**44.5**	**44.8**	**44.0**
	CP May 2004	50.9	50.6	50.4	50.0	49.1
	PEP August 2003	*43.1*	*42.9*	*42.2*	*42.1*	*n.a.*
Real GDP (% change)	**CP December 2004**	**3.8**	**5.7**	**5.0**	**4.8**	**5.6**
	CP May 2004	3.7	5.0	5.0	5.6	5.6
	PEP August 2003	*3.0*	*5.0*	*5.0*	*5.6*	*n.a.*
Sources: *Convergence programmes (CP); pre-accession economic programme (PEP)*						

5.2. Budgetary targets in the updated programme

The updated programme aims at reducing the deficit to below the 3% of GDP reference value in 2007, in line with the Council recommendation under Article 104(7). This is also consistent with the country-specific broad economic policy guidelines in the area of public finances for Poland. As mentioned above, the convergence programme builds its projections for 2005 and beyond upon the government's *Programme for Rationalisation and Reduction of Public Expenditure*, the so-called *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.

The general government deficit is expected to widen from 3.9% of GDP in 2003 to 5.4% in 2004, but to decrease gradually thereafter to 2.2% in 2007. The headline adjustment of the general government deficit between 2004 and 2007 represents 3.2 percentage points. The largest annual reduction is expected for 2005 (1.5 percentage points). The time profile of the primary balance is similar, with an improvement from -2.6% in 2004 to 0.4% at the end of the period. While as from 2005 the pension system is expected to show a stable surplus and the local government a stable deficit, the central government deficit is gradually decreasing, thus driving the improvement in the general government position over the projection period.

[4] The update projects the debt ratio to increase by a cumulative 1.8 percentage points over the period 2004-2007 compared to 7 percentage points in the May programme.

The *Hausner plan*, as described in the updated convergence programme, would deliver in total over the period 2005-2007, if fully implemented, 4.7% of GDP of additional revenues and expenditure savings (see Box 3). The developments in the expenditure and revenue ratios correspond to a large degree to the measures foreseen. Comparison with the adjustment path described in the May convergence programme is made difficult because of the revision of the expenditure and revenue data (see Table 3).

Box 2: The State budget for 2005

No significant change has been announced on the State budget revenue side for 2005, but the structure of revenues is changing. The expected increase of revenues by 10% in real terms compared to 2004 budget would result from rising receipts from VAT and corporate tax (respectively by 11% and 8% in real terms). The increase of the VAT rate on some products after EU accession and higher excise taxes planned for 2005 translate into higher expected receipts from indirect taxes. Revenues from the corporate tax are expected to increase, despite the reduction of the corporate tax rate, due to economic growth and the widening of the taxation base. A very modest increase of receipts from personal income tax (3%) is planned reflecting among other things the low wage dynamics. The State budget foresees a four-percent rise of expenditure (in nominal terms) compared to 2004. Expenditure projections are based on legislation not yet approved.

Structure of revenues in the State budget

Shares in total revenues (in %)	2003	2004	2005
Revenues	**100**	**100**	**100**
Indirect taxes	*62.7*	*65.4*	*67*
Income taxes	*26.2*	*22.7*	*22*
Non-tax revenues	*11*	*10.9*	*9.3*
From EU	*:*	*1.5*	*1.6*

The main measures in the budget for 2005 consist of the implementation of the package of measures contained in the *Hausner plan*: endorsed by parliament but also the ones that are still being discussed. This in line with the country-specific broad economic policy guidelines in the area of public finances for Poland and with the recommendations by the Council under Article 104(7).

Due to the reforms, the share of legally determined expenditure is expected to decrease.

Share of mandatory expenditure (legally determined)

Expenditure (State budget) - % of total	2003	2004	2005
Mandatory	67.6	62.2	59
Flexible	32.4	37.8	41

Following the rejection by Parliament of two measures of the *Hausner* plan, there is still uncertainty over the implementation of the remaining measures that require legislative procedures but contained already in the budget for 2005. Despite the rejection, the government decided to keep the deficit target for 2005 unchanged at 3.9% of GDP.

Overall, the measures adopted and planned appear to be for the largest part of a structural nature (reflecting rationalisation and savings in social spending), thus having a deficit-reducing impact also in subsequent years.

The general government expenditure ratio is expected to decrease by 2.4 percentage points over the projection period reflecting mainly a significant cut in transfers in terms of GDP (see Table 4) obtained as a result of the implementation of the *Hausner plan*. Additional savings would come from cuts in collective consumption. The other components of expenditures are projected to stay virtually stable over the programme period. In particular, public spending on investment is expected to remain stable around an average of 4.1% of GDP over 2004-2007 (well above the EU-average of 2.4% of GDP in 2004) after an increase from 3.4% of GDP in 2003.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	Change: 2007-2004
Revenues	43.7	43.2	44.5	44.8	44.0	**+0.8**
of which:						
- Taxes	22.3	22.1	22.3	22.5	22.5	**+0.4**
- Social security contributions	13.5	13.0	13.2	13.1	13.0	**+0.0**
- Interest revenue	0.6	1.0	1.1	0.9	0.9	**-0.1**
- Other (residual)	7.3	7.1	7.9	8.3	7.6	**+0.5**
Expenditure	47.6	48.6	48.4	48.0	46.2	**-2.4**
of which:						
- Primary expenditure	44.5	45.8	45.8	45.3	43.6	**-2.2**
of which:						
Gross fixed capital formation	3.4	4.1	4.2	4.3	4.0	**-0.1**
Consumption (collective & individual)	17.6	17.3	17.5	17.1	16.9	**-0.4**
Transfers (other than in kind)	17.6	16.1	15.2	15.1	14.4	**-1.7**
Subsidies	0.4	0.7	0.9	0.9	0.9	**+0.2**
Other (residual)	5.5	7.6	8.0	7.9	7.4	**-0.2**
- Interest payments	3.1	2.8	2.6	2.7	2.6	**-0.2**
Budget balance	**-3.9**	**-5.4**	**-3.9**	**-3.2**	**-2.2**	**-3.2**
Primary balance	**-0.8**	**-2.6**	**-1.3**	**-0.5**	**0.4**	**-2.2**
Sources: *Convergence programme update; Commission services calculations*						

The link between the public finance reform and the evolution of the general government revenue-to-GDP ratio, which is projected to increase by 0.8 percentage points over 2004-2007, is less clear. Despite plans to improve the efficiency of tax collection and to broaden the tax base, tax revenues are expected to increase by a meagre 0.4% of GDP. More than half of the increase comes from the change under the unspecified position “other”.

The state of implementation of the Hausner plan measures is well defined compared to the information provided in the May programme. From the measures affecting the revenue side (estimated impact over the projection period of 2.3% of GDP), slightly less than half (0.9% of GDP) is still in the legislative process. On the expenditure side, from the measures (estimated budgetary impact of 2.4% of GDP over the period), one third (0.55% of GDP) is under discussion in Parliament. From all the measures, however, on both revenue and expenditure side, almost half of them are not specified in the updated programme (see Box 3).

The impact of EU accession on the fiscal balance is estimated in the programme at 0.7%, 0.8% and 1.1% of GDP respectively in 2005, 2006 and 2007. On the revenue side, the Polish authorities consider the lump sum cash-flow facilities and Schengen payments. On the expenditure side, they include payments to the EU budget, costs covering the co-financing of structural projects and the topping-up of direct subsidies to farmers. However, the authorities’ analysis of the impact of EU accession on the general government budget should be qualified. First, top-up subsidies to farmers, though agreed in the Accession Treaty, were to a large degree discretionary and decided domestically. Second, there have been some extra tax revenues generated by EU accession as a part of increased VAT and excise duties revenues was due to the harmonisation with EU legislation. It is also up to the discretion of the national authorities to what extent they compensate for co-payments on EU funds by savings on other expenditures in the budget or to what extent they draw on EU-funds, which require co-payments, at all.

Box 3: Programme for Rationalisation and Reduction of Public Expenditure (so-called *Hausner plan*)

The updated convergence programme builds its projections for 2005 and beyond upon the government's *Programme for Rationalisation and Reduction of Public Expenditure*, the so-called *Hausner plan*. The public finance reform, if fully implemented, would deliver in total over the period 2005-2007 2.3% of GDP of additional revenues and 2.4% of GDP of expenditure savings. The estimation of the total budgetary impact of the envisaged measures was revised downwards to 4.7% of GDP in the update from 5.3% of GDP in the May programme.

Budgetary impact of the Hausner plan over the projected period

(% of GDP)	2004	2005	2006	2007	Change 2007-2004
Savings in expenditure (Hausner plan) **May CP**	**-**	**0.83**	**1.2**	**1.03**	**3.06**
Updated CP	***0.06***	***0.79***	***0.62***	***0.93***	***2.40***
Additional revenue (Hausner plan) **May CP**	**-**	**0.75**	**0.76**	**0.74**	**2.25**
Updated CP	***0.07***	***0.71***	***0.76***	***0.75***	***2.29***
Total budgetary impact of Hausner plan **May CP**	**-**	**1.58**	**1.97**	**1.76**	**5.31**
Updated CP	***0.13***	***1.5***	***1.38***	***1.68***	***4.69***

Source: Poland's Convergence Programmes, May 2004 and December 2004; Commission services calculations

On the expenditure side, from the measures (estimated budgetary impact of 2.4% of GDP over the period), one third (0.55% of GDP) is under discussion in Parliament. From the measures affecting the revenue side (estimated impact over the projection period of 2.3% of GDP), slightly less than half (0.9% of GDP) is still in the legislative process. From all the measures, however, on both revenue and expenditure side, almost half of them are unspecified in the update.

Implementation of the Hausner plan

	2004	2005	2006	2007
I. Savings in total expenditure	**0.06**	**0.79**	**0.62**	**0.93**
1. **not requiring legislative changes (reduction in administrative costs):**	**0.01**	**0.05**	**0.07**	**0.07**
2. Requiring legislative changes:	0.05	0.74	0.55	0.87
a) approved by Parliament	0.00	0. 60	0.39	0.67
changes in the pension indexation rules	-	*0.42*	*0.12*	*0.33*
changes in the defence financing rules	-	*0.14*	*0.15*	*0.16*
changes in the pre-retirement benefits system	-	*0.05*	*0.12*	*0.18*
b) **in the legislative process**	**0.04**	**0.14**	**0.16**	**0.20**
changes in the system for employment of disabled	*0.04*	*0.05*	*0.03*	*0.02*
other	-	*0.08*	*0.14*	*0.17*
II. Total additional revenues	**0.07**	**0.71**	**0.76**	**0.75**
1. **not requiring legislative changes**:	**0.00**	**0.40**	**0.39**	**0.38**
a) restructuring of the railways sector	-	0.04	0.04	0.04
b) broadening of the tax base	-	0.35	0.35	0.34
2. requiring legislative changes:	0.07	0.31	0.37	0.36
a) approved by Parliament	0.07	0.04	0.04	0.04
restructuring of coal mining	*0.07*	*0.04*	*0.04*	*0.04*
b) **in the legislative process**	-	**0.27**	**0.33**	**0.33**
additional actions	-	*0.17*	*0.17*	*0.17*
reform of the farmers' pension scheme (KRUS)	-	*0.10*	*0.10*	*0.10*
other	-	*0.00*	*0.06*	*0.05*
TOTAL BUDGETARY IMPACT (I+II)	**0.13**	**1.5**	**1.38**	**1.68**
Out of which "other", "additional" & unspecified (widening of the tax base)	**-**	***0.6***	***0.72***	***0.73***

Source: Convergence Programme, December 2004

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

- The funded pension scheme continues to be recorded inside the general government sector as allowed by the transition period granted by Eurostat. With a change in classification, the deficit figures for each year will be adjusted upwards by 1.5 percentage points. In the absence of additional savings measures, the fulfilment of the Council recommendation to bring the deficit below 3% in the end year of the programme is not ensured, based on the new 2007 deficit target of 2.2% of GDP.

- A risk of implementation of the announced measures in the pre-election period[5]: the risk of a delayed or incomplete implementation of the envisaged measures of the *Hausner plan*, presented as a possibility in the assessment of the May 2004 programme, is already materialising. There is still uncertainty over the implementation of the remaining measures that require legislative procedures but contained already in the budget for 2005. Despite the rejection by Parliament of two important measures, the deficit targets remained unchanged. Almost half of the measures aiming at additional revenue and expenditure savings are not specified in the update.

- Contingent liabilities constitute an additional risk to the sustainability of public finances (see Section 6 on debt developments).

- Downside macro-economic risks: the achievement of the deficit target is also conditional on projected high growth throughout the programme period.

Table 5: Budgetary targets and output gaps

	2003		2004		2005		2006		2007	Change: 2007-2004
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Budget balance[2]	-3.9	-3.9	-5.6	-5.4	-4.1	-3.9	-3.3	-3.2	-2.2	-3.2
Output gap[1,3]		-1.6		-0.2		0.0		-0.2		0.2

Notes:
[1]Commission services calculations on the basis of the information in the convergence programme CP
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services autumn 2004 forecasts (COM); Commission services calculations

Taking account of the balance of risks to the budgetary targets, Poland seems on track so far to correct its excessive deficit according to the adjustment path set by the Council, as confirmed in the Commission Communication of 22 December 2004. This is also consistent with the country-specific broad economic policy guidelines in the area of public finances for Poland. However, for the outer year of the updated programme Poland does not conform to the deficit reduction path specified by the Council taking into account a future change in the treatment of the open pension funds.

In order to bring the deficit below 3% in a sustainable and credible manner, a full implementation of the structural measures contained in the *Hausner plan* should be

[5] Parliamentary and presidential elections are foreseen for 2005

ensured and additional fiscal consolidation measures taken. If political risks materialise, additional effort needs to be taken to introduce alternative measures.

5.3. Sensitivity analysis

The update presents an extensive list of risk factors (economic, political and other), which could significantly impede the implementation of the medium-term fiscal strategy. The sensitivity analysis 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 government sector (inflationary premium) through the indexation mechanism and impact on revenues; (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 (remaining vulnerable despite the reduction in the share of foreign debt in total debt); (iv) the current political situation and the pre-election period, raising some doubts about the effective implementation of the *Hausner plan*. In case of its rejection, the deficit would decrease steadily over the projection period due to cyclical factors but would remain above 3% in 2007.

6. EVOLUTION OF THE DEBT RATIO

Over the period 2001-2003, the deterioration of the fiscal accounts together with the slowdown in the privatisation process resulted in a sharp increase in the government debt ratio, which reached 45.4% of GDP in 2003. The programme expects the debt ratio to increase by a cumulative 2.6 percentage points between 2004 and 2006 to peak at 48% of GDP at the end of 2006, before declining by 0.8 percentage points in 2007. The classification of the open pension funds outside the general government sector in accordance with the Eurostat ruling would lead to an increase in the debt figures by about 6 percentage points on average each year over the period 2005-2007. The debt ratio would thus remain below the 60% of GDP reference value even with this change in classification.

The debt forecast for 2004 has been revised downwards by 3 percentage points compared to the May programme, mainly due to stronger than expected nominal GDP growth, negative valuation effects following the appreciation of the zloty and higher than expected privatisation proceeds. Over the rest of the programme period, improving primary balances and a large nominal growth dividend would partly offset the net debt-increasing impact of the stock-flow adjustment. Part of the positive stock-flow adjustment can be attributed to the pre-financing of EU funds, which would account for about 0.5% of GDP in 2005 and 2006. The planned slowdown and eventual reversal of the increase in the debt ratio is also conditional on sizeable privatisation proceeds. The programme assumes that privatisation receipts in the period 2004-2006 would amount to about 0.5% of GDP on average each year. This assumption appears reasonable in view of the recent experience.

Relative to the programme, the Commission services autumn 2004 forecasts show a less favourable debt development: the debt ratio is projected to increase markedly in 2004-2005, before stabilising at 49.3% of GDP in 2006 (under a no-policy change assumption). The difference with the programme's projections stems mainly from the stock-flow adjustment which has on average a higher debt-increasing impact in the Commission forecast.

The debt remains vulnerable to exchange rate shocks despite the reduction in the share of foreign debt in total debt. 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 about 0.15 percentage points. Contingent liabilities represent another significant risk. State-owned companies in the sectors in need of restructuring are an important source of such liabilities. The stock of outstanding guarantees[6] is estimated to have reached 3.9% of GDP at the end of 2004 and is expected to increase in the coming years. In addition, the outstanding debt of the health-care system continues to grow. and expectations for a bail-out by the government are rising. No steps are described in the update to address these risks, which is not consistent with the country-specific broad economic policy guidelines in the area of public finances for Poland.

Table 6: Debt dynamics

	average 2001-2003	**2004**		**2005**		**2006**		**2007**
	COM	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**
Government gross debt ratio	**41.1**	**47.7**	**45.9**	**49.8**	**47.6**	**49.3**	**48.0**	**47.2**
Change in debt ratio (1 = 2+3+4)	2.9	2.4	0.5	2.1	1.7	-0.6	0.4	-0.8
Contributions:								
- **Primary balance** (2)	**0.8**	**2.5**	**2.6**	**1.0**	**1.3**	**0.0**	**0.5**	**-0.4**
- **“Snow-ball” effect** (3)	**1.5**	**-0.6**	**-0.8**	**-0.4**	**-0.7**	**-0.6**	**-0.6**	**-1.0**
- Interest expenditure	3.0	3.1	2.8	3.1	2.6	3.1	2.7	2.6
- Real GDP growth	-0.8	-2.4	-2.4	-2.1	-2.1	-2.1	-2.1	-2.5
- Inflation (GDP deflator)	-0.7	-1.2	-1.2	-1.3	-1.2	-1.6	-1.2	-1.1
- **Stock-flow adjustment** (4)	**0.6**	**0.4**	**-1.3**	**1.5**	**1.1**	**0.0**	**0.5**	**0.6**
- Cash/accruals	0.1							
- Accumulation of financial assets	0.2							
of which: Privatisation proceeds	-0.5	-1.0	-0.8	-0.6	-0.5	-0.4	-0.4	-0.4
- Valuation effects & residual adj.	0.4							

Note:

The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{PD_t}{Y_t}+\left(\frac{D_{t-1}}{Y_{t-1}}*\frac{i_t-y_t}{1+y_t}\right)+\frac{SF_t}{Y_t}$$

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. The term in parentheses represents the “snow-ball” effect.

Sources:

Convergence programme update (CP); Commission services autumn 2004 forecasts (COM); Commission services calculations

[6] The public debt according to the Polish definition includes the risk-weighted stock of treasury guarantees which amounted to 1.3% of GDP in 2004.

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

As highlighted above (Section 5.2) the reduction in the general government deficit over the programme period should be achieved by a cut in the expenditure ratio (by about 2.4 percentage points) and an increase in the revenue ratio (by 0.8 percentage points). The update outlines briefly the reforms envisaged in the *Hausner plan* to reduce expenditure pressures and widening of the tax base together with their budgetary impact (see Box 4 in Section 2.2). The update complements the May convergence programme, where most of the measures were discussed, with the estimates of the budgetary impact of the measures. 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) and reforming the highly inefficient and costly social security system for farmers. 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. On the revenue side, changes mainly consist of improvements in the efficiency of tax revenue collection. Despite the recent rejection by Parliament of two important measures, the government is planning to take alternative actions. Still, an important number of measures remain unspecified in the update.

One of the challenges for Poland's public finances is the relatively high share of fixed expenditure, out of which the legally determined expenditure constitute a major part. The updated programme discusses the evolution of the structure of the general government expenditure. Due to the public finance reform and the rationalisation of expenditure, the share of fixed expenditure is expected to decrease from 42.5% in 2003 to 39.3% in 2007.

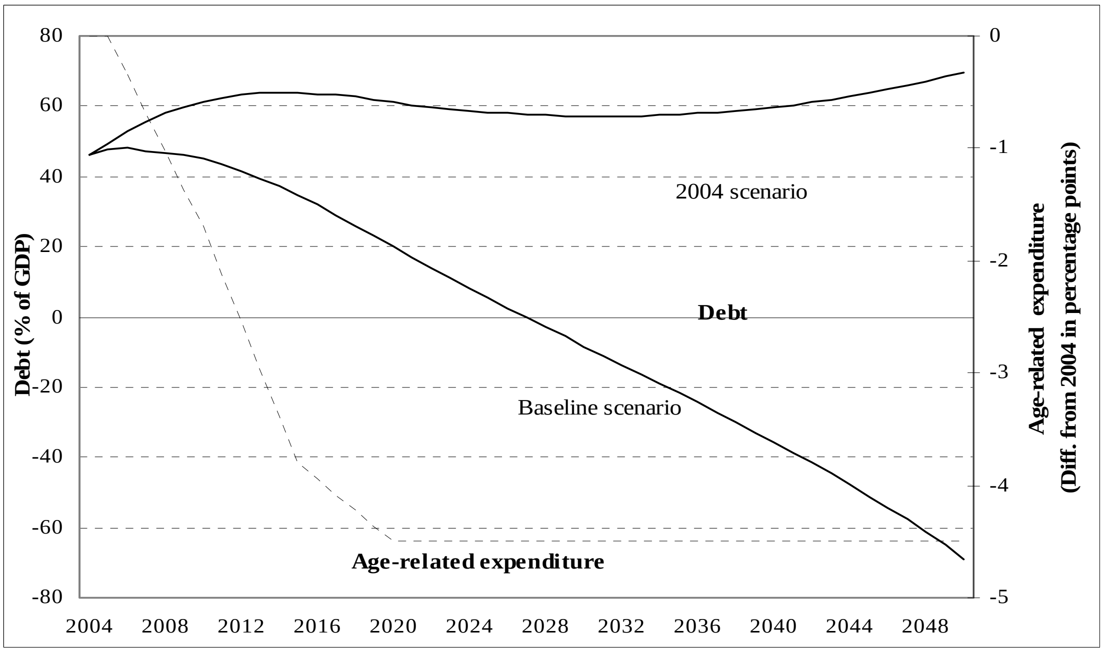
8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Polish public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The assessment is based on data provided by the Polish authorities, which covers only the period up to 2020[7]. These figures are considered as preliminary and a full set of projections is under preparation in the context of the work of the Economic Policy Committee. It should be noted that most of the budgetary impact of ageing population will take place after 2020. Therefore, the assessment of long-term sustainability of public finances is only partial at this stage, with the age-related expenditures as a share of GDP kept constant between 2020 and 2050 in the projections, thus not covering the period where age-related expenditures are likely rise from the current levels.

Long-term sustainability: summary results

[7] According to the Polish authorities, the projected pension expenditure contained in the update did not include the funded defined contribution pension scheme. For consistency, the pension contributions estimated at 1.5% of GDP per year over 2004-2008 (included in government accounts in the medium term scenario in the update) were excluded in the Commission's projections.



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	-2.9	-1.8	-1.8
2004 scenario	0.2	1.3	-1.7

Notes:
* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.
** It indicates the required change in tax revenues as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: 10.9%.
*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the inter-temporal budget constraint of the government.

The graph above presents the gross debt development up to 2050 according to the two different scenarios. According to the projections in the update, age-related expenditure is foreseen to fall by 3.5% of GDP between 2008 and 2020 (see annex for a breakdown of different age-related expenditures)[8]. Gross debt is projected to decrease continuously as a consequence of the strong decline in age-related expenditure and the forecasted primary deficit at the end of the programme period[9]. However, if the budgetary consolidation plans in the medium-term do not materialise a different picture emerges and the debt dynamics would become less favourable.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year

[8] In the absence of the projections for the period 2020 - 2050, real growth of GDP was assumed to converge to the EU-15 level by the end of the period, while old-age related expenditures were assumed to stay at the 2020 level until 2050.

[9] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

2050)[10]. S2 shows the gap between the current tax policies and those that would ensure respect of the inter-temporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter and given the limited information available, Poland may reduce its tax ratio. However, if the planned budgetary consolidation up to 2008 does not materialise, a gap of 1.3% of GDP emerges compared to the level of the tax ratio needed to satisfy the inter-temporal budget constraint. The budgetary effort over the first 5 years of the projections (i.e. after the end of the programme period) to respect the inter-temporal budget constraint requires a primary deficit of about 1.8% of GDP on average, lower than the position projected for the last year of the programme period.

In order to curtail the budgetary impact of ageing, the Polish authorities have been continuously adjusting the pension system to the ongoing demographic changes, which is consistent with the country-specific broad economic policy guidelines in the area of public finances for Poland. However, some of the proposals of the initial *Hausner plan*, aimed at reducing the relatively high level of social expenditure, have been watered down or abandoned, such as the plan to equalize the retirement age of men and women, the reform of the disability pension system and the phasing-out of the early-retirement pension scheme.

The measures incorporated in the budget for 2005 included steps to limit inflows into the pre-retirement programmes and reduce their disincentive effects (via the reduction of benefits), new rules for sickness benefits and family allowances, as well as changes in the farmers' special social security system (KRUS). New steps are envisaged to protect those who want to work longer and accumulate more pension rights.

Regarding the health care, the May programme foresaw financial restructuring of public healthcare institutions to improve the system efficiency. The update, however, provides no qualitative information on related measures that would justify the projected fall in health expenditures.

* * *

[10] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

Annex 1: Summary tables from the convergence programme update

Table 1: Growth and associated factors

	2003	2004	2005 (1)	2006 (2)	2007 (2)
GDP *growth* at *constant* market prices (7+8+9)	3.8	5.7	5.0	4.8	5.6
GDP *level* at *current* market prices, PLN bn.	814.9	884.6	953.1	1023.9	1107.1
GDP deflator	0.5	2.7	2.7	2.5	2.4
HICP change	0.7	3.5	3.0	2.7	2.5
Employment growth (3)	-2.3	-0.5	1.0	1.6	1.7
Labour productivity growth (4)	6.2	6.2	4.0	3.1	3.8
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	3.1	3.8	3.7	4.1	4.8
2. Government consumption expenditure	0.2	2.0	1.5	0.8	0.8
3. Gross fixed capital formation	-0.5	7.4	12.9	12.6	14.4
4. Changes in inventories and net acquisition of valuables as a % of GDP 3	0.6	0.7	0.0	0.0	0.0
5. Exports of goods and services	14.7	14.2	12.0	11.1	11.0
6. Imports of goods and services	9.3	11.1	12.0	12.1	12.4
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	1.8	4.1	5.1	5.3	6.3
8. Change in inventories and net acquisition of valuables (=4)	0.6	0.7	0.0	0.0	0.0
9. External balance of goods and services (5-6)	1.3	0.8	-0.1	-0.5	-0.8

(1) Forecasts

(2) Trend values or period averages.

(3) Occupied population, domestic concept, persons, national accounts definition.

(4) Growth of GDP at market prices per person employed at constant prices.

.

Table 2: General government budgetary developments

% of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
Net lending by sub-sectors					
1. General government	-3.9	-5.4	-3.9	-3.2	-2.2
2. Central government	-5.3	-6.0	-5.2	-4.7	-3.8
3. State government					
4. Local government	-0.2	-0.4	-0.4	-0.4	-0.3
5. Social security funds	1.6	1.0	1.7	1.9	1.9
General government					
6. Total receipts	43.7	43.2	44.5	44.8	44.0
7. Total expenditures	47.6	48.6	48.4	48.0	46.2
8. Budget balance	-3.9	-5.4	-3.9	-3.2	-2.2
9. Net interest payments	3.1	2.8	2.6	2.7	2.6
10. Primary balance	-0.8	-2.6	-1.3	-0.5	0.4
Components of revenues					
11. Taxes	22.3	22.1	22.3	22.5	22.5
12. Social contributions	13.5	13.0	13.2	13.1	13.0
13. Interest income	0.6	1.0	1.1	0.9	0.9
14. Other	7.3	7.1	7.9	8.3	7.6
15. Total receipts	43.7	43.2	44.5	44.8	44.0
Components of expenditures					
16. Collective consumption	9.1	9.3	9.4	9.1	8.8
17. Social transfers in kind	8.5	8.0	8.1	8.0	8.1
18. Social transfers other than in kind	17.6	16.1	15.2	15.1	14.4
19. Interest payments	3.1	2.8	2.6	2.7	2.6
20. Subsidies	0.4	0.7	0.9	0.9	0.9
21. Gross fixed capital formation	3.4	4.1	4.2	4.3	4.0
22. Other	5.5	7.6	8.0	7.9	7.4
23. Total expenditures	47.6	48.6	48.4	48.0	46.2

Table 3: General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	45.4	45.9	47.6	48.0	47.3
Change in gross debt	4.3	0.5	1.7	0.4	-0.7
Contributions to change in gross debt					
Primary balance	0.8	2.6	1.3	0.5	-0.4
Interest payments	3.1	2.8	2.6	2.7	2.6
Nominal GDP growth	-1.7	-3.6	-3.3	-3.3	-3.6
Other factors influencing the debt ratio	2.1	-1.3	1.1	0.5	0.7
Of which: Privatisation receipts	-0.4	-0.8	-0.5	-0.4	-0.4
p.m. implicit interest rate on debt	6.9	6.1	5.5	5.7	5.5

Table 4: Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	3.8	5.7	5.0	4.8	5.6
2. Actual balance	-3.9	-5.4	-3.9	-3.2	-2.2
3. Interest payments	3.1	2.8	2.6	2.7	2.6
4. Potential GDP growth	3.6	4.2	4.7	5.0	5.1
5. Output gap	-1.6	-0.2	0.0	-0.2	0.2
6. Cyclical budgetary component	-0.5	-0.1	0.0	-0.1	0.1
7. Cyclically-adjusted balance (2-6)	-3.4	-5.3	-3.9	-3.1	-2.3
8. Cyclically-adjusted primary balance (7-3)	-0.3	-2.5	-1.3	-0.4	0.3

Table 5: Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	3.7	5.0	5.0	5.6	5.6
Latest update	3.8	5.7	5.0	4.8	5.6
Difference	0.1	0.7	0.0	-0.8	0.0
Actual budget balance					
Previous update	-4.1	-5.7	-4.2	-3.3	-1.5
Latest update	-3.9	-5.4	-3.9	-3.2	-2.2
Difference	0.2	0.3	0.3	0.1	-0.7
Gross debt levels					
Previous update	45.3	49.0	51.9	52.7	52.3
Latest update	45.4	45.9	47.6	48.0	47.2
Difference	0.1	-3.1	-4.3	-4.7	-5.1

Table 6: Long-term sustainability of public finances

% of GDP	**2002**	**2005**	**2010**	**2015**	**2020**	
Total expenditure						
Old age pensions (1)	7.9	7.9	6.6	4.9	4.5	
Health care (excluding care for the elderly)	4.6	4.6	4.2	3.8	3.5	
Interest payments						
Total revenues						
Of which: from pension contributions						
National pension fund assets (if any)	4.2	8.2	15.6	23.4	31.1	
Assumptions						
Labour productivity growth	1.7	2.9	5.0	4.6	4.8	
Real GDP growth	1.4	5.0	6.1	5.0	5.1	
Participation rate males (aged 20-64)	67.5	67.5	66.5	67.9	70.6	
Participation rates females (aged 20-64)	57.7	57.7	57.1	59.0	62.6	
Total participation rates (aged 20-64)	62.6	62.6	61.8	63.4	66.6	
Unemployment rate	20.3	18.5	14.2	12.7	11.3	

(1) Retirement pensions

(2) OPF assets

Table 7: Basic assumptions

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)	5.7	5.8	7.4	7.4	7.0
Long-term interest rate (annual average)	5.8	n.a.	n.a.	n.a.	n.a.
United States: short-term (three-month money market)	1.2	1.6	2.9	3.6	n.a.
United States: long term (10-year government bonds)	4.0	4.3	4.7	5.3	n.a.
USD/€ exchange rate (annual average)	1.13	1.23	1.24	1.22	1.21
Nominal effective exchange rate (euro area)	11.8	2.8	0.6	0.3	n.a.
Nominal effective exchange rate (EU)	12.8	5.9	0.8	0.1	n.a.
PLN/€ exchange rate (annual average)	4.4	4.6	4.3	4.3	4.2
World GDP growth, excluding EU	4.2	5.7	4.8	4.6	n.a.
United States, GDP growth	3.1	4.4	3.0	2.9	n.a.
Japan, GDP growth	2.4	4.2	2.1	2.3	n.a.
EU-25 GDP growth	1.0	2.5	2.3	2.4	n.a.
Growth of relevant foreign markets	n.a.	n.a.	n.a.	n.a.	n.a.
World import volumes, excluding EU	10.3	11.3	8.8	8.3	n.a.
World import prices (goods, in USD)	8.8	10.4	3.7	0.5	n.a.
Oil prices (Brent, USD/barrel)	28.5	39.3	45.1	40.1	n.a.
Non-oil commodity prices (in USD)	6.6	12.9	-2.9	-0.5	n.a.

Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	11.5	10.8	8.0	8.0	8.0	8.0	-3.5
Pensions	7.1	6.6	4.5	4.5	4.5	4.5	-2.6
Health care	4.4	4.2	3.5	3.5	3.5	3.5	-0.9
*Total primary non age-related spending**	31.8						
*Total revenues**	42.5						

* constant

Results (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Baseline scenario							
Gross debt	46.9	44.9	19.9	-8.3	-35.7	-68.8	-115.7
i + 0.5*	47.1	45.5	22.0	-6.1	-34.4	-69.8	-116.9
2004 scenario							
Gross debt	58.0	61.4	61.2	57.2	59.8	69.8	11.8
i + 0.5*	58.3	62.1	64.6	63.1	68.8	83.7	25.4

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.