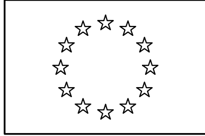

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.2.2007
SEC(2007) 141 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of Poland, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Poland was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Poland, submitted on 30 November 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) Poland's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of Poland's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme) and

(4) the Commission's assessment of the October 2006 national reform programme.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2.1. Recent economic and budgetary performance

Poland is a catching-up country with high economic growth, which is closing the gap with the EU-25 in terms of living standards. Despite labour shortages in some sectors, unemployment is high, while participation is low by EU standards, especially of women. Behind the fast rise in exports, there are foreign direct investments benefiting mainly from relatively low labour costs so far, although the technology content has also been upgraded. Poland has traditionally recorded significant deficits above 3% of GDP. The public expenditure pattern is a cause for concern because high social expenditure is likely to have a negative impact on the labour market performance through wrong incentives. As far as long-run sustainability is concerned, Poland is a low-risk country. However, preserving this status will require sticking to the key features of the pension reform such as uniformity of rules for all social groups.

2.2. The excessive deficit procedure for Poland

On 5 July 2004 the Council adopted a decision stating that Poland had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007, with the following annual targets for the general government deficit: 5.7% of GDP in 2004, 4.2% of GDP in 2005, 3.3% in 2006 and 1.5% of GDP in 2007. These targets do not include the budgetary costs of the 1999 pension reform, which at the time were estimated at 1.5% of GDP each year. In particular, Poland availed (and still avails) itself of the transition period (expiring in spring 2007) for implementing the Eurostat decision of 2 March 2004 on the sectoral classification of funded pension schemes[2].

On 28 November 2006, the Council adopted a decision in accordance with Article 104(8) stating that the "action taken by Poland in response to the Council Recommendation of 5 July 2004 under Article 104(7) of the Treaty is proving to be inadequate to correct the excessive deficit within the deadline fixed by the Recommendation". This was based also on the Commission services' autumn 2006 forecast, which showed that, including the revised pension reform costs (to around 2% of GDP annually), the 2007 deficit was expected to reach 4% of GDP.

According to the excessive deficit procedure, the next step for Member States that have not adopted the single currency, such as Poland, is a new Council recommendation under Article 104(7). The Commission is adopting the recommendation for this Council recommendation, which also takes into account the new update of the Polish convergence programme, together with the attached recommendation for a Council opinion on the new programme.

2.3. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2008. The Council noted that "the convergence programme envisages some progress, but not the effective correction of the excessive deficit in 2007, as required by the Council recommendation of 5 July 2004, and that the Commission intends to recommend further steps under the excessive deficit procedure as required by the Stability and Growth Pact". The Council invited Poland to "(i) strengthen the adjustment in 2006 in particular, by allocating any higher-than-budgeted revenues or lower-

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[2] See Eurostat News Releases No 30/2004 of 2 March 2004 and No 117/2004 of 23 September 2004.

than-budgeted expenditure to deficit reduction; (ii) safeguard the results of the pension reform; (iii) enhance the institutional framework of public finances by complementing the nominal anchor with other measures, for example a medium-term expenditure rule".

2.4. The Commission assessment of the October 2006 national reform programme

The implementation report of the National Reform Programme of Poland, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 31 October 2006. Poland's national reform programme identifies as key challenges/priorities: consolidation and better management of public finances; developing entrepreneurship and innovation; infrastructure development; ensuring a competitive environment in network sectors; creating and sustaining jobs and reducing unemployment; and improving the adaptability of workers and enterprises by investing in human capital.

The Commission's assessment of this programme (adopted as part of its December 2006 annual Progress Report[3]) showed that Poland is making limited progress in the implementation of its National Reform Programme. There are signs that Poland is beginning to move ahead strongly in the micro-economic area, even though implementation of many measures is still in the early stages. Implementation of the macro-economic and employment reforms is so far insufficient.

Against the background of strengths and weaknesses identified, Poland was recommended to take action in the areas of: fiscal consolidation; competition; R&D and innovation; public employment services; tax burden on labour and benefit systems; and education and training.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy

[3] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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4 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

5 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of Poland, 2006-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated convergence programme of Poland, which covers the period 2006 to 2009.

(2) The macroeconomic scenario underlying the programme envisages real GDP growth to have reached 5.4% in 2006 and to broadly stabilise (around 5¼% on average) over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on growth assumptions which are plausible in 2007 and favourable thereafter as the labour market may not improve as rapidly as foreseen in the programme in particular. The programme's projections for inflation appear realistic, tilted to be on the low side towards the end of the programme horizon, notably because of rising wage pressures from the tightening labour market.

(3) In the January 2006 convergence programme, the target for the general government balance in 2006 was set at -2.6% of GDP, the Commission services' autumn forecast points at -2.2% of GDP, while the November 2006 update of the convergence programme estimates the 2006 outturn at -1.9% of GDP. The better-than-expected outturn mainly results from an incomplete execution of expenditure plans (especially social transfers and public investment), while revenue increase resulted mainly from

6 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

stronger-than-expected growth. The above-mentioned deficit figures exclude the pension reform cost, estimated at around 2% of GDP in 2006, in line with the transition period for implementing the Eurostat decision of 2 March 2004 on the classification of funded pension schemes[7], which expires in spring 2007. The main goal of the budgetary strategy in the November 2006 update is to correct the excessive deficit by 2007 by qualifying for the provision of the reformed Pact which allows a part of the pension reform cost to be deducted. For the following years, the programme plans a gradual reduction of the deficit so that the 3% of GDP reference value is reached in 2009.

(4) The deficit is planned to narrow by 0.4 percentage point of GDP annually (0.3 percentage point if the pension reform costs are included), from 1.9% of GDP in 2006 to 0.6% of GDP in 2009. The primary surplus is planned to improve from 0.5% of GDP in 2006 to 1.7% of GDP in 2009. Including the impact of the above-mentioned Eurostat decision, the deficit in the updated programme would improve from 3.9% of GDP in 2006 to 2.9% in 2009. The adjustment is planned to be revenue-based in 2007 (revenue ratio increase by 0.6 percentage point of GDP with a near-constant expenditure ratio) and strongly expenditure-based in 2008-2009 so as to more than offset a large decline in the revenue ratio (average annual expenditure ratio reduction by 1.6 percentage point, especially consumption and social transfers, with the revenue ratio declining by 1.2 percentage point on average mainly reflecting a cut in social contributions and various changes to the tax system, which are not always fully specified). Compared with the previous programme, the deficit targets have been revised downwards in view of much stronger growth and the better-than-expected outcome in 2006.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from around -2% of GDP in 2006 to -¾% of GDP in 2009 at the end of the programme period (pension reform costs not included). As in the previous update of the convergence programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 1% of GDP, which the programme does not aim to achieve within the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO adequately reflects the debt ratio and average potential output growth in the long term.

(6) The budgetary outcomes could be worse than targeted in the programme. The risks mainly stem from the favourable macroeconomic scenario for the period 2008-2009, significant uncertainties about the effective implementation of planned reforms as well as from the lack of information on the measures supporting the envisaged expenditure restraint, which appear to be in an early conceptual phase. Consequently, the action taken so far does not appear adequate and the planned measures should be strengthened to achieve that result.

(7) In view of this risk assessment, the budgetary stance in the programme seems inconsistent with a correction of the excessive deficit by 2007 as recommended by the

[7] See Eurostat News Releases No 30/2004 of 2 March 2004 and No 117/2004 of 23 September 2004.

Council. In addition, the budgetary targets do not provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. In the years following the correction of the excessive deficit, the pace of the structural adjustment towards the MTO implied by the programme should be strengthened taking advantage of good economic times and should be backed up by measures.

(8) Government gross debt is estimated to have reached 42.0% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 1.4 percentage point over the programme period. Including the impact of the above-mentioned Eurostat decision, the government gross debt would rise from 48.9% in 2006 to 50.2% in 2009.

(9) The long-term budgetary impact of ageing in Poland is the lowest in the EU, with age-related expenditure projected to fall, partly as a result of the considerable expenditure-reducing impact of the reform of the pension system – assuming that the pension reforms are fully implemented. The initial budgetary position, although slightly improved compared to 2005, still constitutes a risk to sustainable public finances before the long-term budgetary impact of an ageing population is considered and further budgetary consolidation would contribute to contain risks to the sustainability of public finances. Overall, Poland appears to be at low risk with regard to the sustainability of public finances.

(10) The convergence programme contains a qualitative assessment of the overall impact of the reforms listed in the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition, it provides some information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage some harmonisation of the farmers' social security system with the general national system, the gradual harmonisation of the disability benefits with the reformed pension system and the implementation of the basket of guaranteed medical services.

(11) The budgetary strategy in the programme is partly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, action taken to correct the excessive deficit does not appear adequate.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[8].

The overall conclusion is that the programme envisages the correction of the excessive deficit by 2007 but the action taken so far does not appear adequate and the planned measures appear insufficient to achieve that result. While in subsequent years the programme envisages to

[8] In particular, the data on employment in hours worked and labour productivity measured as GDP per hours worked have not been provided. Contributions to the potential growth are also missing.

make appropriate progress towards the MTO in a context of strong growth prospects, there are important risks to the achievement of the budgetary targets and the durability of the adjustment.

In view of the above assessment, and taking into account a new recommendation addressed to Poland to correct the excessive deficit is adopted by the Council on [27 February 2007] under Article 104(7) of the Treaty, Poland is invited to:

(i) strengthen the adjustment to ensure the correction of the excessive deficit by 2007 in line with the new recommendation under Article 104(7);

(ii) taking advantage of the good economic times, strengthen the pace of adjustment towards the MTO after the planned correction of the excessive deficit, by specifying and implementing the additional measures, especially on the expenditure side, that are necessary to achieve the envisaged adjustment.

Comparison of key macroeconomic and budgetary projections[1]

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Nov 2006**	**3.5**	**5.4**	**5.1**	**5.1**	**5.6**
	COM Nov 2006	3.2	5.2	4.7	4.8	*n.a.*
	CP Jan 2006	*3.3*	*4.3*	*4.6*	*5.0*	*n.a.*
HICP inflation (%)	**CP Nov 2006**	**2.2**	**1.4**	**2.1**	**2.5**	**2.5**
	COM Nov 2006	2.2	1.4	2.5	2.8	*n.a.*
	CP Jan 2006	*2.2*	*1.5*	*2.2*	*2.5*	*n.a.*
Output gap (% of potential GDP)	**CP Nov 2006**[2]	**-0.4**	**0.5**	**0.5**	**0.3**	**0.4**
	COM Nov 2006[6]	-0.3	0.4	0.3	0.1	*n.a.*
	CP Jan 2006[2]	*0.1*	*0.3*	*0.3*	*0.6*	*n.a.*
General government balance (% of GDP)	**CP Nov 2006**	**-2.5**	**-1.9**	**-1.4**	**-1.0**	**-0.6**
	COM Nov 2006	-2.5	-2.2	-2.0	-1.8	*n.a.*
	CP Jan 2006	*-2.9*	*-2.6*	*-2.2*	*-1.9*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2006**	**0.1**	**0.5**	**1.0**	**1.4**	**1.7**
	COM Nov 2006	0.1	0.2	0.4	0.6	*n.a.*
	CP Jan 2006	*-0.3*	*-0.2*	*0.3*	*0.6*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Nov 2006**[2]	**-2.4**	**-2.1**	**-1.6**	**-1.1**	**-0.7**
	COM Nov 2006	-2.3	-2.3	-2.1	-1.8	*n.a.*
	CP Jan 2006[2]	*-2.9*	*-2.7*	*-2.3*	*-2.1*	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2006**[4]	**-2.4**	**-2.1**	**-1.6**	**-1.1**	**-0.7**
	COM Nov 2006[5]	-2.3	-2.3	-2.1	-1.8	*n.a.*
	CP Jan 2006	*-2.1*	*-2.7*	*-2.4*	*-2.1*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2006**	**41.9**	**42.0**	**42.1**	**41.4**	**40.6**
	COM Nov 2006	42.0	42.4	43.1	42.7	*n.a.*
	CP Jan 2006	*42.5*	*45.0*	*45.3*	*45.4*	*n.a.*

Notes:
[1] The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated programme would be -4.3% of GDP in 2005, -3.9% in 2006, -3.4% in 2007, -3.1% in 2008 and -2.9% in 2009, while government gross debt would be 47.3% of GDP in 2005, 48.9% in 2006, 50.0% in 2007, 50.3% in 2008 and 50.2% in 2009.
[2] Commission services calculations on the basis of the information in the programme.
[3] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[4] There are no one-off and other temporary measures in the programme.
[5] There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.
[6] Based on estimated potential growth of 4.1%, 4.4%, 4.8% and 5.0% respectively in the period 2005-2008.
Source:
Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations