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COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

On the updated convergence programme of Poland, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact 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 each Member State has to submit, to the Council and the Commission, a stability or convergence programme 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. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

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 26 March 2008, and is recommending 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 country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure);

(2) the most recent assessment of the country'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);

(3) the May 2008 update of the country-specific broad economic policy guidelines in the area of budgetary policies;

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

[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). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The excessive deficit procedure for Poland

On 5 July 2004 the Council adopted a decision stating, in accordance with Article 104(6), that Poland had an excessive deficit, based on a general government deficit of 4.1% of GDP in 2003. At the same time, the Council issued recommendations, under Article 104(7), to correct the excessive deficit. In particular, Poland was recommended to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner, in line with the Council opinion on the May 2004 convergence programme. In November 2006, the Council decided that action taken until then by the Polish authorities was inadequate. In February 2007, the Council issued new recommendations confirming the 2007 deadline for the correction. The Polish authorities were recommended to ensure an improvement of the structural balance by at least 0.5 percentage point of GDP between 2006 and 2007. In November 2007, the Commission issued a communication to the Council, in which the action taken by Poland in response to the Council recommendation was found consistent with the recommendation. However, as far as 2008 and 2009 were concerned, the Commission expressed concern about the durability of the correction of the excessive deficit without which the excessive deficit procedure cannot be abrogated. Both the Commission and the Council invited the Polish authorities to submit as soon as possible an updated convergence programme describing their medium-term strategy for the whole legislature, consistent with a durable correction of the excessive deficit and further progress towards the medium-term objective.

Together with this recommendation for a Council opinion, the Commission recommends the Council to decide to abrogate the excessive deficit procedure for Poland because, from an overall assessment, it follows that the excessive deficit situation in Poland has been corrected. The 2007 general government deficit outturn is 2.0% of GDP, below the 3% of GDP reference value. The Commission services' spring 2008 forecast indicates that the deficit should remain below the 3% of GDP reference value in 2008 and 2009.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006-2009, as follows. "The programme envisages a correction of the excessive deficit by 2007, referring to the provision of Article 2(7) of Council Regulation (EC) No 1467/97, but the Council recalls that 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 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."

Taking into account a new recommendation addressed to Poland to correct the excessive deficit adopted by the Council on 27 February 2007 under Article 104(7) of the Treaty, the Council invited Poland to "(i) 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, using any extra revenue for deficit reduction, 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; (iii) safeguard the results of the pension reform".

2.3. May 2008 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 14 May 2008, the Council adopted a recommendation on the 2008 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[2]. In the area of budgetary policies, Poland was recommended to “strengthen the fiscal consolidation and supplement the nominal state budget deficit ‘anchor’ (deficit ceiling) with further mechanisms to enhance control over expenditure”.

2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Poland’s national reform programme[3] and is summarised as follows.

Poland’s national reform programme identified as key challenges the consolidation and better management of public finances, development of entrepreneurship, increased innovation by companies; upgrading and developing infrastructure, ensuring a competitive environment in networks sectors, creating and sustaining jobs and reducing unemployment; and improving the adaptability of workers and enterprises.

The Commission’s assessment was that Poland has made limited progress in implementing its National Reform Programme over the 2005-2007 period.

Against the background of strengths and weaknesses identified and the background of progress made, the Commission recommended that Poland was recommended to take action in the areas of: fiscal consolidation (mechanisms of expenditure control); competition in network industries; public research and support to private R&D; flexicurity, including active labour market policy, social benefits, lifelong learning and education.

In addition, Poland is encouraged to also focus on the areas of: transport infrastructure; business registration process; e-government; transposition of internal market legislation; and childcare facilities.

Based on the Commission Strategic Report, the Council adopted recommendations on the 2008 update of the broad guidelines for the economic policies for the Member States, including Poland, on 14 May 2008.

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2 OJ L 139, 29.5.2008, p. 57.

3 Communication from the Commission to the European Council, “Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)” - COM(2007) 803, 11.12.2007.

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 guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' spring 2008 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

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 consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. 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.

Recommendation for a

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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 [8 July 2008] the Council examined the updated convergence programme of Poland, which covers the period 2007 to 2010[7].

(2) Poland made recently progress in closing the gap with average EU income levels as real GDP growth picked up from around 4½% on average in 2003-2005 to above 6% in 2006-2007. The labour-intensive output growth improved considerably the situation in the labour market as unemployment dropped from nearly 20% in 2003 to 9½% in 2007. However, the fall in unemployment reflects, in addition to an extraordinary growth in employment, a shrinking labour force due to migration. Moreover, distortions of incentives to work enhanced by significant emigration increase the shortage of labour in some sectors. The tightening labour market puts pressure on wages impacting negatively on HICP inflation which, after a period of successful moderation from 2005 to the first half of 2007, picked up significantly at the end of 2007. Since peaking at 6¼% of GDP in 2003, the general government deficit declined on average by more than 1 percentage point annually to reach 2% of GDP in 2007. In recent years, outturns were generally better than the targets thanks to positive growth surprises resulting in windfall revenues as well as the incomplete execution of expenditure plans. Further budgetary consolidation will hinge crucially on the reform

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://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

7 The update was submitted 16 weeks beyond the 1 December deadline set in the code of conduct in view of the formation of a new government in November following the October general elections.

of the social transfer system (mainly early pensions and disability benefits) and the increase of labour participation.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will gradually decrease from 6.5% in 2007 to 5.2% on average over the rest of the programme period. Assessed against currently available information[8], this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation appear to be on the low side reflecting slightly favourable assumptions on import prices and a relatively low increase in nominal compensation per employee.

(4) The 2007 general government deficit outturn was 2.0% of GDP, compared to 3.4% projected in the November 2006 convergence programme. Much higher real and nominal GDP growth than assumed in November 2006 was the main reason, but expenditure was also restrained. In particular, high profitability of companies allowed for growth in subsidies to be contained, while the rapid fall in unemployment and the absence of indexation imposed by the Hausner plan[9] also curtailed growth in social transfers. In addition, compensation of public sector employees was lower than planned. Finally, government investment was lower than projected because of a slower absorption of EU funds than planned. Overall, the expenditure-to-GDP ratio was 1.5 percentage point lower than projected in November 2006. On the revenue side, revenue from indirect taxes and social contributions turned out better than envisaged in November 2006, mainly thanks to a much higher employment and wage growth. These positive surprises were offset by a lower performance of other revenue items (direct taxes due to an increase in tax brackets). Overall, this led to a revenue ratio slightly below the planned one. With an improvement in the structural balance ratio by about 1½ percentage point, budgetary implementation in the year 2007 more than fulfilled the invitation in the Council opinion of 27 February 2007 on the previous update of the convergence programme[10].

(5) The main goal of the budgetary strategy is a durable reduction of the structural general government deficit (cyclically-adjusted deficit net of one-off and other temporary measures) aimed at achieving the medium-term objective (MTO) for the budgetary position, which is a structural deficit of 1% of GDP, in 2011, i.e. one year after the programme period. This is consistent with the previous convergence programme, which envisaged achieving the MTO "after 2010". After deteriorating by 0.5 percentage point to 2.5% of GDP in 2008, the headline deficit is planned to improve to 1.5% by 2010. The primary balance follows a similar path and is projected to increase from −0.2% of GDP in 2008 to 0.8% in 2010. Against the backdrop of moderating output growth, the changes in the structural balance calculated according to the commonly agreed methodology are foreseen to be larger, with the structural deficit narrowing from about 2¾% of GDP in 2008 to slightly above 1% in 2010. The budgetary adjustment is expenditure-based and back-loaded to 2009 and 2010. In 2008, the deficit deterioration is mainly driven by a sharp increase in the investment

8 The assessment takes notably into account the Commission services spring 2008 forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

9 The most comprehensive and specific attempt at expenditure reform so far, proposed in 2003 and aimed at reducing public expenditure on social protection, public administration and state aids. Among other things, the Hausner plan replaced annual indexation with an indexation after cumulated inflation exceeds 5% or every three years (whatever comes first).

10 OJ C 72, 29.3.2007, p. 13.

ratio as well as a large cut in social contributions (partly compensated by an increase in other revenues). In 2009-2010, the consolidation is to be achieved mainly through restraint in compensation of employees, social transfers and intermediate consumption. The planned rate of deficit reduction between 2007 and 2009 is lower than in the previous update, however the starting point (2007) and each of the new deficit targets of the March 2008 update of the convergence programme are better than the targets in the November 2006 update.The risks to the budgetary projections in the programme appear broadly balanced in 2008, but the outcomes could be worse than projected in the programme afterwards. The 2008 deficit target in the programme is the same as in the spring 2008 forecast (2.5% of GDP). The 2008Q1 cash data for central budget point to a revenue performance above the budgetary projections, but the programme assumes slightly higher growth in 2008 than in the spring 2008 commission forecast and still mounting wage pressure in the public sector poses a risk for public finances. On the other hand, higher inflation than assumed in the programme will reduce the expenditure ratio in 2008, as expenditure is predominantly fixed in nominal terms. However, in 2009, the higher 2008 inflation could stimulate wage growth in the public sector and lead to higher pensions and social benefits than assumed in the programme, further exacerbated by a reform of the indexation mechanism which links, as from 2008, social benefits not only to consumer prices but also partially to wages. While deficit-increasing measures have already been adopted by parliament (personal income tax rate reductions), offsetting measures are vague and their budgetary impact is uncertain (except for excise duty hikes related to EU harmonisation, which will not completely offset the personal income tax cut). If further high employment growth assumed by the government is not maintained, the continuation of the 2006-2007 job-rich-growth-based budgetary consolidation after 2008 may be difficult. On the other hand, the track record for the development of the general government balance is good: revenues have turned out frequently higher than projected while expenditure plans have been under-executed.

(6) In view of this risk assessment, the budgetary stance in the programme seems consistent with a durable correction of the excessive deficit by 2007 as recommended by the Council. However, the safety margin against breaching the 3% of GDP deficit limit could not be ensured within the programme period. In addition, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2011, as envisaged in the programme. As the economy enjoys favourable growth conditions, the pace of adjustment towards the MTO implied by the programme is insufficient and needs to be strengthened in 2008 to be in line with the Stability and Growth Pact. Thereafter, it should be backed up with measures. In addition, should inflationary and wage pressures materialise, a tighter fiscal stance than foreseen in the programme would be required to avoid overheating.

(7) Poland appears to be at low risk as regards the sustainability of public finances. According to the projections made in 2005 and based on the common methodology, the long-term budgetary impact of ageing is among the lowest in the EU. However, as from 2008, social benefits will be indexed not only to consumer prices but also partially to wages, which will raise expenditure in the long-term. The budgetary position in 2007 with a small structural primary deficit, despite being better than the starting position of the previous programme, constitutes a risk to sustainable public finances before considering the long-term budgetary impact of an ageing population. Further consolidation of public finances, including the reform of the early retirement

(introduction of "bridge pensions" which limit early retirement to certain difficult professions) as intended in the convergence programme, would therefore contribute to both stimulating labour activity and employment and limiting risks to the sustainability of public finances.

(8) The convergence programme seems to be consistent with the October 2007 implementation report of the national reform programme. In particular, both programmes envisage the reform of early retirement and disability benefits, the reform of the farmers' social fund, the healthcare reform, the reorganisation and decentralisation of public finances, the multiannual task budgeting. The convergence programme does, however, not contain a qualitative assessment of the overall impact of the October 2007 implementation report of the national reform programme within the medium-term fiscal strategy (discussing, e.g., the impact on potential growth and employment). Though, the programme provides systematic information on the direct budgetary costs of the main reforms envisaged in the national reform programme.

(9) The budgetary strategy in the convergence programme is partly consistent with the country-specific broad economic policy guidelines, included in the integrated guidelines, in the area of budgetary policies issued in the context of the Lisbon strategy. While the programme envisages continued fiscal consolidation, further mechanisms to enhance control expenditure are not mentioned.

(10) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the optional data.

The overall conclusion is that, following the correction of the general government deficit in 2007 and while the deficit and the debt will remain below the reference values of respectively 3% and 60% of GDP, the programme envisages a deterioration of the general government balance by 0.5 percentage point of GDP in 2008 and a back-loaded progress towards the MTO in the following years in a context of favourable growth prospects. In 2008, the projected structural deterioration by almost ½ percentage point of GDP is not in line with the Stability and Growth Pact. Given the risks to the budgetary targets from 2009, mainly due to a lack of specified measures, the MTO may not be achieved by 2011 as planned in the programme. Moreover, should inflationary pressures emerge, a tighter fiscal stance than foreseen in the programme would be required. As regards the long-term sustainability of public finances, Poland appears to be at low risk, but the early retirement system is in need of reform.

In view of the above assessment and the need to ensure sustainable public finances, Poland is invited to exploit the favourable growth conditions to strengthen the pace of structural adjustment towards the MTO, in particular in order to contain possible inflationary pressures, by using any extra revenue and unspent resources for deficit reduction in 2008 and by specifying and implementing measures, especially on the expenditure side, in the following years.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Mar 2008**	**6.2**	**6.5**	**5.5**	**5.0**	**5.0**
	COM Apr 2008	6.2	6.5	5.3	5.0	n.a.
	CP Nov 2006	*5.4*	*5.1*	*5.1*	*5.6*	*n.a.*
HICP inflation (%)	**CP Mar 2008**	**1.3**	**2.6**	**3.5**	**2.9**	**2.5**
	COM Apr 2008	1.3	2.6	4.3	3.4	n.a.
	CP Nov 2006	*1.4*	*2.1*	*2.5*	*2.5*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Mar 2008**	**0.5**	**1.1**	**0.7**	**−0.2**	**−0.9**
	COM Apr 2008[2]	0.6	1.2	0.5	−0.7	n.a.
	CP Nov 2006	*0.5*	*0.5*	*0.3*	*0.4*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Mar 2008**	**−2.6**	**−2.6**	**−3.5**	**−4.2**	**−4.6**
	COM Apr 2008	−2.5	−2.6	−2.3	−3.6	n.a.
	CP Nov 2006	*−1.6*	*−1.8*	*−2.2*	*−2.7*	*n.a.*
General government balance (% of GDP)	**CP Mar 2008**	**−3.8**	**−2.0**	**−2.5**	**−2.0**	**−1.5**
	COM Apr 2008	−3.8	−2.0	−2.5	−2.6	n.a.
	CP Nov 2006	*−3.9*	*−3.4*	*−3.1*	*−2.9*	*n.a.*
Primary balance (% of GDP)	**CP Mar 2008**	**−1.1**	**0.2**	**−0.2**	**0.3**	**0.8**
	COM Apr 2008	−1.1	0.6	0.2	0.1	n.a.
	CP Nov 2006	*−1.5*	*−1.0*	*−0.7*	*−0.6*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Mar 2008**	**−4.0**	**−2.4**	**−2.8**	**−1.9**	**−1.1**
	COM Apr 2008	−4.0	−2.5	−2.7	−2.3	n.a.
	CP Nov 2006	*−4.1*	*−3.6*	*−3.2*	*−3.0*	*n.a.*
Structural balance[3] (% of GDP)	**CP Mar 2008**	**−4.0**	**−2.4**	**−2.8**	**−1.9**	**−1.1**
	COM Apr 2008	−4.0	−2.5	−2.7	−2.3	n.a.
	CP Nov 2006	*−4.1*	*−3.6*	*−3.2*	*−3.0*	*n.a.*
Government gross debt (% of GDP)	**CP Mar 2008**	**47.6**	**44.9**	**44.2**	**43.3**	**42.3**
	COM Apr 2008	47.6	45.2	44.5	44.1	n.a.
	CP Nov 2006	*48.9*	*50.0*	*50.3*	*50.2*	*n.a.*

Notes:

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

[2] Based on estimated potential growth of 5.2%, 5.9%, 6.0% and 6.2% respectively in the period 2006-2009.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures in the most recent programme and Commission services' autumn forecast.

Source:

Convergence programme (CP); Commission services' spring 2008 economic forecasts (COM); Commission services' calculations.