REPUBLIC OF POLAND

CONVERGENCE PROGRAMME
2017 UPDATE

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The European Union Member States submit annually the updates of stability or convergence programmes to the European Commission and the Ecofin Council. Based on the analysis of these documents, the Ecofin Council subsequently issues recommendations for the economic policies of the Member States, which shall be taken into account when designing budgets for the next year. The Ecofin Council in its opinion of 12 July 2016 on the last year's update of the *Convergence Programme* recommended that Poland take action to:

- reduce the structural deficit by 0.5 percentage point of GDP both in 2016 and 2017;
- strengthen the fiscal framework, including by establishing an independent fiscal council;
- improve tax collection by ensuring better VAT compliance, and limit the extensive use of reduced VAT rates.

This *Convergence Programme* (hereinafter referred to as the *Programme*) presents in Chapters III, VI and VII the state of implementation of measures recommended by the Ecofin Council in its opinion on the previous *Programme*. Moreover, it presents the medium-term forecast of the Polish economy and public finances through 2020. This document was developed in accordance with the *Council Regulation No. 1466/97/EC of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies* and the guidelines on stability and convergence programmes of EU Member States approved by the EU Economic and Financial Committee in July 2016.

The Polish *Programme* is a part of the *Multiannual Financial Plan of the State (MFPS)*, developed pursuant to the *Public Finance Act of 27 August 2009*. The MFPS was approved by the Council of Ministers on 25 April this year and shall provide the basis for the preparation of the draft Budget Act for 2018.

The current Programme was prepared simultaneously with this year's edition of the *National Reform Programme* (NRP), which contains, inter alia, an overview of structural reforms aimed at Poland meeting the objectives of the *Europe 2020* strategy and implementing the Council policy guidance formulated based on an analysis of the 2016 NRP.[1] Information on the *Programme* and the NRP was discussed at a joint meeting of parliamentary committees for EU affairs, public finances and the economy and development on 21 April this year.

As in previous years, the opinion of the Council on this *Programme* and the Council recommendations concerning the 2017 NRP will be the subject of discussion of the Polish Parliament.

[1] *Council Recommendation of 12 July 2016 on the National Reform Programme of Poland for 2016 and delivering a Council opinion on the Convergence Programme of Poland for 2016*, available at http://eur-lex.europa.eu/legal-content/PL/TXT/?uri=uriserv:OJ.C_.2016.299.01.0015.01.POL&toc=OJ:C:2016:299:FULL

I. Overall policy framework and objectives

I.1. Fiscal policy in the EU context

Fiscal policy in Poland is conducted within limitations contained in the provisions of the national and EU law, comprising:

— the upper limit of the state budget expenditure - which is set for the next year based on the stabilising expenditure rule contained in the *Public Finance Act of 27 August 2009* (Journal of Laws of 2016, item 1870, as amended), hereinafter referred to as the "Public Finance Act" (cf. Chapter III);

— respecting reference values for the general government nominal deficit (3% of GDP) and the general government debt (60% of GDP), and attaining the so-called medium-term budgetary objective.

Article 126(1) of the *Treaty on the Functioning of the European Union* (TFEU) requires the EU Member States to avoid an excessive nominal deficit , i.e. above 3% of GDP. This obligation has been clarified in the *Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the excessive deficit procedure*, which creates the so-called corrective arm of the *Stability and Growth Pact*. In turn, *Council Regulation 1466/97/ EC on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies* obliges EU Member States to formulate the so-called medium-term budgetary objective (MTO) and achieve it within specified time limits. The compliance with the MTO shall, among others, prevent the growth of the nominal deficit above 3% of GDP (therefore that regulation is called a preventive arm of the *Stability and Growth Pact*).

On 19 June 2015, the Ecofin Council abrogated the excessive deficit procedure for Poland. As a result, Poland is currently subject to the requirements of the preventive arm of the *Stability and Growth Pact*.

I.2. Coordination of the economic policies

In accordance with Article 121 of the *Treaty on the functioning of the EU*, Member States' economic policies are the matter of common concern of those countries and subject to coordination within the Ecofin Council. For the strengthening of the effectiveness of this process, since 2011 the budgetary year has been divided into two semesters. In the first semester, called the European Semester, the EU institutions analyse the economic situation and formulate recommendations for Member States, while in the second semester, called the national semester, the Member States strive to reflect the EU policy guidance in their policies.

The European Semester begins in November with the publication of the Annual Growth Survey (AGS) by the European Commission, describing the economic situation and challenges for the European Union for the following year. Based on the AGS and the discussions of the states in various formations of the EU Council, in March of the following year, the European Council adopts the economic policies of all EU Member States. In the latest edition of AGS, [2]the European Commission has urged Member States to intensify their efforts aimed at implementation of the following priorities:

— stimulating investment,

— implementation of structural reforms[3],

— conducting responsible budgetary policies.

According to the Commission, in their economic policies oriented to attaining those objectives, the Member States should include social justice, so that the economic growth is of more inclusive nature.

[2] https://ec.europa.eu/info/sites/info/files/2017-european-semester-annual-growth-survey_en_0.pdf
[3] The current edition of the NRP is devoted to this issue.

The European Council has also recognized measures of all Member States and the whole European Union in the aforementioned three areas in 2017 as this year's priorities[4].

Supporting investment, promoted by the European Council, is one of key elements of the *Strategy for Responsible Development up to 2020 (with the outlook up to 2030)*, hereinafter referred to as the *Strategy* (cf. Chapter I.3). Since 2015, Poland has been participating in the implementation of the *Investment Plan for Europe* prepared by the European Commission and the European Investment Bank, which is expected to improve conditions for investment and generate additional public and private investments in the European Union in the amount of at least of EUR 315 billion between 2015-17. Poland supports the European Commission's proposal concerning the extension of this instrument until 2020, which should result in the increase of investment in the EU to EUR 500 billion. The main pillar of the Plan is the European Fund for Strategic Investment (EFSI). The guarantees granted by the EFSI (so-called EIF (European Investment Fund) component) worth EUR 47 million enabled Poland to sign 8 agreements with financial institutions, which should generate funding worth over EUR 800 million intended to support investment projects undertaken by small and medium-sized enterprises. It is estimated that more than 12,300 small and medium-sized enterprises and start-ups will benefit from this type of funding. 20 large infrastructural projects with the value of EUR 1.7 billion were approved, which should generate financing worth approximately EUR 5.4 billion.

The projects co-financed from the EU funds will have a significant share in investment – Poland remains one of the leaders in their use. According to data for 2016, the rate of absorption of structural funds (the ratio of paid funds to the available budget) under the financial perspective 2007-13 amounted to 95%. It means that payments for Poland have already reached EUR 63.8 billion - the most in the EU. The remaining funds of the 2007-13 financial perspective (maximum 5%) will be transferred as a payment of the final balance following the audit activities performed by the European Commission.

Moreover, in 2016, the Council of Ministers adopted the plan aimed at ensuring full use of the allocation available for Poland from the cohesion policy budget for 2014-20 - PLN 82.2 billion - in the manner sustainably translating into the social and economic development. The implementation of the plan generates results: at the end of 2016, over EUR 6.6 billion from the current financial perspective has already reached Poland, which is the highest amount among all EU Member States. According to the information provided by the European Commission, in 2016, Poland as the only state reached the level of payments compliant with its forecasts. Payments transferred to Poland in 2016 amounted to 101% of the amount projected, whereas the EU average reached only 52%. Thus, at the current stage, Poland is a country best prepared for absorption of cohesion policy funds.

A growth-friendly fiscal consolidation, recommended by the European Council, is also a priority of the Polish government. Poland supports initiatives of the EU and the OECD for reducing tax evasion and measures fostering more efficient tax administration. Focusing efforts on reducing aggressive tax planning and on combating tax fraud (cf. Annex: *Measures increasing tax compliance in the years 2017–18*) shall help in providing revenues necessary e.g. to finance investment and combating social exclusion. Planned deficit reduction will allow a faster accumulation of capital in the private sector and in the entire economy in the *Programme* horizon through the positive impact on domestic savings and a lower risk premium that is included in the price of capital. As a result, an acceleration of potential GDP growth in Poland is expected: from 2.9% in 2016 to 3.9% in 2020.

I.3. Economic policy objectives

Directions of the economic development of Poland in the coming years are indicated in the *Strategy* adopted by the Council of Ministers on 14 February 2017. It proposes a model of economic development based on inclusive growth, sustainable in social and territorial terms. Concentration of legal, institutional and investment measures on three directions is foreseen:

[4] Cf. conclusions of the President of the European Council of 9 March 2017, available at http://www.consilium.europa.eu/en/meetings/european-council/2017/03/09-conclusions-pec_pdf/

- sustainable economic growth increasingly based on knowledge, data and organisational excellence;
- socially sensitive and territorially sustainable development;
- efficient state and institutions aiming at growth and social and economic inclusion.

The expected effects of the *Strategy* implementation will include a growth of Poles' affluence and reduction of the number of persons exposed to poverty and social exclusion. This will contribute to a faster convergence of Poles' incomes to the average European Union level. In a long-term perspective, Poland's GDP structure will change as a result of increased role of innovation in its creation.

The inclusive economic growth will be supported by the fiscal policy, taking account of constraints in the national law (cf. e.g. Chapter III.4) and the EU law (cf. Chapter I.1). Systemic changes in the area of public finance indicated in the *Strategy* will strive to ensure funding of strategic objectives of the state, while maintaining stable public finances. This requires measures to be performed in the overall public finance area, both on the revenue and on the expenditure side, also in relation to rules concerning allocation of financial resources to various groups of public finance sector and various areas of public tasks, taking into consideration their territorial aspect. Accordingly, the *Strategy* indicates three strategic projects:

- sealing of the tax collection system;
- budget system reform;
- reform of the system of financing local government units.

Implementation of reforms aimed at strengthening the capacity and performance of the Polish economy, arising from the *Strategy*, should result in bridging the development gap between Poland and the euro area. Differences observed so far between the economies of both areas, in particular, in terms of the level of development, as measured e.g. by GDP *per capita*, could pose a threat of negative shocks affecting the Polish economy after the euro adoption. In addition, the analysis of the situation at European level indicates that the prospect of stability of the euro area, which is a prerequisite for potential accession of Poland to the common currency area, remains a distant and still unclear perspective.

II. Economic outlook

II.1. Cyclical developments and current prospects

The average quarterly GDP growth rate in 2016 amounted to approx. 0.7% (qoq, sa) and was lower than recorded in 2014-2015 (approx. 0.9%). Throughout the year, in those terms, GDP growth rate simultaneously demonstrated a relatively high volatility. At the same time, results of the Polish economy in 2016 Q4 Indicate a clear improvement in the growth of economic activity at the end of the year (qoq, sa). In the entire 2016, GDP grew by 2.7% in real terms, i.e. 1.1 percentage point less than a year earlier. The domestic demand continued to act as the main growth driver, although its growth rate was lower than a year earlier due to the decline investments. Net exports had a slightly positive contribution to the GDP growth.

In 2016, a moderate recovery in the economic activity in the EU countries continued (the GDP growth rate in the EU was slightly lower than a year earlier and amounted to 1.9% against 2.2%). At the same time, a weaker growth rate in the volume of EU imports was observed, i.e. the main indicator of demand for Polish goods and services (the EU accounts for almost 80% of Polish export of goods). Despite the slowdown in EU imports growth rate and deceleration of exchange with the developing countries, the growth rate in the volume of Polish exports of goods and services has not only maintained its relatively high level but it has even slightly accelerated. The improvement of price competitiveness of Polish foreign sales was one of the contributing factors. However, the aforementioned developments were not reflected in the growth rate of industrial output which was lower than a year before.

Despite the slowdown in the growth of economic activity, in 2016, further improvement in the labour market was recorded[5]. The number of employed increased by 0.7%, i.e. at a rate slower than a relatively high rate of 1.4% recorded a year earlier. This increase mainly resulted from a growth in the number of employees, accompanied by the first decline in the number of employers and self-employed recorded for three years. The number of contributing family members followed the downward trend. The growth in the number of employees referred to persons employed for an indefinite period of time. The growth in the number of employed resulted mainly from the increase in the number of employed in the industrial sector (including industry and construction) and, to a lesser extent, in the service sector, with a significant decline of this category in the agricultural sector. The increase in the labour demand has contributed to a continued decline in unemployment. The unemployment rate dropped to 6.2% from 7.5% in the previous year, against the EU average of 8.5%. The participation rate stabilised at a level of two previous years, i.e. 56.2%.

The improved situation on the labour market, a low growth rate of consumer prices and the implementation of the Family 500 plus programme, accompanied by improvement of consumer sentiment, were reflected in a higher growth rate of private consumption. The growth of private consumption in 2016 amounted to 3.8% (against 3% in 2015). The consumption growth rate has reached the highest level since 2008. At the same time, the savings rate in the household sector has clearly increased. On the other hand, contrary to the situation in the years 2014-15, investment showed a negative contribution to the GDP growth. One of the reasons of a low growth rate in this category was the deceleration of implementation of projects financed from the European Union funds in the context of the transitional period, between the old and the new financial perspective. The decline in the absorption of EU structural funds and its adverse impact on the growth rate of investment was visible in the economy across almost the entire the region of Central and Eastern Europe in 2016.

Estimates of the potential growth of the Polish economy prepared in accordance with the methodology of the European Commission[6] indicate that since the beginning of the world crisis a slowdown of potential economic growth rate occurred in Poland, accompanied by a negative output gap since 2013. The developments in the growth rate of potential GDP were not set off even by a strong decline in the

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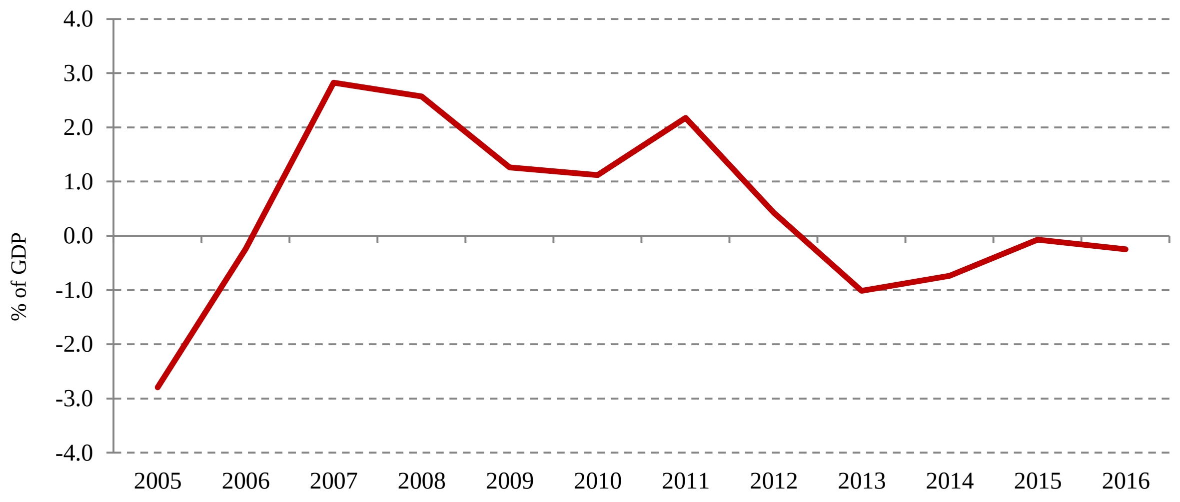
[5] Information on labour market is based on LFS data (15 years and more).
[6] Cf. Havik K. et al., *The Production Function Methodology for Calculation Potential Growth Rates & Output Gaps*, European Commission, *Economic Papers 535*, November 2014

equilibrium unemployment rate in the Polish economy (NAWRU) followed since 2002. The positive structural changes in the Polish labour market allow for continuation of this positive trend also at present. In addition, since 2014, a gradual increase in the growth rate of total factor productivity takes place. Consequently, in the years 2014-15, the potential growth rate in Poland increased by approx. 0.3 percentage point to 3.2%. The growth rate of observed GDP was even faster which enabled gradual closing of the output gap. However, in 2016 this gap slightly opened again as a result of a strong slump in investment and the associated slowdown in the GDP growth rate.

Figure 1. Output gap



Source: Ministry of Finance

A relatively weak demand pressure, low inflation expectations and weak cost pressures caused that in 2016 the core inflation (CPI excluding food and energy prices) remained below levels of the previous year and was lower, on average, by 0.2%. The overall inflation indicator (CPI) turned out even lower. Throughout the major part of the year (from January to October) deflation in consumer prices in annual terms was recorded and the average annual prices were lower by 0.6% (following the decline of 0.9% in 2015). It means that inflation remained clearly below the inflation target of the National Bank of Poland (NBP) and below the bottom of the acceptable deviation against this target. It was mainly due to supply-side shocks in the energy commodity markets. A sharp decline in oil prices at the turn of 2015/16 triggered deflation of energy prices in the national CPI, continuing during most of 2016. The situation changed at the turn of 2016/17. An upward trend of prices on the commodity market, in particular, oil prices, ended the several-year period of deflation in industrial prices, followed by deflation in consumer prices. In February 2017, the annual growth rate of industrial prices increased to 4.5% and that of consumer prices - to 2.2%.

Due to the external nature of factors contributing to deflation in Poland, in 2016 the Monetary Policy Council (MPC) did not change the level of NBP interest rates. The main interest rate - the reference rate remained at a level of 1.5%. Keeping the cost of central bank money unchanged, the MPC argued that the observed decline in growth of economic activity during the year was associated with the decline in investment, resulting predominantly from the temporary decline in the absorption of EU funds following the completion of the 2007-13 financial perspective. The temporary nature of weakening in the investment processes indicated that under a stable growth in consumption, the slowdown in GDP growth will be also temporary and the economic growth rate should accelerate in the coming quarters. Consequently, the MPC assessed that the current level of central bank interest rates fosters maintaining of the Polish economy on the sustainable growth path and preserving the macroeconomic balance.

The decline in the positive contribution of net exports to GDP growth was fully balanced by the positive impact of the terms of trade and, consequently, in 2016 the total nominal surplus in trade in goods and services to GDP reached a record level of 3.7%. The main source of external imbalances was still the negative primary income component, reflecting mainly the income of non-residents from direct investment, as well as, but to a lesser extent, income of non-residents from portfolio investment. This balance was also negatively affected by a growth in transfers associated with seasonal labour immigration of citizens of Ukraine. As a result, the current account deficit in 2016 decreased slightly to 0.3% of GDP. External imbalance of the Polish economy was financed by long-term capital inflows with a large surplus, however the factor affecting the balance of payments in 2016 was a transitional period between financial perspectives of the European funds which translated into a decline in the positive balance of the capital account.

In 2016, the exchange rate of the zloty against the euro was subject to considerable volatility. Following a strong weakening in January, triggered by the unexpected decision of Standard & Poor's agency on downgrading the credit rating of Poland, the zloty gradually strengthened against the euro, reaching the year's strongest level slightly below 4.23 at the beginning of April. The appreciation of the Polish currency in this period was fostered by the growth in the global risk demand associated with more dovish stance of main central banks. However, the decline in sentiment in the global financial markets, accompanied by unfavourable domestic factors, contributed to renewed weakening of the zloty in April. The EUR/PLN rate remained at an increased level until the beginning of August, when the Polish currency rapidly strengthened under the influence of the President's proposal concerning housing loans denominated in foreign currency. Following a period of relative stabilisation, the zloty once again depreciated strongly in November, as a result of increased chances of faster increase in interest rates in the USA after the victory of Donald Trump in presidential election. The EUR/PLN exchange rate exceeded 4.40 and remained above this level until the end of the year. On average, in 2016 the EUR/PLN exchange rate amounted to 4.3625 and the USD/PLN exchange rate - to 3.9431 and it was higher by 4.3% and 4.6%, respectively that a year before.

II.2. Medium-term scenario

Winter forecasts of the European Commission concerning the economic situation of Polish main trading partner, which is the EU, are slightly more optimistic than the expectations presented still in the autumn last year. Although the EC sustained the forecasts indicating a slightly slower GDP growth rate in the EU and in the euro area in the current year in relation to the result recorded in 2016, the scale of the growth rate itself is slightly higher - 1.8% for the EU and 1.6% for the euro area in 2017 against 1.6% and 1.5%, respectively, projected in the autumn. In accordance with the forecast, in the coming years the real growth rate of EU imports will amount to 3.9% in 2017 and 4.1% in 2018 (against 3.5% in 2016 estimated by the European Commission in winter forecasts). The EU imports represent one of important indicators of changes in the external demand for the Polish economy and the implementation of the scenario adopted by the Commission for the development of this economic category means a relative improvement in the external environment for the domestic export production as compared to conditions of the previous year. Winter forecasts of the European Commission cover a period until 2018. For the needs of the macroeconomic scenario presented in the *Programme* it was assumed that in the subsequent years the GDP and EU imports growth rate will be close to the long-term average, which means the continuation of a slight acceleration of the external demand growth rate.

A relative improvement in the external environment of the Polish economy will be accompanied by faster spending of the EU funds from the 2014-20 financial perspective. As a result, it can be expected that the growth rate of general government investments will strongly accelerate and their share in GDP will increase to 4.5% in 2017 and 5.0% in 2018, against 3.3% in 2016. In the subsequent years, along the expected acceleration of the private sector investment, the share of public investments should stabilise at a high level of 4.6% of GDP on average.

Poland belongs to those EU countries where the phenomenon of population ageing will strongly intensify. The forecasts indicate that in the period of subsequent fifty years the demographic burden ratio in Poland measured as a ratio of persons over 64 to population aged 15-64 will increase by almost three-fold. The conditions of demographic projections presented in the *Programme* are based on the assumption of the realisation of the demographic changes expected in the EUROPOP2015 scenario adjusted by CSO data available until March 2017. In the horizon to 2020, Poland expects, therefore, a stabilisation in the level of population, against a slight decline anticipated only a year ago (by approx. 0.1%). A relative improvement in the scope of demographic tendencies is associated with better results in this area in 2016, which provide good starting points for the consecutive years. This improvement may be associated with the positive effects of the structural reform introduced by the government - the *Family 500 plus* programme and the observed higher number of births as compared to forecasts, however, the full evaluation of the reasons of this phenomenon will be possible only from the longer-term perspective. Despite a relative improvement in the scope of the total level of population, the population aged 15-74 will decrease in the period up to 2020. In the horizon of the forecast, the participation rate will also slightly decrease in relation to 2016, although final changes in this scope will depend on the impact of potential government's measures aimed at extension of economic activity of the elderly.

It is expected that in 2017, the number of employed persons in the Polish economy will increase on average by 0.5%. In the subsequent years, this growth rate will gradually decrease to approx. 0.4% in 2018-19 and to 0.3% in 2020. Changes in total number of employed include the assumption adopted the *Programme* concerning the stabilisation of the number of employed in the general government by 2020. Considering the expectations related to the developments in the participation rate in the horizon of the *Programme*, a further systematic reduction in the unemployment rate is expected. It is estimated that in 2017 the unemployment rate will fall to 5.7% from 6.2% recorded in the previous year. In 2018, on average, it shall be at a level of 5.0%, lowering to a record level of 4.0% in the period up to 2020.

The continuation of the improvement in labour market conditions will be conducive to the growth of wages in the market sector. Taking into account the changes in wages in the public finance sector units (Chapter III), it is expected that the nominal growth rate of the average wage in the national economy will amount to 4.8% in 2017. In the subsequent years, it will reach 4.7% in 2018, 5.1% in 2019 and 5.3% in 2020, respectively. The real growth in wages in the subsequent years will be close to expected changes in the long-term trend on labour productivity.

Taking into account the estimated growth of the average remuneration, number of employees and the number of beneficiaries, it is expected that positive changes in the scope of disposable income will continue in the period of the forecast. The continuation of the *Family 500 plus* programme will provide additional support in this scope. Favourable tendencies in the scope of disposable income of households will allow for maintaining a relatively high growth rate of private consumption after the period of a slower growth in the years 2010-14 (on average, 1.9% in real terms). It is expected that in the current year, the real private consumption growth will accelerate to 4.0% against 3.8% of 2016. In subsequent years, the real growth rate of consumption shall amount, on average, to 3.5%.

Real growth in public consumption will depend on government measures aimed at compliance with the applicable fiscal rules and a strive to achieve the medium-term budgetary objective. It is estimated that the real growth rate in this economic category shall amount to 3.5% in 2017, to stabilise at a level of approximately 1.3-1.6% in the years 2018-20.

The continuing high price competitiveness of Polish products accompanied by a relatively lower growth of production costs allows companies to achieve relatively high rates of sales profitability. Considering additionally a high level of production capacity use and investment financing structure observed in the recent period, the conditions for acceleration of enterprises' investment action should be recognised as favourable. The factors supporting the growth in investment demand of the private sector will also include: the cost of capital remaining on a relatively low level due to low interest rates and effective implementation of measures stipulated in the Strategy adopted by the government aimed at increasing the investment rate and productivity of our economy. Among the most important elements of support in this area, launching of the Polish Development Fund should be mentioned, offering entrepreneurs multiple instruments fostering foreign expansion, development of innovation, human capital, financing of investment projects and establishing new companies. The above measures will result in the transformation of the Polish economy towards knowledge-based economy with innovative manufacturing sector and modern service sector. In accordance with the foregoing, it is expected that the share of investment in GDP will grow in the period of the forecast. It is projected that in 2017, gross fixed capital formation expenditures will increase by 7.2% in real terms and the growth on a similar level will be maintained in the subsequent years of the forecast. This will allow for the growth in investment share in GDP to 20.6% in 2020 against the level of 18.1% in 2016. The status of inventories is linked with the level of demand in the domestic market and in foreign markets. It is estimated that in the period covered by the *Programme*, the contribution of changes in inventories to GDP growth will be negative in 2017. (minus 0.5 percentage point in connection with a relatively large base of 2016), and it shall remain neutral for economic growth in the subsequent years.

Since 2002 (excluding years 2008-09) a systematic growth in the share of exports in GDP has been observed. In 2016, it reached a record level of 52.3% against 27.1% in 2001. One of the factors explaining such a dynamic change in the structure of the Polish GDP is the continuing high competitiveness of Polish enterprises. Periods of relative weakness of domestic demand, especially in the years 2012-13 were also significant. It is expected that by 2020 the share of exports in GDP will continue to rise, though at a slower pace. Real export growth will remain on the average above the growth rate of export markets and will reach 7.1% in 2017, 6.4% in 2018 and 6.0% in each of the years 2019-20.

On the other hand, the growth rate of imports will be a consequence of final demand development. The estimated real growth in imports will be slightly higher than the growth in exports in the horizon of the *Programme* and in the years 2017-20 it will reach 7.7%, 6.9%, 6.1% and 6.1%, respectively. As a result, the contribution of net exports to GDP in 2017 will amount to minus 0.1 percentage point, in 2018 it will already become neutral for GDP growth, to amount to plus 0.1 percentage point in each of the years in the period 2019-20.

The development of net exports is, in turn, reflected in the balance of trade in goods and is an important factor affecting the current account balance of payments. In 2017, the deficit of the current account will remain low, however, slightly higher than in 2016. The main source of external imbalances will be still a deficit of primary incomes, which reflects the negative net international investment position of the Polish economy. In the horizon of the forecast, a slight increase in the deficit of the current account balance of payments should be expected. However, it is expected that this deficit will be financed from the inflow of long-term capital with a surplus, i.e. funds classified in the capital account (mainly European structural funds) and foreign direct investments.

In summary, the expectations related to the development of GDP components allow predicting that the economic growth in Poland will amount to 3.6% in 2017, i.e. 0.9 percentage point above the level of 2016. Private domestic demand will remain the main factor of growth, under a significant growth in the share of investments in GDP creation, as compared to 2016. In the subsequent years, the real GDP growth will gradually accelerate and reach 3.8% in 2018 and 3.9% in each of the years in the period 2019-20.

In the period to 2016 the macroeconomic policy was carried out under the conditions of a negative, but closing output gap. It is estimated that in 2017, the output gap in relation to the potential GDP will close and the forecast horizon will remain at zero. Potential GDP growth in the forecast period will gradually increase from 2.9%% estimated for 2016 to 3.9%, which will be fostered by the expected acceleration in the growth rate of the productivity of production factors, decreasing balance unemployment rate and gradual increase of the share of capital in creation of economic growth.

Due to the negative balance of risk factors in the external environment of the Polish economy (Chapter IV.1), for the needs of the macroeconomic scenario presented in the *Programme* it was assumed that throughout the entire forecast period, the exchange rate of the zloty will remain at a level of 4 April 2017 (i.e. 4.25 EUR/PLN and 3.99 USD/PLN). Considering costs of foreign debt servicing and the level of this debt in relation to GDP, this technical assumption is relatively conservative from the point of view of the budgetary policy pursued. Strengthening of the Polish currency in the coming years should be fostered by the strong fundamentals of the Polish economy.

It is forecast that after the deflation period of 2015-16, as of 2017 the average changes in CPI will gradually follow towards the NBP inflation target. Under the conditions of stabilisation in commodity markets and assuming that no shocks will occur in the food market, the average annual CPI in the current year should stay at a level of 1.8%, to amount to 2,3% in each of the years in the period 2018-19 and reach the level of 2.5% in the horizon of 2020.

II.3. Growth implications of major structural reforms

The development policy of Poland in the coming years will be based on the assumptions of the *Strategy*. One of detailed objectives of the *Strategy* is the sustainable GDP growth at a level which will allow for real convergence of the Polish economy (measured by GDP *per capita*) to the most developed economies of EU Member States. Its achieving will require measures aiming at increasing cohesion, growth in the level of savings, mobilisation of capital for investment (including the R&D&I investment) and creation of a friendly business environment. Implementation of measures in all those areas will allow for building growth mechanisms resistant to development traps faced by highly developed countries. Building of the sustainable and predictable macroeconomic environment will enable to achieve the expected GDP growth rate in 2020 (expressed in fixed prices) at a level of 3.9%. In the context of maintaining macroeconomic stability, ensuring the balance of public finances is essential, which determines the occurrence of sustainable level of domestic savings, cost of capital and public debt and, consequently, maintaining a high level of potential GDP. Due to ensuring the stability of public finances, it will be possible to neutralise pro-cyclical mechanisms of budgetary policy and negative consequences arising from society ageing as well as mitigate uncertainties through providing sustainable conditions for operation of economic operators.

One of the major problems of Poland so far has been a low rate of investment. A high rate of economic growth achieved despite those developments confirms a high effectiveness of invested capital. However, in a long-term perspective, the share of investment in creating the sustainable, long-term development of Poland is indispensable. A new investment policy coordinated by the Polish Development Fund will contribute to the growth in investment. It is assumed that the investment rate indicator measured as a ratio of gross fixed capital formation to GDP, will be significantly higher in 2020 as compared to the level of 2016 (18.1%).

The economic growth will be also supported by selectively adjusted sectors and industries. Such an approach is aimed at intensifying the measures within public policies in order to build foundations of the Polish economy based on the domestic capital. Structural transformation triggered by intervention in the area of re-industrialisation will enable restructuring and contribute to the change in the model of Polish industry competing. The changes to be introduced will contribute to increasing the share of manufacturing in gross value added (up to 20% in 2020).

The structural changes in the economy should be supported by the state's activities aiming at enhancing the innovativeness of enterprises. Stimulating the development of new technological solutions, supporting product innovation based on advanced technology, or promoting the cooperation between science and business, will be pursued by removing barriers jeopardising the development of innovation and strengthening of enterprises' legal and institutional environment. Organisational, marketing or technological innovations are also particularly important in terms of operation of small and medium-sized enterprises. A comprehensive offer adjusted to the needs will enable building additional competitive advantages based on fuller exploitation of local and regional resources. Such activities will contribute to the TFP (Total Factor Productivity) growth, which will have an impact on internationalisation of the Polish economy and increasing of the volume of exports, in particular, in the area of high-tech products. It is estimated that the share of exports of high-tech products will grow from 8.5% to 10% in 2020. Besides direct investment undertaken by foreign companies, the strengthening of Polish entities' presence in international markets and the expansion into new markets will have a positive impact in the current account balance. Consequently, it is expected that the growth in the share of exports in GDP observed in the recent years will be continued.

Activities in the labour market will be an essential tool for the implementation of the *Strategy* objectives. They will be used for mitigating the adverse effects of demographic phenomena through the mobilisation of the human capital. Programmes supporting activation of groups occupationally inactive so far will lead to the growth in employment, to translate into mitigating the poverty and increasing the income of households.

Active pro-family policy and support offered to groups exposed to poverty and exclusion, combined with the growth in employment, will positively affect the level of private consumption and the standing of households.

The growth in the level of investment, accompanied by a more extensive exploitation of domestic capital, institutional and legal reforms in the scope of creating business environment favourable to entrepreneurs and measures fostering the development of labour market and human capital implemented under the development policy of Poland, will contribute to building mechanisms of sustainable economic growth. Only such growth shall enable achieving sustainable results in a long-term perspective.

III. General government balance and debt

III.1. Policy strategy and medium-term objectives

Maintaining the sustainability of public finances while supporting inclusive growth remains the goal of fiscal policy. Measures in the area of the economic and social policy – including those implementing the *Strategy* (cf. Chapter I.3) will be taken in a way that does not harm the sustainability of public finances. EU regulations serving as a reference for the nominal deficit and the general government debt (cf. Chapter I.1) as well as regulations laid down in national legislation will be respected. They envisage, among others, the constraints arising from the stabilising expenditure rule which defines the general government limit of expenditure (cf. Chapter III.4).

III.2. Actual balances

In 2016, the major goal of fiscal policy was accomplished - maintaining the sustainability of public finances taking into account the limitations contained in the provisions of the national and EU law – while introducing the *Family 500 plus* programme of priority importance for the family-friendly policy. Creation of the space for additional expenditure was possible, among others, due to strengthening of the revenues side of the state budget, both through introducing new sources of revenues, as well as measures aimed at improving tax compliance

In 2016, the general government deficit (according to ESA2010) amounted to 2.4% of GDP, which means an improvement by approx. 0.2 percentage point in relation to the previous year. The reduction of the deficit was achieved despite having taken into account the methodological change related to recording large scale proceeds from the sale of frequencies while calculating the general government balance (in 2016, cash inflows from the sale of LTE frequencies amounted to PLN 9.2 billion, i.e. approx. 0.5% of GDP). In accordance with the Eurostat recommendations, those revenues are recorded as a fixed rate annuities distributed over the time of using the rights obtained, instead of being treated as a one-off income. The decrease in the general government deficit resulted from a stronger growth of general government revenue as compared with the expenditure. In the last year, the ratio of domestic revenues[7] to GDP reached the level of 38.0%, i.e. 0.4 percentage point higher than in 2015, and domestic expenditures - the level of 40.4%, i.e. 0.2 percentage point higher than in 2015.

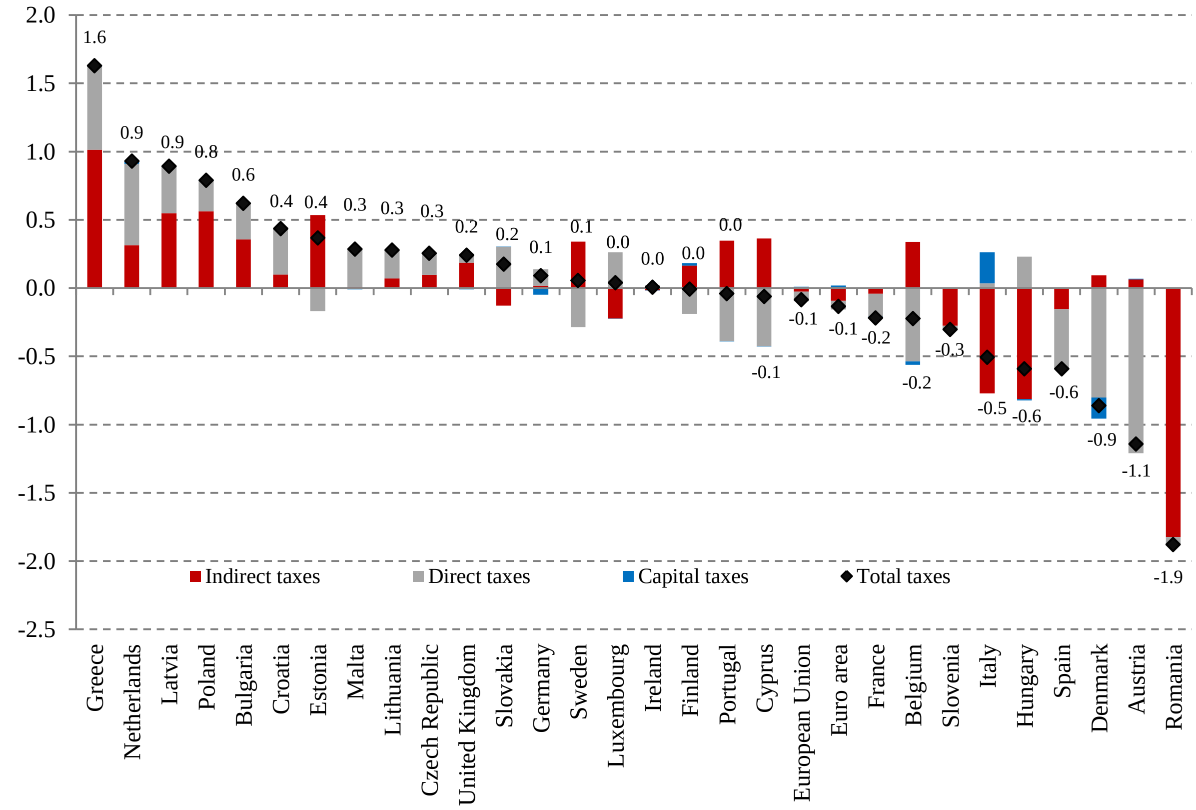
General government revenues

Taxes

In 2016, tax revenues amounted to 20.6% of GDP, which means a growth by 0.8 percentage point as compared to 2015, including a 0.6 percentage point growth in taxes on production and imports and 0.2 percentage point rise in income taxes. In 2016, a greater improvement in the share of tax revenues in GDP yoy occurred only in Greece, the Netherlands and Latvia (see Figure 2).

[7] Domestic expenditures/revenue means the expenditures /revenue adjusted by expenditures financed from the EU funds for which the ultimate beneficiaries are the general government units. According to the EU methodology ESA2010, the EU funds absorption by the general government units are neutral to the balance. In 2016, the total level of all domestic expenditures and expenditures financed from the EU funds for which the ultimate beneficiaries are the general government units, in relation to GDP, was lower than in 2015 (41.3% as compared to 41.6%).

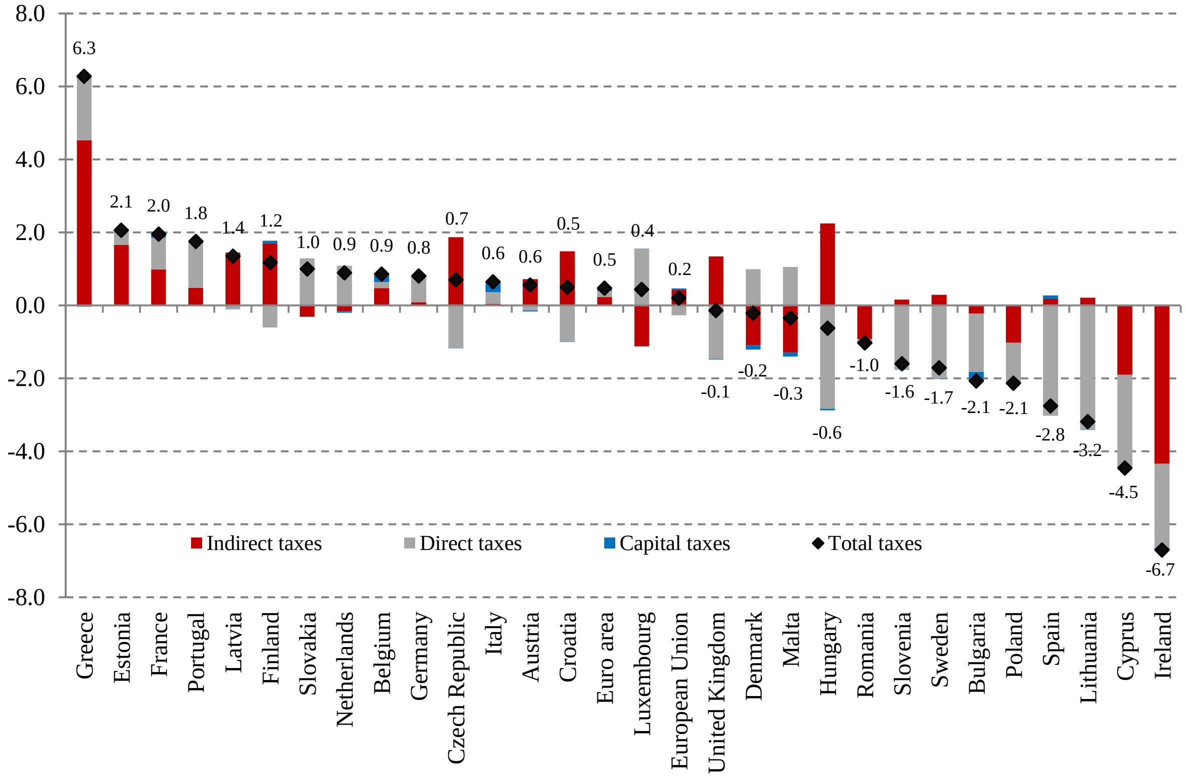
Figure 2. Changes of the ratio of tax revenue to GDP in 2016 in relation to the previous year



Source: Ameco (*Annual macro-economic database of the European Commission's Directorate General for Economic and Financial Affairs* (DG ECFIN)). 2016 data: EU Member States – European Commission *Winter 2017 Forecast*, Poland – preliminary execution as transmitted to the Eurostat in the April fiscal notification.

However, the ratio of tax revenues is still significantly lower as compared with the situation prior to the crisis in the global economy. In 2007, the general government tax revenues amounted to 22.7% of GDP, while in 2016 revenues amounted to 20.6% of GDP which means a loss by 2.1 percentage points, whereas, on average, this ratio in the European Union recovered already in 2013 to the level recorded directly before the crisis. Decrease in the ratio of tax revenues to GDP in Poland is one of the highest in the EU, the greater loss of revenues in relation to GDP occurred only in Ireland, Cyprus, Lithuania and Spain (cf. Figure 3). Nevertheless, the recent year shows that Poland has become one of the leading EU countries in terms of improvement of general government tax revenues as a share of GDP.

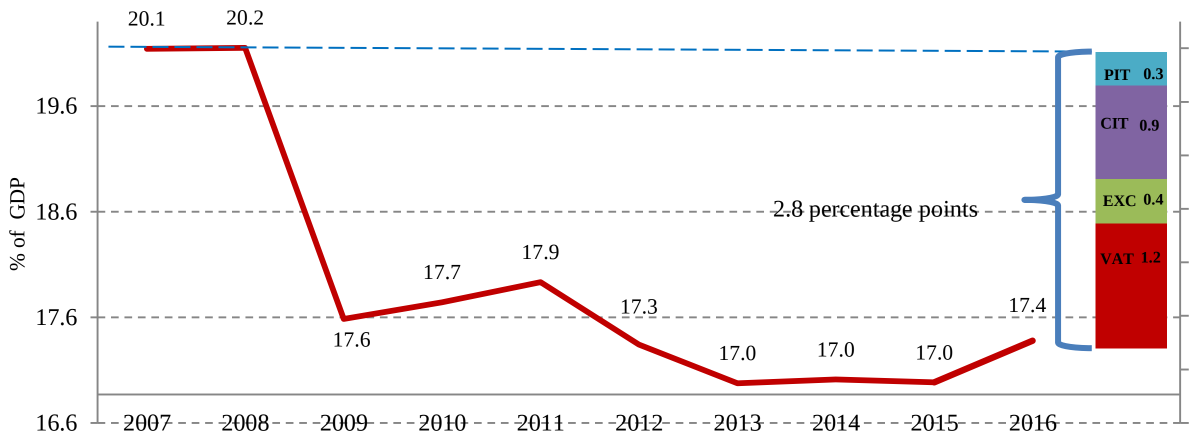
Figure 3. Changes of the ratio of tax revenue to GDP in the years 2007-16



Source: Ameco (*Annual macro-economic database of the European Commission's Directorate General for Economic and Financial Affairs* (DG ECFIN)). 2016 data: EU Member States – European Commission *Winter 2017 Forecast*, Poland – preliminary execution as transmitted to the Eurostat in the April fiscal notification.

In 2016, as compared to 2007, the fall in the ratio of revenues from main central taxes (i.e. taxes being the revenues of the central budget, together with shares of local government units in PIT and CIT) to GDP reached 2.8 percentage points on an accrual basis. In the conditions of 2016, it corresponds to approx. PLN 51.8 billion. The components of this difference are illustrated in Figure 4. In years 2007-15, the strongest decline in the share of tax revenues in GDP occurred, amounting to 3.2 percentage points. In 2016, for the first time since 2011, the said share has increased.

Figure 4. The ratio of revenues from main taxes (State Budget revenues and local government units shares) to GDP (in %) and the structure of the loss divided into individual taxes

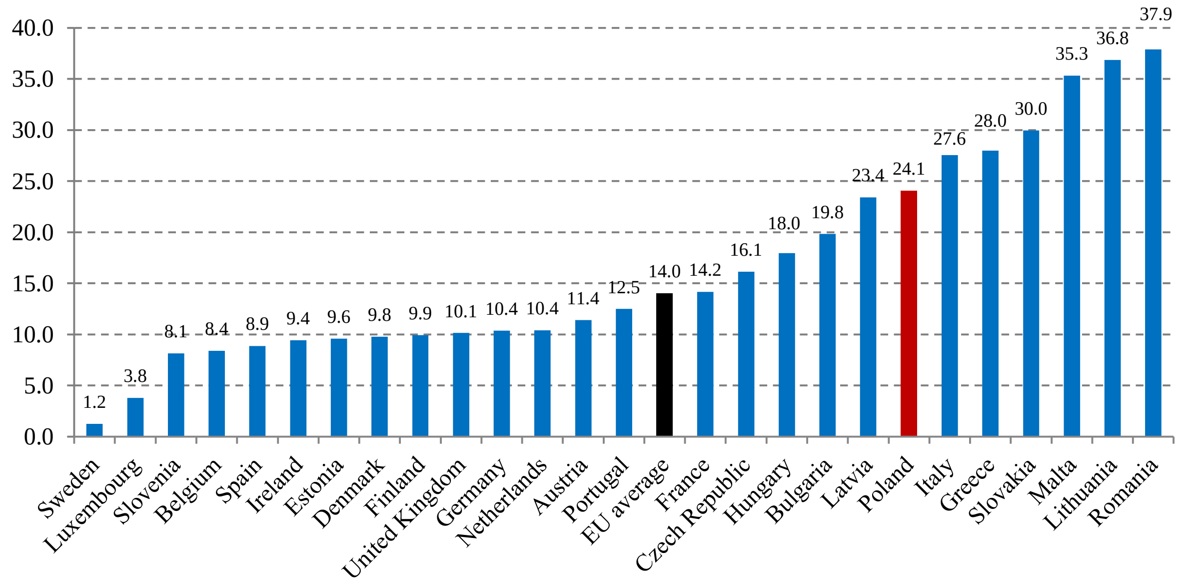


Source: Ministry of Finance

Changes in a stream of VAT revenues in recent years, are largely the result of changes in the so-called tax gap. This measure reflects the degree of failure to fulfil of tax obligations. While estimating the tax gap, the actual tax revenues are compared with theoretical revenues that result from the current regulations.

According to the European Commission (as at the end of 2014)[8], Poland belongs to EU Member States with the highest VAT gap, and a higher gap was recorded only in 6 countries: Italy, Greece, Slovakia, Malta, Lithuania and Romania[9]. The VAT gap below the EU average is recorded only by the countries of the so-called old European Union, excluding France, Italy and Greece. The countries that joined the EU in 2004 and 2007 record the VAT gap significantly higher than the EU average. However, among the emerging markets, better result (lower gap) than in Poland was recorded in the Czech Republic, Hungary and Bulgaria. The unfavourable situation of Poland compared to other Member States as to the VAT gap shows a high potential for improvement. Therefore, for the purpose of the presented forecasts, introduction of new measures focused on the improvement of tax collection is assumed (cf. Chapter VI.2 and Annex).

Figure 5. VAT gap (% of theoretical revenues) in the EU Member States in 2014



Source: Ministry of Finance estimates on the basis of the European Commission data.

In 2016, for the purpose of estimating the VAT gap, the top-down method was applied, which uses macroeconomic data on VAT base (private consumption, net purchases and general government investments). The estimates of VAT gap obtained by applying method used at the Ministry of Finance are very close to the European Commission estimates. The analysis shows that in the period 2007-15, an increase in the VAT gap was observed. According to preliminary estimates of the Ministry of Finance[10], in 2016, a noticeable reduction of the tax gap was recorded (by 1.6 percentage points, i.e. by approx. PLN 2.5 billion), although it still amounted to approx. PLN 37 billion, i.e. approx. 21.9%

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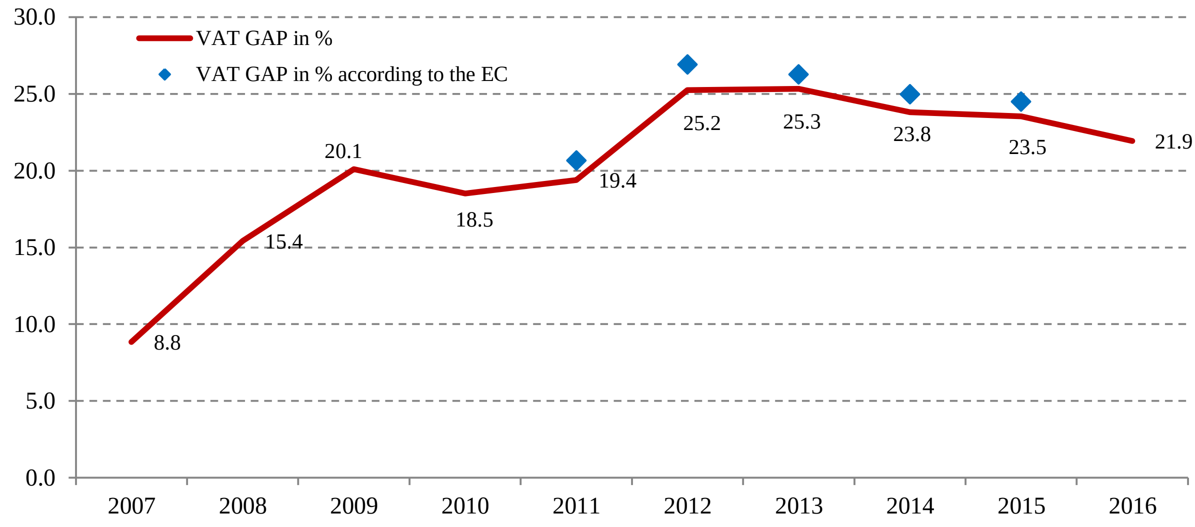
[8] For comparison, the most recent data from the European Commission (August 2016) covering the EU countries was used. Estimates of the VAT gap relate to 2014. For comparative purposes the percentage index is applied - i.e., the percentage of the VAT gap share in the theoretical proceeds (VTTL). This ratio indicates the percentage of potential tax revenue lost by state budget.

[9] *Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report*, TAXUD/2015/CC/131, https://ec.europa.eu/taxation_customs/sites/taxation/files/2016-09_vat-gap-report_final.pdf

[10] For years 2014–16 the data are of preliminary nature due to the lack of sufficiently detailed statistical data to carry out complete estimates.

of potential revenues (cf. Chart 5). On the other hand, including additionally the cyclical effects, the reduction of the VAT gap in 2016 may be estimated even at a level of PLN 4 billion.

Figure 6. VAT gap in % of theoretical revenues



Source: Ministry of Finance, European Commission, *Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report.*

A decrease of the tax gap may be directly interpreted as an decrease in the level of fulfilling the tax obligations. However, due to the delays in data publication, the method used above does not include current changes in the VAT base structure. Therefore, an additional econometric analysis of developments in VAT revenues in 2016 was performed. To that end, the VECM model was used within which a long-term relationship between revenues from VAT and the indicator of VAT macroeconomic base was estimated. This indicator consists of main elements of the VAT base, such as private consumption and investment and net purchases of the general government. In addition, a series representing the developments in household consumption was used as supplementary variable in explaining short-term changes of revenues from VAT.

The model constructed quite well reflects the developments in VAT in the period when its parameters were estimated. The adjustment of the model to the series in the sample exceeds 98% and demonstrates a minor error of the forecast. However, the dynamic forecast for 2016 based on the above model quite significantly deviates against actual revenues from VAT in each of the quarters examined. The comparison of the forecast arising from the model with the actual revenues suggests the occurrence of a structural change in the relationship estimated earlier, which may be associated with the growth of VAT collection effectiveness. It was estimated that a part of revenues unexplained by the model in 2016 could have amounted from PLN 3 to 4 billion.

The reduction of the tax gap is the result of implementation of numerous measures aimed at increasing tax compliance. In 2016, so-called Standard Audit File – Tax (SAF) was introduced: a collection of data created from accounting systems of firms through direct export of data containing information on economic operations for a given period, with a standardised structure and format which enable easy processing[11]. The basic purpose of SAF is to remove the barrier in electronic data transmission. Consequently, the inspection time is reduced, its burden is mitigated and costs are decreased. The benefit for administration is also the automation of tax data verification as a result of obtaining a tool enabling fast performance of verification activities and control. Large entities are obligated to submit

[11] *Act of 10 September 2015 on amending the Tax Ordinance Act and other acts (Journal* of Laws item 1649 as amended).

SAF files on request of tax authorities and fiscal control authorities as of July 2016, while micro, small and medium-sized enterprises - as of 1 July 2018.

At the beginning of 2016, so-called fuel package entered into force which amends the regulations and eliminates a number of gaps in VAT, excise and concession provisions regulating trading in liquid fuels[12]. The most important amendments refer to:

- introducing the obligation to pay VAT on fuels in case of intra-EU purchases within 5 days of the day of placing such goods in the tax warehouse or the place of receipt of excise goods, or upon the transfer of such goods on the territory of the country (if the goods are transferred outside procedure of suspension of excise duty, in accordance with the excise duty law),
- appointing tax warehouses and registered consignees as VAT tax payers,
- introducing penal fiscal liability for the infringement of the terms of supplies and purchases,
- tightening conditions of obtaining the concession for foreign trading in fuels.

On the other hand, the energy package effective since September 2016[13] introduced a number of detailed regulations, inter alia, a uniform definition of liquid fuel based on energy statistics (CN codes), introduced a concession for reloading of fuel, harmonised the provisions concerning the operation of the liquid fuel sector (including licensing, quality, mandatory reserves), increased penalties for activity without a licence, introduced a change of definition of an entity implementing the National Indicative Target[14]. The initial results of introducing the fuel package and the energy package meet the expectations of the legislator regarding additional revenues resulting from expanding of the legal fuel market.

Besides a positive effect in the scope of VAT revenues, a favourable situation can be also observed in excise tax on motor fuels. Revenue on motor fuels in 2016, on a cash basis, increased by 5.3% yoy, i.e. PLN 1.5 billion. The official sales of fuels in 2016 increased by 15% yoy for diesel oil and by 8% yoy for motor gasoline. For comparison, in 2015 the official sales of diesel oil increased by 9% yoy and sales of motor gasoline - by 4% yoy. The increase in the legal consumption of motor fuels had also a positive effect on revenues from the fuel duty. The obligation to pay the fuel duty, identical as the excise duty imposed on motor fuels, arises on the day of arising of the excise duty. In 2016, revenues from the fuel duty increased by 14.1% yoy.

The improvement of tax collection was also observed on the market of tobacco products. In 2016, a growth was recorded in sales of cigarettes - by 1.1% and smoking tobacco - by 8.3% which, compared to the multiannual downward tendency of the legal sales in this market, confirms the effectiveness of changes introduced under the amendment to the *Act of 24 July 2015 on amending the Act on excise duty and other acts* (Journal of Laws item 1479, as amended). The new provisions have been effective since 1 January 2016 and impose the obligation on intermediary tobacco entities to provide an excise collateral in the amount covering the tax liabilities which have arisen or may arise in the scope of excise duty. The objective of the obligation introduced was to improve tax compliance and eliminate pathology in dried tobacco trading. The reason is that a number of irregularities was disclosed in activities carried out by intermediary tobacco entities, resulting in reduction of revenues from excise

[12] *Act of 07 July 2016 on amending the Act on Value Added Tax and other acts (Journal* of Laws item 1052 as amended).

[13] *Act of 22 July 2016 on amending the Act on Energy Law and other acts (Journal* of Laws item 1165 as amended).

[14] The National Indicative Target (NCW) is the minimum share of biocomponents and other renewable fuels used in all types of transport in the general quantity of liquid fuel and liquid biofuel used during a calendar year in the road and railway transport, calculated according to calorific value (*Act of 25 August 2006 on biocomponents and liquid fuels* (Journal of Laws of 2017, item 285, as amended). The NCW is the implementation of *Directives of the European Parliament and of the Council no. 2009/28/EC and 2009/30/EC*, committing all Member States to ensure a mandatory minimum 10% share of biofuel in the total transport petrol and diesel consumption by 2020, whereas the path leading to reaching this target is discretionary. In Poland, the NCW was determined at the following levels: 7.1% in 2017, 7.5% in 2018, 8.0% in 2019, 8.5% in 2020.

duty to the state budget. In 2016, for the first time since 2013, a growth in revenues from excise duty on tobacco products was recorded in yoy terms. In 2016, those revenues rose by 3.9% yoy on a cash basis, i.e. by PLN 0.7 billion. While analysing the developments in historic trends of official consumption of excise goods, in particular, motor fuels and tobacco products, it can be assessed that the high increases of revenues on taxes on the aforementioned products in 2016, apart from positive market developments, result also from measures improving tax compliance described above. It can be assessed that effects of those measures generated approx. PLN 1 billion of additional revenues to the state budget.

Another solution addressed to the improvement of tax revenues collection is the General Anti-Avoidance Rule which entered into force on 15 July 2016. The objective of this solution is to combat artificial activities (or their groups), usually containing foreign elements, commonly used by large corporations in order to avoid tax payments. The preventive effects of the clause are difficult to estimate although they certainly contribute to the limitation of tax avoidance in Poland.

Summing up, within the improvement of the tax revenue to GDP ratio by 0.8 percentage points of GDP. Applying a conservative approach limited to the most important taxes, it can be estimated that effects of administrative changes and measures oriented to increasing tax payers' compliance as well as combating tax fraud and abuse contribute to approx. 0.3 percentage point of GDP.

Social security contributions

Besides the growth of tax revenues, an increase in revenues of the sector due to social security contributions registered in the social security subsector contributed to the improvement of the general government balance in 2016 – by approx. 0.4 percentage points (by approx. 6% yoy in nominal terms). This growth partially resulted from the changes in the pension system introduced under the *Act of 6 December 2013 amending certain acts in connection with the definition of principles for pension payments from funds accumulated in open pension funds* (Journal of Laws item 1717) in the scope of voluntary participation in the capital pillar (Open Pension Funds - OFE). The changes introduced result in a higher number of persons transferring full contributions to the FUS (Social Insurance Fund). The growth of contributions corresponds to the growth of the annual wage fund in the national economy.

Other non-tax revenue

In 2016, a decline in other domestic revenues by 0.8 percentage points of GDP was recorded, including, in particular, the decline in the category "revenues due to ownership" by 0.2 percentage points of GDP (in 2016, a nominal decline in proceeds from dividends in the state budget amounted to approx. 56% yoy), the change in cash-accrual adjustments due to receivables in the state budget by 0.2 percentage points of GDP as well as the deterioration (by 0.1 percentage points of GDP) of capital transfers in the social security subsector due to a higher one-off deduction of contributions deemed irrecoverable in the FUS.

General government expenditures

The main factor determining the developments in expenditures in 2016 was the growth in expenditures for social and child benefits (the *Family 500 plus* programme). The programme has significantly mitigated the decline in public investment associated mainly with the termination of the use of the funds from the EU financial perspective 2007-13.

In 2016, a decline in the general government investment was recorded by as much as 22.3% yoy in nominal terms (a slump by even 1.1 percentage point in relation to GDP). The level of execution of investment expenditures implemented by local government units was significantly low, in particular, as a result of a very low use of the European Union funds in the framework of the new financial perspective 2014-20. In the local government subsector, the nominal decline in the level of investment expenditures amounted to as much as 36.4% yoy (in relation to GDP, a decline by 0.8 percentage points) and it was deeper than in the previous year (in 2015, the decline amounted to 8.1% y/y). The reduction of investment expenditures was also recorded in the central government subsector where investment expenditures dropped in relation to GDP by 0.3 percentage points, i.e. by 9.8% yoy in nominal terms (in 2015 they increased by 12.7% yoy). The factors which contributed to the decline in investment expenditures of the central government subsector in 2016 included mainly lower infrastructural expenditures incurred by the PKP PLK company which were partly offset by the growth in infrastructural expenditures founded by the National Road Fund under the *National Road Construction Programme for 2014-2023 (with the prospect until 2025)*.

The highest growth in expenditures was related to the area of social benefits. In 2016, the expenditures on social benefits other than social transfers in-kind, increased in relation to GDP by as much as 1.0 percentage point. The main reason behind such a significant growth of social expenditures was the introduction as of 1 April 2016 of the governmental programme supporting families, *Family 500 plus*, which constitutes a new instrument of social policy. Owing to the programme, a child benefit of PLN 500 for the second and subsequent child up to the age of 18 is disbursed on monthly basis. For less wealthy families (following the fulfilment of the income criterion amounting to PLN 800 per capita in a family, or PLN 1200 in case of families with children with a disability), the benefit is also provided for the first child.

At present, 2 million 560 thousand families take advantage of the *Family 500 plus* programme and the benefit is received by 3 million 820 thousand children. It supports 55% of all Polish children up to the age of 18 and the expenditures associated with the programme in 2016 amounted to over PLN 17 billion. The programme is a real incentive to make decisions about having a larger family[15]. However, the highest share in the category of social benefits refers to the subsector of social insurance and expenditures on retirement and disability pensions. In 2016, the expenditures of the social security subsector incurred on social benefits in relation to GDP dropped by 0.1 percentage point. The expenditures of FUS (Social Insurance Fund) incurred on retirement and disability pensions amounted to approx. PLN 179 billion and were lower by PLN 2.2 billion, i.e. by 1.2% than assumed in the plan. Compared to the previous year, a growth of expenditures on those benefits by 2.6% yoy was recorded.

In 2016, a slight growth of public consumption was also recorded in nominal terms, only by 2.2% yoy (against 3.8% yoy in 2015), and in relation to GDP - a decline by approx. 0.1 percentage point. Limiting the public consumption in relation to GDP resulted from the decline in expenditures for the purchases of goods and services executed by the general government units in relation to GDP by approx. 0.1 percentage point. Expenditures related to labour costs in relation to GDP in 2016 increased by approx. 0.1 percentage point, which resulted from the growth of remuneration in the central government subsector by over PLN 2 billion, partly due to the increase of funds for employee groups which, as a rule, were subject to so-called wage freezing as of 2010. In the local government subsector, the remuneration expenditures in relation to GDP did not change.

III.3. Medium-term budgetary outlook

The baseline scenario of the *Programme* foresees that the general government deficit in 2017 will reach 2.9% of GDP and in subsequent years 2.5% of GDP, 2.0% of GDP and 1.2% of GDP, respectively.

Deficit scenario for 2017 is the result of the implementation of priority reforms of the new government supporting inclusive economic growth in the conditions of one of the highest tax gap in the EU, which is a result of fraud and low efficiency of tax administration. On the one hand, a significant improvement of tax collection will take place and, on the other hand, the reforms promoting the family-friendly policy will be continued. The reforms promoting the family-friendly policy cannot be postponed for the future due to the accrued significant demographic risk factors. Moreover, in 2017, a significant acceleration of investment projects is assumed.

[15] Cf. Chapter V.1.

In the subsequent years, a significant fiscal adjustment is assumed that will enable the achievement of the medium-term budgetary objective (MTO) after 2020 while implementing the priorities of social policy and development-friendly measures defined in the *Strategy*.

Factors determining the general government revenues

The forecasted ratio of general government domestic revenues[16] to GDP in 2017, excluding a one-off operation of cancellation of loans from the state budget granted to the Social Insurance Fund[17] will reach 38.6% (as compared to the level of 38.0% recorded in 2016, which means a growth by 0.6 percentage point of GDP). The growth in the general government revenues in relation to GDP will result from systemic measures improving tax compliance. In the years 2018-19, the share of revenues in GDP will stabilise at a level of approx. 38.9%, to decrease to 38.8% in 2020. At the same time, a growth of revenues from the EU from 0.8% of GDP in 2016 to 1.8-1.9% of GDP in the years 2017-19, has been assumed,; in 2020, the revenues from the EU were assumed at a level of 1.3% of GDP (change in revenues from EU is neutral for general government balance).

Social security contributions

The most important source of the general government revenues will be social insurance contributions. Revenues from contributions will depend on the development of the base for their calculation, which main component is the wage fund in the national economy, however they will be also determined by the results of the changes to the system. The nominal growth rate of the wage fund, after the increase in2016 by approx. 6.0% yoy and the expected high growth in 2017 (approx. 8.2% yoy), should stay at a high level in the coming years, although remaining below the nominal GDP growth rate. In relation to GDP, social security contributions in the years 2017-20 will amount to 14.1%, 13.8%, 13.7%, 13.6%, respectively.

Taxes

Revenues from taxes are determined in a natural way by the development of their base, thus, mainly the private consumption, income from work, retirement and disability pension benefits and profits of enterprises. However, in the horizon of the forecast, systemic changes will play a very important role, to result mainly in increasing the efficiency of the tax system. Activities in this area will focus on strengthening effectiveness of enforcement of due taxes through combating pathologies of criminal nature, consisting of tax fraud in the scope of VAT, as well as the application of aggressive tax optimisation and avoidance the taxation of profits in the country where profits are earned. A package of measures was developed in order to increase the level of tax payers' compliance with tax obligations and combat tax fraud. It comprises, among others:

- limiting of the tax gap in connection with VAT fraud and counteracting tax avoidance,
- closing loopholes in the VAT system based on current regulations,
- establishment of a system for monitoring of road carriage of goods,

[16] Domestic expenditures/revenue means the expenditures /revenue adjusted by expenditures financed from the EU funds for which the ultimate beneficiaries are the general government units. According to the EU methodology ESA2010, the absorption of EU funds by the general government are neutral to the balance.

[17] In accordance with the *Act of 2 December 2016 on special solutions aimed at implementation of the Budget Act for 2017* (Journal of Laws item 1984), as of the day of entry into force of the Act, loans granted to the Social Insurance Fund (FUS) from the state budget in the years 2009–14, with the maturity date expiring on 31 March 2017, were cancelled. The cancellation at a level of approx. PLN 39.1 billion (i.e. approx. 2% of GDP) was taken into account in forecasts for 2017 on the FUS revenues side, as a capital transfer (D.9) and, at the same level, on the side of the state budget expenditure, also in the category of capital transfer (D.9). Due to the consolidation, the aforementioned cancellation shall not affect the balance of the general government, both according to the EU methodology (ESA2010) and the national methodology. The cancellation of the loan granted to FUS from the state budget is also neutral in terms of the stabilising expenditure rule, however, it means the necessity to adjust the dynamics of the expenditure benchmark due to its one-off character.

- introduction of the anti-avoidance clause,
- closing loopholes in the income tax system,
- increasing of tax administration effectiveness,
- extension of international cooperation.

It is expected that the implementation of those measures as well as measures scheduled for years 2019-20 will contribute to the increase in the tax revenues in the horizon of the *Programme* from 1.2 to 1.5 percentage points of GDP (cf. Chapter VI.2 and the Annex).

Taxes on production and import

The relation of taxes on production and import to GDP in 2017 will increase to 13.9% (from 13.4% in 2016), in 2018, it will rise to 14.4% and remain at this level by 2020.

The most important indicator of the VAT tax base is private consumption, which is forecast to accelerate the pace of growth yoy in 2017, to be followed by stabilisation at a slightly lower level from 2018. In nominal terms, the growth rate will remain at a slightly lower level than the nominal GDP growth throughout the 2018-20 forecast horizon. In terms of VAT, it assumed that the effects associated with the improvement of tax collection, with no changes of the remaining parameters, will allow for gradual increase of the VAT relation to GDP throughout the forecast period.

Throughout the forecast horizon no changes in rates of excise duty were assumed for all products excluding motor fuels. In accordance with the current legal status, in the years 2015-19 excise duty rates are reduced by PLN 25.00 /1000 litres for diesel oil and motor gasoline and by PLN 25.00/1000 kilograms for LPG shall apply. At the same time, the level of the fuel duty for motor fuels is increased by those amounts. As of 2020, the excise duty rates will be increased and the fuel duty rates will be reduced by the amounts indicated above. It means that the total burden of excise duty nature (i.e. taking into account the excise duty rate and the fuel duty) will remain at the current level. Due to the fact that the majority of excise duty rates is expressed as an amount (only in case of excise duty for cigarettes the amount and percentage rate is used, and in case of excise duty for personal cars, the percentage rate is used), the total revenues from excise duty in relation to GDP will slightly decrease.

The category of taxes on production and import also includes revenue from the new sector taxes, i.e. the tax on certain financial institutions and retail sales tax. In 2017, as compared to 2016, revenues from the tax on certain financial institutions will increase due to the fact that in 2016 this tax was effective only as of February, and the first revenues were acquired in March. On the other hand, in case of the retail sales tax, the revenues were not included in connection with the suspension injunction issued by the European Commission in relation to the application of this tax. The European Commission expressed concerns that the progressive tax rates based on the level of income will grant selective advantage to low-income enterprises over their competitors, with the vioaltion of the state aid rules, however, it did not challenge Poland's right to take the decision on the level of taxation. Positive results of the European Commission audit, expected in 2017, related to the compliance of this tax with the public aid rules will allow to assume that revenues from retail sales tax will be gained as of 2018.

Taxes on income and assets

In the years 2017-18, the relation of taxes on income and assets to GDP will reach the level of 7.3% (against 7.2% in 2016); in the years 2019-20 will grow to 7.5%, 7.6%, respectively.

The most important change in PIT is the introduction, as of 2017, of a new digressive formula for calculating the tax deductible amount[18]. As a result of introduction of this change, tax payers with the annual income below PLN 6,600 shall not pay any tax, while tax payers with a low income (up to PLN 11,000 on an annual basis) will pay a lower tax. On the other hand, tax payers with income exceeding the first tax bracket (PLN 85,528) will pay a higher tax - the deductible amount will decrease to PLN 0 along with the growth in income (after exceeding the annual income in the amount of PLN 127,000 – the tax deductible amount shall not apply). The effect of the aforementioned solution will be visible in an annual tax settlement for 2017, i.e. in 2018. Moreover, as of 2018, the tax deductible amount will be raised again, so that persons with the annual income up to PLN 8,000 would not pay the tax (the effect will be visible in 2019). In the baseline scenario, the changes of the main parameters of the PIT (tax brackets, deductible expenses) are not assumed.

In case of CIT, it should be mentioned that as of 2017 a lower 15% rate has been introduced for tax payers whose revenues on sales, including the VAT due did not exceed the equivalent of EUR 1.2 million in the previous fiscal year. This preference will be also applied to the taxpayers starting the activity, which will create incentives for newly created businesses by increasing the potential return on investment. Moreover, in the case of CIT, the increased tax collection rate is also assumed, which allows to expect a slight increase in the relation of revenue from this source to GDP in the coming years.

Other revenues

In 2016, the tax on hydrocarbons became effective, i.e. the tax on profits from hydrocarbon extraction. Pursuant to the *Act of 25 July 2014 on the special hydrocarbon tax* (Journal of Laws of 2016, item 979, as amended), hydrocarbons include: crude oil, natural gas and their natural derivatives, excluding methane occurring in coal deposits and methane occurring as accompanying fossil. The tax payment obligation arises for revenues gained as of 1 January 2020.

As a result of Eurostat decision concerning the change in recording the revenues on large-scale sales of frequencies, single payments acquired in 2016 will be recorded as an annuity distributed over time for the period of granted frequency reservations (15 years).

Factors determining the general government expenditures

The forecasted ratio of domestic expenditures of the general government to GDP in 2017, excluding a one-off operation of cancellation of loans granted from the state budget to the Social Insurance Fund will reach 41.5% (as compared to the level of 40.4% recorded in 2016, which means a growth by 1.1 percentage point of GDP). In subsequent years, the ratio will amount to 41.4%, 40.9% and 40.0%, respectively. A growth of expenditures financed from the EU in the years 2017-19 to 1.8-1.9% of GDP has been assumed, from 0.8% of GDP in 2016; in 2020, the expenditures from the EU were assumed at a level of 1.3% of GDP.

The projected level of general government expenditure is determined by the stabilising expenditure rule defined in the *Public Finance Act* (cf. Chapter III.4), which indicates the limit of expenditures of the central budget to be planned in the Budget Act, assuming the planned/projected scope of units and funds covered by the rule. On the other hand, other provisions of the *Public Finance Act* specify that the amounts of expenditures contained in the Budget Act constitute an absolute limit and, consequently, determine the ceiling of expenditure possibilities to operators of budgetary parts.

[18] Gaining of the annual income not exceeding PLN 6,600 by tax payers shall mean lack of tax, since the tax deductible amount will reach PLN 1,188. Tax payers whose income is contained in the brackets from PLN 6,600 to PLN 11,000 will be able to deduct a digressive amount - from PLN 1,188 to PLN 556.02, whereas tax payers gaining the annual income exceeding PLN 11,000, but not exceeding PLN 85,528 will use the tax deductible amount at the currently level, i.e. PLN 556.02. On the other hand, tax payers gaining the annual income exceeding PLN 85,528, but not exceeding PLN 127,000 will use a digressive tax deductible amount from PLN 556.02 to PLN 0. Tax payers gaining the annual income exceeding PLN 127,000 will not use the tax deductible amount.

At the same time, while executing the budget, the operators are bound to comply with the rules of financial management defined in Article 162 of the *Public Finance Act*, including, inter alia, the principle of rational management of public funds, in accordance with the purpose and in a cost-effective manner, maintaining the conditions of obtaining the best effects from the specific outlays. The above conditions and other operating factors cause that every year the funds spent are lower than the expenditures limit recorded in the Budget Act, e.g., as a result of completed public procurement procedures and the execution of tasks in amounts lower than originally assumed, or in connection with the necessity to restart a new tender procedure, which result in transferring the implementation of some tasks to the consecutive budgetary year. The differences between funds planned and finally spent also arise from the amendments to the schedules of task implementation, which usually means a lower demand for funds in a given year.

As of 2018, i.e. for years which are not covered by the Budget Act, in the presented scenario the level of expenditure compliant with maximum limits arising from the stabilising expenditure rules has been adopted. As a result of adopting this assumption as well as taking into consideration the historic deviations against the plans, execution of expenditures at a level below the limit can be expected and, at the same time, the development of the general government deficit at a level lower than forecast.

It should be noted that the average level of failure to execute the state budget expenditures in a medium term amounts to approx. 3% of the total amount of expenditures planned in the Budget Act. In 2016, the execution of the state budget expenditures amounted to 97.9% of the plan, i.e. PLN 7.6 billion less than originally planned, and in the years 2011-15 it amounted to approx. PLN 12 billion on average.

Social transfers

A significant impact on the level of expenditures over the forecast horizon, and therefore on the shape of fiscal policy will be influenced mainly by the government measures aimed at an active pro-family policy of the state (*Family 500 plus* programme) and in the area of social policy. The main goal of the *Family 500 plus* programme (cf. Chapter V.1) is to support families bringing up children and to counteract the demographic decline in Poland, by granting families the new child benefit.

In addition to the *Family 500 plus* programme, also other measures were implemented to support persons in difficult situation and the poorest. At the beginning of 2017, the provisions of *the Act of 4 November 2016 on the support pregnant women and families - "For life") entered into force* (Journal of Laws item 1860). One of the key elements of this instrument is granting a one-off benefit in the amount of PLN 4,000 to families where a child with a severe and irreversible disability or incurable disease is born, which is allocated irrespective of the income held. Obtaining of the benefit depends only on the condition of a child's health impairment in the prenatal period and the condition of submitting the application within maximum 12 months following the childbirth. Accordingly, the oldest children to be covered by this aid are those born on 1 January 2016.

In connection with the increase of the minimum wage, the amounts of the nursing benefits for carers of the disabled were also increased - up to PLN 1,406 net per month (PLN 1,355). At the same time, as of 1 January 2017 the provisions extending the group of persons authorised to receive the aid are effective. So far, the benefit has been granted to only one carer and one disabled person in the family. The amendment of the provisions allows the second member of a household (e.g. a spouse) to be entitled to receive the benefit due to care for other disabled person.

Moreover, in 2017 income thresholds for entitlement to family benefits allowance will be raised: as of 1 November 2017, by PLN 80 to PLN 754 (a general criterion) and by PLN 844 in families with a disabled person. The amounts of benefits for children up to 23 years old and amounts of the following allowances will be increased:

- education and rehabilitation of a disabled child;
- starting education by a child at a school outside the place of residence, including, for the coverage of expenses associated with living in the locality of the school and the expenses associated with commuting to the locality of the school;

- the allowance for bringing up a child in a family with many children;
- allowance for single parents.

As a consequence, the social security expenditures in 2017 will increase by approx. 0.3% of GDP.

In the years 2018-20 the ratio of social aid expenditure to GDP will decrease by 0.3 percentage points as a result of a significant improvement of the income situation of households and, as a consequence, the reduction of the number of families using social aid and additionally because of the lack of indexation.

The payments within benefits from social insurance will be determined by the annual indexation of retirement and disability benefits, depending on inflation and the real wage growth in the previous year as well as on the Act introducing the reduction of the retirement age to 60 for women and to 65 for men as of 1 October 2017. According to the *Act of 16 November 2016 amending the act on retirement and disability benefits from the Social Insurance Fund and other acts* (Journal of Laws of 2017 item 38), the reduction of the retirement age will refer to both retirement systems - the general and the agricultural one. Until the end of 2017, farmers will have a possibility to retire earlier, at the age of 55 for women and 60 for men, subject to the fulfilment of the specific conditions. A similar rule related to retirement will be effective until the end of 2017 for judges and prosecutors - depending on the period being employed in those professions.

Moreover, as of 1 March 2017, the level of a minimum retirement benefit was increased to PLN 1000 and the indexation mechanism was corrected through introducing a guaranteed indexation rise at a level of PLN 10.

As a result of the aforementioned measures, in 2018 expenditures for FUS retirement and disability benefits will increase in relation to GDP, to 9.9% against the 2016 level of 9.7%. It is estimated that as of 2019, taking into account the macroeconomic parameters affecting indexation and the forecasts related to the number of beneficiaries, the amounts of the aforementioned expenditures will grow at a slower pace than the nominal GDP. Consequently, in the years 2019-20 the share of expenditure on FUS retirement and disability benefits in GDP will stabilise at a level of 9.8%, i.e. by 0.1 percentage points above the level recorded in 2016. The scale of expenditure for FER retirement and disability benefits is much smaller than in case of FUS and in the years 2016-20, the share of those expenditures in relation to GDP will remain stable, at a level of 0.8%.

Consequently, the total social transfers in 2017 will increase by 0.4 percentage points of GDP, to the level of 17.6% of GDP, in 2018 they will remain at the same level and in the horizon of 2020, they will drop to 17.2%.

Public investments

Public investments, which in accordance with the recommendations of the Council should not be subject to consolidation, after a significant decline to 3.3% of GDP in 2016, resulting mainly from the termination of the EU financial perspective for 2007-13, shall accelerate in the coming years, staying on the average in relation to GDP at a level of approx. 4.7% - above the EU average amounting to approx. 3.1% in the years 2010-15 – within the whole forecast horizon. In 2017, the growth of the ratio of public investment to GDP will amount to 1.1 percentage point of GDP, including investment expenditures financed by the EU funds amounting to 0.8 percentage points.

The level of general government investments will be determined by multiannual governmental programs, particularly in the area of infrastructure and by the implementation of the EU financial perspective for 2014-20. The investment projects related to construction and reconstruction of national roads and motorways are funded from the resources of the National Road Fund (KFD), as well as from the state budget. The objectives and priorities for the development of road infrastructure (including maintaining the proper technical condition of the road network already existing) together with indications on level and sources of the necessary financing, in particular the use of the new EU financial perspective for 2014-20, are included in the *National Road Construction Programme for 2014-2023 (with the prospect until 2025).*

Due to the fact that the limit of the *National Road Construction Programme* amounts to PLN 107 billion, while the value of the tasks contained therein is approx. PLN 200 billion, it is necessary to take measures to ensure funds for the implementation of this programme through optimising the implementation of road projects included in the *National Road Construction Programme,* both in the legal and technological context as well as in financial terms.

The effect of works of the Steering Committee for optimisation of the implementation of road projects, is the formulation of concepts constituting a package of measures which shall lead to the improvement of the road construction process and reduction of its costs, to allow the implementation of all investments entered into the *National Road Construction Programme*. The most important measures recommended by the Steering Committee include:

- the statutory assignment of competence in the scope of issuing recommendations and instructions related to technical, construction and operational requirements to the minister responsible for transport;
- creating of the formal and legal platform for financial cooperation between local government units (JST) and the State Treasury in the scope of financing road investments;
- appointment of the Team of Experts as a body to act in the transitional period until the establishment of the National Contracting Forum);
- recommendations concerning the participation of representatives of the Public Procurement Law (PZP) group in the processes of issuing opinions on acts regulating granting public procurement contracts.

The other major multiannual programme determining the investment level of the sector is the *National Railway Programme to 2023*, including the capital expenditures for the construction and modernization of railway lines, operated by PKP Polskie Linie Kolejowe S.A. (PKP PLK S.A.). These investments are financed by the Railway Fund, the state budget, EU funds and the own resources of PKP PLK S.A., coming from EIB loans and the issuance of bonds. According to the *National Railway Programme to 2023* and financial projections of PKP PLK S.A., after a temporary decline in capital expenditures in 2016, which is associated with the gradual use of funds from a new EU perspective, from 2017 spending will be expedited.

Moreover, the investment level of the sector will also be determined by the scale of investment expenditure in the local government subsector. In 2016, a decline in investment of local government units occurred (yoy). This decline resulted from the slump in investment financed with the participation of the EU funds (both in the part related to financing from EU funds and co-financing). Despite significant fluctuations of investments financed with the share of EU funds, the level of “purely” domestic investment was changing insignificantly. In the years 2017-20, a recovery in investments financed with the share of EU funds is expected and, at the same time, the absorption of EU funds at a level higher than in 2016 by local government units.

It is expected that the implementation of the investments of local government units from EU funds will take place in such areas as urban transport, low-carbon economy, revitalization, environmental protection (with particular emphasis on water conservation). It is worth noting that local governments will have to bear significant financial outlays to adapt their infrastructure to the requirements of environmental protection, including water and wastewater management (construction and/or modernization of wastewater treatment plants, sludge network reconstruction, construction of sewage systems). Undoubtedly the conduct of investments by local governments will be facilitated by a new instrument – Integrated Territorial Investments – facilitating the investments in the administrative area of more than one unit of local government.

The level of public investment will be also affected by the implementation of numerous multiannual investment programmes, including the programme on “*Securing air transport of the most important persons in the state (VIP)*” to be implemented in the years 2016-21; “*Development Programme of the local (commune and district) road infrastructure for the years 2016-2019*”, programmes on investments in the field of culture – construction of museums and programmes in higher education.

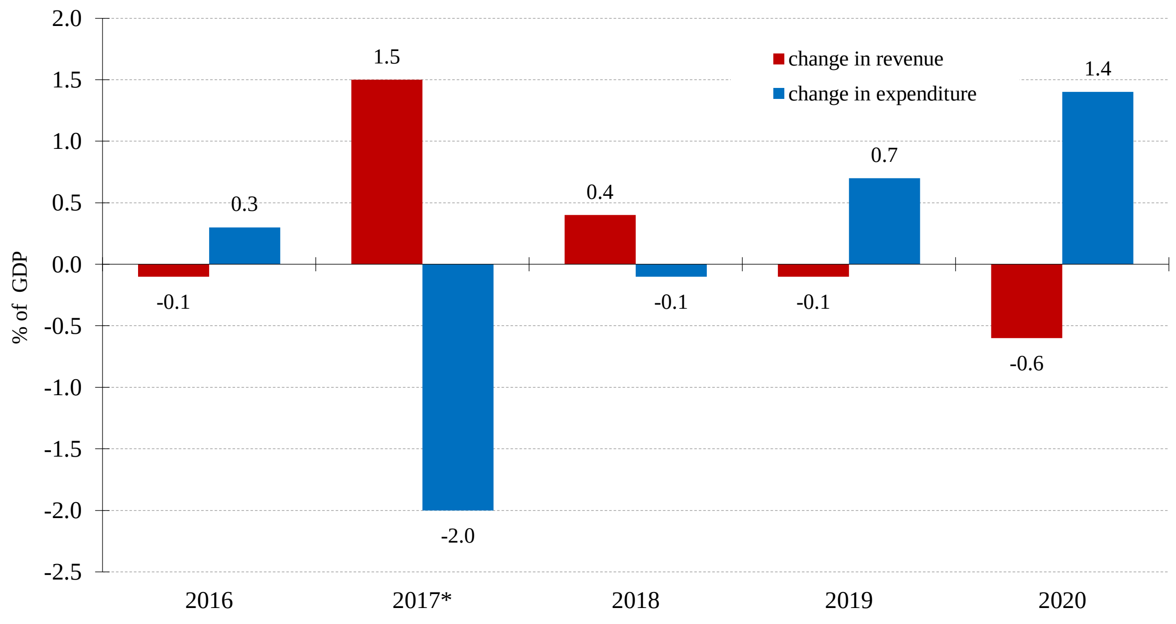
Moreover, in 2016 the Council of Ministers adopted the resolution concerning establishing of the multiannual programme on the *Construction a water tract connecting the Vistula Lagoon with the Gdańsk Bay*, and its implementation will enable the connection of the Vistula Lagoon with the Gdańsk Bay. The Programme will be implemented in 2017-22 and its cost, to be financed from the state budget, was estimated at the level of PLN 880 million.

Other current expenditures

An important factor determining the expenditures is also the development of labour costs in the general government. It is assumed in the draft Budget Act for 2017 that remuneration in state budgetary units for employees covered by the provisions of the *Act of 23 December 1999 on the shape of remunerations in the government sector and on change of some other acts* (Journal of Laws 2016, item 966 as amended) in comparison to 2016, will increase by 1.3% for all employee groups. The total cost from the state budget arising from the aforementioned title, comprising also remuneration financed by subsidies, overheads on wages and expenditures determined in relation to wages, amounts to approx. PLN 1.4 billion. For 2018, the "freezing wages" is assumed whereas in the subsequent year, the increase by inflation rate of the previous year is projected. The wage fund of state budget units will develop within the expenditure limit envisaged by the stabilizing expenditure rule, while maintaining the current indexation systems for a part of employees of the general government. For example, in accordance with the provisions of the Act, the basis for determining the basic salary of a judge in a given year is the average wage in the national economy in the second quarter of the previous year but not less than the previous base.

As a result, labour costs in the general government in relation to GDP in the period 2017-20 will remain at a level of 10.0%, 9.7%, 9.4% and 9.1% respectively. Throughout the forecast horizon it was assumed that the rate of growth of intermediate consumption, i.e. purchases of goods and services implemented by the sector, with the exception of EU funds will grow at a rate of nominal GDP growth.

Figure 7. The impact of changes in revenue and expenditures for the general government balance in relation to GDP



Source: Ministry of Finance

** – without impact of the one-off cancellation of loans granted from the state budget to the FUS (Social insurance Fund) (on the revenue as well as expenditure side)*

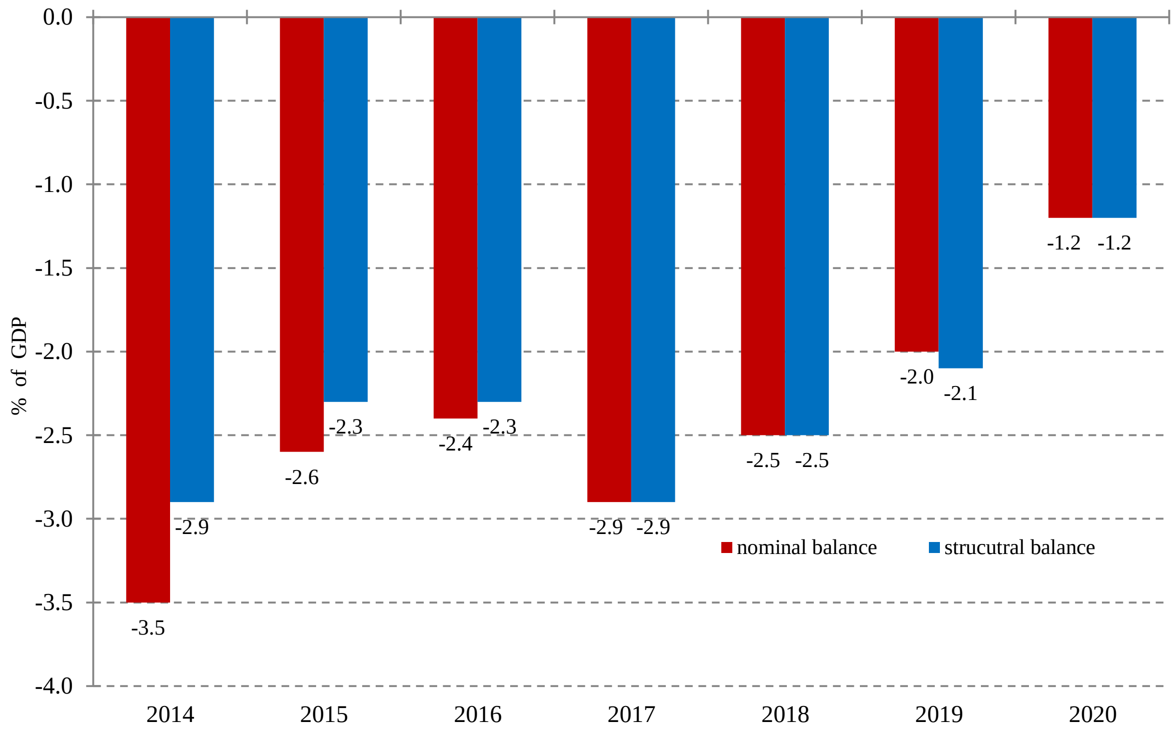
Explanations: revenue – "plus" column means an increase of the share of revenue to GDP for respective years, "minus" column – the decrease; expenditure – "plus" column means the reduction of the share of expenditure to GDP for respective years, "minus" column – the increase.

III.4. Structural balance

Poland has adopted its medium-term budgetary objective, i.e. target for structural balance of the general government at the level of -1% of GDP. On the basis of the matrix used for determining of the annual structural effort under the preventive arm of the *Stability and Growth Pact*[19], until the MTO is reached, the improvement in the structural balance should be 0.5 percentage point of GDP (assuming that the output gap in Poland will be within ± 1.5%, and the debt will remain at a level below 60% of GDP).

The assessment of the fulfilment of the preventive arm of the *Stability and Growth Pact* by the member state is based on two pillars: a structural effort (change in the structural balance) and expenditure benchmark. The structural effort is a non-observable value, subject to frequent changes due to revision of the output gap and the potential growth. For this reason, in December 2016, the EU Member States decided to strengthen the role of the expenditure benchmark.[20]

Figure 8. Nominal and structural balance of the general government



Source: Ministry of Finance

In the baseline scenario of the *Programme*, which assumes, in particular, a consolidation on the expenditure side in line with the stabilising expenditure rule as well as strengthening the revenue side through implementation of the package of measures improving tax compliance, as described in the Annex, it is forecast that in the years 2017-20 the structural balance (see figure 8) will be significantly reduced, from 2.9% of GDP in 2017 to 1.2% of GDP in 2020, and the MTO will be achieved a year later.

[19] Communication from the Commission – *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact* (COM/2015/012).

[20] European Commission, *Vade Mecum on the Stability and Growth Pact*, March 2017, Annex 17. In accordance with the Commission's announcement, the new methodology taking into account the impact of one-off and temporary measures will be first applied in the assessment for 2017.
Cf. https://ec.europa.eu/info/sites/info/files/ip052_en_0.pdf

The following one-off measures were taken into account to perform the calculation of the structural balance in 2016:

- net effect of adjustment of the EU budget arising from the revision of VAT and gross national income in the amount of PLN minus 0.7 billion;
- revenues of FOŚG (the Fund for Protection of Guaranteed Assets) resulting from the disbursement of guaranteed funds to depositors of the Cooperative Bank of Crafts and Agriculture in the amount of PLN 2.0 billion;
- CIT loss due to the decline in bank profits as a result of expenditures for the benefit of FOŚG, in the amount of PLN 0.4 billion;
- expenditures resulting from a one-off cash allowance for some retirees, pensioners, persons receiving pre-retirement benefits, pre-retirement allowances, bridging pensions or teachers' compensation benefits in the amount of PLN 1.4 billion.

According to the Ministry of Finance estimates, both the structural effort as undertaken in 2016 and as forecast in 2017 will be lower than, as implied by the adjustment path towards the MTO, the recommended annual improvement by 0.5 percentage point of GDP. However, it should be stressed that the deviation from the structural balance reduction path occurred after stronger than implied from the requirements of the Pact adjustment in 2015, which amounted to 0.6 percentage point of GDP (so-called *frontloading*).

Table 1. Cyclical developments

	% of GDP	ESA code	2016	2017	2018	2019	2020
1.	**Real GDP growth (%)**		**2.7**	**3.6**	**3.8**	**3.9**	**3.9**
2.	**Net lending of general government**	EDP B.9	**-2.4**	**-2.9**	**-2.5**	**-2.0**	**-1.2**
3.	**Interest expenditure**	EDP D.41	**1.7**	**1.7**	**1.8**	**1.8**	**1.8**
4.	**One-offs and temporary measures**		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
4.1	One-offs on the revenue side: general government		0.1	0.0	0.0	0.0	0.0
4.2	One-offs on the expenditure side: general government		-0.1	0.0	0.0	0.0	0.0
5.	Potential GDP growth (%)		2.9	3.3	3.8	3.8	3.9
6.	Output gap		-0.3	0.0	0.0	0.0	0.0
7.	Cyclical budgetary component		-0.1	0.0	0.0	0.0	0.0
8.	Cyclically-adjusted balance (2-7)		**-2.3**	**-2.9**	**-2.5**	**-2.1**	**-1.2**
9.	Cyclically-adjusted primary balance (8+3)		-0.6	-1.3	-0.7	-0.3	0.6
10.	**Structural balance (8-4)**		**-2.3**	**-2.9**	**-2.5**	**-2.1**	**-1.2**

Source: Ministry of Finance.

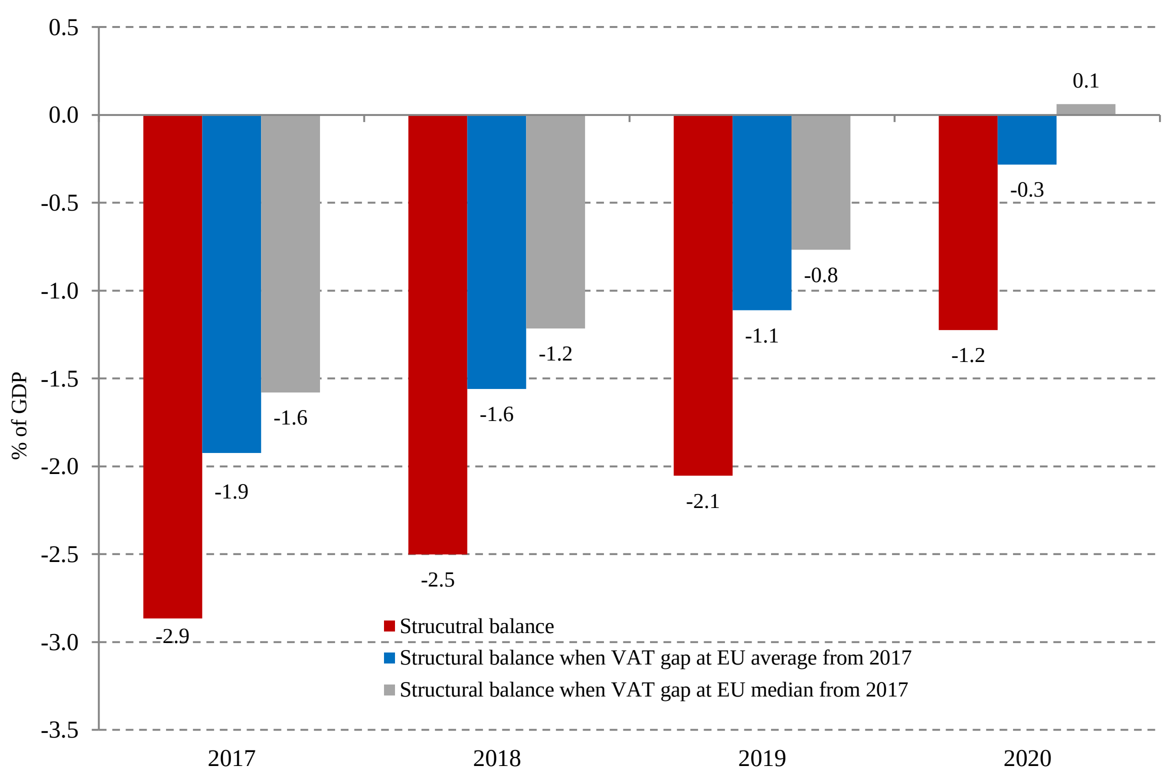
Consequently, in biannual terms, i.e. in the years 2015-16, the cumulative structural effort amounted to 0.7 percentage point of GDP. The deviation from the required annual improvement in the structural balance in the years 2016-17 indicated above is mainly a consequence of a high tax gap, in particular, in VAT, and the economic policy implemented by the government, consistent with the EU targets[21], supporting the inclusive growth.

In accordance with the estimates of the European Commission for 2016[22], Poland belongs to the EU Member States with the highest VAT gap. According to the Commission estimates, in 2014 the VAT

[21] Cf. Chapter I.1.
[22] Cf. footnote 8.

gap in Poland amounted to 24.1% of the potential proceeds from this tax. Only 6 the EU Member States had a higher level of this indicator in 2014. The average for all member states [23] in 2014 amounted to 14.0%, whereas the median - to 10.4%. The estimates presented in figure 9 indicate that the improvement of the VAT gap in the years 2017-20 to the level of the EU average would *ceteris paribus* result in the improvement of the structural balance in this period by 2.6 percentage points of GDP and would be sufficient to reach a medium-term budgetary objective already in 2019. On the other hand, reducing of the VAT gap to the level of the median would mean a cumulative effort at a level of 3.0 percentage point of GDP and reaching the MTO between 2018 and 2019. Therefore, one of the main tasks of the National Fiscal Administration is to reduce the tax gap, including the VAT gap, in the horizon up to 2020, to the level of the median of EU Member States.

Figure 9. Structural balance assuming hypothetical scenarios



Source: Ministry of Finance simplified estimates on the basis of the European Commission data.

Measures aimed at increasing tax revenues through the improvement of tax collection, in particular, through combating tax fraud compliant with the EU priorities[24], should allow the budgetary policy to support the inclusive growth, while respecting budgetary constraints arising from the national and EU law. Deeper than already undertaken adjustment of the expenditure policy under the conditions of erosion of tax revenues would be too detrimental for the social and economic policy.

[23] EU-26, excluding Cyprus and Croatia
[24] Cf., e.g.:
– *Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (OJ L 193 19.07.2016, p. 1) (so-called ATAD Directive), required to be introduced by the Member States by 31 December 2018;
– works carried out by the Ecofin Council on the draft ATAD2 Directive, which shall implement OECD recommendations concerning counteracting tax optimisation using inconsistencies between Member States' systems, including, with the participation of third parties.

The second benchmark for the assessment of the progress towards the MTO, strengthened in accordance with the findings of the Ecofin Council of December last year, is the annual rate of the general government expenditures. This rate is adjusted according to the methodology used by the European Commission (expenditure growth is modified, among others, by subtracting from it the discretionary measures on the revenue side as well as adjusted for the impact of one-off and temporary measures on the revenue and expenditure side [25]). It should not exceed the reference rate minus the amount corresponding to the required adjustment towards the MTO, i.e. 0.5% of GDP. The reference rate (10-year's average of the real growth of potential GDP (t-5, t+4)) used for evaluation of the expenditures of Poland amounted to 3.7% in the years 2014-16, whereas as of 2017 it will amount to 3.1%. After taking into account the adjustment necessary to achieve the medium-term budgetary objective, it would mean the required real limit rate equal to 2 5% to 2016 and 1.8% from 2017.

In 2015 Poland has undertaken stronger than required adjustment on the expenditure side. The annual real growth rate of the general government expenditure in 2015 amounted to 0.7 percentage point and was significantly lower than the aforementioned real limit rate of expenditures on the path towards the MTO. Consequently, the fiscal effort measured by the benchmark amounted to approx. 0.7 percentage point of GDP. In 2016, due to the implementation of the priorities of the polish economic policy supporting the inclusive economic growth, in particular, the counteracting of demographic decline in Poland, a certain acceleration of the real rate of expenditure growth has been noted (to 1.8 percentage point), however, in terms of the expenditure benchmark it remained consistent with the EU requirements, i.e. below the real limit rate. At the same time, the average fiscal effort in the years 2015-16 was still higher by 0.4 percentage point of GDP than implied by the limit rate of the expenditure benchmark.

While calculating the expenditure benchmark in the years 2016-17 the following factors were taken into account:

- fiscal measures generating new budgetary revenues: tax on financial institutions, freezing of tax thresholds in PIT, applying social insurance contributions on civil law contracts and contracts of supervisory board members, proceeds from so-called digital dividend,
- effects of measures aimed at improving of tax collection as estimated in 2016 (cf. Chapter III.2) and expected in 2017 (cf. Chapter VI.2),
- a one-off measure in 2017 in the form of redemption of a loan of the Social Insurance Fund in the amount of PLN 39.152 billion (measure neutral for the general government balance, cf. Chapter III.3).

Comparison between the growth rate of adjusted expenditure and the expenditure benchmark is a more appropriate tool for the assessment of the fiscal effort undertaken on the path towards the MTO than the comparison of the structural balance with the recommended effort. Also, the European Commission, within the recently introduced changes in the methodology for assessing the compliance with the Stability and Growth Pact, had made a greater emphasis on the expenditure benchmark, both in the preventive and the corrective arm.

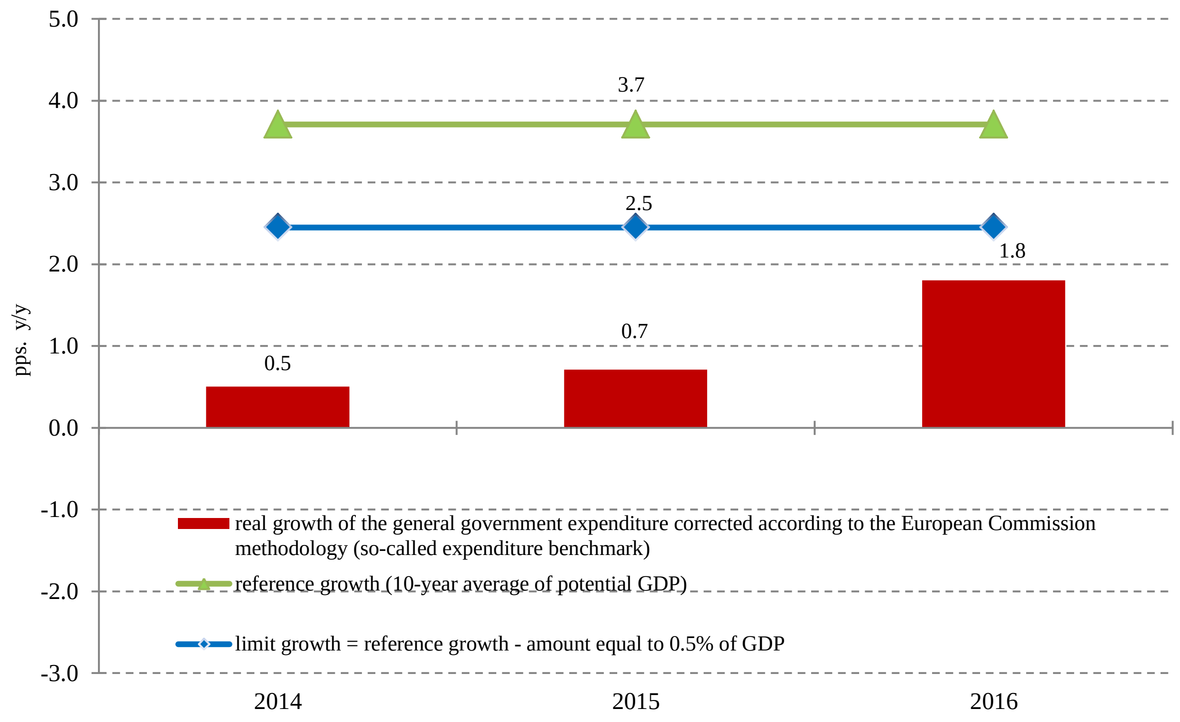
According to the Commission, its application increases the predictability of the budgetary policy. The expenditure benchmark is an effective instrument for preparing annual budgets and on-going monitoring of expenditure execution. Factors outside the control of the government, e.g. an unpredictable change in the level of revenues in response to the economic outlook, have a relatively lower impact on the assessment of the expenditure benchmark fulfilment.

Contrary to the assessment based on the structural balance and the structural effort, whose value depends on estimates of the potential growth and the output gap, the assessment based on the expenditure benchmark is carried out on observable variables (the level of expenditure and other discretionary measures of the government on the expenditure and the revenue side). Moreover, any potential changes in the level of tax revenue (observable, among others, in states with a large tax gap),

[25] Cf. footnote 20.

as well as the volatility in the level of investment expenditure, have a negative impact on the estimation of the structural effort, which is not the case of the assessment based on the expenditure benchmark.

Figure 10. General government expenditure modified according to the methodology of the European Commission



Source: Ministry of Finance

A similar concept to expenditure benchmark is the stabilising expenditure rule [26] (hereinafter referred to as the SER, more in Chapter VII.1). The adjustment by 0.5% of GDP, required in the benchmark, is also built in the correction mechanism of the SER, which requires a reduction in expenditure dynamics by 1.5-2 percentage points in the situation of public finance imbalance, caused by accumulated deviations from the MTO or by exceeding the reference values, set out in the *Public Finance Act*, by the general government deficit or public debt.

It is worth noticing that the amount of expenditure is obtained using the NBP inflation target which, in principle, reflects a growth in prices in a medium term, i.e. compliant with the time horizon of the rule. The requirements associated with the expenditure benchmark refer to the GDP deflator forecast for a given year. Therefore, in periods of significant negative inflation surprise the requirements from the expenditure benchmark are excessively restrictive and do not include downward rigidity characterising most categories of expenditures.

According to the *Public Finance Act*, an update of the *Convergence Programme* which is part of the *Multiannual Financial Plan of the State* determines the preliminary level of expenditure on the basis of the stabilising expenditure rule. The estimation of the level of expenditure for 2018 consistent with the stabilising expenditure rule was made on the basis of:

[26] The differences between the rules are following: application of the 8-year average of the real growth of GDP in the SER instead of the 10-year average of potential growth of GDP in the benchmark, the inflation target instead of the average GDP deflator forecast, as well as absence in the SER of an exclusion of the debt servicing costs and cyclical component of unemployment benefits, and finally replacing the in-year investment level with the 4-year average.

- the level of expenditure for 2017 specified in Article 1 of *the Budget Act for 2017 of 16 December 2016* (Journal of Laws of 2017 item 108) in the amount of PLN 764,799,654 thousand[27],
- the total GDP dynamics in the years 2011-16 at fixed prices, and
- the forecasts of the real GDP growth, adopted to prepare the *Programme*.

As a result, to obtain the level of expenditure for 2018 the following indicators were used:

- 1.0314 - medium-term GDP growth indicator,
- 1.025 – NBP inflation target,
- 2 percentage points – correction due to the public finance imbalance,
- PLN 8.86 billion – forecast value of the total discretionary measures, which is a result of measures increasing the effectiveness of tax compliance enforcement and changes related to the tax on retail sales.

As a result, the estimated amount of expenditure for 2018 is equal to PLN 801.7 billion (39.0% of GDP).

On the basis of Article 112aa of the *Public Finance Act* the level of expenditure for 2019-20 was estimated too. In line with the correction mechanism, the adjustment due to public finance imbalance in these years will be -2 percentage points, which is a result of exceeding by the forecast public debt, calculated in accordance with Article 38a(4) of the *Public Finance Act*, the threshold of 48% of GDP in the years 2017-18. The estimated level of expenditure for 2019 amounts to PLN 836.0 billion (38.3% of GDP), while for 2020 – PLN 872.0 billion (37.5% of GDP).

Table 2. Level of expenditure in 2017-20

	2017	2018	2019	2020
Medium-term GDP growth indicator	1.032	1.031	1.030	1.033
NBP inflation target	1.025	1.025	1.025	1.025
Correction*	-1.50%	-2.00%	-2.00%	-2.00%
Total value of discretionary measures (PLN bn)	5.65	8.86	6.0	4.0
Level of expenditure – *Convergence programme. 2017 update* (PLN bn)	764.8**	801.7	836.0	872.0

Source: Ministry of Finance.
** - according to Art. 112aa Act of 27 August 2009 on Public Finance*
*** - estimated on the basis of a starting point, defined in Art. 2 of Act of 10 December 2015 amending the Public Finance Act, and taking into account inflation forecast errors for 2015-16*

III.5. General government debt

In the *Programme* horizon the debt management will be focused, as in previous years, on achieving the objective set out in the *Public Finance Sector Debt Management Strategy*, i.e. minimization of debt servicing costs in the long term, subject to assumed constraints on risk.

Debt management will be conducted under the conditions of gradual reduction of the general government deficit and continuing uncertainty in the financial markets, resulting, among others, from the monetary policy conducted by major central banks, including the European Central Bank and the Fed, the uncertainty associated with the political and economic situation in some EU Member States and the budgetary policy in the USA. In the domestic market, measures associated with reduction of the general government deficit should have a considerable impact on the level and shape of the yield

[27] Detailed calculation of the level of expenditure for 2017 was included in the explanatory memorandum to the draft Budget Act for 2016.

curve, and as a consequence, on the State Treasury debt servicing costs.

Changes in the ratio of debt to GDP in the period 2017-20 will result mainly from the borrowing needs of the state budget (the State Treasury debt represents more than 85% of the general government debt), the GDP growth rate and the exchange rate of zloty against other currencies, especially euro.

Changes in the debt of other general government units will result mainly from the change in the debt of the National Road Fund (the increase in debt will be associated with financial obligations incurred for the implementation of road projects) and from the expected decline in debt of local government units.

It is expected that in the Programme horizon, the debt, as defined by the EU, to GDP ratio, after rising to 55.3% in 2017 will decrease in subsequent years, reaching the level of 52.1% at the end of 2020.

Maintaining of the average interest rate on debt of the general government and the debt servicing cost to GDP ratio at a stable level is assumed.

Table 3. General government debt (end of year)

	% of GDP	ESA code	2016	2017	2018	2019	2020
1.	**Gross debt**		**54.4**	**55.3**	**54.8**	**54.0**	**52.1**
2.	**Change in the gross debt ratio**		**3.3**	**0.9**	**-0.5**	**-0.7**	**-1.9**
	Contributions to changes in gross debt						
3.	**Primary balance**[1]		0.7	1.2	0.7	0.2	-0.6
4.	**Interest expenditure**	EDP D.41	1.7	1.7	1.8	1.8	1.8
5.	**Stock-flow adjustment**		0.8	-2.0	-3.0	-2.8	-3.1
	of which: difference between cash and accruals		0.5	0.1	-0.2	-0.1	-0.2
	net accumulation of financial assets		0.8	0.7	0.2	0.5	0.3
	of which: privatisation proceeds		*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
	valuation effects and others		-0.5	-2.8	-3.1	-3.1	-3.2
	p.m. implicit interest rate on debt (%)		**3.4%**	**3.2%**	**3.5%**	**3.5%**	**3.5%**
	Other relevant variables						
6.	Liquid financial assets		4.5	3.6	3.4	3.2	3.1
7.	Net financial debt (=1-6)		**49.9**	**51.7**	**51.4**	**50.8**	**49.1**
8.	Debt amortisation (existing bonds) from the end of the previous year[2]		5.8	3.8	5.4	4.4	3.9
9.	Percentage of debt denominated in foreign currency (%)		35.1%	32.8%	32.4%	31.7%	31.1%
10.	Average maturity[3]		5.3	5.1-5.3	5.1-5.3	5.0-5.3	4.9-5.3

Source: Ministry of Finance.

1) Impact of primary balance on debt: (-) means primary surplus.

2) In the case of public finance units' debt other than the State Treasury – estimate based on available reports.

3) Interval forecast for State Treasury debt.

IV. Sensitivity analysis and comparison with the previous update

IV.1. Risk factors

1) Economic situation among Poland's trade partners

The forecast presented in this update of the *Programme* assumes that the economic growth in the EU, which is the largest trade partner of Poland, will be consistent with the scenario presented by the European Commission in the winter edition of forecasts published in February 2017. According to the Commission experts, the balance of risk factors for this forecast remains negative. Among the most important possible positive impulses for the world economy, the EC mentions potential short-term effects of fiscal stimulation and facilities for business announced by the new US administration.

On the other hand, there are growing concerns related to potential adverse effects of protectionism growth in the US trade policy or a faster normalisation of the monetary policy by Fed. It overlaps with the risk of potential adjustments in the growth of asset prices so far, which was fostered by the environment of low interest rates, growing imbalances in the Chinese economy, Brexit negotiations, the political risk in connection with the election timetable in EU Member States, or continuing geopolitical stress in Europe and worldwide. Considering still unresolved structural problems of the European banks which may act as a barrier in the development of lending required for the recovery of investment share in GDP, the scale of challenges to be faced by the Polish economy becomes enormous.

2) Other risk factors

Apart from the aforementioned risk factors for the economic projections of our largest trade partner, other limitations also exist which may result in the development of economic processes in Poland other than assumed. The economic growth scenario presented in the update of the *Programme* stipulates a significant acceleration in the use of European Union funds awarded to Poland under the 2014-20 financial perspective. The actual scenario in this area may turn out other than assumed, which would be significant for the adopted investment path and, as a consequence, the GDP growth. Direct effects for the Polish economy associated with the United Kingdom’s exist from the EU or the potential escalation of the conflict across our eastern border should not be disregarded.

Although the exposure of Polish exports to the Ukrainian and Russian market has recently decreased and the direct share of the United Kingdom in the trade exchange with Poland is significantly lower than that of Germany, nevertheless, the potential escalation of the conflict in the East or the growth of uncertainties related to potential implications of Brexit may translate into a noticeable growth of volatility in financial and commodity markets. The materialisation of adverse risk factors may result in the growth of risk aversion which, in turn, is significant for the implementation of the adopted inflation path, interest rates or assumptions related to capital flows in international financial markets and the developments in foreign exchange rates. Risk factors for the fulfilment of the inflation forecast also include a possibility of other developments in prices in world markets of commodities and food than assumed, which will directly translate into the path of price changes in Poland.

3) Sureties and guarantees

In subsequent years, the possibility of further growth in potential contingent liabilities on account of sureties and guarantees granted by the State Treasury is assumed, which may translate into a slight increase in the ratio of these liabilities to GDP. Further concentration of sureties and guarantees granted by the State Treasury to support investments fostering development in the area of road and rail infrastructure is expected. In addition, it is possible to grant sureties and guarantees for other purposes permitted by the Act, in particular as regards support for: exports, environmental protection, creation of new jobs, innovation, corporate restructuring, regional development, entrepreneurship, and programmes or projects under the EU assistance programmes.

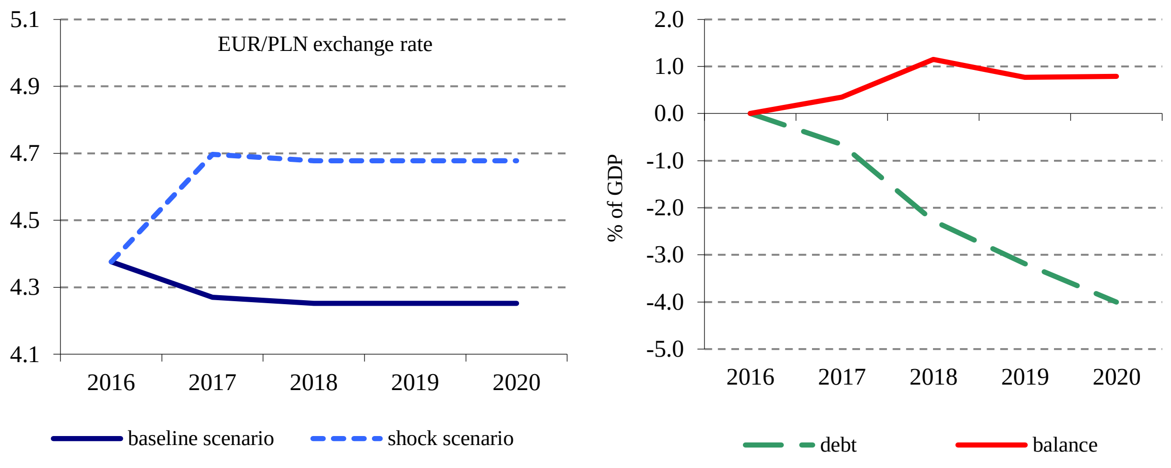
Sureties and guarantees will be mainly granted for investments implemented based on EU funds (loans and bonds underwritten or guaranteed by the State Treasury should enable the acquisition of EU funds), as well as for other investment tasks arising from potential new support programmes stipulating granting sureties and guarantees (in accordance with EU regulations). At the same time, maintaining of the long-term risk factor for the portfolio of sureties and guarantees granted by the State Treasury at a level of 5-10% is anticipated.

The value of new sureties and guarantees granted by the State Treasury in a given year is limited by the Budget Act. The 2017 limit in the Budget Act was determined at PLN 200 billion and, apart from supporting the above projects, may also be allocated to measures which may have to be undertaken should the global financial and economic crisis deteriorate the functioning of the Polish financial system.

IV.2. Sensitivity analysis

The sensitivity of the general government balance and debt in the years 2017-2019 to a depreciation of the zloty exchange rate and the increase in the domestic interest rate is presented below. The analysis was performed on the basis of the econometric Model of Public Finance (eMPF) developed by the Ministry of Finance. The results of simulations should be interpreted with great care, since they do not take into account potential changes in the economic policy in response to imposed shocks, are based on historical flexibilities estimated for the assumed forms of behavioural equations, and the model itself, despite its relatively extensive range, is not capable of including all mechanisms present in the real economy.

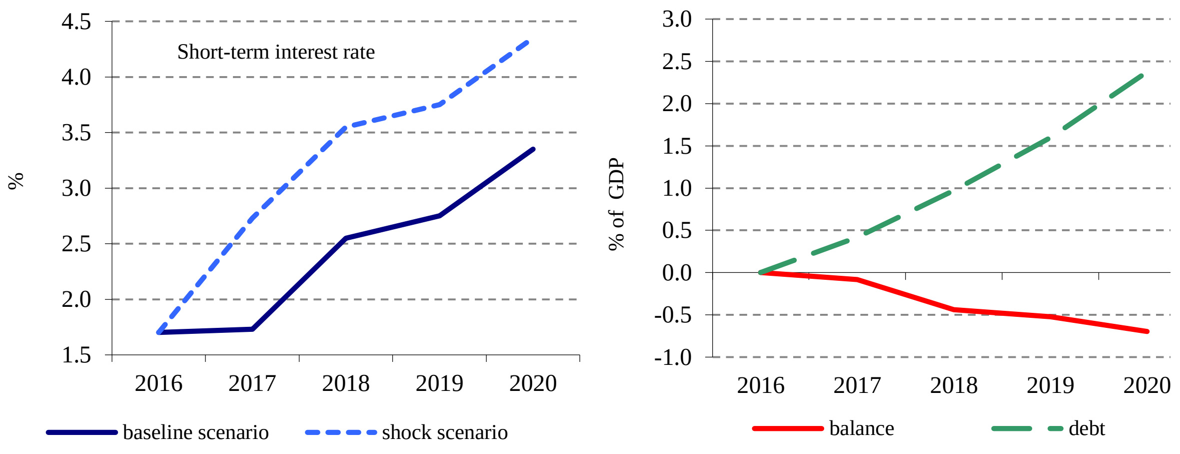
Figure 11. EUR/PLN exchange rate (left chart) and its impact on the general government balance and gross debt (right chart)



Source: Ministry of Finance

The exchange rate impulse was introduced as a permanent 10% depreciation of the EUR/PLN exchange rate. The weakening of the zloty improves the competitiveness of domestic products, which directly results in an increase in the volume of exports. Due to the high import intensity of exports, the growth in exports is also accompanied by the growth in imports. An increase in demand for Polish goods fosters the improvement of labour market conditions and an acceleration of investment activity, which is favourable for the GDP growth in the horizon of the forecast. A higher economic growth triggers a rise in general government revenues which exceeds the growth in expenditure associated with servicing debt denominated in foreign currency, which ultimately leads to the improvement in the public sector result and, as a consequence, in the shock scenario, the general government debt to GDP ratio in 2020 shall be lower than in the baseline scenario.

Figure 12. Short-term interest rate (left chart) and its impact on the general government balance and gross debt (right chart)



Source: Ministry of Finance

The interest rate impulse has been defined as an increase in the nominal short-term interest rate of 1 percentage point for the entire period covered by the analysis. A rise in short-term interest rates results in an increase in long-term interest rates and consequently leads to a higher cost of capital acquisition, which results in limiting of the investment level against the baseline scenario and higher debt financing costs. As a result of a shift in consumption over time due to inter-temporal substitution and tightened conditions for granting loans, the level of private consumption is also decreasing. As a result, the monetary impulse triggering the enhancement of monetary policy restrictiveness leads to a decrease in GDP volume in the forecast horizon. Parallel to the growing debt servicing costs and a relatively lower GDP level, the general government balance to GDP ratio deteriorates and the share of the general government debt to GDP grows against the relation in the baseline scenario.

IV.3. Comparison with the previous update

The real GDP growth in 2016 turned out lower by 1.1 percentage point than assumed, mainly as the result of the recorded relatively strong decline in investment. Although a slight slowdown in the growth rate on gross fixed capital formation was assumed in the previous update in connection with the shift from the old to the new EU financial perspective, the scale of slowdown in the implementation of projects financed from the EU funds appeared much higher. The decline in the use of EU structural funds and its negative impact on the growth rate of investment in the economy in 2016 was visible across almost the entire the region of Central and Eastern Europe. Results of the Polish economy in 2016 Q4 indicate the transitional nature of the slowdown in the economic growth. In the last quarter of the previous year, a clear improvement in the GDP growth in qoq terms (sa) was noticed; moreover, a significant growth in the inflow of EU funds was recorded. In the scope of other GDP components, the outcomes were close to the forecast.

As compared to the previous Programme, the forecast of real GDP growth rate in the years 2017-20 was revised downwards (by 0.2 percentage point on average). The most important factor behind the revision is expected lower path of real consumption growth rate - mainly in the public sector. The structure of growth is also slightly different: the major change refers to the contribution of net exports to GDP growth. Better than expected results in 2016 and the generally weaker zloty in the horizon of the forecast allow to assume that the contribution of net exports in the years 2017-20 will be neutral for GDP growth. In the previous Programme, a negative contribution of net exports was expected: minus 0.4 percentage point in the years 2017-19.

The general government deficit in 2016 amounted to 2.4% of GDP and turned out lower by 0.2 percentage point than anticipated in the last year's Programme. It resulted primarily from better than expected results of the local government subsector and the social insurance subsector. The forecast of the general government deficit for 2017 has not changes as compared to the last year’s update. The revision of the general government balance path in 2018 and 2019 results, in particular, from including the costs of lowering the retirement age and adopting the assumption that the execution of expenditures will be at a level compliant with maximum limits arising from the stabilising expenditure rule.

A higher ratio of general government debt to GDP in 2016 against the forecast from the previous update of the Programme was mainly the result of higher exchange rates of currencies in which approximately 1/3 of debt is denominated, and a lower nominal GDP growth. A higher forecast for 2017-20 is the effect of higher borrowing needs of the State budget, higher exchange rates of foreign currencies and a slower nominal GDP growth compared to that assumed in the previous update.

Table 4. Divergence from previous update

	ESA code	2016	2017	2018	2019	2020
Real GDP growth (%)						
Previous update		3.8	3.9	4.0	4.1	
Current update		**2.7**	**3.6**	**3.8**	**3.9**	**3.9**
Difference		-1.1	-0.3	-0.2	-0.2	-
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.6	-2.9	-2.0	-1.3	-
Current update		**-2.4**	**-2.9**	**-2.5**	**-2.0**	**-1.2**
Difference		0.2	0.0	-0.5	-0.7	-
General government gross debt (% of GDP)						
Previous update		52.0	52.5	52.0	50.4	**-**
Current update		**54.4**	**55.3**	**54.8**	**54.0**	**52.1**
Difference		-2.3	-2.8	-2.8	-3.6	-

Source: Ministry of Finance, Central Statistical Office.

V. Sustainability of public finances

V.1. Long-term budgetary prospects, including the implications of ageing populations

Sustainable public finances support long-term economic growth and make a critical element of macroeconomic stability. It is therefore necessary to monitor the sustainability of public finances in a short and long term for the early identification of possible threats and to introduce countermeasures at an early stage. In this context, it is crucial for the sustainability of public finances to have a strong, sustainable fiscal framework.

One of the elements of the Polish fiscal framework are the fiscal rules, including public debt rules, stabilising expenditure rule, which has a stabilising effect on public finances in the medium and the long term and corrects possible imbalances, minimising the risk of over-tightening of fiscal policy, and rules limiting the growth in debt of local government units. The above-mentioned set of fiscal rules reduces the risk of high deficits and excessive debt growth, and thus the risk to the sustainability of Polish public finances.

The European Commission regularly assesses the situation in the EU Member States in terms of the sustainability of their public finances, based on fiscal gap ratios in the medium (S1 indicator), and the long, infinite horizon (S2 indicator). The fiscal gap reflects the scale of the necessary adjustments to the primary structural balance, so that the public debt is at a certain level (S1 indicator), or so that the solvency condition is satisfied in the infinite horizon (S2 indicator). The indicators are derived assuming the no-policy change scenario. Therefore, the fiscal gap indicators reflect whether the current policy is sufficient to maintain fiscal sustainability. However, their aim is not to show the most likely scenario. The increase in an indicator means that a greater improvement of the primary structural result is needed.

Table 5. Fiscal sustainability indicators

% of GDP	*Fiscal Sustainability Report 2016*[28]	Current update base year: 2017	Current update base year: 2018	Current update base year:. 2019	Current update base year: 2020
S1	1.3 medium risk	-0.8 low risk	-1.3 low risk	-1.8 low risk	-2.8 low risk
S2	3.7 medium risk	2.7 medium risk	2.3 medium risk	1.6 low risk	1.0 low risk

Source: European Commission, *Joint Report on Health Care and Long-term Care Systems and Fiscal Sustainability*, October 2016; Ministry of Finance.

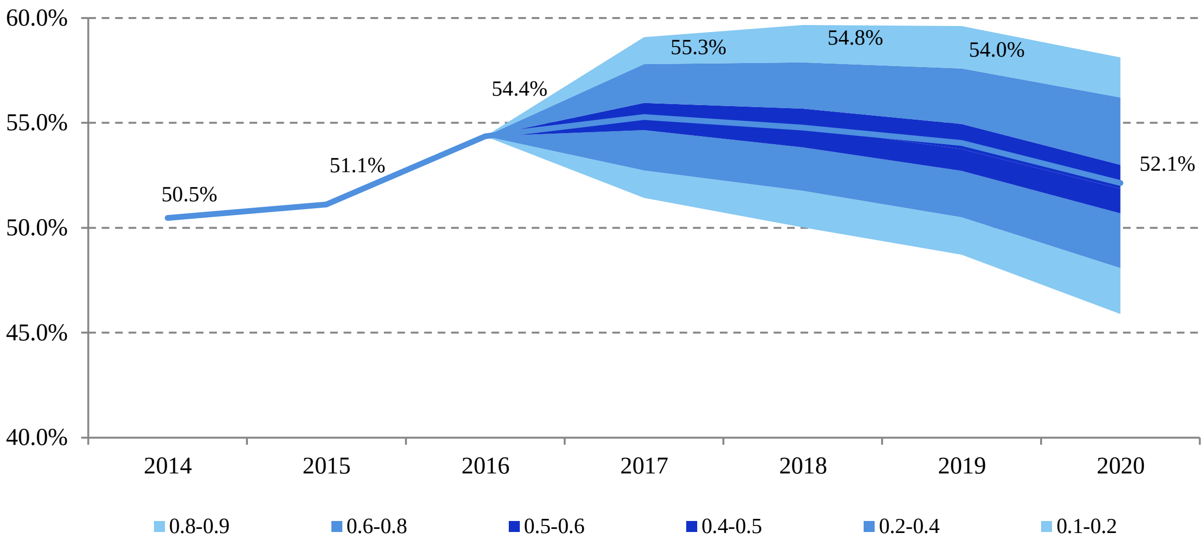
Table 5 shows the S1 and S2 indicators estimated by the Ministry of Finance as compared with the assessment of the European Commission contained in the *Joint Health Care and Fiscal Sustainability Report* of 2016. The Ministry of Finance estimate is based on projections of macroeconomic indicators presented in the *Programme* and the current forecast of ageing cost, prepared by the Economic Policy Committee Ageing Working Group (AWG) and presented hereunder in this chapter. The indicators were estimated in four variants, taking the years 2017-20 as the base year.

The indicators included in the aforementioned European Commission Report are calculated choosing 2018 as the base year and using the Spring forecast of the European Commission of May 2016. Assuming that the consolidation will be carried out in a manner consistent with the forecast presented in this *Programme*, it can be expected that the S1 and S2 indicators for Poland will improve in the coming years. The forecast improvement of the primary structural balance and the forecast decline in public debt in the years 2017-20 shall have a reducing effect on the indicators. In the future, the continuation of fiscal consolidation leading to stabilising the balance at the level of MTO and the

[28] *Joint Health Care and Fiscal Sustainability Report 2016.*

observed economic recovery will work towards reducing the risk to the sustainability of public finances of Poland in a medium and long term.

Figure 13. Stochastic debt projection from 2017



Source: Ministry of Finance

A similar level of risk to the sustainability of public finances is indicated by stochastic simulations of the debt development based on the approach adopted by the European Commission and the International Monetary Fund[29]. The forecasts were derived based on the baseline scenario presented in the *Programme* and using the annual shocks obtained for the following variables: real GDP growth, real effective rate of yield of general government debt, the primary balance and the exchange rate. In the graph above, 80% of possible paths of the debt derived with the use of the aforementioned approach are presented (the paths below 10 and above 90 percentiles, representing the scenarios associated with the most extreme set of shocks in the economy, were excluded). The analysis shows that even with a considerable combination of adverse shocks, the general government debt over the forecast horizon shall not exceed the reference value of 60% of GDP.

Forecast of the long-term sustainability of public finances used to calculate sustainability indicators S1 and S2 were published by the European Commission in 2015.

The forecasts of long-term stability of public finance take into account the legal status as at 31 December 2014 (cf. Table 6). The new forecasts based on the latest Eurostat demographic assumptions and taking into account the current legal status, including, in particular, the restitution of the retirement age applicable until 31 December 2012, i.e. at least 60 years for women and at least 65 years for men, will be presented at an occasion of the next round of works of the AWG (in autumn 2017).

Table 6. Long-term sustainability of public finances

% of GDP	2013	2020	2030	2040	2050	2060
Total expenditure						
Of which **age-related expenditure**	20.7	20.1	20.4	20.1	21.0	22.1
Pension expenditure	11.3	10.6	10.4	10.0	10.4	10.7
Social security pension	11.3	10.6	10.4	10.0	10.4	10.7

[29] Stochastic forecasts are developed using the Monte Carlo simulation based on 1000 draws.

% of GDP	2013	2020	2030	2040	2050	2060
Old-age and early pensions	9.8	9.5	9.3	8.6	9.0	9.5
Other pensions (disability, survivors)	1.5	1.1	1.1	1.4	1.4	1.2
Health care	4.2	4.4	4.8	5.1	5.2	5.5
Long-term care (previously as a component of health care)	0.8	0.9	1.1	1.3	1.5	1.7
Education expenditure	4.4	4.1	4.1	3.8	3.9	4.3
Other age-related expenditures						
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0
Total revenue						
Of which: from pension contributions	6.8	7.3	7.5	7.7	7.7	7.7
Assumptions						
Labour productivity growth	2.8	3.1	2.3	1.9	1.8	1.5
Potential GDP growth	1.6	2.6	1.9	1.3	0.6	0.7
Participation rate males (aged 20-64)	80.2	82.4	82.8	81.5	81.8	82.2
Participation rate females (aged 20-64)	65.2	66.7	68.3	68.4	69.3	69.8
Total participation rate (aged 20-64)	72.7	74.5	75.6	75.0	75.6	76.1
Unemployment rate (aged 20-64)	10.3	8.5	8.4	7.3	7.3	7.3
Population aged 65+ over total population	14.5	18.4	22.7	25.1	29.9	33.0

Note: forecasts take into account the legal status as at 31 December 2014.
Source: European Commission, *The 2015 Ageing Report. Economic and budgetary projections for the EU-28 Member States (2013-2060)*, May 2015.

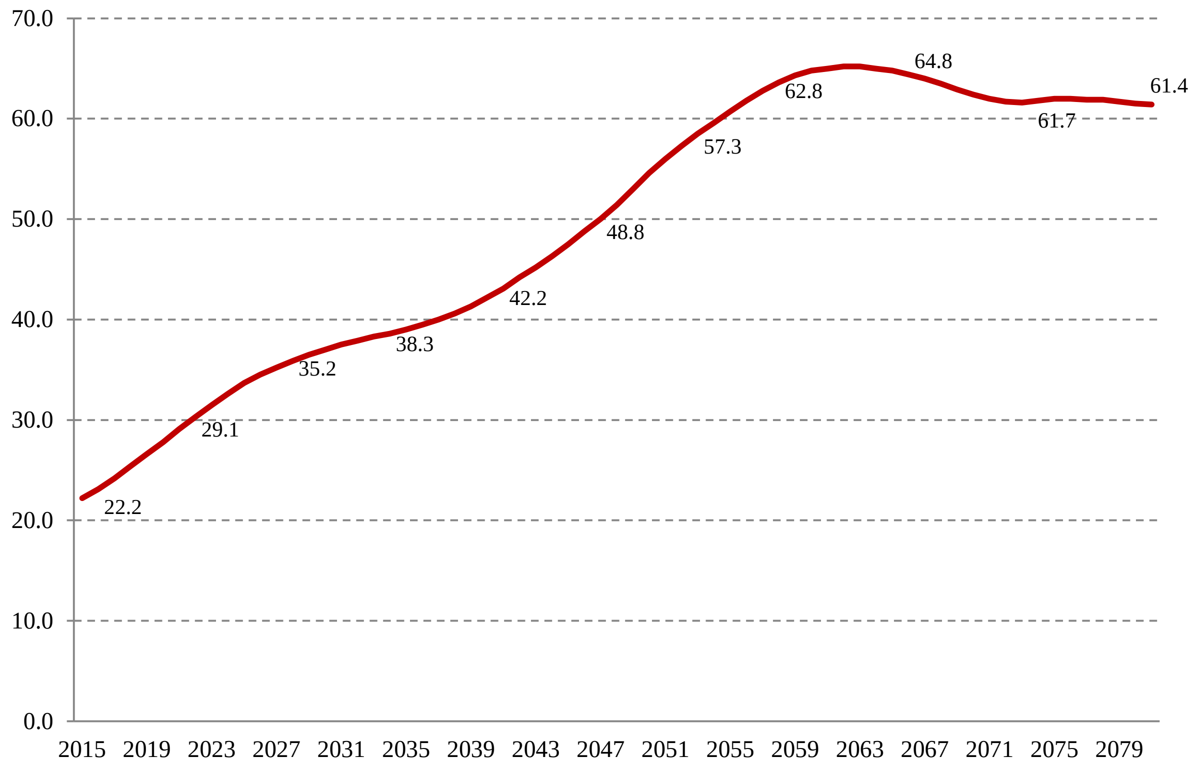
The effect of the restitution of the retirement age on deterioration of the balance of the general pension scheme will depend on the decision of the pensioners about effective retirement age. Despite the lowering of the statutory retirement age introduced in the system of defined contribution, the algorithm of determining the level of the retirement benefit promotes persons with a long-term insurance record and prefers the longest possible continuation of economic activity. The changes adopted leave the discretionary decision to persons eligible to obtain retirement benefits concerning the continuation of their economic activity and payment of contributions, which will translate into a higher retirement benefit in the future. This decision depends on many individual factors, both economic and health-related. Persons whose health condition is satisfactory will be still able to undertake economic activity despite reaching the statutory retirement age.

In terms of impact on the labour market, the effective age of retirement is the factor of key importance. In Poland, this effective age has increased significantly over the recent years (for women - from 56 years in 2004 to 60.7 years in 2015, for men - from 58.7 years in 2004 to 62.8 years in 2015), despite relatively minor changes in the statutory year. The available data indicate that in many countries, the effective age of the retirement exceeds the statutory age. Examples of countries where this difference exceeds three years on average for women and men include: New Zealand, Japan, Chile, Mexico and South Korea (OECD, data for 2014[30]). In South Korea, a record-holder in the OECD ranking, the effective age of retirement in 2014 reached 72.9 for men and 70.6 for women, compared to the statutory age enabling to retire without the reduction of the benefit due at a level of the age of 61. These data indicate that in Poland, a huge space exists to create such conditions on the labour market which will enable to extend the economic activity of Poles and it is not necessary to increase the statutory retirement age for this purpose.

[30] OECD, *Ageing and Employment Policies - Statistics on average effective age of retirement*, http://www.oecd.org/els/public-pensions/ageingandemploymentpolicies-statisticsonaverageeffectiveageofretirement.htm.

Demographic changes constitute one of the major challenges for the long-term sustainability of public finance in most European countries. Against that background, the current situation in Poland seems advantageous as Poland remains a country of relatively young people. On the other hand, it should be expected that the ageing population phenomenon observed in recent years will continue, which is caused by the extension of life expectancy, low fertility and the current age structure of the population. As a result, the old-age dependency ratio shall deteriorate, i.e. the relationship between the number of population at post-working age (65 and more) against the number of population at working age (i.e. aged 15-64), expressed as percentage. According to the Eurostat forecast of February 2017, this ratio will increase from 22.2% in 2015 to 61.4% in 2081 (cf. Figure 14).

Figure 14. Old-age dependency ratio in Poland in 2015-81



Source: Eurostat

Measures aimed at reducing the negative impact of demographic transformation on public finances comprise, inter alia, reducing expenditure associated with ageing of the population, including mainly through the reforms of pension systems introduced in the recent years. At present, works on the target form of the new solutions in the retirement system which were announced in the *Strategy* are in progress[31]. They comprise, in particular, the creation of a voluntary capital saving system and long-term investment products under the execution of the *Capital Accumulation Programme*.

Within the planned reconstruction of the operating model of open pension funds (OFE) and in order to improve effectiveness of functioning from the perspective of an OFE participant, it is planned to transfer 75% of OFE assets to Open Investment Funds in the framework of Individual Pension Security Accounts (IKZE). The remaining funds collected in the OFE (25%), mainly in the form of assets other than Polish shares, will be transferred to the Demographic Reserve Fund, with the simultaneous recording of those funds on subaccounts in ZUS (Social Insurance Institution). As of the

[31] Due to the foregoing reasons, the baseline scenario presented in the Programme does not contain effects of proposed changes in the pension system.

moment of effectiveness of the changes, a part of the pension contribution which is currently transferred to the OFE will be recorded on a subaccount in ZUS. This means, additional revenues in FUS (Social Insurance Fund) in a short term, whereas in a long-term, due to the nature of the Polish pension system (the system with defined contribution), the changes should be neutral for the pension system.

Moreover, under the *Capital Accumulation Programme*, establishment of so-called Employee Capital Plans (PPK) is planned, based on an automatic record for employees aged from 19 to 55. For employees aged over 55, a voluntary participation in the PPK is envisaged. At the same time, a possibility will exist for an employee to resign from participation in this scheme through submitting the declaration of withdrawal within 3 months. Successive covering of employers under the obligation to create PPK is envisaged.

The *Strategy* also assumes undertaking information and education measures to encourage the growth of savings, limiting of retirement privileges as well as development of incentives for employees to stay occupationally active.

Measures aimed at reducing the negative impact of demographic changes on public finances also consist in supporting fertility and migration. A set of pro-family measures in Poland includes, among others:

- parental benefits and the minimum maternity allowance in the amount of PLN 1000,
- tax deduction in the child tax credit,
- a mechanism for gradual withdrawal of family benefits for households with an income higher than the income threshold; and
- an increase in the amounts of family allowances (cf. also the entry in last year's *Programme*).

In April 2016, this catalogue was recently completed by the *Family 500 plus* programme, implemented under the *Act of 11 February 2016 on State aid in raising children* (Journal of Laws item 195, as amended).

The Act allows for the provision of child care benefit in the amount of PLN 500 per child under 18 years of age. The right to benefits is vested in the Polish citizens and foreigners on the basis of Community legislation and international agreements. The *Family 500 plus* programme assumes a personal benefit for the second and subsequent child in the family. It also provides the benefit for the first child, if the family income per capita does not exceed PLN 800 or 1200, when a family member is a child with a disability (i.e. possessing a decision on disability or decision on disability in moderate or severe degree).

The main objective of the Act is the economic support for the families bringing up children and enhancement of the incentives to make decisions about having children, especially the second and subsequent ones. The proposed solution shall also counteract child poverty, especially in families with many children. For this reason, the income from the child care benefits was excluded from the catalogue of the income taken into account while granting family benefits and social assistance benefits.

In 2016, as compared to 2015, approximately 12.9 thousand children were born (in 2015: 369.4 thousand, in 2016: 382.3 thousand). In accordance with its assumptions, the *Family 500 plus* programme will allow for accomplishing a very high variant of the *GUS demographic forecast* in the scope of fertility. It was expected that owing to the introduction of the child benefit, in 2016, 11.2 thousand children more will be born than in the high variant of the *GUS demographic forecast*. However, approximately 17 thousand children more were born - 5.8 thousand more than in the very high variant. It is worth emphasising that also in the years 2014-15 the number of births exceeded, although not significantly, the values assumed under the high variant.

If the very high variant of births continues in the coming years, the summarised growth in the number of births in the years 2016-17 will amount to approximately 278 thousand, whereas the number of births in the nearest years will follow the developments shown in the table below.

Table 7. Births in the years 2017-26, the high and very high variant (thousand)

Scenario	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
1. high	362.6	360.2	357.4	353.7	347.4	341.0	334.8	328.5	322.1	316.9
2. very high (result of *Family 500 plus*)	378.2	379.5	380.4	380.0	375.5	370.9	366.4	361.9	357.3	352.1
Difference: 2-1	**15.6**	**19.3**	**23.0**	**26.3**	**28.1**	**29.9**	**31.6**	**33.4**	**35.2**	**35.2**

Source: Annex no. 2 to the Assessment of Regulation Effects to the draft Act on State aid in raising children.

The child benefit will also affect the decline in the percentage of persons exposed to relative poverty by 3.7 percentage points (approximately 1.4 million persons)[32]. In addition, the *Family 500 plus* programme may reduce the percentage of children below 17 exposed to relative poverty by over 10 percentage points. (approximately 800 thousand children)[33]. The programme will have an impact on the improvement of situation mainly in families with many children (a decline of relative poverty from 35.8% to 9.0%, i.e. from the level of 675 thousand persons living in such families to 170 thousand), single parents (a decline from 27.6% to 13.1%, i.e. from the level of 179 thousand persons to 85 thousand) and families with two children (from 15.4% to 6.4%, i.e. from the level of 651 thousand to 269 thousand).

V.2. Contingent liabilities

Potential contingent liabilities on account of sureties and guarantees granted by general government in Poland reached 6.9% of GDP at the end of 2016, against 6.5% of GDP at the end of 2015 (in accordance with updated GDP for 2015 and preliminary estimated GDP in the fourth quarter of 2016). A significant share in this category was represented by sureties and guarantees granted by the State Treasury – at the end of 2016 they reached about 6.7% of GDP against 6.3% of GDP as of the end of 2015.

The State Treasury activity with regard to sureties and guarantees does not impose a significant risk to public finances. At the end of 2016, approximately 85% of contingent liabilities on account of sureties and guarantees granted by the State Treasury were classified as a low-risk group. The long-term risk ratio for the State Treasury sureties and guarantees portfolio decreased slightly to approx. 6.5%, as compared to 2015, when it reached the level of approx. 7%. Simultaneously, parallel to the growth in potential contingent liabilities on account of sureties and guarantees granted by the State Treasury, their increase in relation to GDP occurred. As in the previous year, that increase was mainly the result of a significant volume of guarantees granted for the support of infrastructure development.

As part of the surety and guarantee portfolio, the State Treasury guarantees given for the liabilities of the financial sector (excluding guarantees given to support the National Road Fund by Bank Gospodarstwa Krajowego) amounted to only approx. 0.1% of GDP as of the end of 2016, and did not comprise potential measures against the crisis.

In 2016, no guarantees were granted to the financial sector under the *Act of 12 February 2009 on granting support by the State Treasury to financial institutions* (Journal of Laws of 2016, item 1436) or the *Act of 12 February 2010 on recapitalisation of certain institutions and on governmental financial stability instruments* (Journal of Laws of 2016, item 2009, as amended).

[32] The simulation was performed on the data for 2014 – in accordance with it, the poverty would decrease from the level of 17.0% to 13.3%, i.e. from the 6.4 million persons to 5.0 million persons.
[33] The simulation was performed on the data for 2014 – in accordance with it, the poverty among children would decrease from the level of 22.3% in 2014 to the level of 10.5%, i.e. from the 1.5 million persons to 0.7 million persons.

Table 8. Contingent liabilities

% of GDP	2016
Public guarantees	6.9
Of which: linked to the financial sector*	0.1

Source: Ministry of Finance.

** Data on potential liabilities of other public finance sector entities on account of sureties and guarantees for the financial sector are not subject to reporting (only total potential liabilities are available). Therefore, the presented value of guarantees granted for financial sector liabilities refers to the State Treasury sureties and guarantees portfolio (excluding guarantees granted for supporting the KFD at BGK).*

VI. Quality of public finances

VI.1. Composition, efficiency and effectiveness of expenditure

The expenditure structure is influenced by systemic changes, in particular, solutions oriented to the support of inclusive growth through reduction of poverty and more effective distribution of monetary and non-monetary benefits (cf. chapter III and V). Changes in the expenditure policy for 2017 and subsequent years are carried out taking into account the *Strategy*.

The introduction of stabilizing expenditure rule (cf. Chapter III.4 and VII.1), which determines the maximum level of expenditure of almost the entire general government forced a change in approach to the budget process. The budgetary process currently focuses on the method of expenditure distribution instead of their level which is pre-determined, (calculated based on the algorithm).

The binding limit of expenditure is determined at an early stage of the budget process, whereas changes in expenditure covered by the scope of the rule (their increase or introduction of new categories of expenditure) are possible, provided, however – as in the expenditure benchmark – that important discretionary measures are taken up in the area of taxes or contributions, or appropriate adjustment of the level of other expenditure categories is made. By including the discretionary measures concerning taxes and contributions in the rule, any discretionary measures having a negative impact on the revenue are neutral to the balance of the sector. It changes the context of the analysis of structural measures in the area of taxes and contributions, which currently, diminishing or increasing the maximum amount of expenditure, automatically ensure sustainability of public finances. Works on introducing binding and indicative multiannual expenditure limits are ongoing (cf. Chapter VII.3).

In 2016, works started in 2014, aimed at institutionalising the public expenditure reviews, were continued, i.e. works allowing for systemic inclusion of expenditure reviews to the budget process. Since 2015, the Steering Committee for public expenditure reviews appointed by the Minister of Finance has been operating, which is a consultative and advisory body to the Minister of Finance on matters of reviews. The Committee's tasks include, in particular, the acceptance of programmes of public expenditure reviews and approving of conclusions and recommendations formulated during the reviews.

In 2016, spending reviews comprising, in particular, the following areas were performed:

- road programmes financed by the National Road Fund (excluding public-private partnership),
- indexation mechanisms and legal conditions determining the level of fixed expenditure, in particular, social and health expenses.

In the subsequent years, it is planned to conduct three to five expenditure reviews per year, which in the cycle of 3-4 years shall allow for covering with reviews most of the areas in which significant expenditures from public funds are incurred.

VI.2. Structure and efficiency of revenue systems

General government revenue in the forecast horizon will be determined by the economic situation and measures closing loopholes in the tax system. The most important implemented and planned measures in this area in the years 2017-18 are presented in the Annex to the *Programme*. The set of instruments supporting the effectiveness of tax collection presented in the Annex is an update and extension of the package of measures oriented to increasing the level of taxpayers' compliance with the tax obligations and combating tax fraud, presented in the last year's *Programme*. Measures aimed at increasing tax collection through ensuring the improvement of VAT compliance simultaneously respond to the recommendation of the Ecofin Council of 12 July 2016 [34] and are consistent with the horizontal approach undertaken at the Ecofin level [35].

[34] Cf. footnote 1.
[35] Cf. footnote 24.

Increasing value added tax collection and combating fraud associated with this tax will be the priority issue in the nearest years. Limiting the VAT gap, which is the main goal of the National Fiscal Administration, will be possible, in particular, through:

- SAF analyser – a computerised system supporting detection of invoices documenting fictitious activities based on monthly single audit files (SAF) sent by taxpayers to the tax authority, containing records of VAT purchase and sale;
- introduction of the obligation to provide the Head of the National Fiscal Administration with bank statements in electronic form for the purpose of fast identification of suspicious transactions and verification of consistency of declared revenues and costs with turnover on the bank account;
- implementation of the ICT system maintained by the clearing house (STIR) and the mechanism of analysing the risk of using the activity of banks and credit unions (SKOK) for criminal activities in the scope of VAT fraud - limiting the use of imperfections in information flow within the banking system by offenders participating in VAT fraud;
- introduction of a so-called split payment model - dividing the payment for goods supplied or services provided into the net amount which is paid by the purchaser to the account of the supplier or service provider and the amount of tax which is transferred directly to a separate VAT account, designed for payment of input VAT and liabilities due to VAT by the VAT payer to the tax office;
- enforcement of provisions introduced in 2016 under a so-called fuel package.

Amendments to the Gambling Act and establishment of a system for monitoring of road carriage of goods will also generate positive effects for the state budget. Amendments to the tax law, improvement of tax enforcement effectiveness, introducing tools of preventive and disciplinary nature, such as anti-avoidance clause, should also foster limiting the irregularities, change of tax payers' mentality and limitation of tax behaviours unfavourable for the state budget.

The financial effects (in cumulative terms) of measures presented in the said Annex in the years 2017-18 are estimated at over PLN 20 billion.

In the coming years, measures aimed at closing loopholes in the tax system will be oriented to limiting the tax gap by further PLN 6 billion in 2019 and by PLN 4 billion in 2020. Expected improvement in tax collection effectiveness of the National Fiscal Administration will play a key role. The improvement in tax collection and discouraging tax payers against undertaking actions aimed at tax avoidance should be also fostered by effective use of solutions implemented in the years 2017-18.

Accordingly, a gradual growth in tax revenues in relation to GDP is expected, to 22.0% in 2020 against 20.6% in 2016.

VII. Institutional features of public finances

VII.1. National budgetary rules

The objective of fiscal rules is to reduce the discretion in shaping the fiscal policy through imposing restrictions on the size of budget aggregates such as expenditure, revenues, deficit or public debt. Fiscal rules contribute to maintaining budget discipline, ensuring fiscal and macroeconomic stability as well as to maintaining (possibly reducing) the deficit of the public finance sector at a given level.

The fiscal framework in Poland is based on the set of rules. At the level of the public finance sector it is the debt rule, at the level of the general government - the stabilizing expenditure rule, and at the level of local government units – individual debt limits. The debt rule, whose main objective is to prevent public debt (calculated according to the Polish methodology) from breaching the threshold of 60% of the GDP is enshrined in the most important Act - the *Constitution of the Republic of Poland*, and the constitutional rule is supplemented with prudential thresholds defined in Article 86 of the *Public Finance Act* and the conditions of the correction mechanism of the stabilising expenditure rule defined in Article 112aa(4).

After exceeding the prudential thresholds defined in Article 86 of the *Public Finance Act*, the relevant sanctions apply, including the obligation of the Council of Ministers to submit the recovery and resolution programme aimed at reducing the amount of the state public debt and its relation to GDP to the Parliament, On the other hand, the objective of the stabilising expenditure rule (SER) is to ensure the stability of Polish public finance through stabilisation of the general government balance in mid-term, at the level of the Medium-Term Budgetary Objective (MTO).

This rule covers approx. 90% of the general government expenditure. The following expenditures are excluded from the rule: (1) financing from the budget of European funds or funds from non-repayable EU assistance, (2) units which do not have a capability to generate high deficits; and (3) units which were included into the scope of the general government in the years 2014-15, excluding the Bank Guarantee Fund (BFG), which was covered under the SER in 2015 due to its systemic nature.[36]

The amount of the expenditures is defined on the basis of a numeric formula provided in the Public Finance Act which stipulates that the SER amount grows, in principle, in accordance with the medium-term GDP growth rate [37] corrected in compliance with the automatic correction mechanism described below. The objective of ensuring the relevant flexibility of fiscal policy, i.e. the optimum ratio between the consolidation on the expenditure and revenue side, the expenditure amount shall include planned significant (exceeding 0.03% of GDP) and sustainable discretionary measures in the scope of taxes and contributions to social insurance within the meaning of *Regulation of the European Parliament and of the Council (EU) no. 549/2013 of 21 May 2013 on the European system of national and regional accounts in the European Union* (OJ L 174 of 26.06.2013, p. 1, as amended)

The automatic correction mechanism of the stabilising expenditure rules limits the growth rate of the expenditure amount in case of public finance imbalance. The imbalance was defined as exceeding the determined thresholds expressed in % of GDP by:

1) state public debt recalculated in accordance with Article 38a of the *Public Finance Act;* or

2) balance of the general government; or

3) sum of differences between the MTO and the general government balance.

[36] *Act of 22 July 2015 amending the Public Finance Act* (Journal of Laws item 1190).
[37] 8-year average of the real GDP growth rate multiplied by the medium-term NBP inflation target. The variables defined in such a manner enable to include the entire cyclical developments (structural approach) whose length in Poland is estimated as 8 years.

In case if an imbalance is found in public finance, i.e. if the general government deficit in the previous year exceeded 3% of GDP, the state public debt [38] exceeded 43% of GDP or 48% of GDP, or the cumulative deviation in the balance exceed +/- 6% of GDP – the growth rate of the amount of expenditures for the next year is reduced due to operation of the correction mechanism. This mechanism operates automatically and defines precisely the type of correction of the estimated expenditure amount, whereas a lower correction (by 1.5 percentage point) is not applied in so-called "bad time". Bad time means a situation when the projected next year's real GDP growth rate is lower by over 2 percentage points than the medium-term real GDP growth rate.

The application of the expenditure rule shall enable the fulfilment of the requirements of the preventive part of the *Stability and Growth Pact* related to MTO in a medium term. For this reason, the formula of the expenditure rule relies on the expenditure benchmark, in particular, in relation to the scale of adjustments in the correction mechanism.

Council Regulation no. 1466/97/EC of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies determines 0.5% of GDP as a reference value for the annual improvement of the structural balance for the euro area states and members of ERM2 following the path leading to MTO. States whose debt exceeds 60% of GDP should implement a higher adjustment. The Regulation does not define the reference value for non-euro area states and countries which do not participate in ERM2 striving to achieve the MTO, whose debt is lower than 60% of GDP. However, the correction expected by the European Commission also constitutes 0.5% of GDP per year [39].

The total general government expenditure, excluding the expenditure financed by funds of the non-repayable EU aid and EFTA, and after excluding the expenditure of units unable to generate high deficits, constitute approx. 1/3 of GDP on average. The foregoing implies that in order to achieve the required improvement of the structural balance by 0.5% of GDP, the adjustment by approx. 1.5 percentage point is required. Taking into account the foregoing, it was decided that the correction of the indicator of medium-term real GDP growth rate occurring when the state public debt is in the range (43%, 48%), and the general government balance (after including costs of the pension reform) is equal to or higher than 3% of GDP, amounted to 1.5 percentage point. In case the general government deficit (after including the costs of the pension reform) exceeds 3% of the GDP, or if the state public debt exceeds the level of 48% of GDP, the adjustment of the structural balance by 0.5% of the GDP is required. Due to this fact, it was proposed that the correction determined by the stabilising expenditure rule should amount to more than 1.5 percentage point, i.e. 2.0 percentage points in the situation of a serious public finance imbalance.

The aim of determining a legally binding limit of expenditure, the aforementioned amount of SER expenditure is reduced by projected expenditure of the National Health Fund, local government units, BFG and institutions defined in Article 139(2) of the *Public Finance Act* (including the chancellery of the Parliament and the President, NIK, common courts). In case of significant one-off and temporary measures on the revenue side foreseen in a given budgetary year (exceeding 0.03% of GDP), within the meaning of the *Council Regulation (EC) no. 1466/97/EC of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*, the maximum limit is increased by their forecast value. The value obtained in this way, constitutes so-called impassable limit of expenditure for approx. 2/3 of the general government.

[38] Calculated in accordance with Article 38a of the *Public Finance Act*, i.e. after conversion of liabilities in foreign currency to Polish zloty using the arithmetic mean of the average exchange rates of each of the foreign currencies announced by the National Bank of Poland and applicable on weekdays in the respective budget year, and after deduction of the amount of available funds for financing the borrowing needs of the state budget for the next financial year.

[39] Cf. European Commission, *Vade Mecum on the Stability and Growth Pact*, March 2017, the matrix of structural effort on the path towards the MTO presented on pp. 37–39, https://ec.europa.eu/info/sites/info/files/ip052_en_0.pdf

The provisions concerning the rule contained in the *Public Finance Act* shall not apply exclusively in extreme situations defined in the Act, such as: martial law, state of emergency or natural disaster on the entire territory of the Republic of Poland.

Consequently, the stabilising expenditure rule harmonises national and European frameworks of fiscal policy, increasing the stability of budgetary policy. Contrary to the debt rule, it imposes restrictions on public finance on an annual basis, not only after exceeding the threshold, and allows for pursuing the anti-cyclical fiscal policy. The correction mechanism, due to including of the medium-term budgetary objective constitutes an element of monitoring of the medium-term public finance stability.

VII.2. Independent fiscal institutions

The Polish fiscal framework, apart from the system of fiscal rules discussed in Chapter VII.1, comprises a system of independent fiscal institutions with well-established position and reputation. The Supreme Audit Office (NIK), whose establishment dates back to 7 February 1919, plays the central role in the network of fiscal institutions operating in Poland. Up till now, despite changing provisions of individual acts of law, the NIK is the chief state control authority acting pursuant to the *Constitution of the Republic of Poland, the Act of 2 December 1994 on the Supreme Audit Office* (Journal of Laws of 2017 item 524) and internal acts. *The Constitution of the Republic of Poland* of 2 April 1997 places the NIK as the leading, functionally separated, professional state control authority and, among others, provides this authority with the constitutional warranty of independence from executive authorities as well as regulates the scope of control powers of the NIK.

It is worth stressing that the system of independent fiscal institutions, including specifically defined tasks in the scope of oversight of the budgetary policy, operated in Poland long before the requirements introduced under *Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States* (OJ L 306 of 23.11.2011, p. 41) (hereinafter referred to as the *Directive*), in relation to the role of independent fiscal institutions in the budgetary process, which comprise:

- an *ex ante* control of the fiscal policy compliance with domestic and EU fiscal rules;
- an *ex ante* assessment of macroeconomic and budgetary forecasts;
- an *ex post* assessment of compliance with the fiscal rules.

Moreover, the *Directive* defines that in organisational terms, fiscal institutions should be financially and operationally independent from the government.

Within the process of implementation of the *Directive*, which was implemented by Poland in 2013, a detailed assessment of the compliance of the Polish fiscal framework with the requirements of the *Directive* was performed, as regards the role of fiscal institutions in the budgetary process. Below, a detailed discussion is presented about the measures and practice functioning in Poland to address the requirements, set in the EU law, for independent fiscal institutions in non-euro area Member States.

An *ex ante* assessment of macroeconomic and budgetary forecasts and an *ex ante* control of the fiscal policy compliance with domestic and EU fiscal rules

In Poland, one of the key roles in conducting an *ex ante* assessment of macroeconomic and budgetary forecasts and control of fiscal policy compliance with the fiscal rules is played by the Monetary Policy Council (MPC), a body of the independent National Bank of Poland (NBP), empowered under the *Constitution of the Republic of Poland*. Pursuant to Article 23(1)(2) of the *Act of 29 August 1997 on the National Bank of Poland* (Journal of Laws of 2013, item 908, as amended) The President of the NBP, on behalf of the MPC, presents the opinion on the draft Budget Act to the Council of Ministers and the Minister of Finance. The opinion of the MPC is published and made available to the Parliamentary Commission of Public Finance (to Sejm – the lower chamber of the Parliament), during their discussion on the draft Budget Act.

In its opinion, the MPC compares the macroeconomic and budgetary assumptions of the draft Budget Act for the subsequent year with the latest NBP forecasts prepared by the Economic Analysis Department (formerly: the Economic Institute). NBP forecasts provide basis for MPC decisions, are officially published and presented at regular seminars with economists representing the banking sector. In its opinion, the MPC also evaluates the application of the stabilising expenditure rule in the draft Budget Act, including the assessment of the credibility of forecasts used for calculating the rule. It is worth stressing that, as indicated in Chapter III.4, the Polish expenditure rule contains only one forecast variable, used for the calculation of the expenditure level , i.e. the forecast of the real GDP growth for the current and future year. Moreover, this forecast together with the real GDP growth for the last 6 years, provides basis for calculation of the medium-term GDP growth in fixed prices for the last 8 years, which means that the weight of the forecast constitutes only 1/4 of the said indicator. On the other hand, in the nominal part of the formula of the rule, direct reference to the inflation target determined by the MPC was applied.

Another institution engaged in the control and assessment of forecasts and macroeconomic assumptions used in the budgetary process is the Supreme Audit Office (NIK) which, pursuant to Article 3 *of the Act of 2 December 1994 on the Supreme Audit Office* audits the execution of the state budget. During the audit of the preparation and execution of the Budget Act, NIK pays special attention to the method of application of the stabilising expenditure rule in the budget process. This audit is a basis for the analysis of preparation of the state budget, which includes, since 2015, the application of the stabilising expenditure rule during the budget planning (Article 7(1)(1) of the *Act of 2 December 1994 on the Supreme Audit Office*). This analysis is submitted by NIK to the Parliament. In practice, the control of application of the stabilising expenditure rule comprises a detailed analysis of all assumptions adopted at the stage of estimation of the expenditure level, covering both the forecast of macroeconomic indicators and the catalogue of discretionary measures considered in a given budgetary year and the automatic correction mechanism of the rule.

The Social Dialogue Council (RDS), which is the main body of the trilateral dialogue comprising independent institutions (trade unions and employer organisations) is another body responsible for an *ex ante* control of the budgetary process. On the basis of article 16(1) of the *Act of 24 July 2015 on the Social Dialogue Council and other social dialogue institutions* (Journal of Laws item 1240), by 10 May of each year, the government provides the RDS with the preliminary macroeconomic forecast, prepared for the draft Budget Act for the following year. Moreover, in accordance with Article 17(1) of the aforementioned Act, by 15 June each year the government submits the explanatory memorandum of the draft Budget Act for the following year to the RDS for the purpose of issuing opinion by the employee and employer parties. On the other hand, in accordance with Article 18(1), no later than 30 days prior to the submission of the draft Budget Act to the Parliament, the government submits the draft Budget Act for the following year to the RDS for their opinion. The positions of social partners within the RDS, including those related to macroeconomic and budgetary forecasts, or the MPC, or the members of the Council of Ministers are subject to clarification and agreement during the meeting of the Committee of the Council of Ministers and the Council of Ministers (cf. Resolution no. 190 of the Council of Ministers of 29 October 2013 - *By-laws of the Council of Ministers* (Official Gazette “Monitor Polski” of 2016, item 1006, as amended).

Besides measures arising from the legal regulations, there are non-formalised rules in the budgetary process, such as:

— the Parliamentary Commission of Public Finance orders opinions of independent experts concerning the draft Budget Act for the following year, which comprise, among others, the assessment of reality of forecasts contained in the draft Budget Act and the application of the stabilising expenditure rule. Subsequently, those opinions are presented to MPs and senators and sent to the Ministry of Finance;

— external assumptions used in the budgetary process are based on the European Commission forecasts.

It should be also underlined that the form of the stabilising expenditure rule precludes the need to involve independent fiscal institutions in the process of calculation of expenditure lrvrl or functioning of the correction mechanism, since non-observable parameters (such as, e.g. the output gap) are not used in the rule, and correction due to imbalances of public finance is automatic and defined on the basis of last year's level of the general government deficit and public debt to GDP ratio, i.e. data officially published by the Central Statistical Office [40] and the Minister of Finance[41].

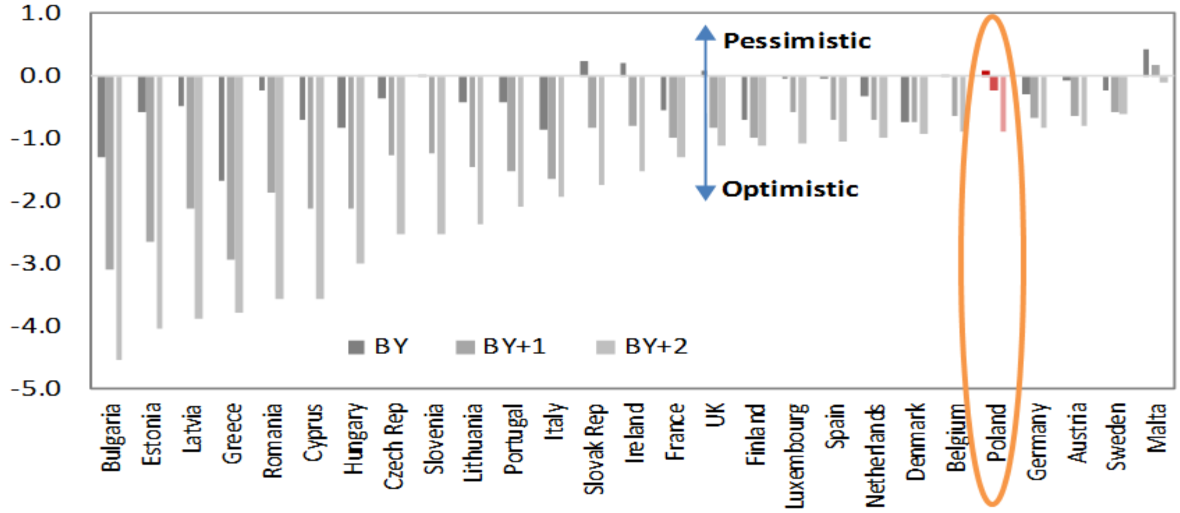
***An ex post* assessment of compliance with the fiscal rules**

In accordance with Article 2 and Article 3 of the *Act on the Supreme Audit Office*, NIK controls the operations of governmental institutions, NBP and other organisational units, including, in particular, the execution of the Budget Act. NIK performs *ex post* assessment of the compliance with the fiscal rules (stabilising expenditure rule and public debt rules). In accordance with Article 6a *of the Public Finance Act*, the detailed description of calculating the amount of expenditure and the expenditure limit within the stabilising expenditure rule is presented in the justification to the Budget Act. Moreover, in accordance with Article 182(1) *of the Public Finance Act*, the execution of the Budget Act is subject to control by the Parliament (the Sejm) and the government presents information on the execution of the expenditure amount and the expenditure limit in the report on the execution of the Budget Act (Article 182(4)(6) of the *Public Finance Act*).

At the same time, the *ex post* assessment performed by the NIK is broader than the requirements of the *Directive*. The NIK also performs an *ex post* assessment of macroeconomic forecasts, in particular analysis of potential discrepancies between the forecast and the execution, and forecasts of other institutions, including the International Monetary Fund, the European Commission and the OECD. It is worth to underline that according to the analyses of the International Monetary Fund and the European Commission, the GDP forecasts in Poland belong to the most accurate forecasts in the EU Member States [42]. In accordance with Chart 15 which compares historical average errors of macroeconomic forecasts in the horizon of a budgetary year (BY), of a year following the budgetary year (BY+1) and the consecutive year (BY+2) for 27 EU Member States (excluding Croatia) throughout the recent 15 years, in Poland, similar to all other countries, certain optimism occurs in forecasts for years BY+1 and BY+2, however, it is relatively low in case of Poland.

[40] Cf. Article 38b *of the Public Finance Act.*
[41] Cf. Article 38a *of the Public Finance Act.*
[42] Cf. Chart II.5 in the European Commission document *The 2015 Stability and Convergence Programmes. An Overview*" (https://ec.europa.eu/info/sites/info/files/file_import/ip002_en_2.pdf) and Table I.A 1.7 in the European Commission document *The 2016 Stability and Convergence Programmes. An Overview and Implications for the Euro Area Fiscal Stance*" (http://ec.europa.eu/info/sites/info/files/file_import/ip034_en_2.pdf).

Figure 15. Average real GDP forecast errors (2000–2015, percent)



Source: International Monetary Fund, *Poland. Developing a Medium-Term Budget Framework*, March 2017.

Bearing in mind the above and the fact that EU law does not require the tasks of independent fiscal institutions to be centralized within a single institution, it is important to recognize that the Polish system fulfills the EU requirements for fiscal councils, which creation was recommended to Poland by the Ecofin Council.

The advantage of the current architecture of fiscal framework in Poland, including the distribution of tasks of the “model” fiscal council, among various bodies is the fact that those tasks are executed through independent institutions of defined position and reliability. Both the NIK and the MPC are recognisable and respected. The establishing of a new institution and assigning the tasks of the fiscal council would thus not contribute to the enhancement of reliability of Polish fiscal framework, since it would mean delegating the aforementioned tasks to a completely new institution without a well-established reputation.

Moreover, among the tasks of the “model” fiscal council defined pursuant to *Regulation of the European Parliament and of the Council (EU) no. 473/2013 of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area*, binding for the euro area Member States, only monitoring of a long-term sustainability of public finance is not assigned to the tasks of any of the aforementioned institutions. It should be noted that this task has not been implemented by the majority of fiscal councils in EU and its introduction is not recommended to any of the euro area Member States, many of which have higher risks for the public finance stability than Poland.

Nevertheless, considering the fact that fiscal institutions mean not only the bodies but also the set of formal or informal rules determining functioning of the economy, certain elements of public finance stability monitoring can be indicated which are present in Poland:

— each draft act of law adopted by the Council of Ministers must be accompanied by its explanatory memorandum and assessment of effects whose scope is not clearly defined in the law (Article 50 *of the Public Finance Act*). Among others, it is mandatory to define the impact of a given act of law on public finance within a maximum period of 10 years;

— the Social Insurance Institution (ZUS) prepares every three years a long-term forecast (up to 2060) of revenues and expenditures of the pension fund (pension expenditures represent the most important factor of a long-term sustainability of public finance) and an annual medium-term forecast of revenues and expenditures of the Social Insurance Fund (Article 61 of the *Act of 13*

October 1998 on the social insurance system – Journal of Laws of 2016, item 963, as amended). Subsequently, the document, including the opinion of an external actuary, is presented by ZUS to the Council of Ministers and made publicly available[43]. The forecast provides basis for management of finances of the Demographic Reserve Fund (FRD) which is a reserve fund of the pension fund;

- the NIK controls not only the preparation and execution of budget acts but also other activities where public funds are involved (Article 2 and Article 3 of the *Act on the Supreme Audit Office*);
- the correction mechanism of the stabilising expenditure rule serves as a tool for monitoring of the sustainability of public finance, since it automatically adjusts the rate of expenditure growth to the public finance stance (the correction of the rate of expenditure growth depends, inter alia, on whether the nominal deficit is higher than 3% of GDP and/or the state public debt exceeds the thresholds of 43% of GDP / 48% of GDP and on the scale of cumulative deviation against the MTO)[44];
- at the level of local government units, Regional Accounting Chambers exercise *ex ante* and *ex post* control over the financial situation of the local government units (Article 1(2) of the *Act of 7 October 1992 on Regional Accounting Chambers* (Journal of Laws of 2016 item 561)).
- local government units are obliged to prepare on an annual basis a multiannual financial forecast comprising revenues, expenditures and the balance, indicating the planned allocation of a surplus or the method of financing a deficit and the amount of debt, indicating the method of financing its repayment. The multiannual financial forecast shall include a budgetary year and at least three consecutive years, however, the forecast of the debt amount shall be prepared for a period for which any liabilities were incurred or are planned to be incurred (Article 226-232 of the *Public Finance Act*). In order to ensure the reliability of the aforementioned forecasts, the Ministry of Finance drafts and publishes on its website the *Guidelines concerning the macroeconomic assumptions for the needs of multiannual financial forecasts of local government units*[45], with the forecasting horizon of 30 years;
- the National Bank of Poland is involved in the analysis of the budgetary policy and results of its works are publicly available[46].

Summing up, it should be stated that no economic and legal premises exist to replace fiscal institutions operating in Poland by a newly established fiscal council.

VII.3. Budgetary procedures, including public finance statistical governance

In 2016, the Council of Ministers adopted the *Assumptions of the budgetary system reform* (hereinafter referred to as the *Assumptions*). The document contains a diagnosis of the current budgetary system, including, in the context of the requirements related to the medium-term budgetary framework and the budgetary process arising from the *Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States*.

The *Assumptions* define the conceptual framework of a new budgetary system. The changes will tend towards the implementation of mechanisms of conducting and coordination of the responsible budgetary policy, enabling management of expenditure and the fiscal space[47] in a multiannual perspective, taking into account strategic objectives and development priorities of the state.

[43] Cf. http://bip.zus.pl/finanse-zus-i-fus/prognozy
[44] Cf. Article 112aa(4) *of the Public Finance Act.*
[45] Cf. *Guidelines concerning the macroeconomic assumptions for the needs of multiannual financial forecasts of local government units*
[46] http://www.nbp.pl/home.aspx?f=/publikacje/publikacje.html
[47] The difference between the amount of the budgetary limit arising from the SER and budgetary liabilities arising from the continuation of executed policies or programmes.

The envisaged changes will contribute to strengthening of the national budgetary framework, inter alia, by integration of multiannual and annual planning, redefinition of the role of the Council of Ministers, the Minister of Finance and other members of the Council of Ministers in the budgetary process, introduction of a new structure of the state budget and budget classification, improvement of data collection systems as well as institutionalisation and inclusion of spending reviews and other instruments supporting the efficiency of public spending into the budgetary process.

In 2017, measures aimed at preparation of legislative solutions will be continued, with the aim of implementing the directional changes defined in the *Assumptions*. In view of the stability of public finances as well as the complex and comprehensive nature of the changes planned, they will be phased-in in a multiannual perspective, using the support of international institutions. In particular, Poland will strive to continue the technical cooperation launched in 2016 with the World Bank and the International Monetary Fund. Other support options are also considered, including the aid offered under the EU *Structural Reform Support Programme*.

Since September 2014, the data on the general government are prepared in accordance with *Regulation of the European Parliament and the Council (EU) no. 549/2013 of 21 May 2013 on the European System of National and Regional Accounts in the European Union* (so-called ESA2010). In 2016, Eurostat published a new edition of the *Deficit and Debt Manual. Introduction of ESA2010* (so-called MDGG). Accordingly, last year the works of the Group for the General Government Statistics focused on the correct implementation of the ESA2010 principles. For this purpose, visits of Eurostat experts to Poland were organised (16-17 November 2016 and 9-20 March 2017).

As a result of the ongoing works, in 2016 the decision was made to classify subsequent units into the general government. They include, inter alia: the Fund for Protection of Guaranteed Assets, , Borrowers' Support Fund, Fund for the Support of Public Benefit Organisations, National Media Council, Zarządca Rozliczeń S.A., a number of captive financial institutions, where attention should be drawn to Towarzystwo Finansowe Silesia Sp. z o.o. The scope of the general government was also extended in connection with the change in the classification of public units in liquidation as well as the change in the approach to calculating the value of the *market/non-market* indicator regarding net interest.

As part of the fulfilment of the requirements of the *Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States*, [48] the following data are subject to publication on the website of the Ministry of Finance:

- monthly data (with a one month delay) concerning the central government subsector and social security subsector,
- quarterly data (with a one quarter delay) - concerning the local government subsector,
- data concerning contingent liabilities of potentially material impact on the budgetary situation.

Additionally, in line the conclusions of the European Commission report prepared on the basis of the aforementioned *Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States*, Eurostat conducts works going beyond the scope of public statistics. Their objective is to develop and implement European Public Sector Accounting Standards (EPSAS). These standards shall require all general government to implement harmonised solutions in the area of financial reporting. In addition, consolidation of financial statements of those entities at a level of the entire sector shall be required.

Differences between the currently binding Polish regulations related to accounting in the public sector and International Public Sector Accounting Standards (IPSAS) (on which the European solutions will be based) have been initially identified at the Ministry of Finance. At present, measures adopted in countries which implemented IPSAS are analysed. The plan for the development of institutional and

[48] Version in Polish: http://www.mf.gov.pl/ministerstwo-finansow/dzialalnosc/finanse-publiczne/dane-fiskalne-na-potrzeby-nadzoru-budzetowego-ue
Version in English: http://www.mf.gov.pl/en/ministry-of-finance/fiscal-data-for-eu-budgetary-surveillance

regulatory solutions enabling drawing up the consolidated financial statements of the country are also being prepared. The objective of the ongoing works is the implementation of the *Strategy* which specifies the consolidated financial statements of the country as one of the elements supporting increasing of the transparency and effectiveness of public expenditure.

Table annex

Table 9. Macroeconomic prospects

	ESA Code	2016 Level	2016 Rate of change	2017 Rate of change	2018 Rate of change	2019 Rate of change	2020 Rate of change
1. Real GDP (PLN billion)	B1*g	1 847.5	2.7	3.6	3.8	3.9	3.9
2. Nominal GDP (PLN billion)	B1*g	1 851.2	2.9	4.7	6.1	6.2	6.4
Componenta of real GDP							
3. Private consumption expenditure	P.3	1 091.5	3.8	4.0	3.5	3.5	3.5
4. Government consumption expenditure	P.3	332.9	2.8	3.5	1.3	1.6	1.5
5. Gross fixed capital formation	P.51	332.8	-7.9	7.2	7.6	7.3	7.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52+ P.53	28.8	1.6	1.0	0.9	0.8	0.8
7. Exports of goods and services	P.6	971.4	9.0	7.1	6.4	6.0	6.0
8. Import of goods and services	P.7	909.9	8.9	7.7	6.9	6.1	6.1
Contributions to real GDP growth							
9. Final domestic demand			1.1	4.3	3.7	3.8	3.7
10. Changes in inventories and net acquisition of valuables	P.52+ P.53		1.2	-0.5	0.0	0.0	0.0
11. External balance of goods and services	B.11		0.3	-0.1	0.0	0.1	0.1

The levels of real volumes are expressed in constatnt prices of 2015.

Table 10. Price developments

	ESA Code	2016 Level	2016 Rate of change	2017 Rate of change	2018 Rate of change	2019 Rate of change	2020 Rate of change
1. GDP deflator			0.3	1.0	2.3	2.3	2.5
2. Private consumption deflator			-0.6	1.8	2.3	2.3	2.5
3. HICP			-0.2	1.8	2.3	2.3	2.5
3a. CPI			-0.6	1.8	2.3	2.3	2.5
4. Public consumption deflator			-0.5	1.8	2.3	2.3	2.5
5. Investment deflator			0.5	1.3	2.3	2.3	2.5
6. Export price deflator (goods and services)			-0.4	0.4	2.0	2.0	2.0
7. Import price deflator (goods and services)			-1.6	1.5	2.0	2.0	2.0

Table 11. Labour market developments

	ESA Code	2016 Level	2016 Rate of change	2017 Rate of change	2018 Rate of change	2019 Rate of change	2020 Rate of change
1. Employment (thousands of persons)*		16196	0.7	0.5	0.4	0.4	0.3
2. Employment (hours worked)**		-	-	-	-	-	-
3. Unemployment rate (%)***		6.2	6.2	5.7	5.0	4.4	4.0
4. Labour productivity (PLN thousand)****		115.0	2.1	3.1	3.4	3.5	3.6
5. Labour productivity (PLN thousand)*****		-	-	-	-	-	-
6. Compensation of employees (PLN billion)	D.1	686.5	2.8	4.4	4.7	5.2	5.3
7. Compensation per employee (PLN thousand)		53.5	1.4	3.9	4.3	4.8	5.0

* Average employment based on LFS (aged 15 and older).
** National accounts definition.
*** Harmonised definition, Eurostat, levels.
**** Real GDP per person employed.
***** Real GDP per hour worked.

Table 12. Sectoral balances

% of GDP	ESA Code	2016	2017	2018	2019	2020
1. Net lending / borrowing vis-à-vis the rest of the world*	B.9	0.8	0.3	1.8	1.7	1.3
of which: - balance on goods and services		3.7	3.1	2.9	2.9	2.9
- balance of primary incomes and transfers		-4.0	-3.9	-3.9	-3.9	-4.0
- capital account		1.1	1.2	2.7	2.7	2.4
2. Net lending/borrowing of the private sector	B.9	3.2	3.2	4.3	3.7	2.5
3. Net lending/borrowing of general government	EDP B.9	-2.4	-2.9	-2.5	-2.0	-1.2
4. Statistical discrepancies				optional	optional	optional

* Balances level in line with the balance of payments statistics. Net lending/borrowing vis-a-vis the rest of the world is equal to sum of capital and current account..

Table 13. Basic assumptions

	2016	2017	2018	2019	2020
Short-term interest rate (annual average)	1.7	1.8	2.6	2.8	3.4
Long-term interest rate (annual average)	3.0	3.8	4.4	4.4	4.8
Nominal effective exchange rate*	4.3	-2.1	-0.4	0.0	0.0
Exchange rate vis-à-vis the EUR (annual average)	4.36	4.27	4.25	4.25	4.25
World excluding EU, GDP growth**	3.2	3.7	3.9	-	-
EU GDP growth**	1.9	1.8	1.8	1.8	1.8
Growth of relevant foreign export markets/*****	3.5	3.9	4.1	4.3	4.3
World import volumes **	1.7	3.3	3.8	-	-
Oil prices (Brent, USD/barrel) **	44.8	56.4	56.9	-	-

* Nominal growth of EUR/PLN exchange rate.
** Source:: *European Commission*, *European Economic Forecast. Winter* 2017, February 2017. (years 2016-18).
*** EU import as an indicator of the foreign export markets.

Table 14. General governments budgetary prospects

	ESA Code	2016 PLN million	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP
Net lending (EDP B9) by sub-sector							
1. General government	S.13	-44 669	-2.4	-2.9	-2.5	-2.0	-1.2
2. Central government	S.1311	-48091	-2.6	-4.9*	-2.2	-1.9	-1.3
3. State government	S.1312						
4. Local government	S.1313	4 523	0.2	0.0	0.0	0.0	0.2
5. Social security funds	S.1314	-1 101	-0.1	1.9*	-0.3	-0.1	-0.1
General government							
6. Total revenue	TR	719 242	38.9	42.4*	40.8	40.7	40.1
7. Total expenditure	TE	763 911	41.3	45.3*	43.4	42.7	41.3
8. Net lending/borrowing	EDPB.9	-44 669	-2.4	-2.9	-2.5	-2.0	-1.2
9. Interest expenditure	EDPD.41	31 587	1.7	1.7	1.8	1.8	1.8
10. Primary balance		-13 082	-0.7	-1.2	-0.7	-0.2	0.6
11. One-off and other temporary measures		-460	0.0	0.0	0.0	0.0	0.0

	ESA Code	2016 PLN million	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP
Selected components of revenue							
12. Total taxes (=12a+12b+12c)		381 048	20.6	21.1	21.7	21.9	22.0
12a. Taxes on production and imports	D.2	248 326	13.4	13.9	14.4	14.4	14.4
12b. Current taxes on income, wealth, etc	D.5	132 442	7.2	7.3	7.3	7.5	7.6
12c. Capital taxes	D.91	280	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	258 375	14.0	14.1	13.8	13.7	13.6
14. Property income	D.4	10 742	0.6	0.5	0.6	0.7	0.7
15. Other		69 077	3.7	6.6*	4.7	4.5	3.9
16. Total revenue	TR	719 242	38.9	42.4*	40.8	40.7	40.1
Tax burden (D.2+D.5+D.61+D.91-D.995)		635 519	34.3	35.1	35.4	35.4	35.4
Selected components of expenditure							
17 Compensation of employees + intermediate consumption	D1+P2	297 434	16.1	16.1	15.7	15.4	15.0
17a. Compensation of employees	D.1	190 441	10.3	10.1	9.7	9.4	9.1
17b. Intermediate consumption	P.2	106 993	5.8	6.0	6.0	5.9	5.9
18. Social payments (18=18a+18b)		318 580	17.2	17.6	17.6	17.4	17.2
***of which* Unemployment benefits**		2 934	0.2	0.1	0.1	0.1	0.1
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	34 687	1.9	1.9	1.9	1.9	1.9
18b. Social transfers other than in kind	D.62	283 893	15.3	15.6	15.7	15.5	15.3
19. Interest expenditure	EDP D.41	31 587	1.7	1.7	1.8	1.8	1.8
20. Subsidies	D.3	9 765	0.5	0.6	0.6	0.6	0.6
21. Gross fixed capital formation	P.51	61 358	3.3	4.5	5.0	4.9	4.2
22. Capital transfers	D.9	8 585	0.5	2.5*	0.4	0.4	0.4
23. Other		36 602	2.0	2.3	2.3	2.2	2.1
24=7. Total expenditure	TE	763 911	41.3	45.3*	43.4	42.7	41.3
p.m.: Government consumption (nominal)	P.3	330 924	17.9	18.0	17.5	17.2	16.8

Source: Ministry of Finance, Central Statistical Ofice.

** Data includes the impact of a ne-off transaction due to the redemption of loans granted to the Social Insurance Fund (FUS) from the state budget in the years 2009–14. The redemption at a level of approx. PLN 39.1 billion (i.e. approx. 2% of GDP) was taken into account in forecasts for 2017 on the FUS revenues side, as a capital transfer (D.9) and, at the same level, on the side of the state budget expenditure, also in the category of capital transfer (D.9). Due to the consolidation, the aforementioned redemption shall not affect the general government balance (ESA2010).*

Table 15. No-policy change projections

	2016 PLN million	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP
1. Total revenue at unchanged policies	719 242	38.9	41.7	40.4	40.4	39.9
2. Total expenditure at unchanged policies	-	-	-	-	-	-

Table 16. Amounts to be excluded from the expenditure benchmark

	2016 PLN million	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	15 365	0.8	1.8	1.9	1.8	1.3
1a. of which investment fully matched by EU funds revenue	12 552	0.7	1.5	1.6	1.6	1.1
2. Cyclical unemployment benefit expenditure	-732	0.0	0.0	0.0	0.0	0.0
3. Effect of discretionary revenue measures	11 251	0.6	0.7	0.4	0.3	0.2
4. Revenue increases mandated by law						

Table 17. General government expenditure by function

% of GDP	COFOG code	2015	2020
1. General public services	1	4.9	4.7
2. Defence*	2	1.6	1.6
3. Public order and safety	3	2.2	2.0
4. Economic affairs	4	4.6	4.5
5. Environmental protection	5	0.6	0.6
6. Housing and community amenities	6	0.7	0.8
7. Health	7	4.7	4.7
8. Recreation, culture and religion	8	1.1	1.0
9. Education	9	5.2	4.8
10. Social protection	10	15.9	16.7
11. Total expenditure (=item 7=24 in Table 14)	TE	41.5	41.3

Source: Ministry of Finance, Central Statistical Office.

** The basic difference between military expenditure recorded according to the European methodology (COFOG function: national defence) and defence expenditure arising from national regulations (statutory ratio of financing national defence expenditure in % of GDP; currently 2% of GDP) is the method of recognising the expenditure on retirement benefits and pensions for uniformed services (0.4% of GDP in 2016). According to the European methodology, social expenditure is not treated as national defence expenditure (recognised in "social security" function), whereas according to the national methodology, expenditure on social benefits for uniformed services are taken into account for calculating the statutory ratio of expenditure for national defence.*

Note: the forecast of expenditure structure includes measures, at a relevant level of detail and a significant degree of conceptual and legislative advancement.

Currently, works are ongoing with the purpose of increasing the level of financing of defence expenditure to 2.5% of (current) GDP in 2030 (2.2% of GDP in 2020); systemic changes are also under development oriented to gradual growth of expenditure on health protection in relation to GDP in the subsequent years. Depending on the final shape of those solutions and decisions of the Council of Ministers, the structure of expenditure presented in the table may be subject to changes, maintaining the total limit compliant with the stabilising expenditure rule.

Measures increasing tax compliance in the years 2017–18

SUMMARY

This document presents the most important measures implemented and planned in the area of tax compliance and effectiveness of tax administration in the years 2017-18. They will implement the Strategy in which the need of regulatory and institutional solutions was indicated, aimed at tightening the tax system and counteracting the depletion of state revenues. At the same time, the measures aimed at increasing tax collection through ensuring the improvement of compliance with the provisions concerning value added tax respond to the recommendation of Ecofin Council of 12 July 2016.[49]

Increasing value added tax collection and combating fraud associated with this tax is the priority issue. Amendments to the tax law, improvement of tax enforcement effectiveness, introducing tools of preventive and disciplinary nature should also indirectly limit the irregularities, change of tax payers' mentality and limit tax behaviours unfavourable for the state budget.

Reduction of the tax gap in VAT will be possible, among others, due to the use of the **JPK analyser**, i.e. an ICT system supporting detection of invoices documenting fictitious operations. Preventing the use of so-called empty invoices to deduct input tax from such documents will translate into limitation of fraud and abuse occurring in case of VAT.

The planned measures also cover **the implementation of the ICT system and the mechanism (STIR) of analysing the risk of using the activity of banks and credit unions (SKOK)** for purposes associated with crime, in particular, VAT fraud by organised criminal groups and related crime. The objective of the planned legislative solution is to limit imperfections in information flow within the banking system by offenders participating in VAT fraud.

The introduction of so-called **split payment model** will be used to close loopholes in payments of the value added tax. The main assumption of this mechanism is dividing the payment for goods supplied or services provided into the net amount which is paid by the purchaser to the account of the supplier or service provider and the amount of tax which is transferred directly to a separate VAT account. From this account, the tax payer could pay input VAT shown in invoices it receives from its suppliers and it could pay its tax liability due to this tax to the tax office. This model, considered as one of solutions to counteract tax fraud and abuse will impede, or even prevent occurrence of abuse already at the stage of the transaction itself. At the same time, it will provide for better transparency of VAT settlements and impede transfer of untaxed money abroad. Introduction of the reduced limit of cash transactions between enterprises up to PLN 15 thousand will additionally facilitate covering a considerable number of transactions in non-cash form under this model.

Creating of the **monitoring system for the road carriage of goods** will have an impact on increasing the effectiveness of control focusing on goods sensitive for the state budget revenue. The implementation of the system will increase proceeds from value added tax and excise duty, discipline tax payers to recognise taxed transactions. It will also provide fiscal administration with access to current information on performed taxed activities in the scope of these goods.

The aforementioned measures constitute the next stage of systemic works, undertaken on a broad scale in order to seal the collection of value added tax. The following significant, **already introduced solutions** can be indicated:

- modification of settlement of VAT due to intra-Community purchase of motor fuels (so-called fuel package), a tool in effective action against criminals importing fuels from other European Union countries;
- premises to refuse registration effective as of the beginning of 2017 and more precise conditions of tax payer's deleting from the register of VAT tax payers;

[49] *Council Recommendation of 12 July 2016 on the National Reform Programme of Poland for 2016 and delivering a Council opinion on the Convergence Programme of Poland for 2016*

- changes in terms of joint and several liability of tax payers and the guarantee deposit;
- modified reporting obligations.

The basic budgetary effect associated with the functioning of **the anti-avoidance clause** results from impacts of preventive nature. Through its provisions and practice, the clause determines the limits of permitted tax optimisation. The application of the mechanism of refusing the issuance of tax interpretation will indicate to tax payers what kind of optimisation is considered as prohibited tax optimisation.

The **reform of income taxes** comprising the separation of remuneration taxation, economic activity, regardless of its legal form and taxation of capital gains, is at the stage of analytical works. **Making data on basic tax categories available to public opinion**, in relation to the group of the **largest enterprises** is also planned. It will enable social understanding and control of corporate income tax payers.

A key factor influencing the enhancement of fiscal administration operating effectiveness is the **establishment of the National Fiscal Administration**, through merging the Customs Service, tax administration and fiscal control. This measure should contribute to reducing of the tax fraud scale and, as a consequence, to the increase in revenues.

Solutions contained in the Act on information exchange with other states will enable **strengthening of international administrative cooperation** in combating tax avoidance and aggressive tax planning. Without limitations, the obligation of automatic exchange of information on tax rulings and advance pricing agreements (APA) between member states, envisaged in this area, will allow for more effective control of such actions of tax payers which result in a lower level of artificially overestimated revenue.

The table presents financial consequences of legislative and institutional measures presented hereunder on a cumulative basis.

Revenue (PLN bilion)	2017	2018
min.	11.8	16.3
max.	14.1	22.4

Source: Estimates of the Ministry of Finance.

In the coming years, measures will be oriented towards **limiting the tax gap by further PLN 6 billion in 2019 and by PLN 4 billion in 2020**. The expected improvement in tax collection effectiveness within the National Fiscal Administration will play a key role: improving the enforcement process of tax liabilities as well as enforcing legal solutions addressed to closing the loopholes in the tax system. It will enable detection and combating fraud, abuse and other crime resulting in noticeable depletion of public finance and, simultaneously, significantly affecting the financial security of the state.

The improvement in tax collection and discouraging tax payers against undertaking actions aimed at tax avoidance should be also fostered by **effective use of solutions implemented in the years 2017-18.** The termination of the several stage digitalisation processes of tax information exchange between economic operators and tax authorities (SAF), the implementation of the ICT system and mechanism of *pre*, *in* and *post* risk analysis (STIR), will limit irregularities related, first of all, to introducing into the economy of VAT invoices which do not reflect real economic events and criminal activity associated with VAT fraud. Functioning of the aforementioned split payment model will also counteract tax fraud and abuse

List of measures

1. LIMITING THE TAX GAP IN CONNECTION WITH VAT FRAUD AND COUNTERACTING TAX AVOIDANCE

It is foreseen that the following measures will enable to accomplish the determined goal:

1. tax payer's obligation to submit the VAT record of purchase and sale (SAF) to the tax authority on a monthly basis,
2. analysis and identification of threats associated with using the activity of banks and credit unions for criminal activities associated with crime in the scope of VAT fraud (STIR),
3. introduction of so-called split payment mechanism.

1.1. Tax payer's obligation to submit the VAT record of purchase and sale to the tax authority on a monthly basis

Objective:

Limiting fraud and abuse in VAT through preventing the use of invoices documenting fictitious activities (so-called empty invoices) in order to deduct input tax. The measures undertaken in this scope directly regulate tax obligations of tax payers and simultaneously aim at closing the loopholes in the tax system.

Tools:

I. Act of 13 May 2016 on amending the Tax Ordinance Act and other acts (Journal of Laws item 846) introducing the obligation of tax payers keeping tax books with the use of computer programmes to submit the VAT record of purchase and sale (JPK_VAT) to tax authorities on a monthly basis.

II. The SAF (Standard Audit File) register - a computerised system enabling the tax payers sending files containing the VAT record of purchase and sale (JPK_VAT) and collecting the files. The SAF register is maintained by the Head of National Fiscal Administration. It contains the record of VAT purchase and sale of individual tax payers, whereas:

1. in 2017, it contains VAT records of approximately 110,000 tax payers (large, medium and small entrepreneurs),

2. in 2018, it will contain VAT records of approximately 1,630,000 tax payers (all VAT tax payers).

The SAF register has the following functionalities:

1. review of files of a tax payer and its customers available to tax authorities,

2. indicating the occurrence of entities deleted from the VAT register in Poland and in selected EU countries among the tax payer's customers.

III. SAF analyser – a computerised system supporting detection of invoices documenting fictitious activities. It enables automatic identification of measures consisting in using invoices issued by existing tax payers, documenting fictitious activities, or issued by entities which are not VAT payers for the purpose of reducing tax liability which is not compliant with the law, or overestimation of the VAT return amount. Moreover, the SAF analyser allows for identification of irregularities consisting in incompatibility of VAT records with the VAT declaration.

An important functionality is automatic sending by electronic means of the report on irregularities found to the Tax Office and to the tax payer, including the request for correction of the VAT declaration.

SAF analyser:

1. allows Tax Offices for fast identification of so-called empty invoices, preventing underestimation of tax liability or overestimation of the return amount with their use,

2. enables fast identification of fraudulent customers by fair tax payers,
3. prevents fraudulent tax payers from effective introducing of invoices documenting fictitious activities into trading, or using such invoices in order to commit a tax fraud.

Addressee:

All payers of VAT and bodies of the National Fiscal Administration

Responsible body:

Minister of Development and Finance and Head of National Fiscal Administration

Deadlines:

The implementation of the measure will commence on 1 July 2017. The table below presents legal regulations to enter into force in the years 2017-18.

Legal regulations / It tools	**2017**	**2018**
The obligation of tax payers keeping tax books with the use of computer programmes to submit the VAT record of purchase and sale to tax authorities on a monthly basis.	Large, medium and small entrepreneurs - approximately 110,000 tax payers.	All VAT payers – approximately 1.63 million of tax payers.
The obligation to keep records of VAT purchase and sale, containing data used for identification of individual transactions, including the number through which the customer is identified for tax or value added tax purposes.	All VAT payers – approximately 1.63 million of tax payers.	All VAT payers – approximately 1.63 million of tax payers.
SAF Register	Large, medium and small entrepreneurs – approximately 110 entities.	All VAT payers – approximately 1.63 million of tax payers.
SAF analyser	SAF analyser will enable identification of measures consisting in using invoices documenting fictitious transactions between small, medium and large tax payers.	SAF analyser will enable identification of measures consisting in using invoices documenting fictitious transactions between all VAT payers.

IV. JPK_WB – introduction of the obligation to provide the Head of the National Fiscal Administration with bank statements in electronic form (JPK_WB) for the purpose of fast identification of suspicious transactions and verification of consistency of declared revenues and costs with turnover on the bank account. This solution will enable the analysis of transactions performed by tax payers in accrual and cash terms and it will allow for:

1. Detecting irregularities concerning using of false VAT invoices and resulting from crime of Missing Trader type and the first payer of Buffer type,
2. Identification of "fast payments" which indicate a high risk of fraud in the area of value added tax.

Addressee:

Large, medium and small entrepreneurs (in total, approximately 80,000 entrepreneurs) and the National Fiscal Administration bodies

Responsible body:

Minister of Development and Finance and Head of National Fiscal Administration

Deadline:

Proposed date of entry into force - 1 September 2017

1.2. Analysis and identification of threats associated with using the activity of banks and credit unions for criminal activities associated with fiscal fraud in the scope of VAT

Objective:

Reduction of the tax gap associated with the crime of VAT fraud.

Tools:

Draft act on amending certain acts in order to counteract using the financial sector for fiscal fraud provides:

- introduction of the ICT system maintained by the clearing house (STIR), designed for data processing in order to counteract using the activity of banks and credit unions for purposes associated with crime, including risk analysis as well as providing information and the request to block the account. This system will be equipped with technical solutions ensuring safe and accurate performance of activities, in particular, the security of legally protected secret, including the required level of security, access control, authorisation and separation of information exchange channels,
- automatic processing in the ICT system of Krajowa Izba Rozliczeniowa S.A. of publicly available data concerning entrepreneurs for the purpose of risk analysis of using the activity of banks or credit unions for committing crime, in particular, VAT fraud, by organised criminal groups and related crime, as well as automatic submission of information on results of risk analysis,
- the obligation of banks and credit unions to submit to Krajowa Izba Rozliczeniowa S.A. of specific information constituting bank secret or professional secret of SKOK related to entrepreneurs in order to have it perform the risk analysis,
- providing results of risk analysis by Krajowa Izba Rozliczeniowa S.A. Based on statutory criteria, only to entities defined in the Act.

Addressee:

Domestic banks (including cooperative banks), branches of credit institutions, branches of foreign institutions, credit unions, Krajowa Izba Rozliczeniowa S.A., Krajowa Spółdzielcza Kasa Oszczędnościowo-Kredytowa, bodies of National Fiscal Administration

Responsible body:

Minister of Development and Finance

Deadline:

The project was published on 20 March this year in the Public Information Bulletin of the Governmental Centre of Legislation. The entry into force of the Act is foreseen in the first half of 2017.

1.3 Introduction of so-called split payment mechanism

Objective:

Ensuring greater stability of proceeds from value added tax as well as counteracting the avoidance of payment of this tax.

Tools:

Introduction of so-called split payment mechanism. The main assumption of this mechanism is dividing the payment for goods supplied or services provided into the net amount which is paid by the purchaser to the account of the supplier or service provider and the amount of tax which is transferred directly to a separate VAT account. From this separate account, the tax payer could pay input VAT shown in invoices it receives from its suppliers and it could pay its tax liability due to this tax to the tax office. Moreover, the tax payer could receive earlier returns of surplus of input VAT to the VAT account.

This model is considered as one of solutions to counteract tax fraud and abuse. The reason is that it enables tax authorities to monitor and block funds on VAT bank accounts, eliminating the risk of disappearance of tax payers, including VAT disbursed to them by customers and not paid. In principle, this model shall impede, or even prevent occurrence of fraud already at the stage of the transaction itself. At the same time, it will provide for better transparency of VAT settlements and impede transfer of untaxed money abroad.

Addressee:

VAT taxpayers

Responsible body:

Minister of Development and Finance

Deadline:

01/01/2018

<u>Estimated financial effect for measures described in sections 1.1-1.3:</u>

The estimated financial effects arise from the planned result of implemented legal and IT tools allowing for reducing the VAT gap through (1) preventing deduction of input tax from invoices documenting fictitious activities, (2) limiting the scale of tax fraud by criminal groups, and (3) eliminating the risk of tax payers' disappearance without settlement of tax liabilities to the state.

The financial effects of the aforementioned measures will result from the amendments to the tax law which will directly affect tax payers' behaviour through elimination of unfair practices. Moreover, the tools planned are of preventive and disciplinary nature.

The estimated level of the budgetary gap in the scope of VAT fraud ranges from PLN 10 to PLN 15 billion per year. For the needs of calculations it was assumed that this value amounts to approx. PLN 15.31 billion [50]. The financial effects were estimated based on the following assumptions:

in 2017:

a. pessimistic variant: reducing the gap by 15% (approximately PLN 2.3 billion),
b. expected variant: reducing the gap by 20% (approximately PLN 3.06 billion),
c. optimistic variant: reducing the gap by 30% (approximately PLN 4.59 billion);

[50] In accordance with the results of the audit performed by the Supreme Audit Office, in 2015, the fiscal control authorities detected fictitious invoices for the amount of PLN 81.9 billion. *Information on results of the audit "Counteracting introducing invoices documenting fictitious activities into the economy"*, NIK, Warsaw, 2016, p. 9. Such invoices were used to deduct input tax in the amount of PLN 15.31 billion

in 2018:

a. pessimistic variant: reducing the gap by 25% (approximately PLN 3.83 billion),

b. expected variant: reducing the gap by 40% (approximately PLN 6.13 billion),

c. optimistic variant: reducing the gap by 50% (approximately PLN 7.66 billion).

Revenue change year to year (PLN million)	2017	2018
min	2 297	3 829
expected change	3 063	6 126
max	4 594	7 657

2. CLOSING LOOPHOLES IN THE VAT SYSTEM BASED ON CURRENT REGULATIONS

The following measures will enable the implementation of the goal set:

1. sealing of VAT collection in relation to fuels imported from other EU Member States through introduction of so-called fuel package,

2. enforcing other amended regulations aimed at closing the loopholes in VAT and the system of its collection through limiting fraud, counteracting fraud and abuse.

2.1. Sealing of VAT collection in relation to fuels imported from other EU Member States through introduction of so-called fuel package

Tools:

Modification of the settlement rules of value added tax due to inter-Community purchase of motor fuels, as a result of which, inter alia:

— the obligation to pay the tax due to inter-Community purchase of motor fuels arises, in principle, within 5 days following the moment of introducing the fuel into the country,

— the right to deduct the tax due to inter-Community purchase of motor fuels arises upon maturity of the output tax,

— *the output tax paid in a given settlement period (the advance payment for tax within the meaning of Article 206 of* Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax *(OJ L 347 of 11.12.2006, p. 1, as amended) due to inter-Community purchase of fuel will respectively reduce the payable output tax or increase the amount of surplus of the input tax over the refundable output tax, or will be carried forward to the next settlement period,*

— in the case of inter-Community purchase of motor fuels outside the procedure of suspension of excise duty, in principle, the tax payment obligation arises immediately, i.e. at the moment of movement on the territory of the country,

— the obligation of submitting monthly declarations concerning due tax amounts related to the inter-Community purchase of motor fuels.

Addressee:

VAT taxpayers

Responsible body:

Minister of Development and Finance

Deadline:

1 August 2016 (19 July 2016 with respect to the publication of fuel prices for VAT purposes) – *Act of 7 July 2016 amending the Act on value added tax and certain other acts* (Journal of Laws item 1052 as amended).

Revenue change year to year (PLN million)	2017	2018
min		
only direct effects		
max	2500	
only direct effects	2500	

2.2. Enforcing other amended regulations aimed at closing the loopholes in value added tax and the system of its collection through limiting fraud, counteracting fraud and abuse

The expected effect is the increase of budgetary proceeds and recovery of principles of fair market competition through the elimination of unfair entities from the economy.

Tools:

1) The amendment to the provisions of the *Act on value added tax*, comprising, among others:

— counteracting VAT fraud in “VAT carousels”, which requires reviewing of the entire chain of trading in specific goods,

— extension of the application of so-called reversed charge mechanism,

— change of the rules of VAT refund within 25 days,

— limiting the application of quarterly VAT settlements,

— modification of solutions regarding joint and several liability and the guarantee deposit, including the extension of joint and several liability to a representative of an entity starting economic activity,

— regulation of prerequisites determining the lack of registration of an entity as a VAT payer and deleting a some other from the register of VAT payers,

— introducing tax sanctions for unreliable VAT settlement, including a tax sanction at a level of 100% in relation to taxpayers committing fraud, including those deducting tax from so-called empty invoices. The proposed sanctions are mainly of preventive nature.

Addressee:

VAT taxpayers

Responsible body:

Minister of Development and Finance

Deadline:

1 January 2017 – *Act of 1 December 2016 on amending the Act on Value Added Tax and other acts (Journal* of Laws item 2024).

2) Waiver of exemption in case of services constituting a part of insurance service provided by third parties to insurance undertakings, as well as the application of the pro-EU interpretation in relation to services constituting an element of the financial service.

Addressee:

VAT taxpayers

Responsible body:

Minister of Development and Finance

Deadline:

Act *of 1 December 2016 on amending the Act on Value Added Tax and other acts* (Journal of Laws, item 2024) waives as of 1 July 2017 sections 13 and 14 in Article 43 of the *Act of 11 March 2004 on value added tax* (Journal of Laws of 2016, item 710, as amended).

Estimated financial effect for measures described in sections 2.1-2.2:

Revenue change year to year (PLN million)	2017	2018
min		
only direct effects		
max	3 663	-512
only direct effects	3 663	-512

3. ESTABLISHMENT OF A SYSTEM FOR MONITORING OF ROAD CARRIAGE OF GOODS

Objective:

Closing the loophole in the tax system through collection of data on carriages of selected “sensitive” goods in connection with their supply to the territory of the country, intra-Community supply, Intra-Community acquisition, export and import and carriage across the territory of the country. The fact of functioning of the register and including the GPS localiser at the next stage, during the actual carriage of goods will discipline taxpayers (economic operators) and entities carrying goods to and across the territory of Poland to recognise taxable transactions, inter alia, value added tax taxable transactions and in the case of excise goods, also the excise duty taxable transactions, which will increase tax revenues and revenues in the fuel duty.

Tools:

The register will be kept in the ICT system by the Head of the National Fiscal Administration. The provision of data related to taxable activities towards certain goods will be associated with submission of the transfer declaration by the obligated persons as well as automatically - with the collection of geolocalisation data sent by GPS localisers. Control services will have an access to the data from the system on the road, in order to target inspections at undeclared carriage.

Addressee:

Entities conducting economic activity, participating in trading in “sensitive” goods indicated in the Act and the regulation issued thereunder as well as carriers and drivers of transport means.

Responsible body:

Minister of Development and Finance

Deadline:

Act of 9 March 2017 on the monitoring system for the road transport of goods (Journal of Laws item 708); entry into force on 18 April 2017. The draft Act stipulates adding GPS localisers to the system (the planned entry into force depends on the position of the European Commission related to the assessment of technical provisions contained in the draft). The effects of the regulations introduced will also occur in the subsequent years.

Estimated financial effect:

The regulations proposed shall have a positive impact on the revenue side of the state budget and reduce the shadow economy, particularly in the scope of depletion in the value added tax. Due to the fact that the extent of the shadow economy is based on estimates, it was assumed that for three sectors, i.e. fuel, alcohol and tobacco industries, in the value added tax and, where applicable, in the fuel duty, it amounts to PLN 11 billion per year, therefore, an increase in effectiveness by only 10% will contribute to reducing the shadow economy by approx. PLN 1 billion per year.

Revenue change year to year (PLN million)	2017	2018
min	330	1067
only direct effects		
max	330	1067
only direct effects		

4. INTRODUCTION OF THE ANTI-AVOIDANCE RULE

Goals:

- eliminating activities undertaken by taxpayers which demonstrate artificiality, non-compliance with the economic reality in which they operate;
- determining, through its provisions and practice, the limits of acceptable tax optimisation;
- ensuring equal treatment of taxpayers engaged in economic activities.

Tools:

Amending the *Act - Tax Code* and some other acts.

Addressee:

Entities conducting business activity and participating in business activity and deriving profits from it (ownership of shares, stocks, management).

Responsible body:

Head of the National Fiscal Administration

Deadline:

Act of 13 May 2016 on amending the Act - the Tax Code and some other acts, entry into force on 15 July 2016

Revenue change year to year (PLN million)	2017	2018
min	2750	50
only direct effects	50	50
max	10920	50
only direct effects	50	50

5. CLOSING LOOPHOLES IN THE INCOME TAX SYSTEM

Goals:

- enforcing regulations that will eliminate the interpretation doubts, which could result in avoidance of tax on certain incomes;

- limiting the application of certain tax preferences for transactions performed exclusively or mainly for the purpose of obtaining a tax advantage (without justified economic reasons);
- changing the provisions used in the tax optimisation schemes applied by taxpayers.

Tools:

Amendment to the *Act on Personal Income Tax and the Act on Corporate Income Tax.*

Addressee:

Non-resident taxpayers of income taxes, receiving income in the territory of the Republic of Poland, taxpayers of income taxes making an in-kind contribution to capital companies in a form other than the enterprise or its organized part, the taxpayers of these taxes having shares (stocks) subject to “cancellation” in connection with company transformation processes, as well as taxpayers participating in the share (stock) exchange transactions.

Responsible body:

Minister of Development and Finance

Deadline:

Act of 5 September 2016 on amending the Act on Personal Income Tax and the Act on Corporate Income Tax (Journal of Laws item 1550), entry into force on 1 January 2017 (excluding Article 7 which entered into force on 28 September 2016).

Revenue change year to year (PLN million)	2017	2018
min		
only direct effects		
max	277	11
only direct effects	277	11

6. INCREASING OF THE FISCAL ADMINISTRATION EFFICIENCY

Goals:

- radical reduction of tax fraud;
- increasing the efficiency of tax and customs duties collection;
- increasing the revenues as a result of reducing the tax gap;
- increasing the level of voluntary tax compliance.

Tools:

Implementation of the National Fiscal Administration created through the merger of the Customs Service, tax administration and fiscal control, which will enable:

- centralising tax collection in a single authority - the tax office;
- introducing a customs and tax inspection - it is a new type of inspection performed by heads of customs and tax offices. This inspection is so-called hard control; its basic task is detecting and combating of irregularities and broad-scale fraud, abuse and other offence resulting in a significant depletion in public finance and, at the same time, significantly affecting the financial security system of the state. The customs and tax inspection will deal, inter alia, with the activity of organised criminal groups, tax carrousels resulting in VAT fraud, etc.;
- introducing additional powers to perform so-called operational and exploratory activities to be used for:

- combating tax and customs fraud generating vast losses for the state budget, in particular, in the scope associated with undue VAT refund fraud (tax carousels) and foreign trading in goods, excise duty, gambling tax;
- combating corruption offences committed by persons employed or serving in KAS.

Within the operational and exploratory activities in relation to entities controlled or entities towards which a justified suspicion of committing a criminal act or a fiscal offence exists, the officers of the Customs and Fiscal Service will be, among others, able to:

— acquire, collect, process and use information containing personal data, information on income, turnover, assets and property rights, billings and some other mailing and Internet data;

— conduct observation in public places and register the image and sound;

— apply to the court for ordering the operational control, including wiretapping;

— perform controlled purchases and sales.

Addressee:

The effects of implementation of the task apply to the entire economy.

Responsible body:

Minister of Development and Finance.

Deadline:

1 March 2017.

7. INTERNATIONAL COOPERATION

7.1. Automatic exchange of tax information

Objective:

Acquiring of information from EU Member States and cooperating states concerning:

— financial accounts held by Polish residents in foreign financial institutions;

— cross-border tax rulings and advance pricing agreements;

— units included in a group of entities

and their use in procedures oriented to combating tax avoidance and concealment of income.

Tools:

Act of 9 March 2017 on the exchange of tax information with other states (Journal of Laws item 648) implementing *Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC (OJ L 64 of 11.03.2011, p. 1, as amended)*

Addressee:

Head of National Fiscal Administration and bodies of the National Fiscal Administration

Responsible body:

Minister of Development and Finance

Deadline:

The Act entered into force on 4 April 2017; some provisions, including those related to automatic exchange of financial account information in tax matters shall enter into force on 1 May 2017

7.2. Implementation of EU regulations in the scope of counteracting tax avoidance practices

Objective:

Implementation of Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (so-called ATAD) into the domestic legal order. Measures in the scope of combating the erosion of the tax base and transfer of profits should discourage the use of tax avoidance practices and contribute to the fair and effective taxation.

Tools:

The amendment to the *Act on corporate income tax* in the scope of: limiting a possibility to deduct interest, rules related to controlled foreign companies, rules counteracting discrepancies in qualification of hybrid structures and taxation of unrealised capital gains in case of the transfer of assets, tax residence or permanent establishment.

Addressee:

CIT payers undertaking optimisation measures to be counteracted by solutions envisaged in the Directive

Responsible body:

Minister of Development and Finance

Deadline:

Conceptual works on the draft act are in progress, before its entering to the register of legislative works of the Council of Ministers. The implementation of a part of solutions is scheduled at the end of 2017. The deadline for implementation of the directive: 31 December 2018.