REPUBLIC OF POLAND

CONVERGENCE PROGRAMME

2014 UPDATE

Warsaw, April 2014

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Summary

The annual update of the *Convergence Programme* (hereafter referred to as the *Programme*) presents medium-term forecasts for Poland's economy and public finances. The document has been prepared in accordance with the guidelines on the format and content of stability and convergence programmes of the European Union Member States.

For the first time, the *Programme* constitutes a part of the *Multiannual Financial Plan of the State* (MFPS), developed pursuant to the *Public Finance Act*. The MFPS shall successively provide basis for the preparation of the draft Budget Act for 2015.

The current *Programme* update 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 recommendations formulated on the basis of the NRP analysis of 2013.[1] Both the *Programme* and the NRP will be submitted to the European Commission and the Council in April, within the framework of the European Semester. The Council recommendations issued on the basis of the assessment of the two programmes should be taken into account before taking key decisions on the budget for next year.

As in 2013, the Council Opinion on this *Programme* as well as Council recommendations on the NRP of 2014 will be discussed by the Polish Parliament.

I. Overall policy framework and objectives

I.1. Fiscal policy in the EU context

In 2009 the Ecofin Council (i.e. Economic and Finance Ministers of the EU Member States) established the existence of an excessive deficit in Poland. At that time it recommended that the deficit be brought below 3% of GDP in 2012 at the latest, among others by a reduction of the structural deficit (the so-called fiscal effort) by at least 1¼ percentage points of GDP on average between 2010 and 2012.

The estimates presented in the *Programme* of April 2013 indicated that the nominal general government deficit had decreased to 3.9% of GDP in 2012 (vs. 5% of GDP in 2011). However, it was by 1 percentage point of GDP worse than assumed in the *Programme* of 2012. A marked deterioration of the economic situation in Poland's external environment followed by a slowdown in domestic economic activity was a key factor explaining the non-achievement of the 2012 budgetary target. As a result of that slowdown, the government revenue was much lower than planned.

On the other hand, the average annual improvement of the structural balance in 2010-12 (1.4 percentage points of GDP[2]) was higher than recommended by the Council. Nevertheless, the level of the nominal deficit exceeding the reference value of 3% of GDP indicated that the excessive deficit procedure could not be abrogated. Consequently, in June 2013, the Ecofin Council, evaluating positively the effectiveness of the measures undertaken by Poland so far with the purpose of the deficit reduction, postponed the deadline for elimination of the excessive deficit by 2 years, i.e. until 2014.[3]

The *Stability and Growth Pact* requires countries subject to the excessive deficit procedure to provide the EU institutions with and publish reports on measures undertaken in connection with the Ecofin Council

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[1] *Council Recommendation of 9 July 2013 on the National Reform Programme 2013 of Poland and delivering a Council opinion on the Convergence Programme of Poland, 2012-2016,* available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:217:0063:0066:PL:PDF

[2] The estimate in accordance with the forecast applicable at that time and the methodology used by the European Commission (cf. chapter III.5).

[3] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-07_council/2013-06-21_pl_126-7_council_en.pdf

recommendations. In the report of October 2013[4] Poland estimated that the nominal deficit would increase in 2013, irrespective of consolidation measures, to 4.8% of GDP. It was stressed that the growth of the deficit results almost entirely from the deterioration of cyclical conditions, the economic growth structure and associated factors determining the decline in government revenue. Considering the impact of fiscal consolidation on the economic growth, it was recognised that a reduction of the deficit in 2013 to the level of 3.6% of GDP defined in the Ecofin Council recommendation would be strongly procyclical. Consequently, it would affect economic growth prospects and pose a significant risk of recession, an even deeper downturn of tax revenue and a continued increase in the general government deficit. At the same time, the report presented measures taken in order to limit the deficit growth, such as in particular the amendment to the state budget for 2013 that reduced the expenditure growth by 0.5% of GDP.

The said report foresaw the achievement of a one-off government surplus of 4.6% of GDP in 2014, as well as a sustainable correction of the excessive deficit to 3% of GDP in 2015. In November 2013 the European Commission recognised[5], based on that report and its latest forecasts, that Poland had not taken effective action to implement the Council recommendation of June. It was also stated that a reduction of the deficit to below 3% of the GDP in the horizon defined by the Ecofin Council would require additional structural measures in 2014 corresponding to 1.6% of GDP[6]. Such a high annual structural effort would be much more significant than the improvement of the structural deficit previously recommended by the Ecofin Council (at least 1¼ percentage points of GDP on average between 2010 and 2012, and 1.3% of GDP for 2013), although the general government deficit was much lower than in 2009 and the government debt remained below the threshold of 60% to GDP. Moreover, the elimination of the excessive deficit in 2014 would result in a considerable reduction of the GDP growth rate that was already significantly below the potential growth rate.

Taking into account those circumstances, the European Commission found it necessary to define a new deadline for the correction of the excessive deficit. As a consequence, the Ecofin Council adopted new recommendation for Poland on 10 December 2013[7], postponing the deadline for bringing an end to the excessive deficit situation to 2015. In the new recommendation, the headline deficit targets for Poland in the period 2013-2015 were defined as nominal deficits of: 4.8% of GDP, 3.9% of GDP and 2.8% of GDP, respectively (excluding the impact of the assets transfer from the open pension funds to the Social insurance Fund). The Ecofin Council also stated that the achievement of the budgetary targets would require an improvement in the structural balance (i.e. this part of the nominal deficit the government may directly influence through the policy implemented) by 1% of GDP in 2014 and 1.2% GDP in the following year[8]. As compared to the European Commission's Autumn forecast[9] this would imply a need of Poland taking additional structural measures of 0.4% of GDP in 2014 and 1% of GDP in 2015.

Furthermore, the Ecofin Council recommended that Poland should:

- improve the quality of public finances, in particular through minimising cuts in growth-enhancing infrastructure investments, a careful review of social expenditures and their efficiency;
- improve tax compliance and increase the efficiency of tax administration;
- make the institutional framework of public finances more binding and transparent, including through adjusting the definitions used in national accounting to the European System of National and Regional Accounts (ESA)

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[4] Available on the website of the Ministry of Finance at: [Information on measures undertaken by Poland in order to implement the recommendations of the Council pursuant to art. 126.7 of the Treaty on the Functioning of the European Union of 21 June 2013]

[5] *Commission Staff Working Document Analysis of the budgetary situation in Poland following the adoption of the Council Recommendation to Poland of 21 June 2013 with a view to bringing an end to the situation of an excessive deficit,* available at http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/other_documents/2013-11-15_pl_communication_swd_pl.pdf

[6] The estimate in accordance with the forecast applicable at that time and the methodology used by the European Commission (cf. chapter III.5).

[7] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0906:FIN:PL:HTML

[8] The estimate in accordance with the forecast applicable at that time and the methodology used by the European Commission (cf. chapter III.5).

[9] http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee7_en.pdf

standards and ensuring sufficiently broad coverage, improving intra-annual monitoring of budget execution and ensuring an effective and timely monitoring of compliance with the permanent expenditure rule, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities.

The current update of the *Programme* contains information on measures taken by Poland in response to the Council recommendation of 10 December last year (cf. chapters III, VI, and VII). The assessment of the effectiveness of actions taken to eliminate the excessive deficit is, on the other hand, performed by the Ecofin Council based on analyses of the European Commission.

The forecasts of the European Commission published in February this year[10] indicate that Poland will achieve its budgetary targets for 2013-14. The estimated nominal deficit in 2013 (4.4% of GDP) is lower than recommended by the Ecofin Council, whereas the deficit forecast for the current year (3.8% of GDP, excluding the impact of the assets transfer from the open pension funds) is better than the level recommended by the Council. On the other hand, the deficit projected for 2015 (3.5% of GDP) is significantly above the deficit target. In the report of 15 April this year[11] Poland, in accordance with the said recommendation, informed the Ecofin Council and the European Commission in detail of the fiscal consolidation measures. Thus, the Winter forecast of the European Commission did not take those measures into account.

In accordance with information and forecasts presented by Poland in the April report and in this *Programme*, the nominal deficit should be reduced in a sustainable manner to below 3% of GDP in 2015. The government remains committed to reducing the imbalance in public finances in the manner which would not pose a threat to medium-term perspectives of Poland's economic development. Therefore, the next years will be oriented towards Poland meeting the medium-term budgetary objective (MTO), i.e. the structural deficit at a level of 1% of GDP. The reduction of the deficit, reaching the MTO and maintaining the government debt much below the reference value of 60% of GDP will be fostered by the compliance with the stabilising expenditure rule introduced in 2013 (cf. chapter VII.1).

I.2. Coordination of economic policies

In accordance with Art. 121 of the *Treaty on the functioning of the EU*, Member States regard their economic policies as a matter of common concern and coordinate them within the Ecofin Council. Since 2011, the budgetary year has been divided into two semesters so as to strengthen the effectiveness of this coordination . In the first semester, called the European Semester, the EU institutions analyse the economic situation in the EU and formulate recommendations for Member States , while in the second semester, called the National Semester, the Member States strive to reflect the EU recommendations in their policies.

The European Semester begins in November with the publication of the *Annual Growth Survey* (AGS), in which the European Commission describes the economic situation and challenges for the European Union for the following year. Based on the AGS and the discussions of the Member States in various formations of the EU Council, the European Council adopts priorities for economic policies of all EU Member States in March of the following year. The set of five priorities for economic policies adopted by the European Council in March this year has remained unchanged for three years and covers, among others, growth-friendly fiscal consolidation[12]. It is also the priority of the Polish government (cf. chapter III).

Until the end of April the Member States provide the European Commission and the EU Council with updates of both *National Reform Programmes* and stability or convergence programmes. Those programmes should take into account the said guidelines endorsed by the European Council. On the basis of the analysis of the documents received, the Ecofin Council issues recommendations for the economic policies of the Member States

[10] http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee2_en.pdf

[11] *Information on measures undertaken by Poland for the implementation of the Council recommendations under the excessive deficit procedure,* available at http://www.mf.gov.pl/documents/764034/1002171/EDP+raport+2014.04.pdf Successive reports will be sent to the Ecofin Council and the European Commission at least every six months.

[12] Cf. conclusions of the European Council of 20-21 March 2014 at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/PL/ec/141756.pdf

in July, thus concluding the European Semester. The Member States should take due account of those recommendations during the National Semester while designing their budgets for the following year.

In its opinion of 9 July 2013 on the previous *Programme* the Ecofin Council recommended Poland among others to take action to[13]:

- with a view to improving the quality of public finances minimise cuts in growth-enhancing investment, reassess expenditure policies improving the targeting of social policies and increasing the cost effectiveness and efficiency of spending in the healthcare sector;
- improve tax compliance, in particular by increasing the efficiency of the tax administration
- ensure the enactment of a permanent expenditure rule in 2013 consistent with the rules of the European System of Accounts. Take measures to strengthen annual and medium-term budgetary coordination mechanisms among different levels of government.

Recommendations concerning the improvement in the quality of public finances and the enactment of the expenditure rule were, to a major extent, repeated in the Ecofin Council recommendation for Poland of December 2013, referred to in chapter I.1. Thus, information on implementing the recommendation of the Ecofin Council under the excessive deficit procedure (cf. chapters VI and VII) also refers to the implementation of the recommendations of the Ecofin Council presented in its opinion on the *Programme* of 2013. On the other hand, those recommendations of the Ecofin Council included in the July opinion on the *Programme* which concerned the implementation of the budgetary strategy ensuring the elimination of the excessive deficit in 2014 have become outdated in the light of the of the Ecofin Council recommendation that postponed the deadline for correcting the excessive deficit to 2015 .

Moreover, according to the Ecofin Council recommendation of December 2013, the fiscal consolidation should be supported by comprehensive structural reforms, in line with the Council recommendations issued in the context of the European Semester. The progress of recommended structural reforms is discussed in this year's edition of the NRP.

I.3. Integration with the euro area

The introduction of the euro constitutes Poland's strategic objective. The government's positive stand on the benefits of adopting the common currency remains unchanged. According to the government, the main reason for the current euro crisis was the way in which certain Member States implemented economic policy as well as some institutional solutions of the euro area - not the common currency itself. In the face of the aforementioned conditions, the strategy for the integration of Poland with the euro area is based on four pillars.

The first pillar concerns targeting sustainable fulfilment of the convergence criteria in the Polish economic policy framework, with particular focus on fiscal discipline. The credible prospect of meeting the Maastricht criteria within two years of inclusion in ERM II as well as reaching the political agreement concerning legislative changes necessary for the common currency adoption are the conditions for joining this mechanism. In 2010, the government specified these conditions in the *Prerequisites for Implementation of the Next Stages of the Roadmap for Euro Adoption in Poland*.

The second pillar constitutes the implementation of additional measures aimed at strengthening the potential of the Polish economy, including institutional measures. The lack of the adequate preparation to functioning under the common monetary and exchange rate policies framework before adopting the euro, could lead to a repetition of the crisis scenario observed in the periphery countries of the euro area.

The third pillar includes a thorough preparation of the technical and organisational aspects of the process. So far, two key documents have been developed: *Strategic Guidelines for the National Euro Changeover Plan*, approved by the Council of Ministers in 2010, and *the National Euro Changeover Plan*, approved by the European Affairs Committee in 2011. Due to the significant reform agenda in the European Union and in the euro area, the current objective is to update the *National Euro Changeover Plan* with reference to the impact of those changes on Poland's euro adoption strategy. The date of completion of the document is conditional on the

[13] Cf. footnote 2.

adoption of binding solutions on the EU forum concerning the key institutional changes, in particular, those referring to the banking union. The outcome of these changes determines the area of the necessary institutional and legal adjustments as well as the national balance of costs and benefits arising from introduction of the common currency.

The fourth pillar comprises stabilisation of the situation in the euro area, especially its institutional strengthening, including the development of a crisis management system and crisis prevention mechanisms. Within the European Union fora, Poland actively participates in the activities aimed at sustainable improvement of the stability of the single currency area, essential for the implementation of this pillar of the strategy.

Due to the significant uncertainty concerning the time horizon in which the requirements for the safe adoption of the common currency can be met, the government at present is not specifying a target date for euro adoption. However, the government regards the continuation of preparations for the introduction of euro as beneficial to Poland, especially within the scope of pillars one and two of the integration strategy. Moreover, the inter-organisational structure for the adoption of euro in Poland analyses the institutional changes in the euro area in terms of their consequences for the euro preparation process in Poland, therefore contributing to the realisation of the third pillar of the integration strategy.

I.4. Economic policy objectives

The Medium-term National Development Strategy 2020[14] (hereinafter referred to as the *Strategy*), adopted by the Council of Ministers in September 2012, defines the main medium-term objective of the government as one that will *strengthen and make use of the economic, social and institutional capabilities in order to ensure rapid and sustainable development of the country, and to improve the quality of life of the population.* The *Strategy* indicates three strategic areas on which the main actions aimed at accelerating development processes should focus: *Effective and efficient State, Competitive economy* and *Social and territorial cohesion*, providing also the basis for the preparation of successive updates of the NRP, including the NRP 2014/2015.

At the same time, the emphasis is put on the complexity of the challenge posed by the necessity to ensure the sustainability of public finances and the increase in savings together with implementing a development vision based on the elimination of major bottlenecks to growth through education, digitalisation and innovation. The assumptions of the *Strategy* which refer to the consolidation of public finances (carried out in line with subsequent updates of the *Programme*) mean that the rationalisation of expenditure and its steering towards actions vital to the socio-economic and spatial development of the country are the prerequisites for the implementation of this development vision.

Sustainable public finances are key for macroeconomic stability and, in consequence, for the long-term economic growth. Other key drivers of macroeconomic stability in Poland include, among others, the planned establishment of the Systemic Risk Board bringing together representatives of financial security bodies (the National Bank of Poland, the Ministry of Finance, the Polish Financial Supervision Authority, the Bank Guarantee Fund). The tasks of the Board will include, inter alia, the identification, evaluation and control of systemic risk, i.e. the risk of disruption in the functioning of the national financial system which may lead to macroeconomic imbalance undermining the stability of the economic growth. Should any systemic risk be detected, the Board will be obliged to undertake actions aimed at reducing the probability of its materialisation or at mitigating its potential effects. The draft act on macro-prudential supervision of the national financial system, appointing the Board and equipping it with the necessary instruments, has been subject to external consultation. At the next stage, the draft will be submitted for consideration by the standing Committee of the Council of Ministers.

Moreover, actions are ongoing aimed at improvement of the security and stability of the whole Polish financial sector, including new solutions regarding the bank resolution framework. The objective of the draft act on the Bank Guarantee Fund, bank resolution and the amendment to certain acts, is mainly to create the legal framework allowing for the execution of the bank resolution procedure, grant powers to the Bank Guarantee Fund enabling the processing of such procedure and to define the sources of financing for these processes. At the

[14] *National Development Strategy 2020 – Active society, competitive economy, efficient state*, adopted by the Council of Ministers on 25.09.2012, available at: http://www.mrr.gov.pl/rozwoj_regionalny/Polityka_rozwoju/SRK_2020/Documents/SRK_2020_112012_1.pdf

same time, the draft Act will partly implement the provisions of the finalised draft directive establishing a framework for the recovery and resolution of credit institutions and investment firms. The Ministry of Finance is currently leading the external consultations on the aforementioned draft act.

II. Economic outlook

II.1. Cyclical developments and current prospects

Following a period of weak growth in 2012, since the beginning of last year, gradual acceleration of the growth rate of activity in the Polish economy has occurred (q/q). Consequently, the GDP level in the 4th quarter was already by 2.7% higher than a year ago, and the data was better than expected. The clear upward trend was maintained in export, which was fostered by the high competitiveness of the Polish enterprises, and, from the 2nd quarter of 2013, also by the improvement in the dynamics of activity in the Polish main export markets. This was reflected by the higher dynamics in industrial production and, in the second half of the year, also in investment. The improvement of the situation in the labour market appeared, demonstrated by the increase in the demand for labour and decrease in unemployment, however, under still limited wage pressure. As a consequence, retail sale and private consumption started to show upward trend. As of the second half of last year, the role of domestic demand in the GDP growth was increasing (year on year), both in terms of consumption and investment demand, although net export remained the main factor of growth.

Despite the gradual improvement in the majority of macroeconomic categories observed during the last year, their average changes in the whole 2013 were generally less favourable than a year before. GDP increased by 1.6%, i.e. less than in 2012 (2.0%). The decline in the economic growth rate mainly resulted from the continued downturn in other EU Member States, particularly those belonging to the euro area. The EU GDP increased by 0.1%, following the slump by 0.4% a year before; as many as ten EU Member States recorded the decline in the GDP. Weak dynamics of the domestic demand also affected the low growth of the EU export, the main indicator of demand for Polish goods and services (the EU contributes to about ¾ of the Polish exports of goods), following the decline recorded in 2012. Although import of Germany, the largest trade partner of Poland, was still growing, the growth rate remained at a low level.

The economic downturn influenced a slight, close to stagnation, increase in labour demand[15]. It was mainly the result of a low growth rate of the number of employees and a deepening decrease in the number of employers and the self-employed. At the sector level, these changes were triggered by a continued downward trend in the number of employed in agriculture, which could not be compensated by an increase in the number of employed in the service sector and a slight growth in the number of employed in the broadly understood industry sector (including industry and construction). Low labour demand contributed to a higher unemployment level. The unemployment rate reached 10.3% (compared to 10.1% in the previous year and 10.8%, on average, in the EU). The employment stagnation was accompanied by a limited wage pressure. Employees' bargaining power in wage negotiations was limited by still relatively high level of unemployment.

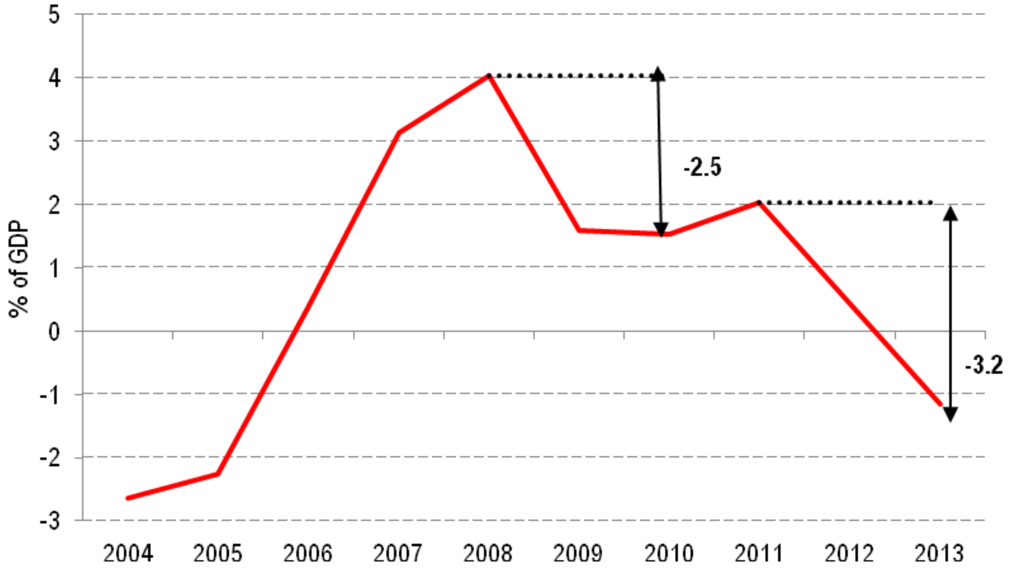
Despite the improvement in the annual private consumption dynamics in the 4th quarter, its increase in the whole 2013 reached only 0.8%, against 1.2% recorded a year before, and it was the poorest result since the beginning of the publication of this variable (i.e. since 1996). Apart from the continued weak dynamics in the growth of real disposable income of households, being a result of labour market situation, this was also spurred by a low dynamics of consumption credits. In addition, households did not support the current consumption by savings and through increasing, still very low, the rate of voluntary savings (i.e. without considering the adjustment due to the change in net share of households in provisions of the pension funds).

In 2013, once again, the continued growth of private sector investment could not compensate for the decrease in general government investment, which limited overall investment in the economy. This factor, along with the slowdown of private consumption and a significant decline in inventories, resulted in a stagnation of domestic demand. Net export remained the main driver of GDP growth as a result of the lower dynamics in import volume as compared to export.

[15] Information on the labour market is based on the LFS data.

Although the real GDP growth was positive in 2013, it was clearly lower than the potential of the Polish economy would have indicated[16]. The consequence of the lower economic growth between 2012-2013 was a rapid closing of the output gap, which in 2011 was still at a relatively high level of plus 2.0% of the potential GDP. In 2013 the real GDP is estimated to have fallen to a level below its potential growth rate, which resulted in a negative output gap of approx. minus 1.2% of the potential GDP. In total, in 2012-2013 the output gap deteriorated by even 3.2 percentage points, i.e. much deeper than in the period of the financial downturn (2009-2010) when the change in the gap reached 2.5 percentage points. This means a significant deterioration of cyclical conditions for economic activities and economic policy.

Chart 1. Output gap between 2004-2013



Source: Ministry of Finance

The stagnation of domestic demand and the negative output gap kept inflation at a low level over the whole last year. From December 2012 the inflation stayed below the NBP target, and from February 2013, also below the bottom limit of the tolerance band for deviations against this target. The very low level of inflation, besides the weak demand pressure resulting in low base inflation - was also the consequence of stabilisation of prices in the global raw material markets. In December inflation reached only 0.7% on an annual basis (against 2.4% in the corresponding month a year before), and the average annual inflation decreased to 0.9% from 3.7% in 2012. The weak inflation pressure in the economy is also confirmed by the fact that in 2013 both prices of sold industrial production and prices of construction and assembly production were lower than a year before.

The structure of GDP growth with the weak domestic demand further improved the negative current account balance in the balance of payments, which reached 1.3% of GDP against 3.7% of GDP a year before. The reduction of external imbalance was mainly the result of the improvements in the trade balance as a consequence of the higher growth of export against import. The income deficit, reflecting mainly the income of foreign direct investors, still remained high, although it was accompanied by an increased share of non-residents' income due to their participation in portfolio investments. The current account deficit was mainly financed by an inflow of long-term capital, i.e. mainly the EU funds, classified on the capital market. On the contrary, the balance of inflow of non-residents' portfolio investments, which are recognised as the least stable source of external financing, recorded only slight surplus.

In the first seven months of 2013, in face of low dynamics of economic activity and increased risk of the inflation remaining below the target in a medium-term, the Monetary Policy Council (MPC) continued the monetary policy

[16] The estimates of the potential GDP and output gap are in accordance with the latest methodology of the European Commission, the details of which are presented in chapter III.5 of the *Programme.*

easing cycle, reducing the NBP interest rates, in total, by 1.75 percentage points. The key interest rate - the reference rate was reduced to record low of 2.5%, and on average it amounted to 2.95% in 2013. In September, the Council presented the *forward guidance* on the future stance of the monetary policy, which stipulated that the NBP's interest rates should be kept unchanged I at least until the end of 2013. This declaration was subsequently extended twice: in November – until mid-2014, and in March 2014 – at least until the end of the 3rd quarter 2014.

In 2013 the exchange rate of zloty was mainly influenced by the global factors. Following several months of relative stabilisation, in May-June the zloty weakened significantly as a result of capital outflow from emerging markets, caused by concerns over the decreased scale of asset purchases program by Fed. In June the NBP intervened in the currency market in order to reduce the excessive volatility in the zloty exchange rate. The depreciation of the Polish currency occurred again at the turn of August and September due to the adverse impact of the increase in the global risk aversion on the domestic currency market. In the last months of the year the volatility of the EUR/PLN exchange rate decreased significantly and the exchange rate of zloty strengthened at the end of the year. Consequently, in 2013 the exchange rate of zloty reached the average level of 4.1975 EUR/PLN and 3.1608 USD/PLN.

II.2. Medium-term scenario

The current forecasts of the European Commission concerning the economic standing of the main trade partner of Poland, which is the EU, allow for an optimistic assessment of the economic growth perspectives in Poland. In accordance with the estimates published in February 2014, the European Commission expects that the return of GDP in the EU to the growth path, observed since the 2nd quarter of 2013, will be supported by the accelerated internal demand starting from 2014, including the increasing growth rate in consumption and investment. This will enable to mitigate the risk for the observed economic growth in the EU posed by external factors and it will constitute an essential factor stabilising the process of economic recovery of the European Union Member States. Experts of the European Commission estimate that the real EU GDP growth in 2014 shall accelerate to 1.5% against 0.1% growth recorded last year. In 2015 the real GDP growth rate should even reach 2.0%. Considering the more balanced structure of the economic growth, the authors of the forecast published in February estimate that EU import, which is the key indicator of changes in demand for the Polish export, will increase by 4.0% this year. This means a significant acceleration of growth in this economic category (by approximately 3.5 percentage points) in relation to the result recorded in 2013. In 2015 the EU import should increase by 5.6% in real terms. For the needs of the macroeconomic scenario presented in the *Programme* it was assumed that in the following years the share of import in the EU GDP will gradually stabilise, which means that the real growth of import should amount, respectively, to 5.4% in 2016 and 4.8% in 2017.

In the years 2014-2015 the share of public investment in GDP shall stabilise at a level observed in 2013, i.e. 3.9% of GDP. A certain decline in this share may be expected in the period 2016-2017. This is associated with terminating of projects financed under the financial framework 2007-2013, to be executed in the years 2014-2015 parallel to projects of the new framework 2014-2020. However, the decline in the public investment share in GDP in Poland will not be considerable, and it should fall to approximately 3.5% of GDP in 2017, whereas the share itself shall remain as one of the highest among the EU member States.

The demographic determinants of the forecast presented in the *Programme* are based on the assumption of demographic changes foreseen in the EUROPOP2013. According to the assumed scenario, in the horizon up to 2017, the slight overall decline in the population in Poland is expected, by 0.1% in relation to the level in 2013. The number of the population at working age (15-74) will decrease by approx. 0.7% in this period. The assumed scenario of the activity rate (using the LFS methodology, age group 15-74), taking into account i.a. governmental measures aimed at placing significant limitations on earlier retirement and raising the retirement age, nevertheless, will allow to reduce the negative demographic effects on the labour market. Within the forecast horizon, i.e. until 2017, the labour supply will increase by approx. 0.3 % in relation to the level of 2013, which means that the upward trend in economic activity will be maintained, at a rate close to that observed in 2013.

Taking into account the expected increase in the number of the economically active population, and the forecast growth of those employed, within the horizon of the *Programme* the systematic reduction of the unemployment rate is expected, following the period of its will growth in the period 2009-2013. It is estimated that in 2014 the unemployment rate will decrease to 9.8% from 10.3% noted in the previous year. In 2015 it will reach the average level of 9.3%, to fall to 7.9% in 2017. Within the horizon of the forecast, the unemployment rate shall stay above the level of Non-Accelerating Wage Rate of Unemployment (NAWRU), estimated at approximately 9.3% in 2014 and 7.7% in 2017, although this difference will shrink in the consecutive years[17]. The changes in the observed unemployment rate shall result from the forecast changes in the labour demand. It is predicted that in 2014 the number of the employed will rise by 0.6% on average, following the decline by 0.1% in the previous year. In the period 2015-2017 the growth in the number of the employed will be slightly higher, to settle at a level of 0.8% on an annual basis. The presented changes in the overall number of the employed take into account the assumption, adopted within the *Programme* horizon, of maintaining the number of employees in the general government at a level recorded in the 4th quarter of 2013.

The unemployment rate staying above the level arising from the Non-Accelerating Wage Rate of Unemployment and the planned limiting of the remuneration fund in the majority of central government sub-sector entities and in the social insurance sub-sector, are the factors to reduce wage pressure in the whole economy, within the *Programme* horizon. In 2014, similar to 2013, the growth rate of the average remuneration (3.8%) will be higher than the growth of productivity at work. However, the difference between these economic categories is minor, reaching 0.2 percentage points, i.e. by 0.5 percentage points less than in 2013. In the successive years the forecast growth rate of the average wage will be lower than the expected changes in productivity, reaching, respectively, 4.7% in 2015, 5.2% in 2016 and 5.6% in 2017.

The system of indexation of social insurance benefits, dependant mainly on inflation of the preceding year, will cause the decline in the share of expenditure on pensions in GDP in the forthcoming years. This arises mainly from the projected path of inflation and remuneration fund, for which the acceleration of growth rate is expected in the years to follow. As a consequence, the share of income available to the retired and pensioners in GDP should fall, irrespective of the expected increase in the number of beneficiaries. In the previous years, growth of this share was observed. However, considering the estimated growth in the average remuneration and the number of the employed, it is forecasted that the real growth of household disposable income, within the horizon of the *Programme*, will be also by approximately by 0.5 percentage point lower than the GDP growth. In the period of the forecast, household disposable income will be supported by the expected relatively fast growth of the operational surplus in this sector, i.e. income of the self-employed, whose changes should be more associated with the dynamics of the market sector than the whole GDP. Considering the aforementioned factors, it is expected that in the years 2014-2015 the real growth of private consumption will amount to 2.2% and 3.0% respectively, irrespective of the foreseen growth of the voluntary savings rate. In subsequent years, due to better conditions on the labour market and the expected improvement of consumer sentiment resulting from brighter economic prospects, the real growth rate of private consumption shall accelerate to 3.9% and 4.0%.

The real growth in public consumption shall be determined by government actions aimed at reduction of the excessive deficit. As a result of the planned measures (cf. chapter III), the share of public consumption in GDP will be reduced, within the horizon of the *Programme.* The estimated real growth rate in this economic category in the following years shall reach, respectively, 2.4% in 2014, 1.1% in 2015, 1.4% in 2016 and 2.5% in 2017.

The continued competitiveness of Polish product prices helps companies to achieve high return on sales. Despite a relatively unfavourable situation in the external environment, since 2011 recovery of private investments has also been observed, after a severe deterioration in this economic category in 2009-2010. The share of private investment in GDP grows systematically and in 2013 it reached 14.6%, i.e. 0.1 percentage points below the level recorded at the beginning of the previous investment recovery (i.e. in the period of accession to the EU in 2004). In spite of the observed growth trends, the share of private investment in GDP remains considerably below the level noted in the period of economic boom preceding the financial crisis, when it reached 17.7% in 2008. It is forecasted that within the *Programme* horizon, this positive trend of recovery of this share will be continued. In 2014, private investment will show real growth by 4.5%, to reach the growth rate at a level of 7.8% in 2015, 9.6% in 2016 and 9.3% in 2017. Irrespective of the high growth rate, the share of private investments in GDP in the last year of the forecast will be lower by approximately 0.5% GDP than on average in 2007-2008. An additional factor fostering the growth of the private sector investment demand will be the predicted maintaining of capital costs at a relatively low level in connection with low interest rates and as a result of the establishment of the *Polish Investments* programme.

[17] The NAWRU estimates are prepared in accordance with the methodology of the European Commission.

Over the next years the expected economic revival will have a positive impact on the growth in inventories which is associated with the level of demand on domestic and foreign markets. It is estimated that parallel to the recovery of the final demand, the contribution of the change in inventory to GDP growth will rise gradually, from approximately 0.2 percentage points in 2014 to 0.3 percentage points in 2015 and 0.5 percentage points in 2016, to decrease to 0.4 percentage points in 2017, which will be associated with the projected stabilisation of the demand growth rate in the country and abroad.

In the period 2009-2013 the share of export in GDP in Poland increased from the level of 39.4% to 47.8%. Such a dynamic change in the structure of the Polish GDP results from a high competitiveness of Polish enterprises towards the foreign trade partners and, which is also important, from the relative weakness of the domestic demand in this period. In the projection period of the *Programme* the dependence of the Polish economy on external market situation will gradually decrease, whereas the share of domestic demand in GDP will increase. It is forecasted that in 2014 the real growth rate of export will be even higher than the growth rate of export markets, reaching 5.0%, as a result of which export share in GDP will reach its historically high level of 48.4%. However, in the subsequent years this rate will start to decline gradually, to 4.9% in 2015, 4.8% in 2016 and 4.1% in 2017. As a consequence, the share of export in GDP will decrease to 46.0% in 2017. The development of final demand will be, next to the exchange rate, the main determinant of the growth of Polish import. It is expected that in 2014 the real import growth, similar to years 2011-2013, will remain lower than the forecasted export growth, reaching 4.0%. Over the next few years, with a further acceleration in domestic demand, an acceleration in the real rate of import growth is predicted, reaching, respectively, 5.1% in 2015, 5.5% in 2016 and 5.4% in 2017. As a consequence, the contribution of net exports to GDP growth in 2014 will fall to plus 0.5 percentage points, against 1.6 percentage points in 2013. In the consecutive years, it will decrease to 0.0 percentage points in 2015, minus 0.3 percentage points in in 2016 and minus 0.6 percentage points in 2017.

The development of the net export is a determinant of the trade balance and a vital factor influencing the current account balance in the balance of payments. In 2014 the current account deficit will fall to 0.9% of GDP in comparison with 1.3% of GDP in 2013. The main source for the external imbalance will continue to be an income deficit triggered by the negative net international investment position of the Polish economy. Over the next years of the forecast the deficit on the current account in the balance of payments will start to deepen gradually and it will reach, respectively, 1.4% in 2015, 2.1% in 2016 and 2.5% in 2017. It is expected that within the forecast horizon this deficit will be mostly financed by the inflow of long-term capital, i.e. resources classified on the capital account (mainly the European structural funds) and foreign direct investments.

In summary, the expectations concerning the development of GDP components enable to expect that the economic growth in Poland in 2014 will reach 3.3%, which is double as much as in 2013. The key factor behind the acceleration of the economic growth will be the expected recovery of the domestic demand, including mainly the higher growth rate of private consumption and maintaining the high dynamics of private investment. The real GDP growth rate is forecast to reach 3.8% in 2015, and to stabilise in 2016-2017 at a level of 4.3%.

Until 2016, the macroeconomic policy will be implemented under the conditions of the continued negative output gap[18], although its gradual closing will occur. It is estimated that in 2014 the output gap in relation to the potential GDP will deepen to minus 1.0% from 1.2% in the previous year. In 2015, the gap will decrease faster, to minus 0.7%, to reach the level of 0.0% of the potential GDP in 2016. Starting from 2017 the gap should be positive, at a level of approximately 0.5% of the potential GDP. The potential GDP growth rate in the period covered by the forecast will gradually increase from the level of 3.2% estimated for 2013-2014 to approximately 3.7% in 2017, mainly due to the expected acceleration in the growth rate of total factor productivity and the continued reduction of the Non-Accelerating Wage Rate of Unemployment (NAWRU). However, it will stay lower than in the years 2007-2011 when it reached ab. 4.0% on average.

By the year 2017, the continuation of the trend of zloty appreciation is expected. The strengthening of the Polish currency should be supported by the strength of the Polish economy, including a relatively small current account deficit, an inflow of foreign investments and a significant decrease in risk premium related to the limiting of the imbalance of public finances. It is assumed that this last factor will have a significant impact on the currency exchange rate, including the planned abrogation of the excessive deficit procedure for Poland.

[18] The estimates in accordance with the latest methodology of the European Commission, the details of which are presented in chapter III.5 of the *Programme.*

In case of inflation, it is predicted that after a marked decrease at the end of 2012, and its staying at a low level in 2013, also in the current year the average annual inflation (measured as CPI) remain low, reaching 1.2%, as compared to 0.9% in the previous year. Over the subsequent years, assuming stable prices on the raw material markets and considering the maintaining high negative output gap and the expected appreciation trend for the zloty, it is predicted that inflationary pressure will be extremely limited. Nevertheless, it is assumed that this factor, along with the continued tightening of fiscal policy, will be reflected in the relevant adjustment of the monetary policy, which will enable to create the proper *policy mix*, resulting in the gradual CPI approaching the area of volatility permissible within the monetary policy. In 2017, in line with the planned reversion of the VAT rates to 22% from 23% and 7% from 8%, a temporary decline of CPI to 2.2% on average is forecast.

II.3. Growth implications of "major structural reforms"

The government, through a number of integrated strategies, has been implementing the policy oriented towards providing favourable conditions for the development of entrepreneurship and the potential for the economic growth of the country. These measures are mainly aimed at improving the access of enterprises to capital, creating the enterprising attitudes, institutional, organisational and financial strengthening of the business environment as well as filling up the information gap and counteracting the adverse effects of the forecasted demographic changes on the balance of individual sectors of the Polish economy. It is expected that the ongoing actions will result in improvement of the total factor productivity and increase of the available resources of this factor, which will consequently enable to achieve a higher level of economic growth and enhance the average standard of life of the citizens.

One of the actions under implementation is the *Polish Investment* programme, the objective of which is to ensure maintaining the high dynamics of investment in infrastructure projects of key importance for the state economy and the strategic interests of the state. The *Polish Investment* programme shall focus on providing conditions for long-term financing of profitable investment projects in the area of energy and gas infrastructure, shale gas management, transport infrastructure, local infrastructure (waste processing, public transport), industrial and telecommunication infrastructure. As a consequence, it will contribute to the achievement of the goals planned in *Transport Development Strategy by 2020 (with the perspective by 2030)* and in *Energy Security and the Environment Strategy (the perspective by 2020)*.

In order to maintain high economic activity, actions foreseen in the *Human Capital Development Strategy* and oriented towards more effective exploitation of the labour factor, are being undertaken. In response to the needs of employers and employees, several provisions of the *Labour Code* were amended, which would permit to introduce flexible working time and to extend the working time settlement period to 12 months. The application of the flexible working time should contribute to the increased effectiveness of human resources involved in the economic processes.

Among structural actions undertaken by the government in favour of improving business climate for enterprises, the *Strategy for Innovation and Efficiency of the Economy* should be mentioned, whose implementation will contribute to building of the knowledge-based economy. The implementation of the measures planned in this strategy will foster the growth of innovation and efficiency of the economy, consequently improving its competitiveness understood as a long-term ability to face external competition. The improvement of the business environment will be also supported by implementation of the *Digital Poland Operational Programme for 2014-2020*. This Programme, addressing the objectives of the *Digital Agenda for Europe*, shall focus, in particular, on supporting the development of broadband networks and public e-services at a central level.

The Polish economy faces a serious challenge arising from changes in the demographic structure. According to the demographic forecasts, the deficit of the working age population shall be observed in Poland. The phenomenon is so strong that even the expected improvement in professional activity indicators may not be sufficient to prevent the decline in labour supply. The decreasing labour supply accompanied by the growing convergence of the growth rate of total factor productivity to the levels noted in the developed countries, shall constitute a serious barrier for the potential growth rate of the Polish economy. In order to mitigate the adverse effects of these tendencies on the economy, the government has undertaken measures, consisting, inter alia, in restricting the entitlements to earlier retirement and the gradual increasing of the retirement age for men and women. These measures will mostly affect the age group of 45+, where the professional activity indicators recorded so far have been clearly lower than, on average, in the developed economies. It is expected that the changes introduced will result in the enhancement of the activity of people aged over 45 (such increase can be already noticed in the current data concerning the professional activity in Poland). The additional incentive for this age group to stay on the labour market will be the increasing share of people whose retirement benefits will be paid from the system of defined contribution. The associated decline in the replacement rate (relation of the level of the pension granted to the last salary) will motivate older generations to retire at a later age.

The professional activity of the Poles should also improve in connection with the convergence of the economic structure towards the structure more typical for the developed economies, i.e. with the higher share of the service sector. This will allow for easier entry of younger cohorts to the labour market, in case of which the professional activity ratio recorded at present is clearly lower than the EU average. The obligation of municipalities to provide places in kindergartens for all four-year-old children, and later also for all three-year-old children, as well as the education reform introducing the compulsory school education covering six-year-old children, will support the activation of the aforementioned age group.

One of the underlying goals of the fiscal policy carried out by the government is to ensure the financial stability of the state within a medium- and long-term perspective. Healthy public finances foster the improvement of the economic results. Through the positive impact on domestic savings and decrease of the risk premium included in the price of capital, public finances allow for faster accumulation of capital, consequently contributing to the accelerated growth rate of the potential GDP. The basic aspect of stability is the need to provide the appropriate distribution of burdens between the current and future generations. The failure to comply with this limitation may result in the necessity of significant and sustainable raise of taxes at a certain moment in the future. Stability of public finances defines the specified framework within which other functions of the fiscal policy should be implemented, i.e. the allocation, redistribution and stabilisation function. The lack of fiscal discipline may lead to the negative and rapid reaction of the financial markets and, as a result, to the negative macroeconomic consequences, such as the decline in the integrated demand and deterioration of the labour market situation. The achievement of the long-term sustainability of public finances through the reduction of excessive deficit is also an important commitment of our country towards the European Union.

The provision of the medium- and long-term financial stability of the state is supported among others by the stabilising expenditure rule introduced in 2013, aimed at reducing the excessive growth of expenditure not reflected in the changes of the tax base. In addition, the introduction of the rule and the resulting budgetary limitation for the total expenditure pool shall result in reorganisation of the public expenditure structure.

Another key element of the fiscal policy is the consolidation strategy adopted by the government, fostering the economic growth, which aims, on the one hand, at minimising the adverse effects of fiscal multipliers on the social and economic situation of the country, on the other hand - at consolidation of public finance so that the change in their structure optimum in terms of economic growth can be achieved. The legitimacy of the measures carried out by the government is confirmed by the results of the Polish economy following the financial crisis.

III. General government balance and debt

III.1. Policy strategy and medium-term objectives

The government is committed to continue the reduction of the imbalance in the public finances in order to create secure and sustainable foundations for the development of the country. The following part of chapter III presents actions aimed at elimination of excessive deficit in 2015 and continuation of the fiscal consolidation in the successive years of the forecast. Moreover, taking into consideration the implementation of the principal objective of the economic policy of the government, i.e. the fiscal consolidation fostering the economic growth, introduction of the sustainable, anti-cyclical stabilising expenditure rule – through the amendment to the *Public Finance Act* – was recognised necessary (cf. chapter VII.1). The objective of the rule is to provide the stability of public finances in Poland and to adjust their potential excessive imbalance and, at the same time, to prevent the need of excessive tightening of fiscal policy, particularly, under the conditions of significant economic downturn. The rule introduced meets the requirements arising from the *Council directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States*.

III.2. Measures taken to reduce the excessive deficit

Consolidation measures by the government, undertaken in the years 2010-2013, led to a reduction of expenditure by 2.8 percentage points of GDP. In turn, expenditure after deducting the expenditure financed from EU funds for which the general government is the final beneficiary, were decreased by as much as 3.2 percentage points of GDP. Such a scale of reduction of the expenditure was possible, among others, through:

- the disciplinary expenditure rule binding from 2011 (Article 112a of the *Public Finance Act*), reducing the growth rate of discretionary expenditure and new fixed expenditure to 1% annually in real terms, In 2013 this rule was replaced by the stabilising expenditure rule (cf. chapter VII.1), additionally used in the development of budget for 2014; the stabilising expenditure rule shall be binding starting from the Budget Act for 2015;
- reducing (since 2011) the remuneration fund in the state budget units, through adopting a general rule on freezing this fund at the nominal level of the previous year;
- temporary (while Poland is subject to the excessive deficit procedure) prohibition of adopting draft acts by the Council of Ministers that may result in a decrease of revenue in public finance sector units in relation to the amounts resulting from applicable regulations and projects that would lead to an increase in expenditure (Article 112 c of the *Public Finance Act*). This regulation was replaced by the stabilising expenditure rule at the end of 2013;
- currently binding – modified in 2009 – fiscal rules for local government units (cf. chapter VII.1):
  - a rule that as a minimum, the current account result must be balanced, arising from Article 242 of the *Public Finance Act* (since 2011);
  - individual limits of debt – stipulated in Article 243 of the *Public Finance Act* (from 2014 – the limit will be calculated based on a three-year moving average, initially for the years 2011-2013). In 2013, in order to facilitate the absorption of the EU funds, the rule was modified through extending the range of exclusions by repayment of liabilities incurred in connection with an agreement concluded for implementation of a programme, project or task financed at least in 60% from the non-refundable EU aid, in its part corresponding to the expenses incurred on the national co-financing, financed by means of such liabilities;
- reducing entitlements to earlier retirement;
- reducing the funerary benefit to PLN 4000 from 2011, followed by maintaining the amount of the benefit at unchanged level over the subsequent years;
- introducing the income criterion for the entitlement to receive the one-off allowance due to a child birth.

On the other hand, the major structural measures regarding revenues included:

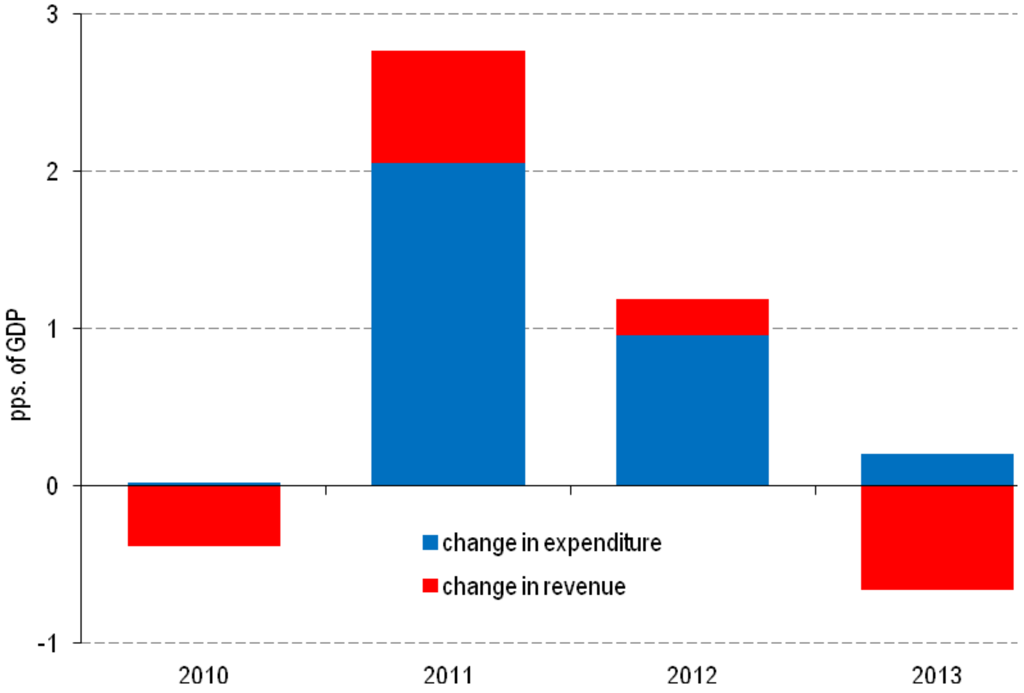
- reduction of the share of the pension contribution transferred to the Open Pension Funds – OFE (the part transferred to OFE was reduced as of May 2011 from 7.3% of the base to 2.3%);
- increasing VAT rates from 22% to 23% and from 7% to 8%, while simultaneously decreasing the rates for basic food products from 7% to 5% (since January 2011);
- increasing the disability contribution, constituting a burden on the employer, by 2 percentage points (since February 2012),
- reduction of the right to deduct VAT on purchasing personal vehicles with certification of approval for goods vehicles, and their fuel (since 2011);
- increasing the excise duty for oil and fuel fee (since 2012);
- increasing the excise duty for cigarettes (annually since 2010);
- removing the excise duty relief for biocomponents (since May 2011);
- freezing tax thresholds and lump sum of tax deductible costs in PIT at a nominal level of 2009;

- changes in the tax on the profits from bank deposits and reducing options for avoiding this tax (introduced in 2012);
- introducing a fee for using certain natural resources (tax on mining copper and silver since April 2012);
- extending the use of the *reverse charge* mechanism (extending the catalogue of goods, to which the reverse charge mechanism applies since 2013);
- introducing the joint and several liability in VAT of the purchaser for tax liabilities of the supplier of steel products and fuel (to which the *reverse charge* mechanism shall not apply) and non-processed gold, as well as for sellers of these goods (since 2013);
- changing VAT rate on non-universal postal services provided by the public operator to 23% (since April 2013);
- reducing the 50% of tax deductible costs due to copyrights and related rights (since January 2013);
- limiting the Internet relief and modification of relief for children (since January 2013);
- applying excise tax on dried tobacco leafs, which were illegally used as a tobacco product not covered by excise duty (since 2013);
- applying excise tax on natural gas used for heating purposes, excluding households (since 1 November 2013);
- reducing the limit authorising tax payers to exemption from the obligation to keep the cash register (from PLN 40 thousand to PLN 20 thousand) (since 2013);
- introducing the system of trading CO_2 emission allowances (in 2013).

In spite of so many structural measures of significant effect the revenues of the general government in the years 2010-2013 increased by only 0.4 percentage points of GDP, while these revenues, after deducting the revenues financed from EU funds for which the general government is the final beneficiary, decreased by 0.1 percentage points. It was mainly the result of a weak domestic demand, economic growth structure unfavourable for public finances (increased contribution of net export), very low inflation and, which is particularly important, the pro-cyclical nature of tax revenue (cf. chapter III.3). Problems related to tax compliance has adverse impact on the government revenues.

As a result, in 2013 the pace of fiscal consolidation slowed down. Whereas the nominal deficit in 2011 was reduced by 2.8 percentage points of GDP, followed by further 1.2 percentage points GDP a year later, in 2013 the deficit increased, reaching 4.3% of GDP, i.e. by 0.4 percentage points more than in 2012.

Chart 2. The impact of the change in revenue and expenditure on the change in general government balance in relation to GDP



Explanations: grants from EU funds, which are neutral for the general government, are excluded from revenue and expenditure

Source: Ministry of Finance

The consequence of the deterioration in the fiscal situation was the adoption of new recommendations for Poland by the Ecofin Council in December 2013[19] under the excessive deficit procedure. In these guidelines, the deadline for elimination of excessive deficit was postponed to 2015. In accordance with the new recommendations, Poland should reduce the deficit to 3.9% GDP in 2014 (from the level of 4.8% GDP forecast at that time for 2013) and to 2.8% GDP in 2015,excluding the impact of the assets transfer of the pension reform . The Ecofin Council also assessed that the achievement of the budgetary targets requires an improvement of the structural balance (i.e. this part of the nominal deficit the government may directly influence through the policy implemented) of 1% of GDP for 2014 and 1.2% GDP in the following year[20]. As compared to the autumn forecasts of the European Commission, it meant the need of Poland taking additional permanent measures at a level of 0.4% of GDP in 2014 and 1% of GDP in 2015.

The consistent implementation of the aforementioned measures by the government, both those implemented earlier with effects visible in 2013 and in the consecutive years, as well as new measures (implemented in the 2nd half of 2013, i.e., inter alia, limiting the expenditure by 0.5% of GDP while amending the Budget Act and introducing tax changes limiting fraud) caused that already in 2013 the deficit reached 4.3% of GDP, i.e. considerably below the level of the budgetary target of 4.8% of GDP, recommended by the Council. Considering the fact that in the previous year the real GDP growth reached the level only slightly above the forecast prepared for the needs of domestic budgetary projections (1.6% against 1.5% in the amendment to the state budget), and the output gap was negative, reaching the lowest level since the Poland's accession to the EU and one of the lowest in the EU, the improved result of the general government in 2013, as compared to the forecast, should be mainly recognised as the effect of all structural factors.

Poland, with respect to the said Council recommendation of 10 December 2013, has decided – apart from retaining measures which, through their mechanism, reduce the deficit every year, as a consequence of a

[19] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0906:FIN:PL:HTML

[20] The estimates in accordance with the forecast applicable at that time and the methodology used by the European Commission (cf. chapter III.5).

positive GDP growth rate[21] - to introduce further measures. For 2014, the following measures have been planned and implemented:

- in excise tax:
  - increasing the excise duty rate for cigarettes (from the beginning of 2014),
  - increasing the excise duty rate for ethyl alcohol (from the beginning of 2014);
- in VAT:
  - maintaining the increased VAT rates at unchanged level - it was originally planned that all VAT rates would be reduced as of the beginning of 2014 by 1 percentage point, the reduction of the VAT rates by 1 percentage point will take place in 2017,
  - limiting the possibility to receive a return of a part of VAT for some expenditures incurred for housing purposes (*the Act on the state aid for purchasing the first flat by young people*),
  - changes in the conditions for deducting tax charged when purchasing cars with a mesh partition and their fuel – this is connected to the expiry of the currently binding derogation in applying these restrictions,
  - introduction of the *mini one-stop-shop* system as of 2014 – this change will involve changing the place of service provision for telecommunications, broadcast, radio and television services as well as e-services to persons who are not taxpayers,
- in CIT:
  - introduction of taxation for limited joint-stock partnerships,
  - elimination of the exemption from CIT for dividend payments and other income (revenues) from inclusion in the profits of legal persons subjected to relief in the paying company and the method for determining the revenues form benefits in-kind (from 2015);
- changes in the rules of VAT deduction from company cars used for private purposes (positive impact on revenue from income tax);
- payments in the years 2014-15 to the state budget by The State Forests National Forest Holding, at an annual amount of PLN 800 million; starting from 2016a system of payments by State Forests to the central budget will apply, at a level of 2% of the income gained by State Forests from the sales of wood;
- increasing the sections of roads on which toll is charged in the ETC system (via TOLL);
- establishing the National Contact Points at the central register of vehicles;
- withdrawal from the implementation of the mechanism enabling tax payers of corporate income tax to transfer 1% of tax to the benefit of scientific entities - in accordance with the decision of the Council of Ministers, these issues will depend on the status of public finances.

In addition, works are in progress on the following issues:

- imposing the social insurance contribution on civil law contracts, in particular, in relation to overlapping contracts for mandate, and introducing the pension and retirement contribution on remuneration of supervisory board members;
- elimination of the lower 50% tax of forest tax for protective forests;

[21] Examples of such measures include: the permanent nominal level of tax threshold and flat tax deductible costs in PIT - which results in an additional increase of effective tax rate every year; freezing of the remuneration fund in the central government and social insurance sub-sectors, or maintaining the fixed nominal level, e.g. for funerary benefit - which, in turn, decrease the level of expenditure in relation to GDP. The examples referred to result in the sustainable, so-called 'growing out' of the deficit in relation to GDP.

- limiting the tax preferences for real property associated with business operations, which cannot be used for conducting these operations due to technical reasons, to buildings and structures, excluding land;
- waiver of exemption due to the purchase of ownership title to real property constituting an agricultural farm, or as a part of tax on inheritance and donations, and the tax on civil law activities.

Moreover, in order to comply with the deadline for elimination of excessive deficit, a package of actions will be implemented to assist tax payers in their fulfilment of the obligations towards the state and increasing the efficiency of tax administration (cf. chapter VI.2 presenting the *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-2017*). Steps in this area were recommended to Poland by the Ecofin Council in the opinion on the *Programme* for last year, as well as in the recommendations of December last year concerning the elimination of the excessive deficit (cf. chapter VI.2). The implementation of the package announced by the Ministry of Finance on 15 April 2014 will result in increase of the sector revenues already in 2014 by PLN 1.9 bn, however, its full effects can be only expected in the following years.

On the other hand, on the expenditure side, measures influencing mainly the level of social and current expenses, are undertaken, among others:

- liquidation of the privileged rules for defining the level of remuneration of officers of uniformed services and soldiers as well as employees of judiciary (judges and prosecutors) during sickness period - they will be subject to solutions similar to the general system, i.e. during a period of sickness they will receive 80% of the remuneration; as a result , savings due to limitation of sick leaves are expected;
- reform of the rules on assessment of the base for sickness allowance in case the period of insurance is shorter than 12 months - the changes refer to persons conducting non-agricultural business activity and other groups of persons for whom a declared amount constitutes the base for calculation of the contribution. In this case, it is proposed that the base for calculation of the contribution should depend on the insurance period, i.e. the base of the charge would be the sum of the lowest base of the contribution charged and the amount constituting 1/2 of surplus amounts over each consecutive period (currently, the declared amount constitutes the base);
- resignation - according to the decision of the Council of Ministers - from the idea to introduce a rector's scholarship for the best students of the first year;
- introducing the regulations allowing for common services of local government units, which will contribute to the limitation of costs of performance of the administrative staff and service departments.

The activities aimed at introducing the e-sick leave system are advanced (electronic system of sick leave). Introduction of this system will reduce printing costs, enable faster control of the accuracy of using sick leaves and control of the accuracy of adjudication of the temporary incapacity to work. As a result, tightening of the sick leave system may be expected, consequently reducing the number of sickness allowance paid (reduction of incorrectly issued sick leaves).

The factors listed in chapter III.4 will also support the elimination of the excessive deficit.

III.3. Actual balances

In 2013 the fiscal consolidation which commenced in 2011 was continued. After reducing the general government deficit in 2012 by 1.2 percentage points of GDP, as compared to the previous year, the deficit in 2013 reached a level higher than last year, i.e. 4.3 % of GDP (against 3.9% of GDP in 2012). It is important to note that the growth of the deficit resulted mainly from the decline in revenue in relation to GDP by 0.8 percentage points of GDP, as compared to the previous year. Similar to 2012, the consolidation was mainly achieved on the expenditure side. The ratio of domestic expenditure [22] to GDP remained at a level of 40.4% last year, i.e. by 0.2 percentage points lower than in 2012.

In 2013, the expenditure on public investments fell by 0.7 percentage points of GDP, of which expenditures in the central government sub-sector by as much as 0.6 percentage points of GDP. Such a significant decrease of expenditure in this sub-sector (by 26.9% y/y) results mainly from lower infrastructural expenditure executed by the National Road Fund (NRF) under the *Programme for Construction of National Roads for the years 2011-2015*. The investments of the sub-sector of local governments decreased by 0.1 percentage points of GDP, i.e. by 1.5% y/y, whereas in 2012 the decline reached as much as 17.8% y/y.

In 2013 the public consumption nominally grew by 3.8 % year to year (against 3.5% y/y in 2012) and the real increase reached 2.8% y/y. This increase was composed of both the decrease in labour costs and, on the other hand, the growth in intermediate consumption, i.e. purchases of public sector. The reduction of labour cost expenditure in relation to GDP by 0.1 percentage points was mainly possible as a result of the freezing of remunerations in the state budget sector and limiting the growth of labour costs in relation to the growth rate of the consumer price index in the local government sub-sector. Freezing of expenditure in the central government sub-sector, constituting the point of reference for other entities of public finance sector indirectly influences the behaviour in terms of shaping the wages of individual units of local governments (through the demonstration effect). Moreover, in 2013 the growth of intermediate consumption, occurred, i.e. purchases of the public sector, by 0.2 percentage points of GDP, at the national intermediate consumption, growth by 0.1 percentage points of GDP (mainly in the local government sub-sector).

Parallel to the consolidation actions, the government also undertakes measures aimed at counteracting the negative demographic trends, i.e., among others within the pro-family policy. Changes in this area refer to the extension of parental leave and popularising the pre-school education. (cf. chapter III.4). In 2013, the duration of additional maternity leave was increased (as well as the additional leave on the same conditions as maternity leave) and the so-called parental leave (26 weeks) was introduced. Moreover, in 2013 the attendance benefits were raised, a new care benefit was introduced - a special care allowance, as well as regulations were adopted resulting in increased availability of pre-school education for children aged 3–5, in kindergartens and other forms of pre-school education. It is expected that as a result of the changes in the scope of pre-school care, the indicator of availability of pre-school education of children will increase to the level comparable to other EU Member States.

Consequently, in 2013 the nominal growth of the category of social benefits other than social transfers in-kind reached 5.4% y/y, and in relation to GDP a growth by 0.4 percentage points of GDP was noted. In 2013, in connection with the actions described in the previous paragraph, these expenditures grew slightly higher than the pension and retirement fund (i.e. the biggest part in this category) in the period discussed (growth by approximately 4.8% y/y), which was affected mainly by the increased expenditure of the Social Insurance Fund (FUS) on maternity benefits, by ab. 18% y/y.

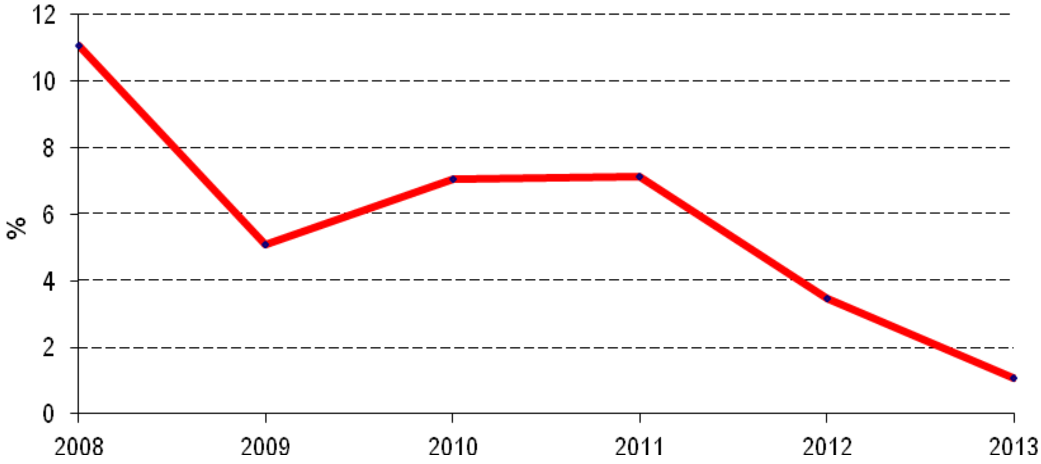
The decline of the relation of domestic revenues to GDP in 2013 reached as much as 0.7 percentage points, irrespective of the introduced systemic changes described in the previous *Programme*. Revenues at a level lower than expected for 2013 were mainly caused by lower VAT revenues than planned, which resulted from the deterioration in the macroeconomic environment and the deepening of the output gap. In 2013 the weighted indicator of the VAT tax base[23] increased only by approx. 1.0%. The structure of the economic growth in 2012-2013 was negatively reflected in the macroeconomic base of the VAT. Since 2008 the unfavourable trend in the development of the VAT tax base has been observed, which is illustrated in Chart 3, presenting the annual

[22] Expenditures after deducting expenditure financed from EU funds whose final beneficiary is the general government unit. Providing this category is important as, in accordance with the ESA'95 methodology, the influence of EU funds on the deficit is neutral, i.e. the sector revenues from the EU are shown in the amount of the sector expenditure financed from EU funds, irrespective of the cash flows. As a result, expenditure financed from EU funds is always neutral for the general government deficit. In 2013 the share of total expenditure in GDP in Poland decreased by 0.2 percentage points, but – as mentioned above – from the point of view of the influence on the general government deficit, it is the change in national expenditure that should be assessed. Similarly, when analysing the influence that the change in revenues has on the government balance, revenues from national sources should be taken into account

[23] Weighted sum of private consumption, investments and net purchase by general government.

growth rate of the indicator of the VAT tax base (a sum of nominal values of private consumption, investments and net purchases of the general government).

Chart 3. Nominal rate of the indicator of the VAT tax base

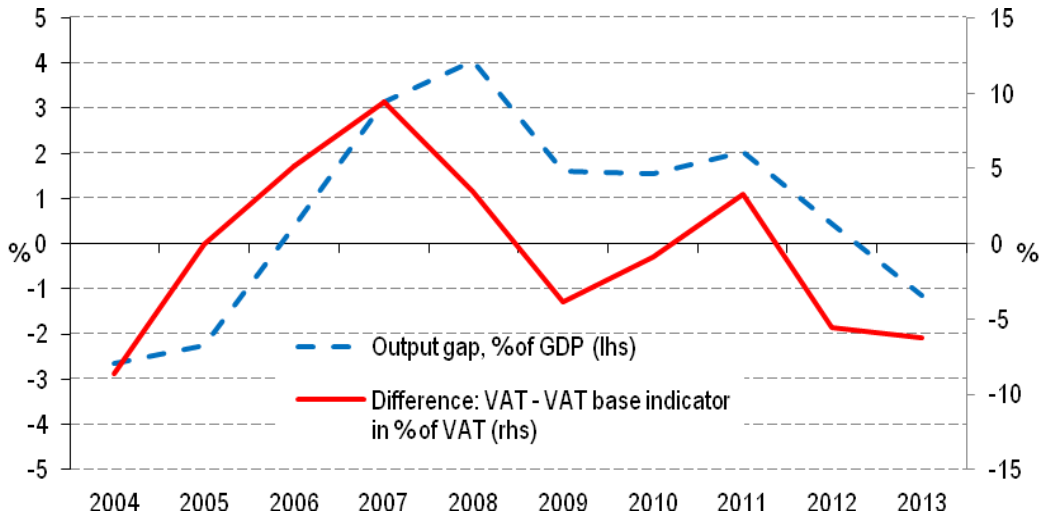


Source: Ministry of Finance

The slowdown in the growth rate of the VAT tax base was particularly visible in the years 2012-2013. The effects of the successive slowdown in the economic growth, particularly strong in the area of private consumption - the main element of the tax base, were enhanced by the pro-cyclical nature of taxes (the elasticity of taxes in relation to GDP, as well as in relation to the indicator of tax base, observed in Poland, is pro-cyclical), strengthening the activity of the automatic stabilisers.

Chart 4 presents the relationship between the "VAT tax gap" and the position in the economic cycle. In the economic cycle much stronger reaction of the "tax gap" occurs, which confirms the pro-cyclical nature of tax elasticity.

Chart 4. Difference between VAT revenues and the indicator of the VAT tax base expressed as a percentage of VAT revenues (i2005 = 100) as compared to output gap



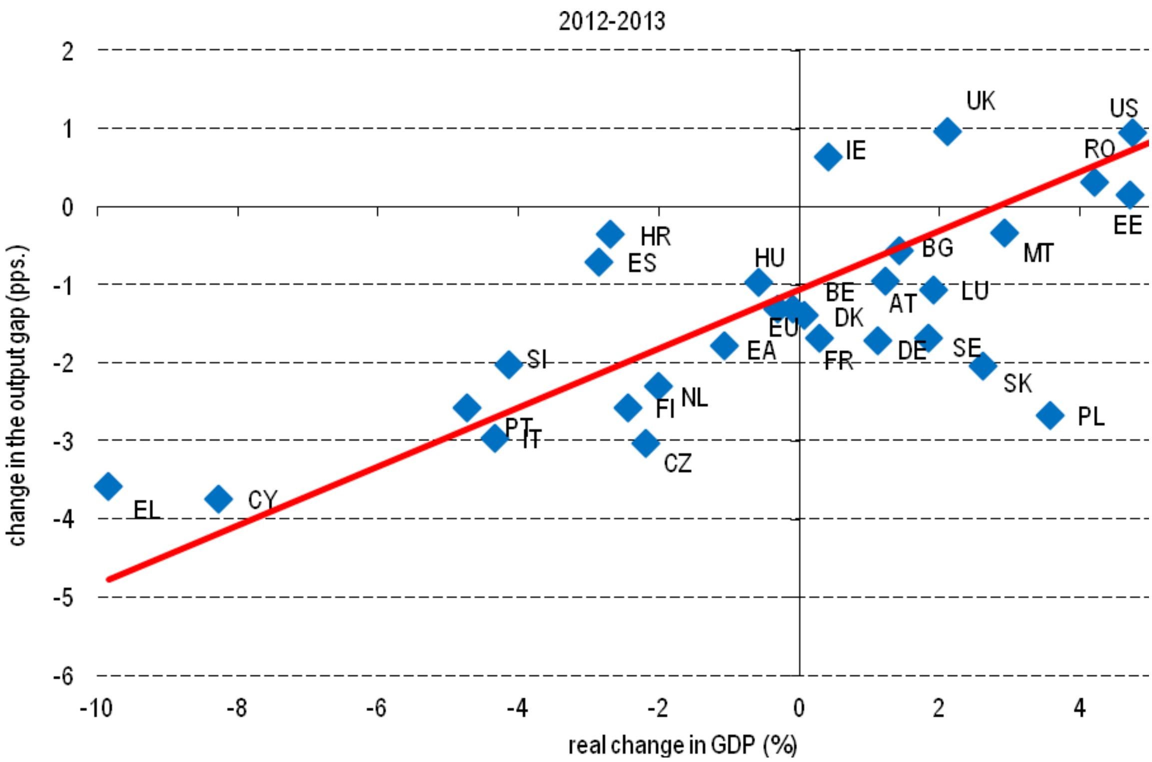
Explanations: the indicator of the VAT tax base includes the private consumption, investments, net purchases by general government

Source: Ministry of Finance

Considering the pro-cyclical nature of tax elasticity, it should be states that in the years 2012-2013 the conditions of tax revenue collection were particularly unfavourable irrespective of the economic growth. In accordance with the estimates of the European Commission concerning the output gap, in the previous year, the deviation of the GDP cyclical component against the potential level of economic growth reached its minimum, with the lowest level since Poland's accession to the EU. It means that the cyclical conditions for revenues collection were the worst noted since 2004. The decline in the economic trends in Poland in the years 2012-2013 was one of the deepest in the EU, next to Cyprus, Greece, the Czech Republic and Italy (cf. chart 5). However, contrary to the aforementioned countries, the economic growth in Poland was positive. This non-typical development of cyclical conditions in Poland (the biggest observed deviation against the trend line representing the average dependence between the change in the output gap and the real GDP) indicates that in our country, in spite of the negative effects of the financial crisis, maintaining of the relatively high growth rate of the potential GDP was possible. In this context, the nevertheless observed positive economic growth in Poland, but at a low level, ab. 1.5%, means a situation for the public finances which is similar to that observed in other countries in the period of economic recession.

Under the conditions of significant weakening of the economic growth, additional cyclical effects also emerged, associated with the effects of automatic stabilisers. In 2013 revenues for CIT were much lower than a year earlier (by over 10%). Such a low dynamic of revenues from CIT was partly caused by significant deterioration of the current results of enterprises. In addition, the low revenues from this tax were also affected, through the mechanism of an annual settlement, by the delayed effect of the poor economic situation in 2012. The observed increase in tax arrears had also an adverse impact on the level of tax revenues in 2013, in particular, in the VAT. The share of these arrears was growing irrespective of increasing the intensity of fiscal inspections.

Chart 5. Change in the output gap in comparison to real GDP changes in the EU Member States



Source: AMECO, Ministry of Finance

In case of other tax revenues, the results were close to the forecasts, however, also in this case, the effects of the economic downturn were visible. It referred, in particular, to excise tax on fuel. Revenues from PIT were slightly higher than planned.

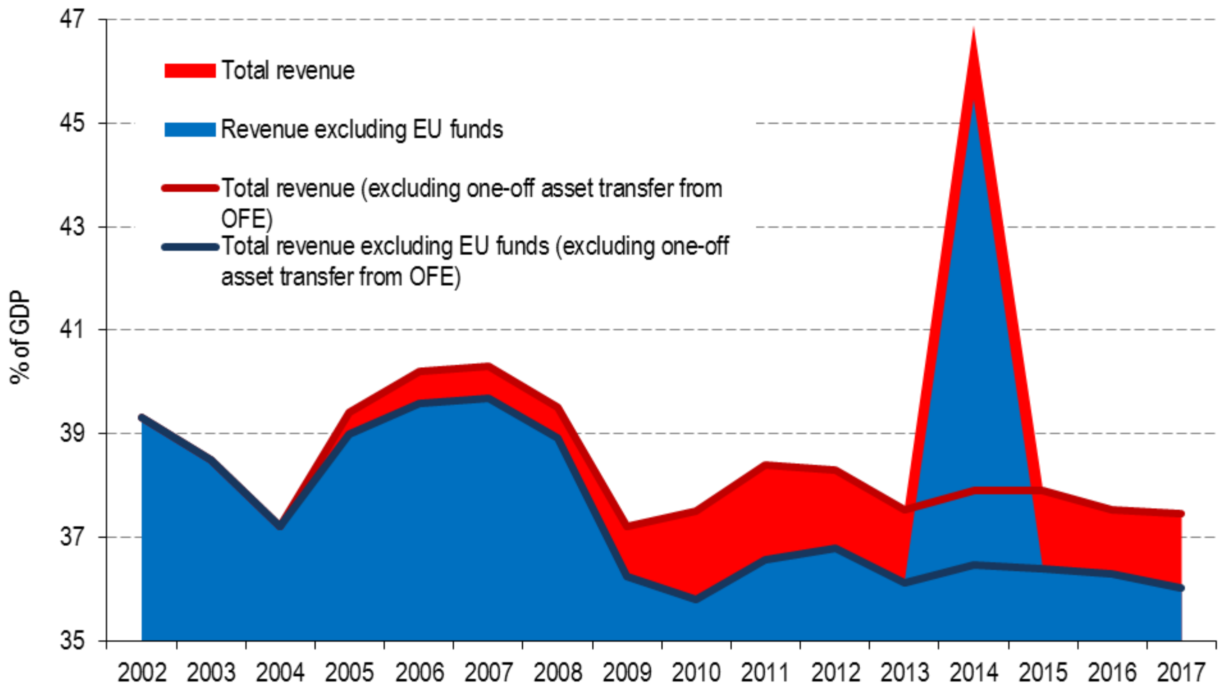
Only due to the enhanced expenditure discipline and undertaking the additional consolidation measures already during the previous year, it was possible to prevent a higher increase in the deficit in 2013.

III.4. Medium-term budgetary outlook

1) Factors determining the general government revenues

According to the latest forecasts, the relation of the domestic revenues of the general government to GDP in 2014 will reach the level of 45.4% of GDP, i.e. by 9.3 percentage points more than in 2013 (it is, among others, the effect of a one-off transfer of assets due to the pension system reform; and in the consecutive years, it will reach, respectively, the level of 36.3% of GDP in 2015, 36.2% of GDP in 2016 and 36.0% of GDP in 2017.

Chart 6. General government revenue



Source: AMECO, Ministry of Finance

The most important source of revenue of the general government is the revenue from the taxes related to production and import, obviously, including indirect taxes. For this group, the major indicator of the tax base growth is the growth of private consumption, for which a significant acceleration .of the growth rate (after 2014) is predicted. In turn, investments and net purchases by general government, which also comprise an important part of the tax base, will remain stable within the horizon of the forecast. As a consequence of the expected sustainable economic recovery, ie. closing the output gap, the occurrence of the pro-cyclical effects of indirect taxes against the tax base is very probable. However, due to the difficulties in precise estimation of such effect and the intention to maintain the conservative nature of the presented forecast of the revenues of the general government, the proportional increase in tax revenues against the tax base was assumed.

The sustainable improvement of the economic growth allows for expectation of the gradual acceleration of growth in inflows gained from taxation of revenues from business operations, inter alia, owing to the annual reduction (over consecutive five years) of the amounts of losses incurred during the period of downturn.

The revenues from the aforementioned taxes will be determined not only by the macroeconomic situation but also by the systemic changes discussed in chapter III.2.

The second biggest position in the revenues of the general government is from social insurance contributions. This category will depend on the shaping of the base for their calculation, the main component being the remuneration fund in the national economy, as well as on institutional changes. The nominal growth rate of the remuneration fund, after the estimated low growth in 2013, by 2.3% y/y, should accelerate in the coming years, to reach a level of slightly above 6% from 2016. It will remain below the nominal growth rate of GDP throughout the entire forecast horizon.

The main institutional factor, which will influence the size of social insurance contributions will be the changes in the pension system introduced pursuant to the Act of 6 December 2013 *on the amendment of certain acts in connection with the determination of the rules for payment of pension from resources collected in the open pension funds.* The impact on the level of contributions will arise both for the determination of the level of contribution transferred to OFE at 2.92%, as well as from the introduction of a possibility to choose the participation in OFE, resulting in (in accordance with the conservative assumptions - cf. chapter IV.1) a lower number of members whose contribution will be transferred to OFE. It was assumed that as a result of the choice, a half of OFE members holding the right of choice[24] will decide to stay in OFE, whereas the other half will collect their contributions on a sub-account in ZUS. At the beginning, i.e. in 2014, this effect will be lower than the effects anticipated in the following years since the changes introduced by the aforementioned act will not apply for the whole year.

Moreover, as a result of the changes stipulated in the aforementioned act, the one-off transfer of assets from pension funds under private management (OFE) to the governmental sub-sector took place. The transaction of takeover of assets by the government in exchange for future retirement commitments was registered as a one-off revenue. The permanent transfers (to FUS) of assets registered on OFE accounts of persons with less than 10 years to reaching the retirement age, will be of similar nature, although they will not be one-off transfers - arising from the gradual transfer of assets to FUS (within the so-called 'safety slider'). The assumptions and expectations associated with the recent reform of the pension system are discussed in chapter III.7

With regard to personal income tax, it is assumed that the current tax thresholds and the statutory flat income tax rates and the allowances exempt from tax will not be indexed within the entire forecast horizon. In addition, from 2014 PIT revenues will be positively influenced by the significant reduction of the Internet tax relief.

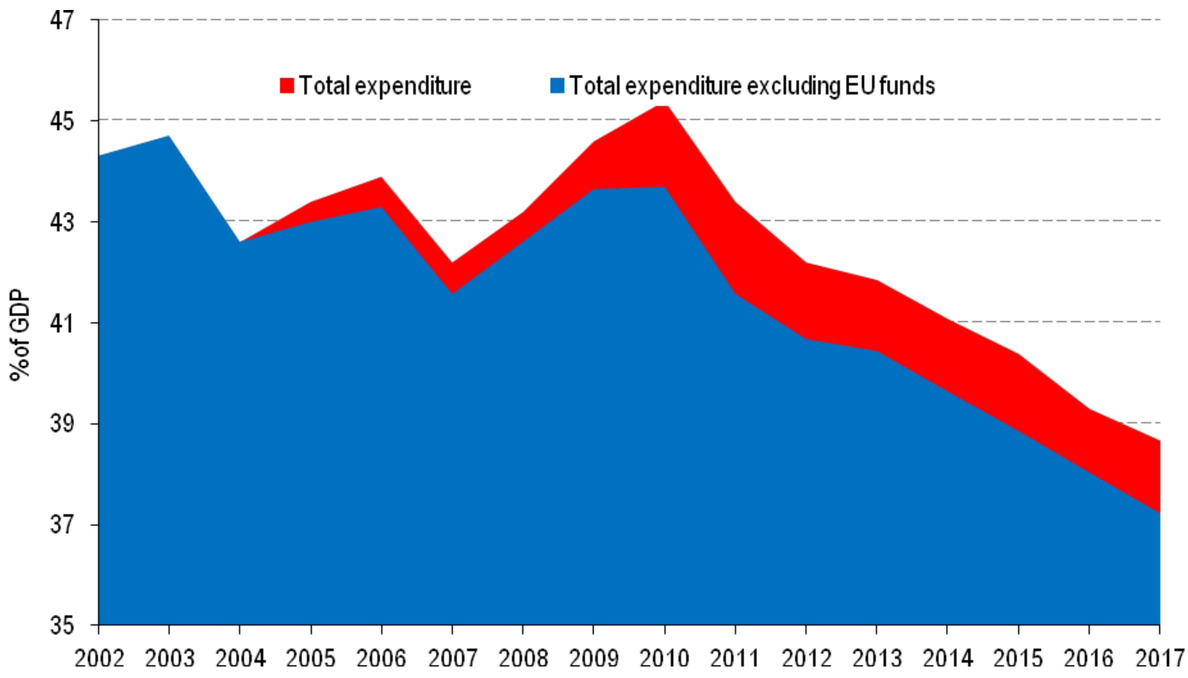
Furthermore, the level of revenues and reduction of the deficit, also after 2015, will be affected by the implementation of the measures envisaged in the document: *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-2017* (cf. chapter VI.2).

2) Factors determining the general government expenditures

Parallel to the structural measures which increase revenues, the government continues a policy oriented towards decreasing the expenditure-to-GDP ratio. According to the latest forecasts, the relation of the domestic general government expenditure to GDP in 2014 will reach the level of 39.6% of GDP, i.e. by 0.8 percentage points more than in 2013. In the following years the downward trend of domestic expenditure will be continued and this relationship will reach, respectively, the level of: 38.9% of GDP in 2015, 36.2% of GDP in 2016 and 37.2% of GDP in 2017.

[24] 10 years before the retirement age is reached, the contributions for retirement insurance will be entirely transferred to ZUS.

Chart 7. General government expenditure



Source*:* Central Statistical Office, Ministry of Finance

The decline in expenditure will result from the already undertaken measures (chapter III.2) and their strong limitation in the Budget Act (the total state budget expenditure, in accordance with the Budget Act for 2014, will decrease nominally, in relation to the expenditure specified in the updated budget act for 2013, by 0.6%). Parallel to the consolidation actions, the government has been implementing the priority measures in the pro-family policy area, aimed at counteracting the negative demographic trends. Changes in this area refer to the extension of parental leave and popularising the pre-school education. In 2013, the duration of additional maternity leave was increased (as well as the additional leave on the same conditions as maternity leave) and the so-called parental leave (26 weeks) was introduced. In accordance with the new regulations, the total amount of maternity leave, additional maternity leave and parental leave amounts to 52 weeks, for a single birth, and in the case of multiple births from 65 to 71 weeks, depending in the number of children born at one delivery. The new solutions will make it possible, to a greater extent than before, for both parents to make better use of maternity and parental leave through introduction of mechanisms facilitating fathers to provide care for the newborn child.

Moreover, in 2013 the attendance benefits were significantly raised, a new care benefit was introduced - a special care allowance, as well as regulations were adopted resulting in increased availability of pre-school education for children aged 3–5, in kindergartens and other forms of pre-school education. It is expected that as a result of the changes in the scope of pre-school care, the indicator of availability of pre-school education of children will increase to the level comparable to other EU Member States.

In addition, support for young married couples and the singles is envisaged in the *Act on the state aid for purchasing the first flat by young people*, effective as of the beginning of the current year. The Act stipulates subsidies to mortgage loans at a level of 10% of the flat value and, in addition, 5% in case of couples with a child; further 5% may be received by couples who shall have a third child (or more) within five years following the purchase of the flat.

The level of the social expenditure will also arise from the implementation of the Constitutional Tribunal ruling concerning the compliance of certain articles of the *Act of 16 December 2010 on the amendment of the Act on public finance and some other acts* with the *Constitution of the Republic of Poland.* In connection with these rulings, the *Act of 13 December 2013 on the determination and payment of pensions in relation to which the right was suspended in the period from 1 October 2011 to 21 November 2012 ,* stipulates the reimbursement of benefits with interest to the retired persons, against whom in the aforementioned period the payment of benefits was suspended due to continuation of employment without termination of the employment relationship with the employer, for whom the work was delivered directly before the day of obtaining the right to the retirement.

In March this year the governmental draft of act on determination and payment of the benefit for caretakers was submitted to the Parliament, re-establishing the right to the attendance benefit to persons who lost this benefit as of 30 June 2013, pursuant to the Act of 7 December 2012 on amendment to the Act on family benefits and some other acts. The aforementioned draft constitutes the implementation of the Constitutional Tribunal ruling concerning the non-compliance of art. 11 items 1 and 3 of the *Act of 7 December 2012 on amendment to the Act on family benefits and some other acts* with the *Constitution of the Republic of Poland.* In accordance with the provisions of the draft, the attendance benefits for caretakers in the amount of PLN 520 monthly will apply for periods after 30 June 2013, if a given caretaker fulfilled the conditions to receive the attendance benefit at that time, as stipulated in the *Act on family benefits*, according to its wording of 31 December 2012. The benefits will be paid including indexation and interest for the period before entry into force of the planned act. The social insurance contributions will be also equalised.

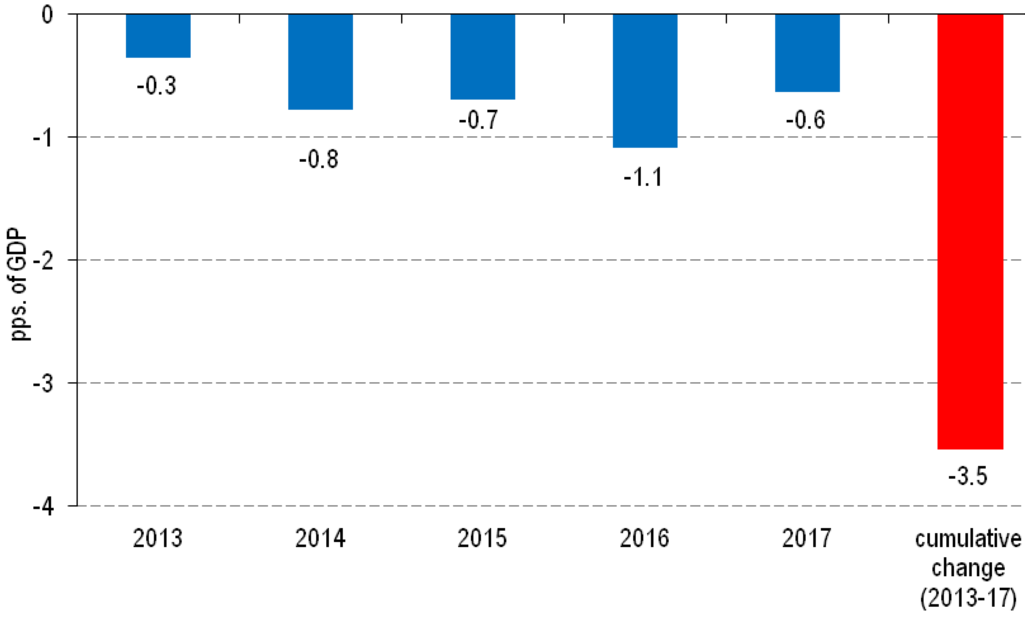
Moreover, works are in progress concerning the draft act defining the path of increasing the minimum level of attendance benefit for a parent who resigns from work to care after disabled child, to the level of the minimum wage. The draft stipulates that as of 1 May 2014 the attendance benefit would increase from PLN 620 monthly to PLN 800 and as of 1 January 2015 - to PLN 1,200, whereas as of 1 January 2016 – to PLN 1,300. At the same time, from 1 January 2014 until 31 December 2014 persons receiving the attendance benefit obtain the supplementary benefit of PLN 200. The total amount of support from 1 May 2014 to 31 December 2014 shall reach PLN 1000.

The measures which may potentially increase the level of expenditure are the regulations arising from *the Act on specific solutions associated with the protection of jobs*, enabling, in specified cases, to increase the expenditure of the Labour Fund and the Fund of Guaranteed Employee Benefits, for the needs of protection measures (granting and payment of benefits for the protection of jobs, to be applied in the periods of economic shut-down or reduced working hours, co-financing of training from the Labour Fund for employees subject to economic shut-down or reduced working hours). The aforementioned act also stipulates the monthly monitoring of the unemployment rate: in case of the dynamics of changes in the unemployment rate equal or higher than 7% in two consecutive months, in relation to the corresponding period of the previous year, the financial plans of the Labour Fund and Fund of Guaranteed Employee Benefits shall be modified.

The main factors influencing the level and the structure of expenditure over the forecast horizon will be systemic changes which have already been introduced as well as those which are planned, changes in public investment expenditures arising from the investment cycle, in particular infrastructural investment, as well as the decisions to maintain the nominal freezing of the remuneration fund in the central government and social security sub-sectors until 2016.

As a consequence, the relation of expenditure of the sector to GDP will systematically decrease, to reach the level of 38.7% of GDP in 2017.

Chart 8. Changes in share of general government expenditure in relation to GDP



Source*:* Ministry of Finance

The share of general government investment, after reaching its record level in 2011, amounting to 5.7% of GDP, decreased to 3.9% of GDP in 2013. It is projected that also in the consecutive years, the share of investment in the GDP will gradually decrease – to 3.5% in 2017, however, still remaining above the EU average over the entire forecast horizon, i.e. 2.5% GDP in the years 2001-13. The level of investments in the sector is largely determined by the implementation of long-term programmes. The biggest of them is the *Programme for Construction of National Roads for the years 2011-2015*, encompassing investment tasks connected with the construction and re-construction of national roads and highways, financed from NRF. In 2013 the programme was supplemented by "Appendix no. 5" comprising the sections of express roads and highways and "Appendix no. 6" comprising the by-passes of cities, the construction of which will be financed under the new EU financial framework for years 2014-20. In 2014 slight increase of the investment expenditure from the NRF is planned, which is associated with the use of a large portion of the EU funds from the previous financial framework and the gradual launching of funds from the current framework. Another significant long-term programme is the *Multi-Annual Programme of Railway Investments to 2015*, encompassing the investment expenditure on the construction and modernisation of railway lines, performed by PKP PLK S.A. These investments are financed from the Railway Fund, the state budget. the European Union funds and by PKP PLK S.A. In accordance with the *Multi-Annual Programme…,* significant increase in the investment expenditure on the development of railway will occur.

The investment level in the sector will also be determined by the scale of investment expenditure in the local government sub-sector. It is foreseen that the investment of the local government units will be mainly determined by the use of the EU funds. It is assumed that in years of lower inflow of aid funds, this deficit will be partly compensated by the increased use of the domestic funds. The investment in the local government sub-sector and the stronger absorption of the EU funds should be fostered by the solutions introduced pursuant to the Act of 8 November 2013 *on the amendment to the Public Finance Act and some other acts*, easing some strict rules arising from art. 243 of the *Public Finance Act.* In accordance with the amendment to the *Public Finance Act,* throughout the entire period of repayment of the liability, the exclusion shall be applied to the redemption of securities, repayment of credits and loans including the interest and discount due, respectively, issued or incurred in connection z the agreement concluded for the implementation of the programme, project or task funded at least in 60% from the non-refundable EU aid, in its part corresponding to the expenditure on the national contribution financed by such liabilities. Thus, the current regulations *de facto* exclude the liabilities incurred for financing of the investment funded with the share of the EU funds, based on debt limits, which should encourage the local government units (hereinafter referred to as LGU) to change their structure of expenditure towards increasing the level of investment. This supports the implementation of the recommendation of the Ecofin Council concerning the minimising of cuts in growth-enhancing infrastructure investment.

Another important factor determining expenditure are the tendencies concerning the costs of labour in general government. It is assumed that until 2016, in its part associated with the costs of labour within the period of the forecast, the nominal remuneration fund in the central government sub-sector and social insurance sub-sector will not change in relation to 2013 (except for the remuneration of employees of public higher schools, which – pursuant to the arrangements of the Council of Ministers – are to grow at a nominal rate of 9.14% per year, so that they rise by 30%[25] in total in the years 2013-2015), whereas in 2017 they will grow according to the pace of the forecast inflation. Moreover, the conservative assumption was adopted (for the level of the deficit) that the remuneration fund in the local government sub-sector will grow at the forecast growth rate of the average remuneration in the market sector. Irrespective of the independence of decisions taken by the local government units, the dynamics of labour costs has been recently significantly restricted, which means that most probably it will be lower than in the market sector in the following years.

The payments of social security benefits will be determined by:

- annual indexation of old age pensions and other pensions (the system of indexation of social insurance benefits which depends on the inflation rate and the real growth in remuneration recorded for the previous year, shall cause that in the period of expected acceleration of the nominal GDP growth the amounts of the aforementioned benefits will grow slower than the nominal GDP, contributing to the reduction of the deficit in the subsequent years);
- extension of maternity leave (and additional leave on the same conditions as maternity leave) and introduction of the so-called parental leave (the increased funds for this measure result from implementation of the priority pro-family targets by the government).

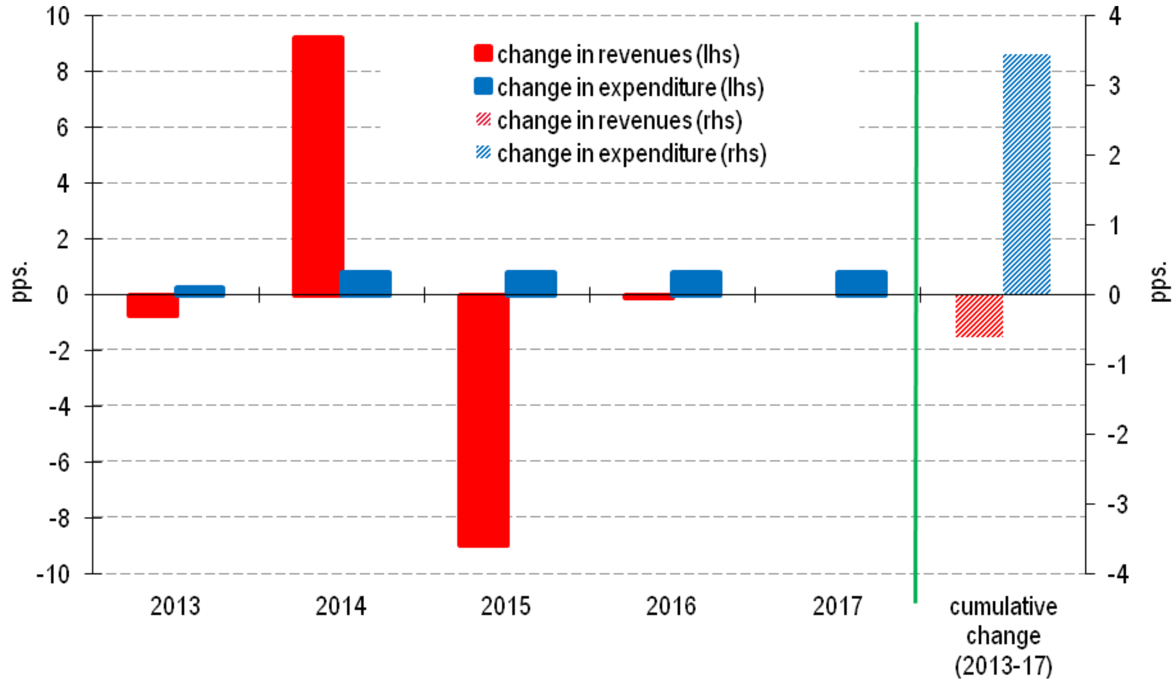
The factors affecting the decrease in the expenditure of the sector will also include the reduced expenditure of the state budget on the implementation of the *Common Agricultural Policy*, to be compensated by higher EU funds neutral for the deficit of the sector.

It should be remembered the stability of the public finances will be supported with a growing strength by effects of the biggest change in the pension system of the recent years, i.e. increasing and equalising the retirement age for women and men at a level of the age of 67. This change shall, on the one hand, increase the future pensions and, on the other hand, improve the balance of the public pension fund, limiting the imbalance of public finance. Moreover, raising of the statutory retirement age will influence the increase in the labour supply which, in turn, shall foster the economic growth, as a consequence of which the improvement of the financial situation should be visible in all institutional sectors, including the public finance sector.

As a result, it is forecasted that in 2014 the sector will achieve the surplus at a level of 5.8% GDP and the following years the deficit shall amount, respectively, to -2.5% GDP in 2015 -1.8% GDP on 2016 and -1.2% GDP in 2017.

[25] Cf. Regulation of the Minister of Science and Higher Education of 5 October 2011.

Chart 9. The impact of the change in national revenue and expenditure on the general government balance in relation to GDP

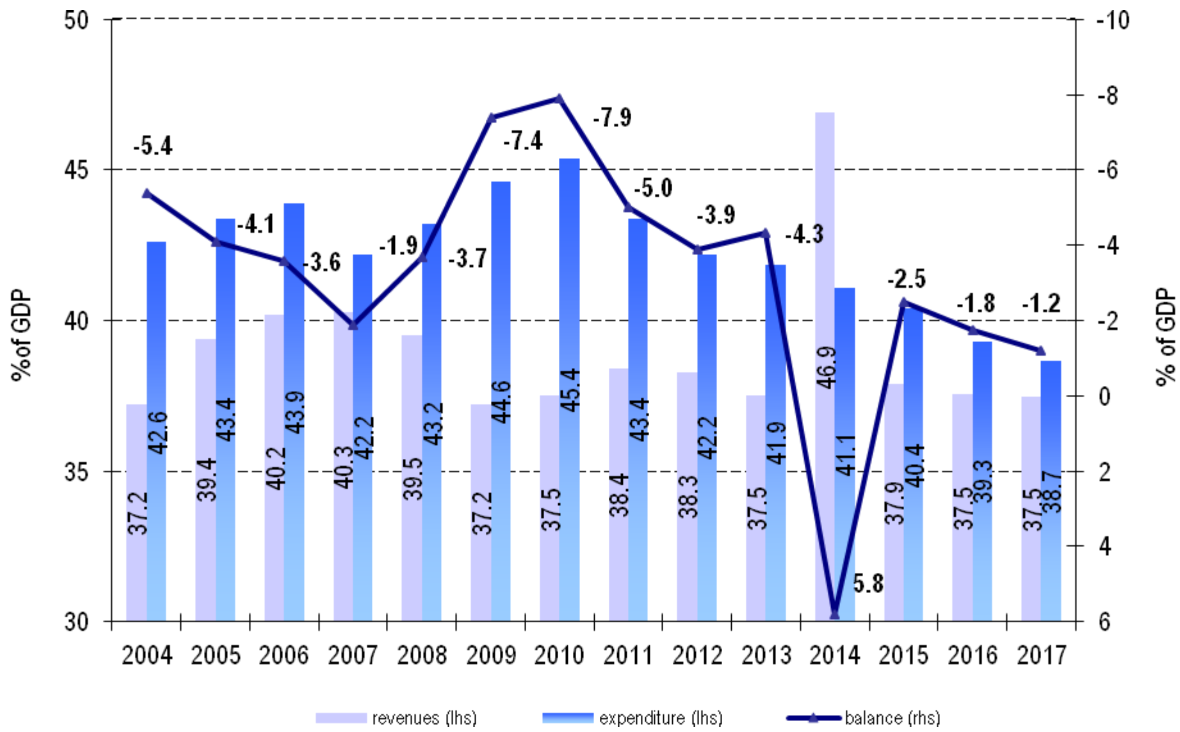


Explanations: revenue – “plus” column means an increase of the share of national revenue to GDP for respective years, “minus” column – the decrease. Expenditure – “plus” column means the reduction of the share of national expenditure to GDP for respective years, “minus” column – the increase.

Source: Ministry of Finance

As a result of the implementation of the presented consolidation strategy, reaching the medium-term budgetary objective will be mainly the result of reduced expenditure, not of increasing sector revenues in relation to GDP (see chart 9). Consequently, as early as in 2014 the share of the national general government expenditure in GDP should, for the first time since the transformation, fall below 40% of GDP. Moreover, this share should continue to decrease in each subsequent year (see charts 7 and 8).

Chart 10. Revenue, expenditure and balance of general government



Source: 2004-2012 – Eurostat, 2013-2017 – Ministry of Finance

III.5. Structural balance

Within the horizon of the *Programme* the structural deficit - in accordance with the forecast based on the new methodology of estimation of the output gap, presented above - will gradually decrease, in total, by approximately 2.4 percentage points, and consequently, in 2017 it will reach the level of 1.4% of GDP. The decrease in the structural deficit will result from the consolidation measures undertaken currently and in the past, leading to a stronger improvement of the nominal balance than would arise from the improving economic trends and the one-off measures. In the period covered by the *Programme,* four one-off measures exceeding the significance threshold of 0.05% of GDP are planned (all implemented in 2014):

- transfer of OFE assets according to the market value, in the amount of PLN 153.2 bn (approximately 9.0% of GDP);
- revenue from sales of radio frequencies in the amount of PLN 1.8 bn (approximately 0.1% of GDP);
- execution of the Constitutional Tribunal ruling in connection with disbursements from the Social Insurance Fund related to persons who acquired retirement entitlement before 1 January 2011, with no need to resign from work, in the amount of PLN 1.0 bn (approximately -0.1% of GDP);
- execution of the Constitutional Tribunal ruling in connection with the payment of overdue carer's allowances in the amount of PLN 1.0 bn (approximately -0.1% of GDP).

The presented structural deficit path allows for the achievement of the nominal targets defined in the recommendations of the Ecofin Council of December 2013 and leads to the sustainable elimination of excessive deficit within the deadline determined in these recommendations.

Table 1. Cyclical developments

% of GDP	ESA Code	2013	2014	2015	2016	2017

% of GDP	ESA Code	2013	2014	2015	2016	2017
1. Real GDP growth (%)		1.6	3.3	3.8	4.3	4.3
2. Net lending of general government	EDP B.9	-4.3	5.8	-2.5	-1.8	-1.2
3. Interest expenditure	EDP D.41	2.6	2.1	2.2	2.1	2.1
4. One-off and temporary measures			9.0			
5. Potential GDP growth (%)		3.2	3.2	3.4	3.6	3.7
6. Output gap		-1.2	-1.0	-0.7	0.0	0.5
7. Cyclical budgetary component		-0.5	-0.4	-0.3	0.0	0.2
8. Cyclically-adjusted balance (2-7)		-3.8	6.2	-2.2	-1.8	-1.4
9. Cyclically-adjusted primary balance (8+3)		-1.2	8.3	0.0	0.3	0.7
10. Structural balance (8-4)		-3.8	-2.8	-2.2	-1.8	-1.4
p.m. Estimate of the level of expenditure in line with the stabilising expenditure rule (bn PLN)		657.6	688.1	707.9	733.2	758.5

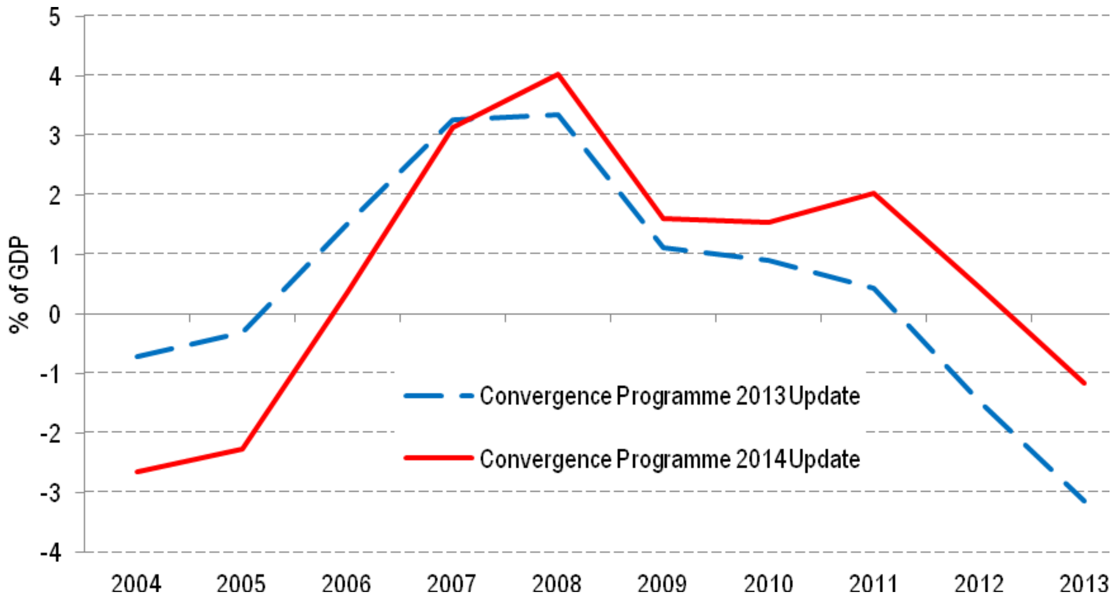
Source: Ministry of Finance

The estimates and forecasts of the structural deficit presented in the *Programme* are not comparable to the forecasts of the European Commission contained in the aforementioned recommendations of the Ecofin Council, the last winter forecast of the Commission, or with the path presented in the previous update of the *Programme*. The reason is that the data contained in Table 1 are based on estimates of the potential GDP and the output gap, prepared in accordance with the new methodology of the European Commission (agreed this year within the Output Gap Working Group (OGWG) acting under the EU Economic Policy Committee (EPC)).

The most important changes in relation to the previously applicable method of potential output estimation refer to the method of determining the Non-Accelerating Wage Rate of Unemployment (NAWRU). In the approach agreed for Poland, the Non-Accelerating Wage Rate of Unemployment (NAWRU) is determined on the basis of the Neo-Keynesian Phillips curve, taking into account inflation expectations. In case of Poland such a form of the Philips curve, allows for obtaining the statistically and economically significant relationship between the change in the real unit labour costs and the cyclical part of the unemployment rate (UR-NAWRU). In the approach used before, this relationship was statistically insignificant.

The change in the method of calculating the Non-Accelerating Inflation Rate of Unemployment in the current method of estimation of the potential output results in significant revision of the historical and forecast NAWRU, in relation to the methodology used before this change. Accordingly, the level of the output gap for the historical data and, consequently, for the forecasts, was revised. The maximum differences in historical periods reach even 2.7% of GDP (cf. chart 11).

Chart 11. Output gap between 2004-2013 calculated in accordance with the new and old methodology

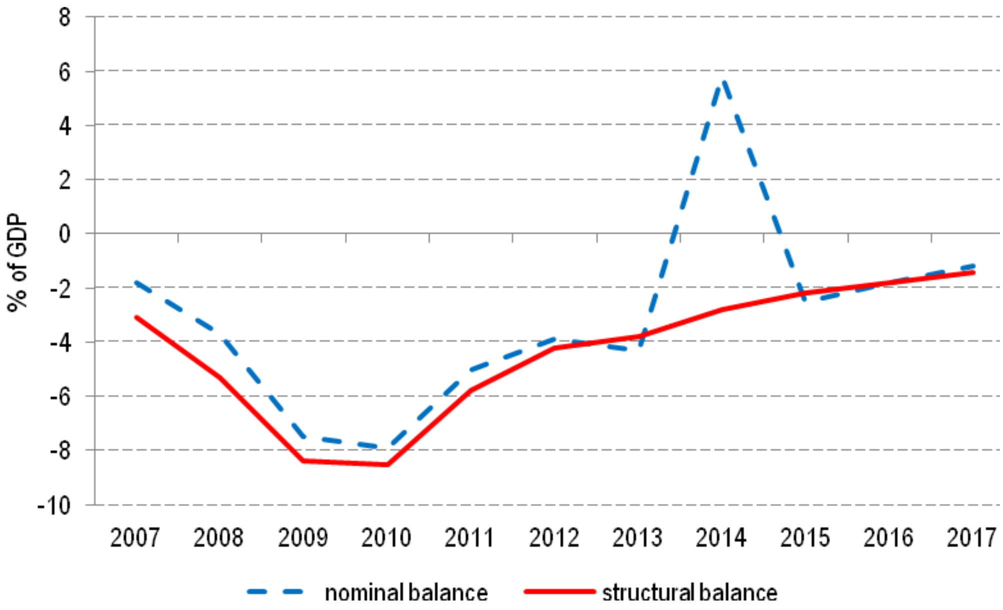


Source: Ministry of Finance

Further to the *Stability and Growth Pact* amended in 2011[26], *sufficient progress towards the medium-term budgetary objective shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of expenditure net of discretionary revenue measures.* Poland adopted its medium-term budgetary objective, i.e. the target structural general government balance at the level of -1% of GDP and it currently follows the adjustment path towards that objective. It is forecasted that in w 2017 the structural balance will amount to -1.4% of GDP and the MTO should be achieved in the following year. The factors to contribute to the fulfilment of this goal include the individual debt limits of local government units and the stabilising expenditure rule which requires the expenditure growth rate to be slower than medium-term GDP growth in case of imbalance of public finances defined, among others, as the general government deficit higher than the medium-term budgetary objective (see: chapter VII).

[26] See Article 9 point 1 of the *Resolution of the EU Council No. 1466/97/EC on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies* as amended.

Chart 12. Structural and nominal general government balance between 2007-2017



Source: Ministry of Finance

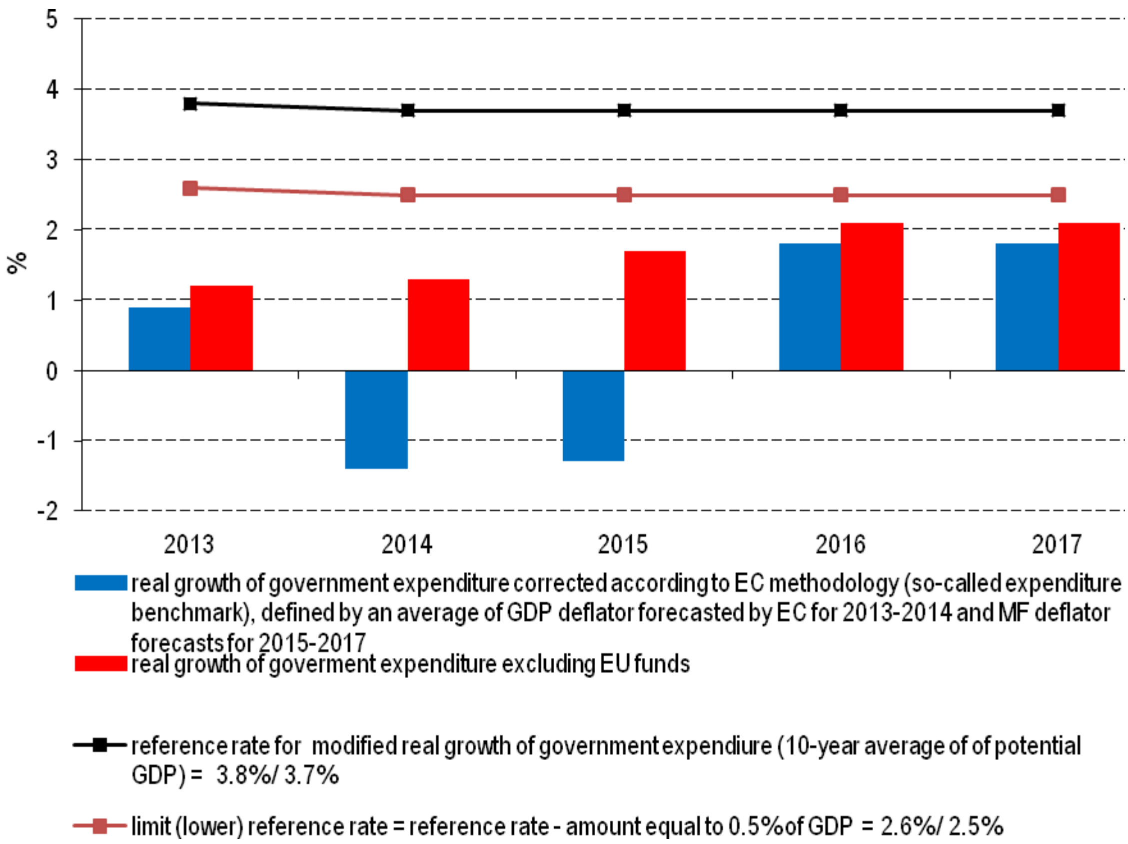
Until the medium-term budgetary objective is achieved, the annual rate of general government expenditures – adjusted according to the methodology applied by the European Commission[27] - should not exceed the reference rate reduced by a value corresponding to 0.5% GDP. Currently, the reference rate, i.e. 10-year average of the potential real GDP growth, for Poland amounts to 3.7% (in case of *ex post* assessment of 2013) and 3.8% (from 2014).Considering the correction arising from the need to achieve the medium-term budgetary objective, it gives the required lower reference rate of 2.5 and 2.6%, respectively.

According to forecasts, in the years 2014-2017 Poland will meet the above mentioned requirement regarding the expenditure growth rate (the so-called expenditure *benchmark*). It is expected that the annual real expenditure rate modified according to the methodology of the European Commission (as well as the real growth rate of domestic expenditure, i.e. expenditure after deducting the expenditure financed from the EU funds which is neutral for the deficit) will vary within the range (-1.5%, +2%) in the years 2012-2017, which is significantly below the lower reference rate. The growth of expenditure is modified, inter alia, through reducing the discretionary measures on the revenue side (cf. table 17).

It should be indicated that these measures, contrary to the structural balance, should also take the one-off measures into account. However, the transfer of assets from OFE and the transfer due to the so-called 'safety slider', were deliberately excluded since, in accordance with the ESA2010 methodology, they will not be classified as revenues. Irrespective of the foregoing, the *benchmark* requirement would be fulfilled even if no discretionary measures were planned in the years 2013-2017 on the revenue side, only the distance to the aforementioned lower reference rate would be smaller.

[27] That is after deducting the costs of debt service, expenditure financed from EU funds whose final beneficiary is the general government unit, periodic growth of expenditures for the unemployed as well as after replacing investment expenditures from the given year with an average for the past four years and after deducting net results of the discretionary measures in revenues.

Chart 13. General government expenditure modified according to the methodology of the European Commission



Source: Ministry of Finance

The stabilising expenditure rule (SER) provides a similar concept to the expenditure *benchmark* (cf. chapter VII.1). The adjustment by 0.5% of GDP required in the *benchmark* will be fulfilled owing to the adjustment of the expenditure dynamics in SER by 1.5-2 percentage points provided that the scope of expenditure covered by the rule[28] exceeds 1/3 of GDP, which is a very safe assumption. There are differences in the *benchmark* and SER methodology: (1) the use of the 10-year average of the potential GDP growth rate instead of the 8-year average real GDP growth rate, (2) the average forecast of GDP deflator, instead of the forecast of CPI inflation, (3) the inclusion of debt service expenditure and unemployment benefits in SER as well as (4) the use of a four-year average instead of the investment level from a given year. Nevertheless, the compliance with the SER should imply fulfilment of the expenditure *benchmark* requirements.

In accordance with the *Act on Public Finance,* in the update of the *Convergence Programme* constituting a part of the *Multiannual Financial Plan of the State,* the preliminary *level of expenditure* (not to be confused with the expenditure limit - more on that issue in chapter VII.1) is defined on the basis of the stabilising expenditure rule provisions, in accordance with the macroeconomic and fiscal indicators forecast in this programme.

The calculation of the *level of expenditure* for 2015 consisted of three stages. First, the planned consolidated expenditure (or, possibly, costs) sum was calculated for units and funds covered by the stabilising expenditure rule. This sum amounted to PLN 657.6 billion. Secondly, the *level of expenditure* for 2014 of ancillary nature was calculated, using the indicators and the correction factors defined in the *Act on Public Finance* as well as the total

[28] Both in case of SER and the expenditure *benchmark,* the scope constitutes the majority of general government sector institutions, following the elimination of expenditure financed from the EU funds.

value of discretionary measures forecast for 2014 on the side of taxes and contributions which amounts to PLN 4.9 billion. It arises from the aggregation of the effects of: (1) reducing the value of transfer of the pension contributions to OFE, (2) increasing the tax rate for ethyl alcohol, (3) liquidation of VAT return in construction and (4) the effects of VAT deduction on vehicles and fuel. Finally, the ancillary *level of expenditure* for 2014 reached PLN 688.1 billion. Thirdly, the *level of expenditure* for 2015 was estimated at a level of PLN 707.9 billion, in accordance with the formula of the stabilising expenditure rule. At the same time, the update of the forecast of the CPI inflation indicator for 2014 was taken into account (1.013 instead of 1.024). On the other hand, the forecast of discretionary measures for 2015 on the side of taxes and contributions, amounting to PLN 3.9 bn, comprised only the reduction of pension contributions transferred to OFE.

In accordance with the formula, the *levels of expenditure* for the years 2016-17 were also calculated. It is planned that the correction of the expenditure dynamics until 2016 will reach -2 percentage points, as in accordance with the forecasts up to 2014 the deficit threshold will be exceeded. In 2017 the correction should decrease to -1.5 percentage points since it is expected that in 2015 the deficit will be lower than 3% of GDP, however, the level of the state public debt will still exceed 43% of GDP. The growth of the *level of expenditure*, slower than the GDP growth rate, will cause the annual decline of its relation to GDP.

III.6. Debt levels and developments

In the period covered by the *Convergence Programme*, debt management will, as in previous years, focus on the achievement of the objective set out in the *Public Finance Sector Debt Management Strategy*, i.e. on the minimisation of long-term debt servicing costs subject to the constraints on the level of risk.

Debt management will be influenced by the gradual reduction of the general government deficit (surplus of the sector in 2014 will be a one-off effect of the transfer of assets from open pension funds resulting from the pension reform), and the uncertainty in the financial markets, arising, among others from limiting of quantitative easing of monetary policy by Fed. In the domestic market, measures associated with limiting the general government deficit should have a considerable impact on the level and shape of the yield curve, and as a consequence on the State Treasury debt servicing costs.

The changes in the pension system introduced in 2013 (cf. chapter III.7) shall have a significant impact on the nominal reduction of public debt in 2014, followed by further decrease of the debt-to-GDP ratio up to 2017.

The changes in the debt–to--GDP ratio in 2015-2017 will result mainly from the state budget borrowing requirements (the State Treasury debt constitutes over 85% of the general government debt), GDP growth rate and the zloty exchange rate in relation to other currencies, especially to the euro. An essential condition influencing the borrowing requirements of the state budget shall be the disbursement of funds from the new EU financial framework for 2014-2020, which will be reflected in the European funds budget balance in the following years. The level of the borrowing requirements will be also influenced by the proceeds from privatization as well as the balance of liquid funds of the public finance sector units which are subject to the public finance sector liquidity management consolidation. It is assumed that further stage of the public finance sector liquidity management consolidation will be implemented, which will contribute to the reduction of borrowing requirements of the budget. The Minister of Finance has prepared and submitted to the meeting of the Committee of the Council of Ministers, the draft of the act stipulating the broadening of a group of units of public finance sector subject to the obligation to deposit liquid funds on the account of the Minister of Finance and to use court deposits in financing of the State budget borrowing requirements.

Changes in the debt of other general government entities will result mostly from changes in the indebtedness of the NRF (the debt increase will result from incurring liabilities to implement road investments within the new EU financial framework) and a relatively limited growth in local government units debt.

In the timeframe of the update , the debt-to-GDP ratio according to the EU methodology will reach the level of 45.5%.

Table 2. General government debt developments

% of GDP	ESA Code	2013	2014	2015	2016	2017
1. Gross debt		**57.1**	**49.5**	**49.5**	**47.5**	**45.5**
2. Change in gross debt ratio		**1.6**	**-7.6**	**0.0**	**-2.1**	**-2.0**
Contributions to changes in gross debt						
3. Primary balance year [1]		1.6	-7.9	0.3	-0.4	-0.9
4. Interest expenditure	EDP D.41	2.6	2.1	2.2	2.1	2.1
5. Stock-flow adjustment		-2.7	-1.8	-2.5	-3.8	-3.2
of which: difference between cash and accruals		0.7	0.4	0.5	0.2	0.0
net accumulation of financial assets		-1.9	0.0	0.5	0.2	0.2
of which: privatisation proceeds		-0.1	-0.1	-0.1	0.0	0.0
valuation effects and other		-1.5	-2.2	-3.4	-4.2	-3.5
p.m.: Implicit interest rate on debt (%)		**4.6**	**4.3**	**4.4**	**4.5**	**4.6**
Other relevant variables						
6. Liquid financial assets		3.1	2.6	2.4	2.2	2.0
7. Net financial debt (=1-6)		**54.1**	**47.0**	**47.2**	**45.3**	**43.4**
8. Debt amortisation (existing bonds) from the end of the previous year [2]		7.0	4.4	6.3	6.0	5.1
9. Percentage of debt denominated in foreign currency (%)		29.4%	34.2%	33.0%	31.5%	31.1%
10. Average maturity [3]		5.3	5.3 – 5.5	5.3 – 5.6	5.3 – 5.6	5.3 – 5.7

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.

Source: Ministry of Finance

Net accumulation of financial assets results from many factors. The most important include the utilisation of the liquid funds under the public finance sector liquidity management consolidation (introduced in 2011), proceeds from privatization and the cash balance of the European funds of the state budget.

III.7. Budgetary implications of "major structural reforms"

The most important decisions of the government affecting the balance of the general government within the horizon of the *Programme* include the measures related to the pension system and the fiscal framework reform.

The measures aimed at gradual increasing in the stability of the pension system comprise, in particular, the gradual increase and equalising of the retirement age for women and men (the target age is 67), raising of the pension contribution, reform of the pension system for the uniformed services (increasing the minimum period of service authorising to retirement benefits for officers and soldiers), changes in the distribution of the pension contribution between the funded and unfunded scheme. At the same time, in 2011 the government was obligated to conduct the periodical reviews of pension system performance. The first review took place in 2013 and it was expanded by the overall analysis of the retirement system reformed in 1999 and effects of this reform on the security and level of future pensions, as well as the analysis of its impact on public finance and the economic growth, including the labour market, capital market and level of savings. Based on the diagnosis arising from the review, a number of decisions were taken, concerning the improvement of effectiveness of the universal pension system, later included in the Act of 6 December 2013 *on the amendment of certain acts that are setting principles of pension benefits' payments from contributions gathered in Open Pension Funds (OFE).*

In accordance with the provisions of the Act, 51.5% of the accounting units recorded in the individual account of each OFE member was cancelled (i.e. a part of the assets invested, among others in the Treasury Securities and bonds guaranteed by the State Treasury), and their equivalent was registered on the sub-account in ZUS; in addition, the level of the contribution transferred to OFE was set at 2.92%, which corresponds to 40% limit of the investment of OFE in stocks at the primary level of the contribution transferred to OFE. At the same time, OFE will not be able to invest in Treasury Securities and in debt instruments guaranteed by the State Treasury. The investment limits for assets managed by OFE will also be changed, aiming at recovering the market (capital) nature of OFE.

Moreover, the insured were offered a possibility to choose whether they are still willing to transfer the new contribution to OFE (in relation to the future contributions), or they prefer to transfer this contribution to the sub-account in ZUS. The maximum level of the fee charged by the OFE managing institutions was also reduced by a half, to 1.75%.

At the same time the issue of disbursement of annuity from the funded part of the pension system was regulated. The annuity will be paid by ZUS, no matter if the insured remained in OFE or moved to ZUS. For this purpose, the so-called safety slider was introduced, based on the gradual transferring - over a period of 10 years prior to reaching the retirement age – of the capital collected in OFE to the pension fund of FUS and its registering on the sub-account kept by ZUS. This solution should reduce the negative consequences of potential market disturbances related to the level of the pensions. At the same time, the contributions paid by persons covered by the safety slider shall be entirely transferred to ZUS.

The funds transferred to the sub-account in ZUS will be subject to the current rules of indexation, applying the indicator equal to the average annual growth rate of GDP for a period of the last five years. It should be expected that the growth rate of the nominal GDP in the nearest years will not be lower than the rate of return the Polish treasury bonds, causing that it will be neutral for the level of the pension of a person insured. As a result, the replacement rates should reach the level similar to the status before the changes were introduced.

The changes in the pension system introduced by the aforementioned act will have a positive impact on the general government balance. The factors to influence the balance will include: transfer of assets (the government has taken over the assets in exchange for the future retirement obligations), the safety zipper, higher contribution submitted to FUS and lower debt servicing costs (in connection with the redemption of treasury securities purchased by the Minister of Finance and decrease of the borrowing needs).

Table 3. Impact of changes in the pension system on the general government balance

Years	2014	2015	2016	2017
bn PLN	167.6	18.2	20.3	23.3
% of GDP	9.8	1.0	1.1	1.1

Source: Ministry of Finance

In February 2014 51.5% of net assets of OFE was transferred to ZUS, including the Treasury Securities, bonds of the NRF and other bonds guaranteed by the State Treasury. The Treasury Securities were acquired by the State Treasury from ZUS and then cancelled. The cancellation of the Treasury Securities and the consolidation of the NRF bonds acquired by ZUS resulted in a one-off reduction of the general government debt by PLN 145.8 billion (ca. 8.5% of GDP). The State budget borrowing requirements will also be limited in the following years due to the improvement of FUS balance and the reduction of the debt servicing costs (as a consequence of the cancellation of the Treasury bonds and reduction of the borrowing needs). The improvement of the FUS balance will mainly arise from reducing the contribution transferred to OFE (resulting from lower contribution rate and introduction of the choice over the transfer of the contributions to OFE), the mechanism of a gradual transfer of assets from OFE to ZUS at ten years before retirement and due to the proceeds from assets other than Treasury bonds, transferred by OFE to ZUS.

The lower borrowing requirements will reduce the debt level in the consecutive years.

Table 4. Cumulated impact of changes in the pension system on the general government debt

Years	2014	2015	2016	2017
bn PLN	-163.9	-182.7	-203.6	-227.1
% of GDP	**-9.6**	**-10.1**	**-10.6**	**-11.0**

Source: Ministry of Finance

In accordance with the ESA2010 methodology binding from September 2014 the transfer of assets and the safety zipper will not be treated as revenue, but as the financial advance – without their impact on the balance of the sector. On the other hand, the transfer from EAS95 to ESA2010 will be neutral for the level of the general government debt.

The act mentioned at the beginning of this chapter has also introduced changes aimed at increasing the participation in the third pillar of pension insurance. The withdrawals from Individual Pension Accounts (IKZE) and the payments to the benefit of persons authorised will be subject to flat rate income tax at a level of 10% of the revenue, replacing the currently applicable taxation according to the PIT scale. The adoption of this solution, through the definite decrease of fiscal burden at the end of saving on IKZE, will constitute the real motivation to saving on this account and eliminate uncertainty concerning the level of tax to be paid in the future when withdrawing the funds from IKZE.

Moreover, in the *Act on Individual Pension Accounts and Individual Accounts of Pension for Retirement,* solutions were introduced concerning the level of the annual limit of payments to IKZE. The annual limit of payments on IKZE will be equal for everyone and may not exceed the amount corresponding to 1.2-fold value of forecast average monthly wages and salaries in the national economy for a given year, defined in the Budget Act.

The entry into force of the agreement shall limit the costs of pension reform, without affecting the level of pensions from the obligatory part of the pension system, significantly strengthening their security.

Parallel to the public reforms in the pension system, positively influencing the stability of public finance, many changes strengthening the fiscal framework were also introduced. Consequently, in the period covered by the forecast, the fiscal policy in Poland will be determined - besides the prudential thresholds (included in the *Constitution of the Republic of Poland* and the *Act on Public Finance*) aimed at limiting the level of public debt - by the stabilising expenditure rule, introduced to the Polish legislation by the *Act of 8 November 2013 concerning the amendment to the Act on Public Finance and some other acts* and the fiscal rules applicable to the local government units. The solutions aimed at reducing the risk of increased indebtedness or loss of LGU liquidity comprise the rule of at least one sustainable current balance of the local government budget and the individual debt limits binding as of 2014. The solution aimed at stabilising the general government in a medium-term at a level of a medium-term budgetary objective, is the stabilising expenditure rule. The SER will be effective as of 2015 while it was used on auxiliary basis during the activities concerning the Budget Act for 2014 (cf. chapter VII.1).

Moreover, in accordance with the declaration of the government of September 2013 submitted upon commencement of the works concerning OFE reform, currently the works are in progress related to the reduction of the thresholds of public debt relation to GDP in the adjusting mechanism of the stabilising expenditure rule. This change will be introduced through the amendment to the *Act on Public Finance* and the *Act concerning the amendment to the Act on Public Finance and some other acts, adopted by the Council of Ministers on* 25 February 2014 (cf. chapter VII.1).

IV. Sensitivity analysis and comparison with previous update

IV.1. Risk factors

1) Economic situation of Poland's major trade partners

The development of economic activity of Poland's major trade partners is a basic risk factor for the macroeconomic forecast presented in chapter II. The forecast was prepared based on the available data concerning the current and expected situation in the EU, consistent with the scenarios presented by the European Commission in the winter edition of forecasts published in February 2014. According to the opinion of the European Commission, in spite of the relatively optimistic expectations concerning the economic growth worldwide, many risk factors exist for the presented scenario, which are not balanced. Similar to the autumn edition of forecasts published in 2013, the negative risk factors prevail, among which the European Commission lists:

- delays in implementation of structural reforms in Member States, resulting in lower potential economic growth, relative deterioration of the situation in the labour market and, as a consequence, the lengthening of a period of low growth in economic activity of the EU countries;
- maintaining excessively low inflation, among others, due to the growth path in the developing countries lower than assumed (and, as a consequence, lower level of raw material prices and relative euro appreciation), and persistence of the low inflation expectations of economic entities in the EU, which, through the interest rate channel, shall lead to the reduction of the aggregated demand and growth of the real level of debt of the economic sectors;
- increased instability in financing of the economic growth in developing countries, which may contribute to the limitation of their economic growth in the context of still unresolved structural barriers jeopardising the potential growth rate, and as a consequence, through the trade exchange channel, unfavourable changes in the balance structure and banking system, it may lead to limitation of the economic activity in the EU.

A factor which could have a potential positive impact on the adopted economic growth path of our biggest trade partners is, according to the European Commission, a possible occurrence of higher effects of the interface between the improved sentiment, increase in investment and GDP as well as improvement of balances of banks and their capacity to increase the credit action.

The additional risk factor for the implementation of the macroeconomic forecast presented in chapter II is the possible further acceleration of the situation in Ukraine, also in the context of possible economic sanctions against Russia - which poses threat of a clear weakening in the dynamics of economic activity in the countries of the Commonwealth of Independent States and, as a consequence, the reduction in the dynamic of trade exchange of Poland with this region. The exposure of the Polish export on the markets of Russia and Ukraine, in spite of the growth recorded in the recent years, still remained moderate and it is still lower than before the Russian crisis in 1998 r. Exposure to the market of Ukraine only, i.e. direct risk, is minor, reaching only 2.8%, however, jointly with Russia, it reaches 8.1%. An essential factor which should partly mitigate the negative consequences of the potential decline in the demand of the eastern markets is also the assumed clear improvement in the dynamics of EU import in the current year, i.e. the main indicator of the Polish export. The escalation of the conflict may be also reflected in weaker results of our key trade partners, in particular, if the conflict resulted in the significant increase of turbulences in the financial and raw material markets.

2) Implementation of the EU requirements concerning CO_2 emission reduction

Both quantitative and qualitative analyses assessing the effects of implementing the climate and energy package in Poland indicate that this carries the risk of a range of negative effects in the areas of energy, economic and social policy. Challenges for the Polish economy related to the implementation of EU climate and energy policy objectives result from the dependence of the Polish energy sector on fossil fuels – over 90% of electricity in Poland comes from lignite and hard coal-fired power plants. Fulfilment of these objectives will require significant investments in the emission intensive sectors. Furthermore, due to an increase in electricity prices, a slowdown in the rate of economic growth may be expected, as well as a lowering of the state budget income, with an increase in unemployment, lower household disposable income and an increase in the cost of energy as a proportion of household budgets (i.e. the risk of the so called "energy poverty" phenomenon).

Polish enterprises are characterised by low energy efficiency compared to the leaders in the EU. As a consequence, domestic enterprises operating in the energy intensive sectors face the risk of a significant increase in operating costs and a loss of international competitiveness. Moreover, domestic entities are exposed to the risk of carbon leakage (transferring energy and emission intensive production from the EU Member States implementing CO^2 emission reduction policy to countries with lower environmental standards).

3) Lower absorption of EU funds

The risk of under-spending of funds from the Polish allocation of structural funds and the Cohesion Fund as well as from the *Rural Development Programme* (RDP) from the programming period 2007-2013, results from the economic situation in the EU , which has led in recent years to the adoption of the EU's annual budgets at a level which is inadequate for the implementation of the cohesion policy and the RDP in Poland, as well as in other countries which are beneficiaries of EU funds (accumulation and prolongation of pre-financing expenditure from the budgets of general government). The necessity of ensuring the availability of public funds for national co- and pre-financing of projects is another source of this risk, since the reimbursement of pre-financing takes increasingly longer (applications submitted in December 2013 will be refunded only about mid-2014).

In 2014, the prolonged negotiations concerning the individual operational programmes may pose threat for advance payment part from the EU budget for the period 2014-2010 (the advance payment is disbursed following the approval of the operational programme by the European Commission).

4) Effects of OFE reform

The forecast presented in the *Programme* takes into account the financial effect in functioning of the capital part of the pension system (introduced by the *Act of 6 December 2013 on the amendment of certain acts in connection with the determination of the rules for payment of pension from resources collected in the open pension funds*.) At the same time, the assumption was made that in connection with the introduced discretion in transferring of a part of the pension contribution to the open pension funds (OFE), 50% of the capital part of the pension system participants will decide to collect the whole pension contribution in the Social Insurance Institution (ZUS). In the period from 1 April 2014 until 31 July 2014, OFE members may submit a declaration to ZUS concerning transferring of the contribution at a level of 2.92% of the basis for assessment to the open pension fund, starting from the contribution paid for July this year.

In the act reforming the pension system of December 2013, the government assumed that 50% of OFE members shall decide to return to ZUS, since it could not assess alternative solutions and suggest in the Act which solution would be more favourable: participation in OFE or participation in the PAYG system. On the basis of public opinion surveys it may be, however, deducted that the preferences of the insured show higher risk aversion and more people will decide to choose safer solutions. Considering the above, the balance of risk factors in the area of impact of changes in the pension system on public finance is positive. The scenario that a higher percentage of the insured (>50%) shall decide to transfer their whole pension contribution to the sub-account in ZUS, is more probable. The contributions which would not be transferred to OFE, would supply FUS and would be allocated for current payments of social insurance benefits guaranteed by the state. As a consequence of maintaining a larger part of the contributions in the sector, the financial needs of FUS would decrease and its balance would improve.

5) Sureties and guarantees

In the coming years, a concentration of sureties and guarantees granted by the State Treasury mainly on investments facilitating developments in the road and rail infrastructure as well as environmental protection, creating new jobs and regional development, is anticipated. Sureties and guarantees will mainly be granted for investments utilising EU funds (loans and bonds underwritten or guaranteed by the State Treasury should enable the obtaining of EU funds), as well as for other investments arising from potential new support programmes for which sureties and guarantees may be granted according to EU regulations.

The value of new sureties and guarantees granted by the State Treasury in a given year is limited by the Budget Act. The 2014 limit in the budget act was determined at PLN 300 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 cause a worsening in the functioning of the Polish financial system.

As of the end of 2013, the sum of potential obligations by the State Treasury for sureties and guarantees already granted amounted to approximately 6.4% of GDP. For the years 2014-2015, a further growth of this sum is predicted, but it is not expected to exceed 9% of GDP. According to forecasts the risk associated with the sureties and guarantees portfolio should be in the range of 5-10%.

Among other operations posing risk of additional burden for public finance the potential takeover of the debt in connection with the granted guarantee of the State Treasury should be listed, which may result in the growth of deficit and debt by the amount of the liabilities taken over.

6) Other risk factors

In the forecast presented in the *Programme* maximum financial effects arising from the implementation of the Constitutional Tribunal rulings were taken into account, adjudicating the non-compliance with the *Constitution of the Republic of Poland* in relation to:

- art. 28 of the *Act of 16 December 2010 on the amendment of the Act on public finance and some other acts (Journal* of Laws No. 257, item 1726, as amended), in conjunction with art. 103a *of the Act of 17 December 1998 on pensions and retirement benefits from the Social Insurance Fund* (Journal of Laws of 2009, No. 153, item 1227, as amended);
- art. 11 items 1 and 3 of the Act of *7 December 2012 on amendment to the Family Benefits Act and some other acts*.

In both cases the state budget expenditure will be incurred after submission of the relevant applications by beneficiaries. The lack of automatic payment of the overdue benefits causes that the accomplishment of the budgetary expenditure at a level lower than assumed is more probable.

At the same time, in accordance with the prudential rule, the measures increasing the tax compliance and improving the effectiveness of the tax administration (broader discussed in chapter VI.2) have been included in the forecast in a conservative manner. First of all, in case of quantifiable measures, their minimum estimated impact on the increase in the revenue of the general government has been taken into account. Secondly, the so-called "soft" measures constitute a part of the planned actions, for which the estimation of the financial benefits is not possible, however, through their nature and direction, they would unquestionably have a positive impact on the improvement of tax collection and the increase in effectiveness of the tax administration.

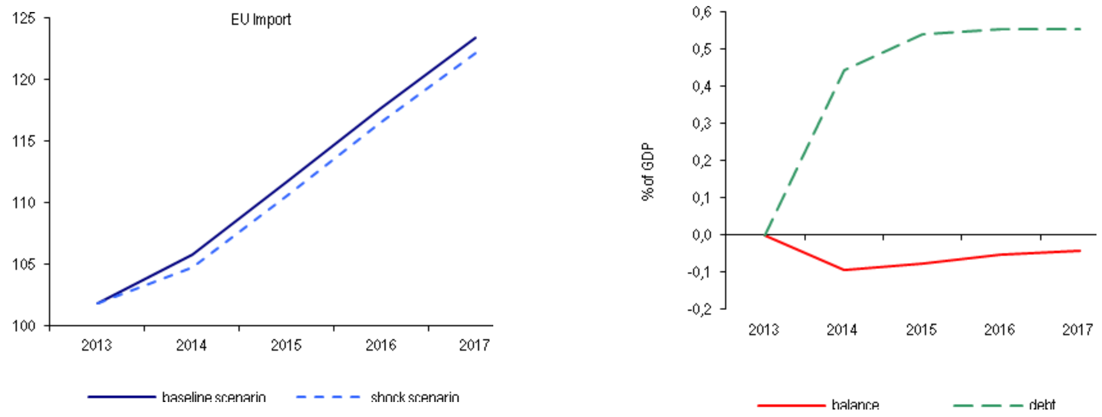
Similar approach was applied to the pro-cyclical effect of the tax flexibility (cf. chapter III.4), as well as in relation to the forecast of remuneration growth in the local government sub-sector. In the latter case, it was assumed that the remuneration will grow according to the growth rate of remuneration in the market sector. In 2013 the growth of labour costs in the local government sub-sector was equal to the consumer price index.

The aforementioned assumptions confirm the conservative nature of the forecast balance of the general government presented in the *Programme*.

IV.2. Sensitivity analysis

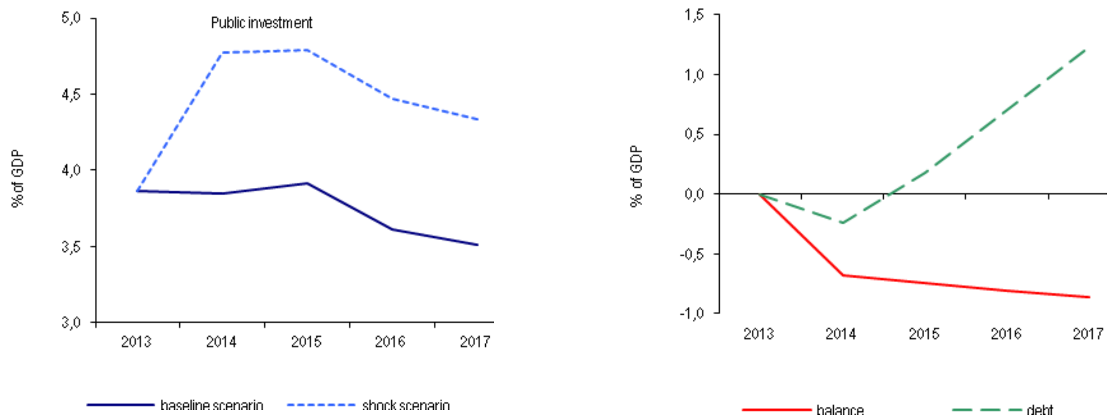
The sensitivity of the general government balance and debt in the years 2014-2017 to a decrease in global demand, increase in public investments, depreciation of the exchange rate of the zloty and the increase in the domestic interest rate is presented below. The analysis was made on the basis of the econometric Model of Public Finance (eMPF) developed by the Ministry of Finance. The simulations were performed for the years 2014-2017 when the economy is not in a steady state. Due to the eMPF model specification, the analysis assumes that the change in interest rates translates fully and immediately into changes in the cost of public debt service. In fact, debt service costs are fixed for a certain period of time, so the impact on the balance and debt of general government should be lessened. Therefore this is an extremely cautious approach to the sensitivity scenario.

Chart 14. EU import (left chart) and the impact of a change in global demand on general government balance and gross debt (right chart)



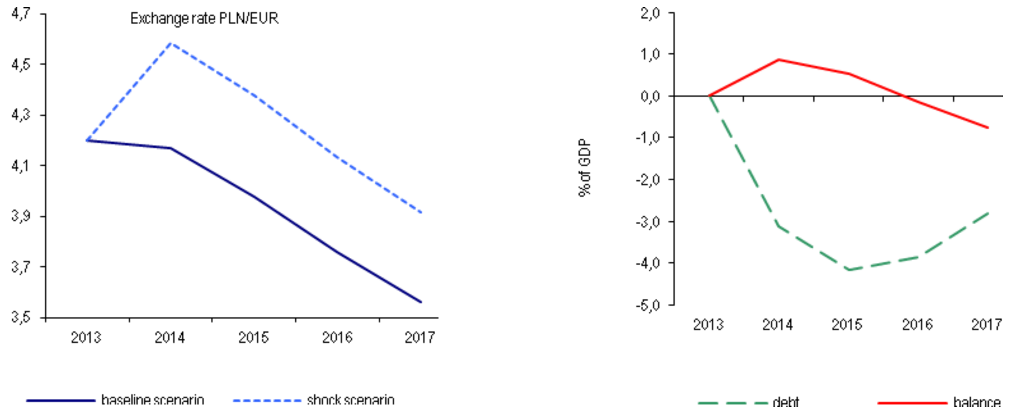
The impulse of the slowdown in global demand has been defined as a permanent 1% decrease in the global demand indicator (EU imports in the model) as compared to the baseline scenario. A direct effect of disturbances in the external environment for the national economy is a reduction in foreign trade. In the first year from the occurrence of the shock the volume of exports declines by 0.6% against the baseline scenario, and in subsequent years it remains lower by 0.5%. Due to the high import intensity of exports, the decrease in the export volume is accompanied by a decline in imports (by 0.6%), additionally supported by depreciation of the national currency which is the result of worsening sentiments in the world economy. The decrease in global demand translates into a limiting of enterprise investment activity (gross fixed capital formation of the private sector in the first two years after the shock remains lower by, respectively, 1.3% and 1.5%, as compared to the baseline scenario, and in the following years they remain at the level of 1.2-1.0% below the base path), reducing employment and remuneration. Household disposable income goes down, which limits private consumption by 0.2-0.3%. As a result of these disruptions, GDP remains persistently lower in the projected period by 0.3-0.4% as compared to the non-shock scenario. A lower domestic demand is accompanied by the lowering of inflationary pressure and a decrease in interest rates. Lower economic growth negatively affects the fiscal condition of the country. The general government deficit increases (in the first year by 0.1% in 2014-2016), as a result of which in 2017 the government debt in the shock scenario is 0.6% of GDP higher than in the baseline scenario.

Chart 15. Volume of public investment (left chart) and its impact on general government balance and gross debt (right chart)



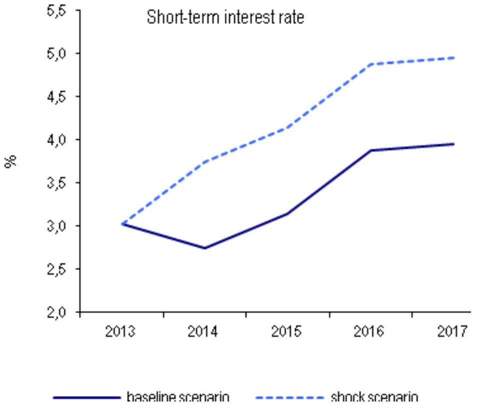
The fiscal impulse has been defined as a sustained increase in general government investment by 1% of GDP as compared to the baseline scenario. The direct effect of an increase in public expenditures is the deterioration of balance of the sector, which during the analysed period remains at a level of 0.7-0.9% of GDP above the base path. Higher public expenditures also imply an increase in private demand which results in an improvement of the condition of the labour market, an increase in inflationary pressure and interest rates as well as worsening of the foreign trade balance. As a result of the introduced disruption, the level of economic activity grows, accordingly, share of investment in GDP increases less than it would result from the disruption which was defined in relation to the GDP level of the base path. Higher economic growth neutralises negative effects of the increase in public expenditure at the beginning of the simulation period, however, in subsequent years, at a sustained worsening of the general government balance, the effects become increasingly more visible in 2017 the government debt is by 1.2% of GDP higher than in the 'no expenditure increase' scenario.

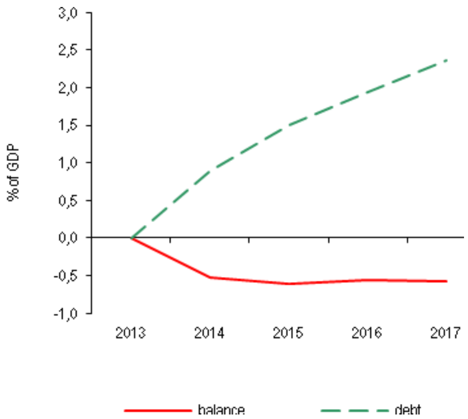
Chart 16. PLN/EUR exchange rate (left chart) and its impact on general government balance and gross debt (right chart)



The exchange rate impulse has been introduced as a sustained 10% depreciation of the PLN/EUR 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 export is also accompanied by growth in import. An increase in demand for Polish goods also fosters the improvement of labour market conditions and an acceleration of investment activity, which supports the permanent increase of the GDP level within the horizon of the forecast. In the first two years following the occurrence of the shock, the higher economic growth facilitates the increase in general government revenue, which exceeds the growth of expenditures associated with the servicing of debt denominated in foreign currencies, and the balance of the sector improves. In subsequent years, the significance of negative factors increases, but in 2017 the government debt still remains lower than in the baseline scenario (by 2.8 percentage points of the GDP).

Chart 17. Short-term interest rate (left chart) and its impact on general government balance and gross debt (right chart)





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 obtaining capital and therefore lower investment (with permanently higher interest rates, private investments in 2017 are by 4-5% lower than in the baseline scenario) and higher debt financing costs. Due to a shift in consumption over time due to inter-temporal substitution and as a result of tightened conditions for obtaining loans, private consumption is also slightly lower (by an. 0.5%).. As a result, the monetary impulse leads to a decrease in GDP volume of 0.5-0.8% in the forecast horizon The general government balance remains permanently lower by 0.5-0.6% of GDP and the general government debt in 2017 is by 2.4% of GDP higher than in the baseline scenario.

IV.3. Comparison with previous update

Compared with the previous *Programme* update, the predicted real GDP growth rate increased in 2014 and did not change in 2015-2017. The GDP growth in 2013 was also close to the expectations, although its structure appeared slightly different - the growth was entirely generated by net export whereas it was expected that the input of the domestic and foreign demand will be similar. The main prerequisite for the upward revision of the GDP forecast for 2014 was the improvement of the economic situation of the main trade partners of Poland. As a result, it is expected that the contribution of net export to the GDP growth in 2014 will amount to 0.5 percentage points, whereas in the macroeconomic assumptions to the previous update it was assumed that it would be slightly negative. The growth rate of the domestic demand has not been adjusted significantly.

The nominal deficit of the general government in 2013 was recorded at a level by 0.8 percentage points higher than anticipated in the last *Programme* update, which mainly resulted from the lower level of tax revenues as compared to the expectations. However, owing to the conservative policy of the government, the negative, cyclical impact of the deteriorated tax revenues on the deficit was limited (sf. chapter III.2). As a result of the measures undertaken earlier and the additional measures, the deficit reached the level of 4.3% of GDP, below the level of 4.8% of GDP, predicted still in autumn last year (also by the European Commission). Considering the fact that last year the real GDP growth was only slightly higher than the forecast for the needs of the national budgetary projections (1.6% against 1.5% in the state budget update), it should be recognised that the additional fiscal effort achieved already in 2013 (0.5 percentage points of GDP) is of structural nature.

The effect of the higher than assumed in the previous *Programme* deficit for 2013 is the revision of the forecasts of general government balance for the following years. The continuation of the consolidation measures introduced in the years 2010-2013, despite the deterioration in the macroeconomic environment, and introduction of new measures in the coming years will enable the continuation of a fiscal policy aimed at reducing the excessive deficit in 2015, followed by achievement of the medium term objective (MTO).

The difference in the general government debt-to-GDP in 2013, compared to the forecast in the previous *Programme* update arises primarily from the higher borrowing needs of the State budget, and slower nominal

GDP growth in comparison to the previous update. The changes in the pension system introduced in 2013 shall have a significant impact on the differences in the subsequent years.

Table 5. Divergence from previous update

	ESA Code	2013	2014	2015	2016	2017
Real GDP growth (%)						
2013 update		1.5	2.5	3.8	4.3	-
Current update		**1.6**	**3.3**	**3.8**	**4.3**	**4.3**
Difference		0.1	0.8	0.0	0.0	-
General government balance (% of GDP)	EDP B.9					
2013 update		-3.5	-3.3	-2.7	-1.6	-
Current update		**-4.3**	**5.8**	**-2.5**	**-1.8**	**-1.2**
Difference		-0.8	9.1	0.2	-0.2	-
General government gross debt (% of GDP)						
2013 update		55.8	55.7	55.6	54.5	-
Current update		**57.1**	**49.5**	**49.5**	**47.5**	**45.5**
Difference		1.3	-6.2	-6.1	-7.1	-

Source*:* Ministry of Finance, Central Statistical Office

V. Long-term sustainability of public finances

V.1. Strategy

The target of the government for the forthcoming years is the further reduction of the public finance imbalance in the manner which would not jeopardise the mid-term perspectives of the country development. Such approach to fiscal consolidation is compliant with the recommendations of the European Council which recognise the growth-enhancing fiscal consolidation as one of the priorities of the economic policy of the EU Member States. Ensuring the continued optimum pace of fiscal consolidation, while fostering sustainable economic growth, is particularly important in the face of the recovering economic growth.

Sustainable public finances support long-term economic growth and are a crucial element of macroeconomic stability. In turn, a high deficit in the public finance sector, through its negative influence on domestic savings, (1) escalates the country risk premium, thus increasing the cost of capital and the servicing cost of increasing debt, (2) hampers capital accumulation and (3) results in slower potential GDP growth. Therefore, the key elements include controlling of fiscal stability of Poland and taking decisions concerning the directions of the fiscal policy considering their impact on the stability of public finance.

Consolidation efforts made so far and the strong fundamentals of the Polish economy have resulted in an improved market reliability assessment, as evidenced by the fall in interest rates on Polish bonds to their lowest levels in recent history. At the same time, in relation to 2009, when the excessive deficit procedure was launched against Poland, the risk factors for the stability of the Polish public finance have been significantly reduced.

In connection with the demographic changes which constitute a challenge for public finance in the long-term, and in order to monitor the fiscal stability of the Member States, the European Commission and the Economic Policy Committee's Working Group on Ageing Populations and Sustainability (AWG) prepare once in three years the long-term forecasts of expenditure of the general government associated with the ageing of the population[29], published in the *Ageing Reports*. Among others, on their basis, for the purpose of assessment of the fiscal sustainability, the indicators are calculated illustrating the fiscal pressure, respectively, in a medium-term, currently up to 2030 (indicator S1) and in a long-term - infinite horizon (indicator S2). During the last assessment, both in the mid-term and the long-term perspective, Poland was classified among countries of average risk level.

[29] The recent report was published in May 2012 and it contains forecasts up to 2060 inclusive.

The estimates of the European Commission of January 2014[30] indicate a relatively favourable situation of Poland as compared to other European countries. The S1 indicator reached 0.7% GDP (against the EU average of 1.3% of GDP), which means that in order to achieve the level of 60% for general government debt by 2030, the aggregate improvement of the primary structural balance by 0.7% of GDP is required until 2020. The component related to the costs of ageing amounts to 0.2 percentage points, including the sub-component associated with a long-term care and health care reaching 0.5 percentage points and the component associated with pension costs at a level of -0.3 percentage points. The S2 indicator was estimated at a level of 2.7% GDP (the EU average is 4.0% of GDP), which means that in order to ensure the sustainability of the public finance in Poland within an infinite horizon, a one-off adjustment at a level of 2.7% of GDP would have to be applied. Such an adjustment is associated both with the component related to the initial budgetary position (1.5 percentage points), as well as with the component related to the costs of ageing (1.2 percentage points), where the additional costs shall arise from the increased costs of long-term care and health care (2.0 percentage points), adjusted by a negative sub-component related to the costs of pensions (-0.8 percentage points).

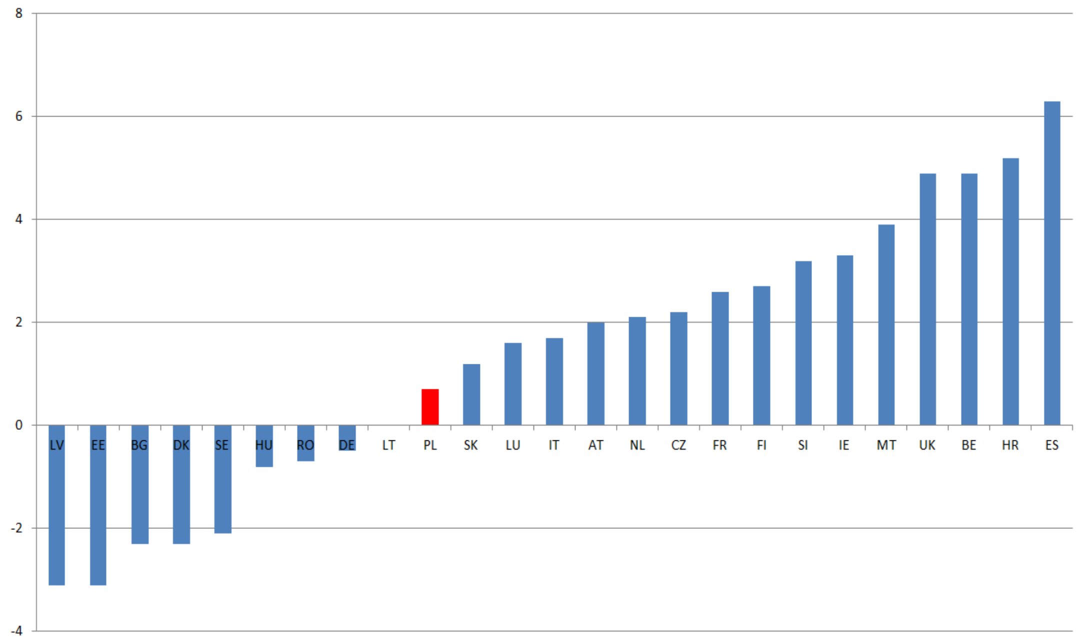
What is important, the indicators have significantly improved against the indicators presented in *the Sustainability Report 2009*, i.e. of the year when the excessive deficit procedure was launched against Poland. In 2009, S1 reached 2.9% of GDP whereas S2 amounted to 3.2% of GDP. This improvement occurred as a result of the improvement of the component associated with the initial budgetary position, mainly due to the significant reduction in the level of the primary structural deficit, which results from the fiscal consolidation conducted. Significant improvement was also recorded for the S0 indicator, which aims at signalling the risk of fiscal pressure at a short term, up to 1 year. In 2009 its value exceeded the threshold value, i.e. the indicator showed the risk of fiscal stress, whereas since 2011 such risk has not been signalled.

At the same time, it should be clearly indicated that the background of method used for calculation of the indicators is the assumption of non-variability of the policy within the forecast horizon, which, in case of S2 indicator, means the infinite horizon. As a result, the presented value of S1 and S2 indicators does not take into account the performed reform of the pension system, described in Chapter III.7.

Thus, the current values of S0, S1 and S2 changed. Estimation of detailed values will be possible after new demographic forecasts will have been developed, taking into account the reforms introduced in 2013, in particular, the pension system reform. At a current stage it is only possible to assess the direction of the pension system reform effects. For each of the indicators the lower level of indebtedness is a positive factor, however, in case of S1 indicator it can be explicitly stated at a present stage that the overall impact of the OFE reform will be positive.

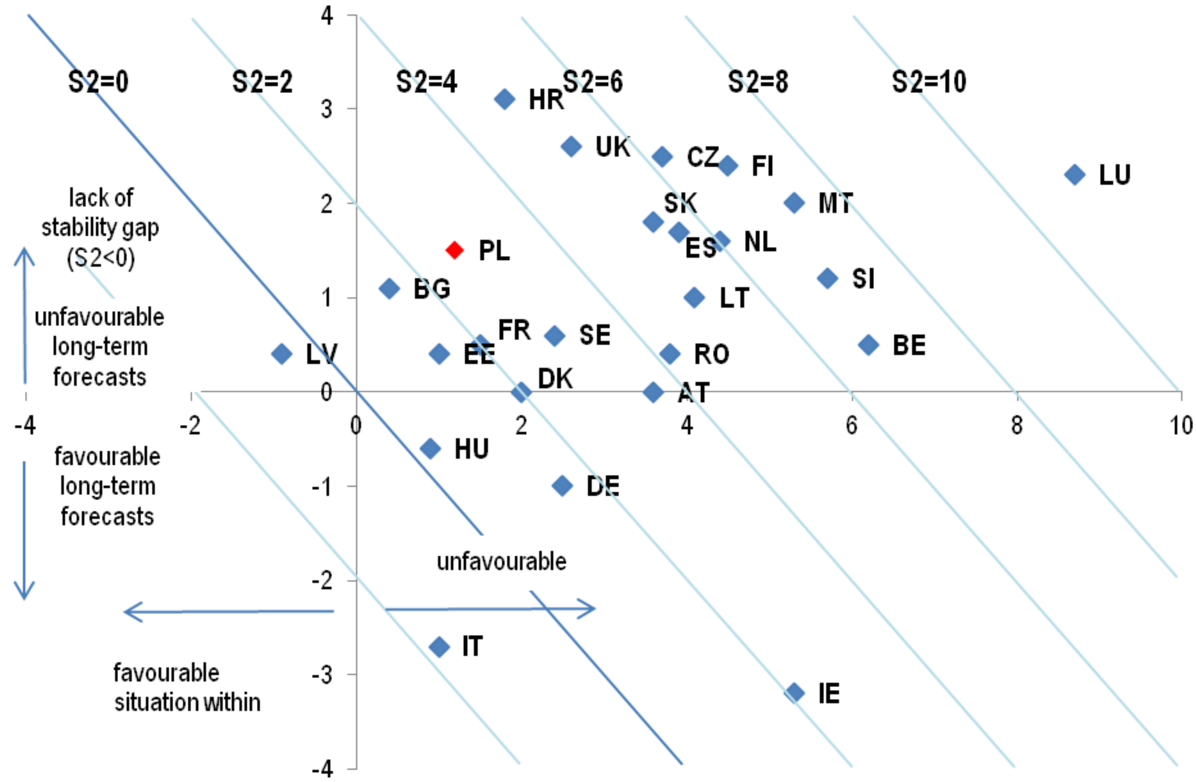
[30] The document of the European Commission: *Ensuring fiscal sustainability: a thematic assessment framework for structural-fiscal reforms,* prepared for the Working Group on Ageing Populations and Sustainability (AWG), January 2014.

Chart 18. S1 indicator for the EU Member States



Source: *Ensuring fiscal sustainability: a thematic assessment framework for structural-fiscal reforms*, European Commission, January 2014.

Chart 19. Decomposition of S2 indicator for the EU Member States



Source: *Ensuring fiscal sustainability: a thematic assessment framework for structural-fiscal reforms*, European Commission, January 2014

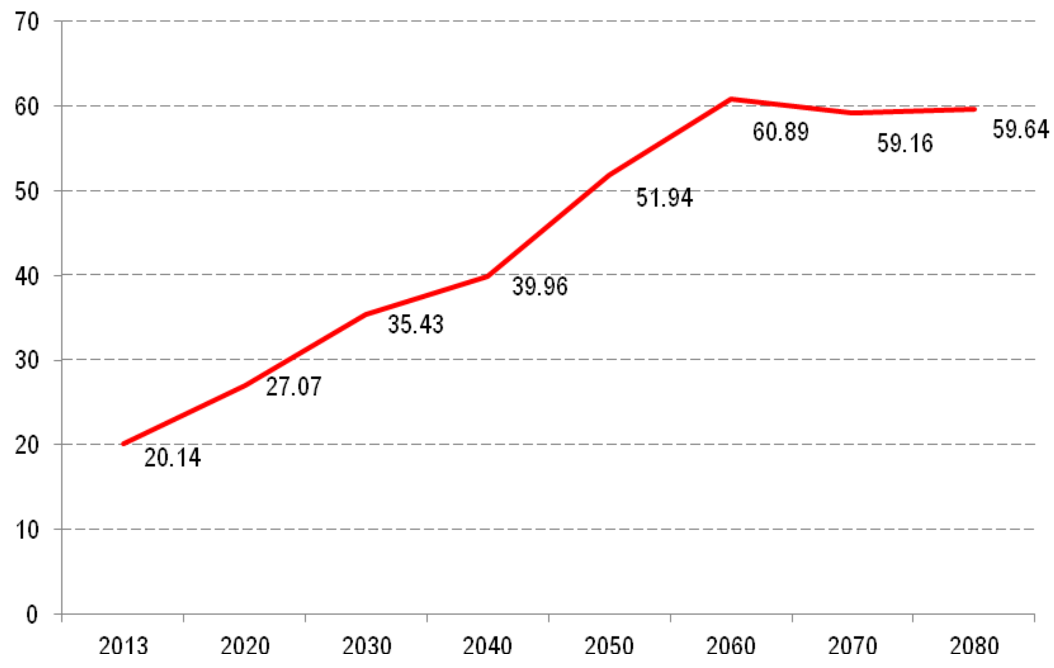
At the same time, the changes introduced within the fiscal policy shall minimise the risk of recurrent increase in the imbalance of the public finance in Poland. The implemented expenditure rule shall have a stabilising impact on public finance in a mid- and long-term period, and it will correct potential imbalances, simultaneously minimising the risk of excessive tightening of the fiscal policy (chapter VII.1). On the other hand, in the local government sub-sector a rule of at least sustainable balance of the current local government budget has been applicable since 2011, and since 2014 - the individual indebtedness limits have been applied (chapter VII.1). These rules are aimed at limiting the risk of excessive indebtedness or loss of liquidity by local government units, simultaneously facilitating the acquisition of the EU funds by LGU, in particular, for projects generating income.

Moreover, the continuation of the fiscal consolidation and the observed economic recovery will foster the improvement of the stability of public finance in the following years and, as a result, through the improvement of the initial budget position, it will positively influence the stability of public finance, both within short-term and a longer time horizon.

V.2. Long-term budgetary prospects, including the implications of an ageing population

Demographic changes constitute one of the major challenges for the long-term sustainability of public finance in the developed and developing countries. Although currently Poland still remains a relatively young country as compared to other European countries, the tendencies observed in the recent years indicate that the situation will be changing. It is associated with the extension of the life expectancy, low birth rate and the current age structure of the population. As a result, the demographic burden ratio shall deteriorate, i.e. the relationship between the number of population at post-productive age (65 and more) against the number of population at productive age (i.e. aged 15-64), expressed as percentage. According to the Eurostat forecast of April 2014, this ratio will increase from 20.14% in 2013 to 59.64% in 2080 (cf. chart 20).

Chart 20. Demographic burden ratio in Poland between 2013-2080



Source: Eurostat

Presented in table 6, forecasts of the long-term sustainability of public finance were developed within the activities of the European Commission and the AWG. They comprise the legal status as of 31.12.2012. The new forecasts, based on the latest Eurostat assumptions, will be presented during the next round of the AWG works (Autumn 2014) and they will take into account the changes in the pension system presented in chapter III.7.

The calculations presented in table 6 comprise the general pension system, the social security provision system and the farmer's pension system. They take into account the effects of increasing and equalising the retirement age for women (currently 60) and men (currently 65) to the age of 67, raising the pension contribution in its part paid by employers by 2 percentage points (from 4.5% to 6.5%), and limitation of retirement privileges for the uniformed services - persons starting the service shall obtain the retirement entitlement after 25 years, instead of the current 15 years in service, with the simultaneous requirement to reach the age of 55.

The package of pension reforms has resulted not only in a reduction of public expenditure, but also in an increase in the amount of future pension benefits and improvement of the balance of the universal pension system. Increasing the statutory retirement age has a positive effect on labour supply which translates into faster economic growth.

Table 6. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure							
Of which **age-related expenditure**	19.9	21.3	19.9	20.6	20.2	20.9	21.8
Pension expenditure	11.1	11.8	10.3	10.3	9.6	9.7	9.8
Social security pension	11.1	11.8	10.3	10.3	9.6	9.7	9.8
Old-age and early pensions	9.3	10.2	9.1	9.1	8.1	8.1	8.5
Other pensions (disability, survivors)	1.7	1.5	1.2	1.3	1.5	1.5	1.3
Occupational pensions							
Health care	4.0	4.9	5.4	5.8	6.2	6.5	6.8
Long-term care	0.4	0.7	0.8	1.0	1.3	1.5	1.7
Education expenditure	4.4	3.9	3.4	3.5	3.1	3.2	3.5
Other age-related expenditures							
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total revenue							
Of which: property income							
Of which: from pension contributions	6.9	5.8	7.1	7.2	7.2	7.3	7.3
Demographic Reserve Fund	0.3	0.7	1.9	3.2	4.7	6.9	10.1
Of which: pension fund assets (assets other than government liabilities)							
Systemic pension reforms							
Social contributions diverted to mandatory private scheme	1.3	1.6	0.9	1.0	1.0	1.0	1.0
Pension expenditure paid by mandatory private scheme	0.0	0.0	0.1	0.3	0.6	1.0	1.3
Assumptions							
Labour productivity growth	3.0	2.5	2.3	2.1	2.1	1.8	1.5
Real GDP growth	6.8	3.9	2.3	1.7	1.5	0.5	0.5
Participation rate males (aged 20-64)	77.4	79.1	81.7	82.2	80.5	80.7	81.2
Participation rate females (aged 20-64)	62.2	64.1	66.0	68.7	68.8	70.2	71.0
Total participation rate (aged 20-64)	69.7	71.5	73.8	75.5	74.7	75.5	76.2
Unemployment rate (aged 20-64)	9.8	9.6	7.5	7.2	7.2	7.1	7.1
Population aged 65+ over total population	13.4	13.5	18.2	22.6	25.3	30.6	34.6

Source*: The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060). Joint Report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee (AWG).*

V.3. Contingent liabilities

Potential contingent liabilities on account of sureties and guarantees granted by general government in Poland reached 6.7% of GDP at the end of 2013, against 6.3% of GDP at the end of 2012. A significant share in this category was represented by sureties and guarantees granted by the State Treasury - at the end of 2013 they reached ab. 6.4% of GDP against 6.1% of GDP as of the end of 2012. Within the State Treasury sureties and guarantees portfolio, guaranties granted for financial sector liabilities (excluding guarantees granted for supporting the NRF at Bank Gospodarstwa Krajowego – BGK) corresponded to only approx. 0.15 % of GDP.

Table 7. Contingent liabilities

% of GDP	2013	2014
Public guarantees	6.7	optional
Of which: linked to the financial sector*	0.15	optional

* 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 NRF at BGK).

Source: Ministry of Finance

The State Treasury activity with regard to sureties and guarantees does not impose a significant risk to public finances At the end of 2013, about 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 remained at the level of approx. 6%. The increase in the potential contingent liabilities on account of sureties and guarantees granted by the State Treasury, which translated into an increase in ratios of these liabilities to GDP, was, similarly to the previous year, mainly the result of the significant volume of guarantees granted for the support of infrastructure development. In subsequent years, the possibility of further growth of potential contingent liabilities on account of sureties and guarantees granted by the State Treasury is assumed, which might translate into a slight increase in the ratio of these liabilities to GDP.

VI. Quality of public finances

VI.1. Composition, efficiency and effectiveness of expenditure

According to the forecast, the general government expenditure to GDP ratio will decrease from 41.9% in 2013 to 38.7% in 2017, so in comparison to 2012, the general government expenditure share of GDP decrease by 3.5 percentage points. However, it is the change in domestic expenditure (i.e. expenses after adjusting for the deficit-neutral expenditures financed with EU funds), which has a more significant impact on the general government balance and should decrease in terms of share in GDP from 40.4% in 2013 to 37.2% in 2017.

The institutional changes, both planned and those already implemented which are aimed at consolidating, rationalizing and increasing the flexibility of expenditure, as well as additional measures aimed at the strengthening of public finance discipline, in particular, the implementation of the stabilising expenditure rule in the national legislation (cf. chapter VII.2), will all affect the level and structure of expenditure. In addition to the measures outlined in the previous *Programme* update, it is worth mentioning those initiatives described below.

In 2013, the work on the systemic review of effectiveness of public expenditure was initiated. The World Bank (WB) has been involved in this activity, to develop, jointly with the Ministry of Finance, the concept of reviewing the effectiveness of public finance sector expenditure and to propose the institutional solutions necessary to perform the review. As a result of the joint works, instruments of fiscal policy will be prepared to support public expenditure management, in particular, in the scope covered by the stabilising expenditure rule and facilitating the fulfilment of targets and requirements arising from the SER and MTO. In agreement with the WB, the methodology for performing the expenditure review will be developed, defining the subjective and objective scope of the mechanism as well as the rules of procedure and the requirements concerning collection of information needed for analyses. The cooperation with the WB also comprises the formulation of the recommendations specifying the proper implementation method of a new fiscal policy instrument as well as a joint performance of a pilot programme in the selected scope of expenditure. The experience to be gathered shall improve public finance management, in particular, in the area of cohesion between expenditure of the general government and the priorities of the social and economic policy of the state. The institutional approach to the expenditure review will also facilitate the implementation of new regulations implementing the objectives of the state policy. At the same time, it will provide for the implementation of the recommendations of the Ecofin Council of 10 December 2013.[31]

In parallel, actions on the national level are carried out. Pursuant to the *Action Plan for the implementation of the National Development Strategy 2020* the inter-sectoral works were initiated concerning, among others, the rationalisation of the expenditure structure of the public finance sector and the effectiveness improvement of spending public funds supporting the growth-enhancing activities. The activities of the team established for this purpose are coordinated by the Ministry of Finance. The actions initiated by the team shall support the implementation of the Ecofin Council recommendations.

In addition, measures were undertaken with the aim of increasing the effectiveness of public instruments in the labour market. On 14 March 2014 the Parliament adopted the *Act on Amendment to the Act on Employment Promotion and Institutions of Labour Market and Some Other Acts,* which significantly reforms the performance of labour offices, introducing the bonus system in allocating salaries to employees of these budgetary units. The Act also introduces a number of additional regulations enhancing the effectiveness of support to the unemployed. Adoption of the amended regulations shall increase the effectiveness of social expenditure addressed to the unemployed, both in terms of direct benefits and the services provided by the state within the activities of the labour offices. The reform of institutions supporting the labour market is compliant with the directions defined by the EU institutions which identified long-term unemployment and unemployment of young people as important inhibitors of the economic development. The amendment to the *Act on Employment Promotion and Institutions of Labour Market* also constitutes the implementation of the programme on *Guarantees for the Youth*, imposing the obligation on the labour markets to undertake the effective activation of young people.

Significant changes have been introduced in the health care sector. As a result of expenditure review, measures were undertaken limiting costs and increasing the effectiveness of health care expenditure. The *Act of 11 October 2013 on Amendment to the Act on Health Care Services Financed from Public Funds and Some Other Acts* modified the system of contracting the services, taking into account, much more extensively than before, the complexity of the health services offered. Moreover, the works are in progress concerning the extension of availability of basic health care services and reducing the frequency of issuing announcements related to refunded medication, which shall increase the effectiveness of provision of medical services and positively influence the reliability of trade in this market. The plans of legislative actions of the Ministry of Health also include the preparation of draft acts of law streamlining the organisational structure of the universal health insurance, introduction of close cooperation of service providers in the area of basic health care, outpatient specialist care and hospital treatment. The aforementioned measures shall significantly reduce the transaction costs of the health care system, increasing the effectiveness of the expenditure incurred.

Moreover, on 1 January 2013, provisions of art. 174 item 2 and 175 paragraph 1 item 4 *of the Act of 27 August 2009 on Public Finance* entered into force (Journal of Laws No. 157, item 1240). As a result, the responsibility and supervision over public expenditure was increased. Besides the Minister of Finance empowered to carry out a general audit of the efficiency and effectiveness of the implementation of the performance budget, while holders of budget sections have been authorised to supervise and audit the efficiency and effectiveness of the execution of the performance budget in accordance with the indicators of the degree of accomplishment of the objectives. Based on the relevant measures, within the semi-annual and annual reporting, the effectiveness information is acquired, supporting the decisions concerning the allocation of public funds, taken in the framework of the budgetary process.

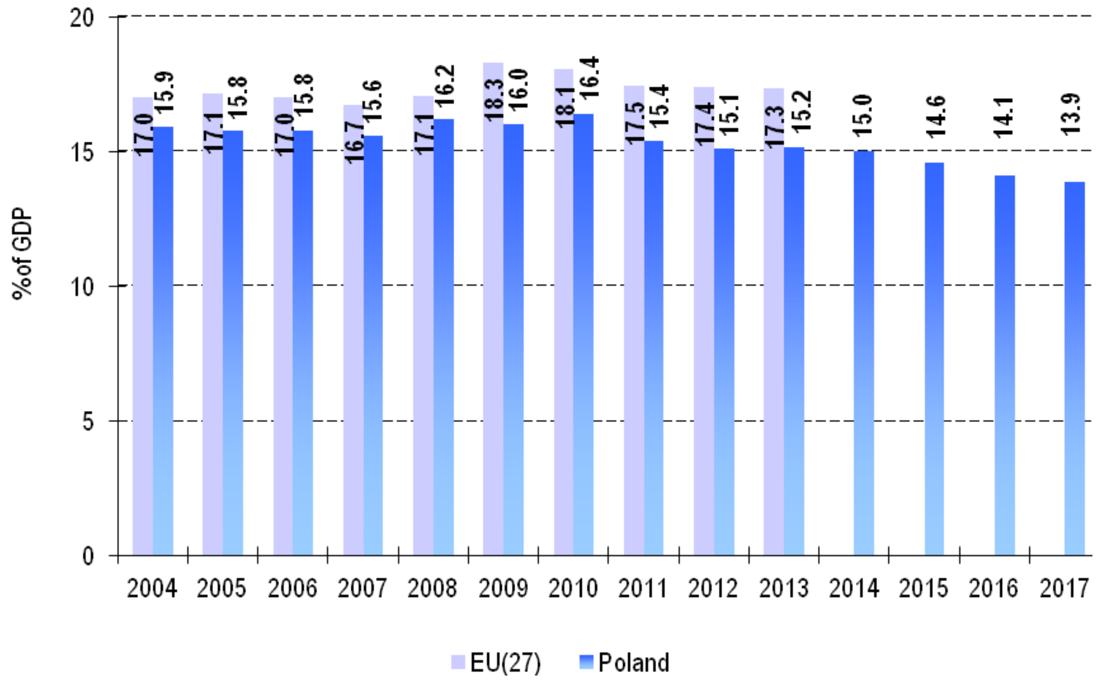
At the same time, within the activities planned under the *Better Regulations 2015* programme, on 29 October 2013, the Council of Ministers adopted the new *By-Laws of the Council of Ministers*. The amendment increases the role of impact assessment in relation to new acts of law, in particular, in terms of their economic and social effects, focusing on the quality of the regulations: from the analysis of the problem and draft assumptions of the

[31] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0906:FIN:PL:HTML.

act of law, to its evaluation and monitoring. The fundamental rule to be applied in the assessment of acts or other legal regulations shall be the *evidence-based policy making*. During the legislative process, three documents are prepared, comprising the regulation impact assessment: the regulatory test prepared already at the stage of submission of the application for entering the draft to the working schedule of the Council of Ministers (i.e. before the decision on commencement of works concerning the specific action is taken), regulatory impact assessment (RIA) *ex ante,* prepared for the draft act of law and, what is particularly important, *ex post* RIA, presenting the real effects of the regulation observed during the effective period of the legislative act. The *ex post* RIA shall play a special role in the periodical monitoring and reliable assessment of the applicable legal status, by synthetic presentation of the impact of the regulation in the period of time adjusted to the problem and area of social and economic life. The RIA teams established in individual ministries shall provide for high quality assurance of the RIAs.

The improvement of effectiveness of administration performance is illustrated in chart 21.

Chart 21. Administration costs (as a sum of remuneration and indirect consumption)

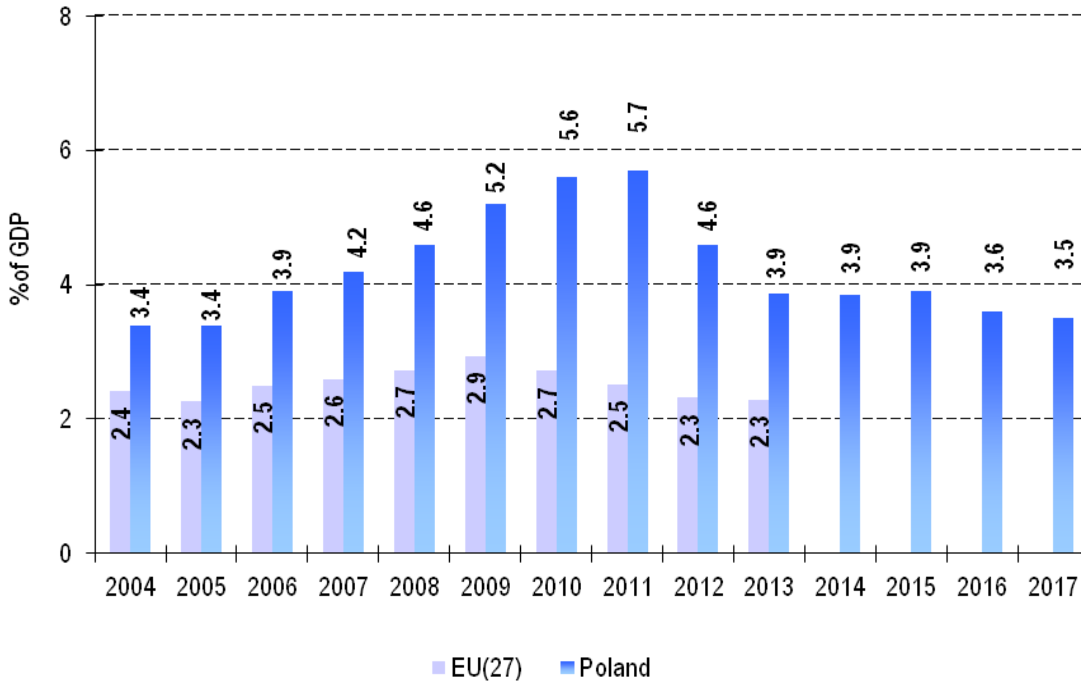


Source: AMECO, Ministry of Finance

The biggest decrease in spending is expected in general public services (by 1.0 percentage points of GDP), which results from the substantial reduction in debt servicing costs over the forecast horizon. The significant decrease in debt servicing costs will result from the introduction of changes in the pension system in 2014, in particular, the redemption of state treasury securities purchased by the Minister of Finance, and reduction of the borrowing needs.

As in the previous *Programme* update, the biggest decrease of expenditure is predicted in also the area of economic affairs – by 0.8 percentage points of GDP, which is due primarily to a decrease in public investment from 4.6% of GDP in 2012 to 3.5% of GDP in 2017 (the share of capital expenditure in economic affairs is more than 40%).

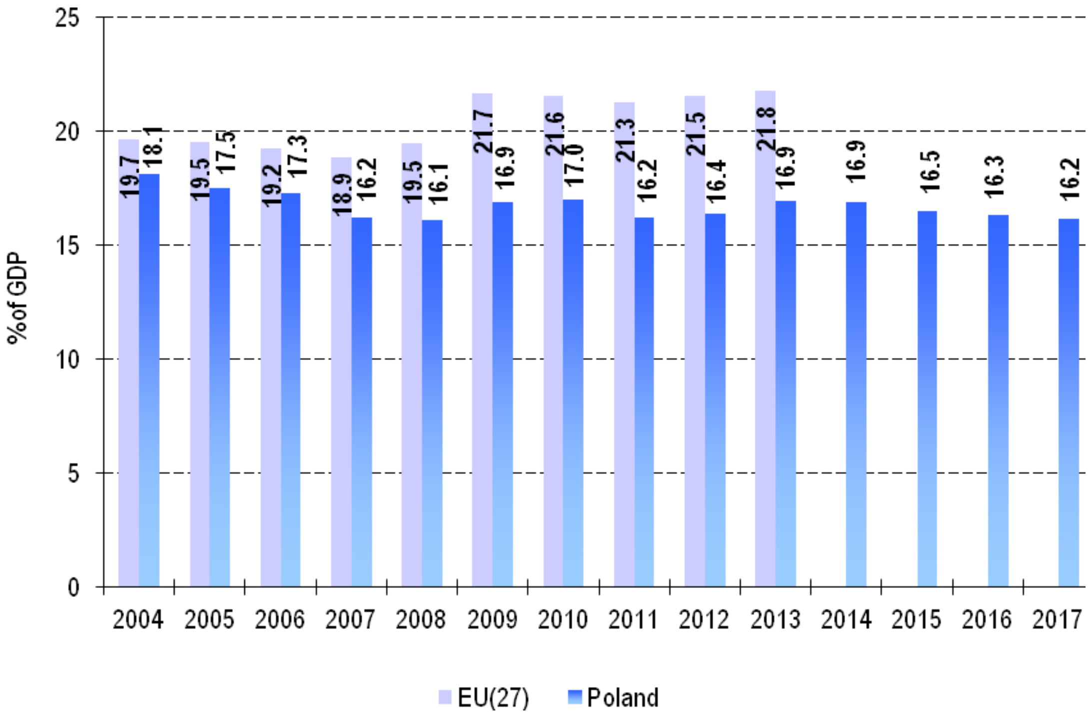
Chart 22. Gross fixed capital formation



Source: AMECO, Ministry of Finance

Moreover, the reduction in expenditure is also expected in the social protection function (by 0.4 percentage points against GDP). Social protection spending is also expected to decline in relation to GDP, which will result, inter alia, from limiting (introduced in 2009) entitlements to early retirement and the minimum indexation of pension benefits, in accordance with the formula: CPI + 20% of the real increase in wages and salaries in the national economy.

Chart 23. Social expenditure



Source: AMECO, Ministry of Finance

Table 8. General government expenditure by function

% of GDP	Kod COFOG	2012	2017
1. General public services	1	5.9	4.9
2. Defence	2	1.2	1.1
3. Public order and safety	3	1.7	1.6
4. Economic affairs	4	4.7	3.9
5. Environmental protection	5	0.6	0.5
6. Housing and community amenities	6	0.8	0.8
7. Health	7	4.6	4.3
8. Recreation, culture and religion	8	1.2	1.0
9. Education	9	5.5	5.0
10. Social protection	10	16.1	15.7
11. Total expenditure	TE	**42.2**	**38.7**

Source*:* Ministry of Finance, Central Statistical Office

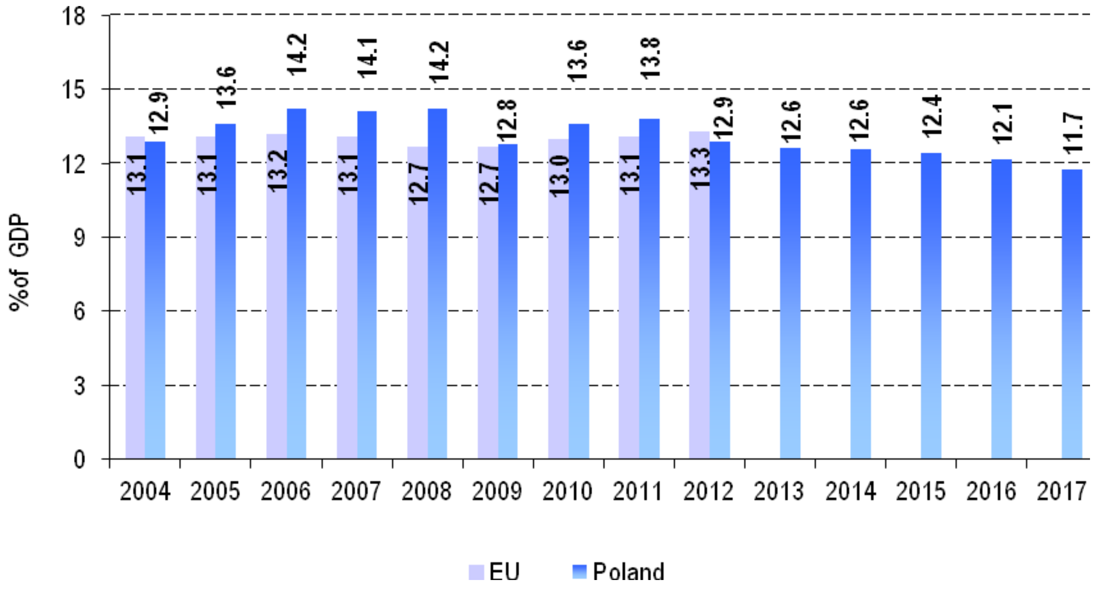
VI.2. Structure and efficiency of revenue systems

The general government revenue in 2013 decreased in relation to 2012 by 0.8 percentage points of GDP and reached 37.5% of GDP. In 2014, this ratio is projected to increase to 46.9% (mainly as a one-off effect of the pension reform), followed by its return to the level of 37.5% of GDP in 2017. From the perspective of the impact on the general government balance, the change in domestic revenue is more significant (i.e. revenue after adjusting for deficit-neutral transfers related to non-refundable EU aid), whose relation to GDP in the current year is projected at a level of 45.5% of GDP (36.1% in 2013), and in 2017 - at a level of 36.0%.

In the structure of general government revenues, the tax revenue is the most important, whose share in the total revenue in 2013 reached 52.4%. Another important source of general government revenue are the social contributions. The total share of general government revenue from taxes and social contributions amounted to 84.9% in 2013.

The general government revenue from taxes and social contributions (the so-called tax burden) in 2013 constituted 31.8% of GDP. In the years 2014-2015 a slight increase in this relation is projected, arising, among others, from the recent pension system reform, whereas in the following two years, its slight decline is foreseen.

Chart 24. General government revenue from taxes associated with production and import

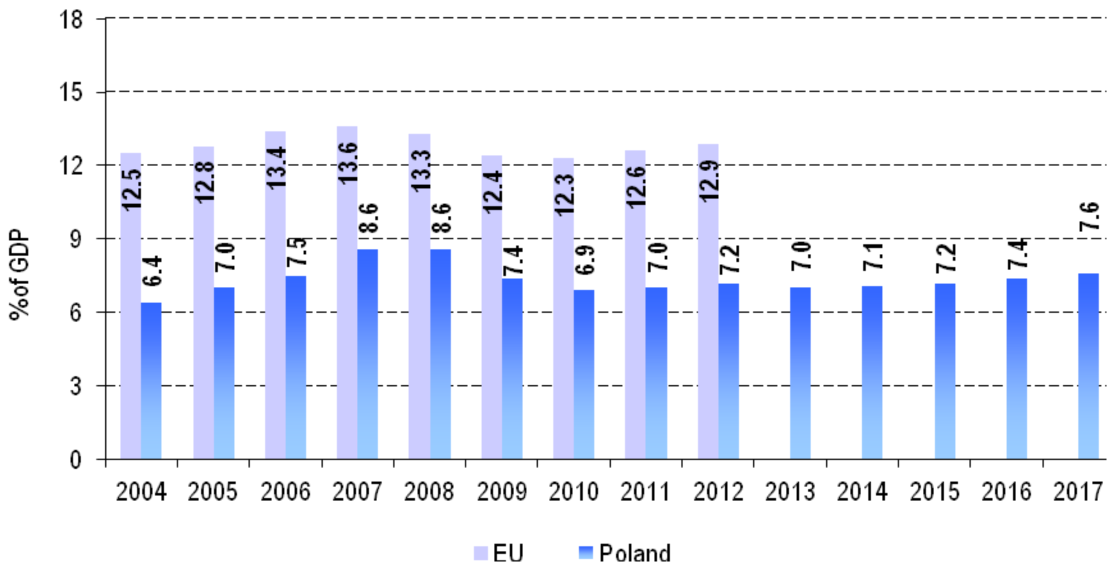


Source: Eurostat, Ministry of Finance

The average share of general government revenue from taxes on production and imports in GDP in the years 2004-2013 reached 13.5%. Until 2008 the gradual increase in revenue due to this title was observed, whereas after the outbreak of the global economic crisis, the decline of revenue in relation to GDP occurred. In the period 2010-2011 the increase in revenue from taxes on production was observed, however, it did not return to the level recorded before 2008. In the years 2014-2017, gradual decline of this revenue is forecasted, as a percent of GDP. This is associated with the projected decrease in revenue from excise tax in GDP as a result of the gradual reduction of the real excise tax burden of individual products. Moreover, from 2017 the return to the VAT rates at a former level is planned.

In Poland, slightly higher share of revenue of the general government from taxes on production and imports is recorded than the average of the EU Member States – in 2004-2012, by 0.5 percentage points, on average.

Chart 25. General government revenue from taxes on income and assets

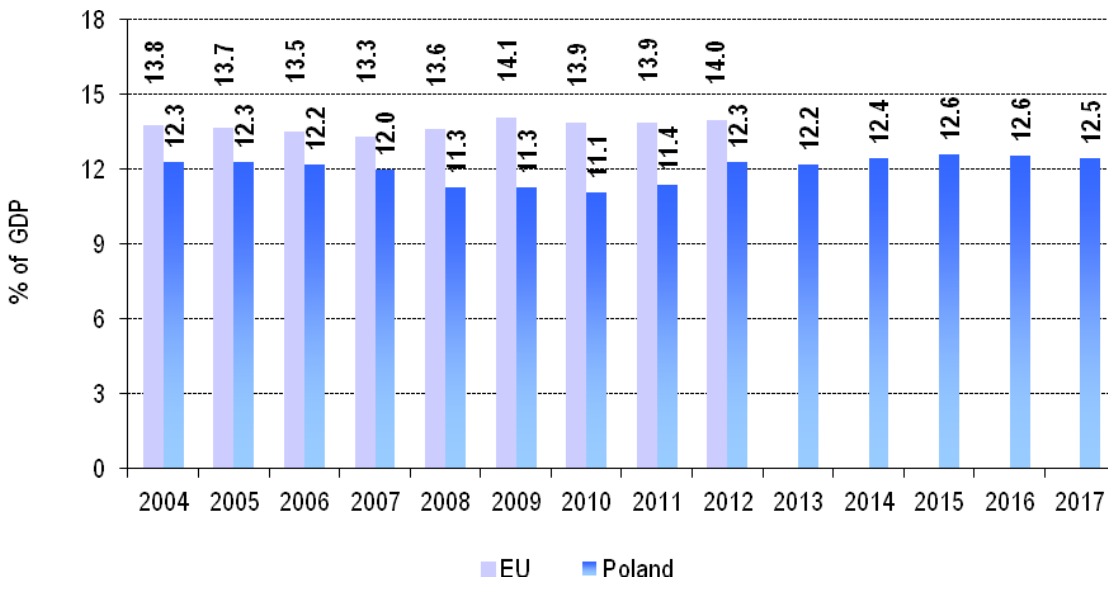


Source: Eurostat, Ministry of Finance

The average share of general government revenue from taxes on income and wealth in GDP in the years 2004-2013 reached 7.4%. Similar to the taxes on production and imports, until 2008, the gradual growth of general government revenue from taxes on income and wealth was observed, after which the decline of this relationship occurred. In the years 2014-2017, in connection with the forecast gradual improvement of the economic situation, their recovery to the growth path is expected (in relation to GDP).

In Poland, as compared to the EU, lower share of general government revenue from taxes on income and wealth in GDP is noted. In 2004-2012 the average share of general government revenue from taxes on income and wealth in GDP was lower by 5.5 percentage points than the EU Member States average.

Chart 26. General government revenue from social insurance contributions

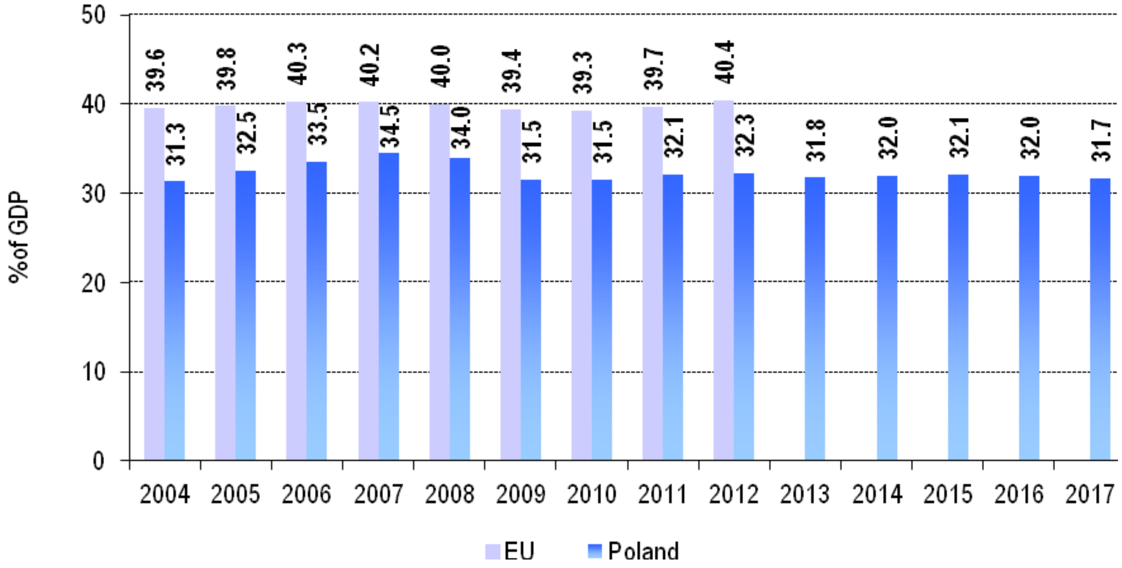


Source: Eurostat, Ministry of Finance

In the years 2004-2013 the average share of the general government revenue from social contributions in GDP reached 11.8%. The higher inflows observed since 2012 are associated with the increase in the pension contribution rate by 2 percentage points, payable by employer as of 1 February 2012. In the years 2014-2017 similar share of the general government revenue from social contributions in the GDP is projected, on average 12.5% of GDP.

Similar to revenue from taxes on income and wealth the share of the general government revenue from social contributions in the GDP is lower in Poland than the average for the EU Member States. In 2004-2012 the average share of the general government revenue from social contributions in the GDP was lower by 2.0 percentage points than the EU Member States average.

Chart 27. Tax burdens



Source: Eurostat, Ministry of Finance

In 2004-2012 the average share of the general government tax burdens in GDP in Poland was lower by 7.3 percentage points than the EU Member States average. It is forecasted that in 2014-2016 the general government tax burdens in the as a percentage of GDP shall reach the level of ab. 32%, whereas in 2017, as a result of the planned decrease of the standard and reduced VAT rate (by 1 percentage point), the share will fall to 31.7%.

In connection with the aforementioned decline in revenue, in particular, tax revenue, in relation to GDP in 2013 and in order to implement the recommendations of the Ecofin Council for Poland (cf. chapter I.1), the diagnosis of the key problems in the area of tax compliance and effectiveness of tax administration was performed. Based on this diagnosis, the Ministry of Finance prepared *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-2017.* The document was adopted by the management of the Ministry of Finance on 8 April and announced on 15 April this year. It defines a list of actions for the years 2014-2017, specifying for each of 43 projects: objective, planned tools, recipients and effects for the public finance sector.

Among these projects instruments which will have a positive impact on improvement of tax collection represent an important group. They refer to the improvement of the process of enforcement of tax receivables as well as influencing tax payers in order to increase the level of voluntary settlement of taxes. For that purpose, measures are planned which should produce effects within a short-time perspective, e.g. establishment of the Central

Register of Debtors, as well as long-term measures, such as promoting civic attitude, education and information actions addressed also to children and teenagers.

The planned or already conducted activities also refer to the use of IT systems and databases for the purpose of identification and analysis of threats (risk areas) for the implementation of the goals, including the improvement of effectiveness and efficiency of tax administration operations. Activities are or will be continued in the area of control and detection of processes leading to tax abuse and fraud, in particular, in the VAT.

A key factor influencing the effectiveness of the tax administration is the relevant structure of its organisation, which has to follow the changing economic reality. Consequently, activities aimed at consolidation of auxiliary processes implemented in tax chambers and tax offices are conducted. The effectiveness of the tax administration is also assessed in terms of quality of service provided to tax payers. Special attention is paid to this element of administration performance, among others, through increasing the use of electronic forms of contact with tax payers, which should also increase the tax compliance.

Many changes in tax procedures are also under implementation, which shall directly influence the effectiveness of collection of liabilities. Some of them, especially the introduction of the clause against tax avoidance, will not only generate indirect but also direct financial effects. Furthermore, the dissemination of use of electronic communication forms, introduction of new and abandoning ineffective solutions related to tax collection procedure, should generate measurable financial benefits through reducing the costs of tax administration performance.

The individual measures aimed at improvement of tax collection and increasing the effectiveness of tax administration will have various impact on increasing of the level of tax revenues. The group of projects of the highest impact on improvement of tax collection includes:

- establishing the Central Register of Debtors
- external risk management and tax control,
- coordination of detection and control in combating organised fraud in VAT - task forces,
- differentiation of rates of interest for tax arrears,
- introducing the *General Anti-Avoidance Rule*.

The analysis of implementation effects only for this group of projects indicates that these measures will contribute to generating the growth in revenue of the general government in the years 2014-2017 at least at a level of PLN 6.2 bn. Implementation of all measures envisaged in the action plan would generate the growth in revenue of the sector by at least PLN 8.2 bn.

Table 9. Financial effects of implementation of *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-2017*

Revenue (mln PLN)	2014	2015	2016	2017
Minimum*	1 898.0	4 681.4	5 279.3	8 191.3
Only direct results	**1 898.0**	**4 281.0**	**4 479.0**	**5 491.0**
Maximum*	2 098.0	7 531.4	8 729.3	17 441.3
Only direct results	**2 098.0**	**5 931.0**	**5 529.0**	**6 741.0**

Source: Ministry of Finance, *Measures increasing the tax compliance and improving the effectiveness of tax administration in the years 2014-2017*

VII. Institutional features of public finances

VII.1. Fiscal rules

The basic objective of numerical fiscal rules is to ensure fiscal and macroeconomic stability, as well as to maintain (possibly reduce) the size of the general government at a given level. The fiscal framework in Poland is based on several rules. From legal points of view, the most important of these is the debt rule, enshrined in two legal acts – the *Constitution of the Republic of Polan*d and the *Public Finance Act.* Its main objective is to constrain public debt (calculated according to the Polish methodology) to certain defined limits (55 and 60% of the GDP). However, from practical point of view, the stabilising expenditure rule fulfils a more essential role, since, contrary to the debt rule, it imposes restrictions on public finance on an annual basis, not only after exceeding the threshold. Individual indebtedness limits imposed on the local government units are also of key importance.

1) Stabilising expenditure rule

The stabilising expenditure rule (hereinafter referred to as SER) was established on 28 December 2013 pursuant to the amendment of the *Act on Public Finance* (hereinafter referred to as *APF*). This rule replaced the temporary disciplinary expenditure rule and introduced new regulations applicable after the state public debt exceeds 50 per cent in relation to GDP. The mechanisms replaced referred to much narrower fraction of the general government than the SER. The final shape of the SER will also arise from the amendment to the *APF*, currently at the stage of a draft adopted by the Council of Ministers on 25 February 2014, pursuant to which the debt thresholds[32] in the correction mechanism of the rule shall be reduced by 7 percentage points as a result of rapid decrease in public debt caused by the pension system reform. Consequently, four debt thresholds will be defined in the *APF*: 60 per cent and 55 per cent, applicable since 1998 as well as 48 per cent and 43 per cent contained in the correction mechanism of the SER.

The compliance with the stabilising expenditure rule shall result in bringing the excessive deficit procedure to an end, followed by further reduction of the general government deficit and, consequently, the reduction of public debt and maintaining these categories at safe levels. The aim of the rule is the stabilisation of the general government balance in the medium-term at a level of a medium-term objective (MTO).

The *level of expenditure* calculated on the basis of the SER formula comprises the general government, with two exceptions. First, the expenditure of European funds budget and this part of expenses which are financed with non-refundable EU and EFTA aid shall be excluded. It is justified by the fact that the impact of UE funds on the deficit (calculated in accordance with ESA95 and ESA2010) is neutral, i.e. the revenue of the sector from the EU is always indicated at a level of expenditure of the sector, financed from the EU funds, irrespective of the cash register flows. Second, the expenditure of entities which have no capacity to generate high deficits will be also excluded.

As a result, the *level of expenditure* covers two groups of the general government: 1) state budget, Social Insurance Fund, Labour Fund, Pension and Retirement Fund, Bridging Allowance Fund and the funds established, entrusted or assigned to BGK (including NRF) and 2) National Health Fund, local government units and their associations and the units referred to in art. 139 item 2 of the APF. The total expenditure of both these groups constitute approximately 90 per cent of the expenditure of the general government, where group 1) makes approx. 2/3. Such a broad scope of the rule is consistent with the recommendation of the Ecofin Council, stating that it is necessary to *make the institutional framework of public finances more binding and transparent, including through adjusting the definitions used in national accounting to ESA standards and ensuring sufficiently broad coverage*.

In order to obtain the legally binding, impassable expenditure limit, the forecast expenditures of units from group 2) are deducted from the *level of expenditure*. It means that if the forecasts indicate a faster growth of expenditure of units from group 2) than arising from the rule, the units classified in group 1) would have to incur the burden of adjustment. Escape clauses allowing for the suspension of the rule, are envisaged only in the event of martial law or a state of emergency, or a natural disaster throughout the territory of the Republic of Poland. Failure to comply with the rule will entail the same consequences as an infringement of the *Act on Public Finance*.

[32] The state public debt (the so-called net debt) calculated in accordance with art. 38a item 4 *of the Act on Public Finance*.

The formula defining the *level of expenditure* for year n includes six factors: 1) *the level of expenditure* from year n-1 (WYD_{n-1}); 2) adjustment associated with the update of forecasts of CPI inflation for year n-2 (CPI_{n-2} / $E_{n-1}(CPI_{n-2})$) and n-1 ($E_n(CPI_{n-1})$ / $E_{n-1}(CPI_{n-1})$); 3) forecast CPI inflation for year n ($E_n(CPI_n)$); 4) eight-year average real GDP dynamics for a period from n-7 to n ($WPKB_n$); 5) correction component (K_n) and 6) forecast value of discretionary measures related to revenue and contributions $E_n(\Delta DD_n)$. The calculation method of the *level of expenditure* may be expressed with the following formula, where $E_n(x)$ symbol means the value of x variable forecast in year n:

$$WYD_n = WYD_{n-1} \cdot [CPI_{n-2} / E_{n-1}(CPI_{n-2}) \cdot E_n(CPI_{n-1}) / E_{n-1}(CPI_{n-1})] \cdot E_n(CPI_n) \cdot [WPKB_n \pm K_n] + E_n(\Delta DD_n).$$

The correction will amount to -2 percentage points, if the deficit of the general government exceeds 3 per cent of GDP (including costs of pension system reform, calculated in accordance with ESA), or the state public debt exceeds 48 per cent of GDP. The correction will amount to -1.5 percentage points, if the state public debt ranges from 43 to 48 per cent of GDP. If the debt and deficit fall below thresholds, but the sum of differences of the nominal balance of the general government against the medium-term budgetary objective exceeds -/+6 per cent of GDP, the adjustment will amount to -/+ 1.5 percentage points. The adjustment of -/+1.5 percentage points shall be suspended in case of forecast the so-called good/bad times, i.e. if the forecasted dynamics of the real GDP for year n is lower/higher than the eight-year average by over 2 percentage points. Such a formula is aimed at limiting the risk of pro-cyclicality of fiscal policy and it will enable Poland to fulfil its obligations in the area of fiscal policy, arising from the *Stability and Growth Pact* in relation to the excessive deficit and indebtedness, the medium-term budgetary objective and the so-called *expenditure benchmark*.

In accordance with the *Act on the Supreme Audit Office (NIK)*, NIK examines, *in particular, the implementation of the state budget and execution of acts of law and other legislation in the scope of financial, economic and organisational-administrative activity*, as well as controls the accomplishment of the budget. The recommendation by the Ecofin Council concerning *ensuring an effective and timely monitoring of compliance with the permanent expenditure rule, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities* does not require any amendments to the Polish legislation. In particular, independent institutions should fulfil a more limited role in the states where strong fiscal rules apply, especially if such rules are equipped with the numerical formula and the automatic adjustment mechanism, such as the SER.

The following forecasts constitute the only discretionary elements of the formula: 1) GDP (however, they should not significantly affect the dynamics of the *level of expenditure*, since the average GDP used in SER consists mainly of historical records), 2) inflation (subject to annual adjustment) and 3) discretionary measures, originating mainly from information available in the public domain, in particular, regulatory tests and assessments of effects of the regulation, attached to the draft acts of law, assumptions of acts of law and regulations. At the same time, it should be stressed that the macroeconomic assumptions used for calculating the *level of expenditure* in accordance with the SER formula, forecasts of inflation and GDP growth, are prepared after consultation with social partners and independent institutions, including the Monetary Policy Council and the Trilateral Commission for Social and Economic Affairs, and compared to the available forecasts of other institutions. Therefore, concerning the recommendations of the Council, the reliability of analyses and assumptions providing background for the SER is ensured,

The introduction of the stabilising expenditure rule was an element of implementation of the *Council Directive 2011/85/EU of 8 November 2011* in the scope of numerical fiscal rules. Poland was bound to implement the aforementioned directive by the end of 2013. The text of the provisions required for its implementation was submitted to the European Commission by Poland on 13 January 2014 (more in chapter VII.3).

2) Rules in the local government sub-sector

The most important solutions protecting the local government units (LGU) against losing the liquidity and excessive indebtedness include: 1) the rule of at least sustainable current balance of the local government budget and 2) individual indebtedness limits. Both these solutions are defined in the *Act on Public Finance*.

In accordance with the rule of at least sustainable current balance of the budget, applicable since 2011, the LGU are not allowed to adopt a budget in which the current budgetary expenditure is not covered by current revenue, increased by the budgetary surplus of the previous years and fee available funds, arising from the settlements of the issued securities, credits and loans of the previous years.

The budgetary resolutions for 2014 are the first to be compliant with the new rule introducing the individual indebtedness limits reflecting the economic capacity of the LGU to repay the liabilities. The new rule prohibits the LGU to adopt a budget whose accomplishment would cause that in the budgetary year and in each year following the budgetary year the ratio between payments associated with servicing of debt and the revenue would be higher than the arithmetic mean of ratios between its current revenues, calculated for the last three years, increased by the revenue from sales of assets and decreased by current expenditure, and the total revenue of the budget.

This rule is defined by a formula (art. 243 APF):

$$\frac{R+O}{D}_n \leq \frac{1}{3}\left(\frac{Db_{n-1}+Sm_{n-1}-Wb_{n-1}}{D_{n-1}}+\frac{Db_{n-2}+Sm_{n-2}-Wb_{n-2}}{D_{n-2}}+\frac{Db_{n-3}+Sm_{n-3}-Wb_{n-3}}{D_{n-3}}\right)$$

where:

R – the total amount due to repayment of instalments of specific loans and credits, and redemption of securities, planned for the budgetary year; O – interest on specific loans and credits, interest and discount on securities issued for the specific purposes and repayments of amounts arising from the loans and guarantees granted, planned for the budgetary year; D – total revenue of the budget in the specific budgetary year; Db – current revenue; Sm – revenue from sales of assets; Wb – current expenditure; n – budgetary year, for which the relationship is defined.

The indebtedness ratio, calculated based on the value of three preceding years, on the one hand, waives the limitations binding the LGU for whom incurring even substantial financial liabilities may be an instrument of safe development policy, and on the other hand, introduces discipline for such entities which, due to high burden on revenues arising from repayment of liabilities are obliged to be careful when drawing new credits and loans or issuing securities. The limit of indebtedness is aimed at securing the local government entities against excessive accumulation of payments due to debt service in relation to their revenue.

Introduction of changes in the rules related to indebtedness of local government units had a positive impact on balance of these entities. In the years 2010-2013, in spite of the relatively poor economic growth, the number of entities which recorded deficit in the current part of the budget was decreasing, and the total level of surplus in the current part of the LGU budgets was growing. This fact should be mainly associated with the entry into force of the new *Act on Public Finance,* from 2010 (introducing the aforementioned rules), which subordinated the ability of LGUs to indebtedness to the capacity to generate surplus in the current part of the budget by individual LGUs.

The amendment to the *Act on Public Finance* of 8 November 2013, besides introduction of the SER, defined the changes in individual limits of indebtedness facilitating the acquisition of the European Union funds by the local governments. This change is mainly related to the liabilities arising from agreements on co-financing of projects funded by the EU, concluded after 1 January 2013, in at least 60 per cent (following the deducting of the forecast revenue generated by the project from the total project costs) and its aim is to foster the increased absorption of the EU funds in the new financial framework, favourable for the economy.

VII.2. Budgetary procedures, including public finance statistical governance

The introduction of the stabilising expenditure rule imposes the change in philosophy of the annual budgetary process - increasing the role of the top-down approach. The budgeting process will focus on the methods of distribution of the expenditure limit, instead of its level. In addition, the *amounts of expenditure* will be defined in accordance with the formula, within the multi-annual perspective, which shall improve the budgetary planning process.

Accordingly, on 12 March 2014 at the Ministry of Finance a team was established whose tasks include: the relevant adjustment of the budgeting process, development of the concept of monitoring the compliance with the *amount of expenditure* and the expenditure limit, including the system for cyclical reporting of the expected accomplishment of expenditure covered by the limit, and the risk of their implementation, as well as the procedures ensuring the limit shall not be exceeded. The tasks of the team also comprise the development of, inter alia, the procedure on change of the financial plans of the entities in which the expenditure is covered by the limit, a concept of the new *Multiannual Financial Plan of the State* and the task-oriented budget, consistent with the SER.

The team should complete its activities by 30 September 2014, and submit the report, including the recommendations and the implementation schedule of the relevant solutions to the Minister of Finance for approval.

The monitoring of implementation of the state budget and budgets of individual units of the general government during the year will be supported by the implementation of the *Council Directive 2011/85/UE of 8 November 2011 on requirements for budgetary frameworks of the Member States*, in the scope of publication of fiscal data. Starting from January 2014 the following documents are subject to publication on the website of the Ministry of Finance[33] :

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

In addition, a reconciliation table has been published, showing the methodology of transition between data published in accordance with the requirements of *Council Directive 2011/85/UE* and the data based on the European System of National and Regional Accounts (ESA) standards.

Introduction of the methodological solutions consistent with ESA is essential for ensuring the reliable statistical data in the scope of public finance. Accordingly, the Team for Statistics of the General government, established by the President of the Central Statistical Office in 2004 has been continuing its activities. The permanent members of the Team include representatives of the Central Statistical Office, Ministry of Finance and the National Bank of Poland. Depending on the subject of discussion of a meeting, experts of various disciplines are also invited to the meetings of the Team and, in case of doubts which cannot be resolved at a national level, Eurostat is consulted. Further methodological work within the Team is important, among others, in connection with the application of the new ESA2010 rules as of September 2014.

VII.3. Other institutional developments in relation to public finances

One of the objectives of the governmental policy in 2013 was the strengthening of the national fiscal framework, including the ensuring of the consistent compliance with the budgetary discipline in relation to the avoidance of excessive deficit. At the same time, until the end of 2013 Poland was obligated to adopt effective provisions implementing the *Council Directive 2011/85/UE of 8 November 2011 on requirements for budgetary frameworks of the Member States,* which introduced the specific requirements, among others, in the area of public finance transparency, accounting, statistics and budgetary planning.

The rules referring to the aforementioned EU regulations are included in the national legislation, both at a level of the Act of Law, i.e., inter alia, *the Act on Public Finance, the Accounting Act,* and in the implementing acts issued on the basis of statutory authorisation. Considering the necessity to achieve full compliance of the national regulations with the EU regulations, the analysis of issues and areas requiring potential legislative changes in the effective acts of law was performed. As a consequence, legislative work was undertaken, oriented towards the strengthening of the national fiscal framework, within the meaning of the aforementioned Council Directive, which was concluded with the adoption of the *Act of 8 November 2013 concerning the amendment to the Act on Public Finance and some other acts* and the adoption of the *Regulation of the Minister of Finance of 25 October 2013 amending the regulation concerning the reports of entities of public finance sector in the scope of financial operations*. The aforementioned Act introduced not only the stabilising expenditure rule and changes in the scope of individual indebtedness limits of local government entities (more details in chapter VII.1), but also the changes

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

to the *Multiannual Financial Plan of the State (MFPS)* prepared as of 2010, and the funds established, entrusted or assigned to BGK.

In accordance with the adopted solutions, the MFPS shall continue to provide basis for the preparation of the draft budgetary act for the next budgetary year. At the same time, the MFPS will be prepared for a given budgetary year and three following years and it will consist of two elements, i.e. update of the *Convergence Programme*, prepared in accordance with the rules specified in the *Regulation of the Council 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 annex defining the goals, inducing the measures of the level of their implementation, according to the arrangement comprising the main functions of the state. Moreover, the MFPS, in its part containing the *Convergence Programme* shall specify, among others: the priorities of the governmental policy, the planned actions and their impact on the level of revenue and expenditure of the general government and the preliminary *level of expenditure* (defined using the stabilising expenditure rule).

In connection with the introduction of the stabilising expenditure rule, the changes were introduced in relation to the deadlines for submission of the proposal, negotiating and submission of the report on implementation of the financial plan (possibly, the expenditure plan) of the NRF, Fund of Loans and Credits for Students, Inland Navigation Fund and Reserve Fund, Subsidy Fund (to housing loans of fixed interest rate), Zone Fund, National Health Fund, National Capital Fund, Railway Fund and Fund of Thermal Modernisation and Renovation. These changes shall be first applicable in relation to financial plans for 2015. In addition, in all aforementioned funds, the role of the Minister of Finance in the process of development of financial plans was strengthened.

At the same time, amendments were introduced to the *Regulation of the Minister of Finance concerning the reports of public finance sector entities in the scope of financial operations.* Their aim was to create the formal and legal basis for the acquisition of the relevant data and information providing background for preparation of a list of entities of the general government. The list will be verified on an annual basis during works on the fiscal notification. At the same time, the indicated implementing act fulfils the requirement arising from the provisions of the aforementioned Council Directive, which obliged the Member States, within the budgetary process, to specify entities classified in the general government.

Moreover, in the amendment to the *Act on Public Finance* of 8 November 2013 changes were included which regulate the issues of the remedying procedures for LGUs in case of the risk to the implementation of public tasks and failure of the unit to comply with the individual debt limit. The new provisions also regulate the issue of replacement local government budget to be defined by the Regional Chamber of Audit. The aim of the changes is to direct the local governments towards the independent remedying of finance in a given entity based on own resources. The solution - assuming certain requirements concerning the financial management of the entity conducting the remedying procedure - enables to concentrate resources and efforts of the local government entity required in terms of effective financial recovery. These requirements include, inter alia, the provision stating that a local government entity subject to the remedying procedure is not permitted to undertake new investments financed by a credit, loan, or issue of securities, grant sureties, guarantees ad loans. Further regulations concerning applying changes in the replacement budget defined by the Regional Chamber of Audit, by a LGU and clarification of any doubts related to the establishment of replacement budgets of LGUs by the Regional Chamber of Audit are included in the draft amendment to the *Act on Public Finance,* adopted by the Council of Ministers on 25 February 2014.

Annex

Table 10. Macroeconomic prospects

	ESA Code	2013 Level	2013 Rate of change	2014 Rate of change	2015 Rate of change	2016 Rate of change	2017 Rate of change
1. Real GDP (PLN billion)	B1*g	1620.9	1.6	3.3	3.8	4.3	4.3
2. Nominal GDP (PLN billion)	B1*g	1635.7	2.5	4.2	5.9	6.9	6.7
Components of real GDP*							
3. Private consumption expenditure	P.3	987.9	0.8	2.2	3.0	3.9	4.0
4. Government consumption expenditure	P.3	292.9	2.8	2.4	1.1	1.4	2.5
5. Gross fixed capital formation	P.51	305.3	-0.2	4.1	7.2	6.9	7.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	5.5	0.3	0.5	0.9	1.3	1.7
7. Exports of goods and services	P.6	778.7	4.6	5.0	4.9	4.8	4.1
8. Imports of goods and services	P.7	749.2	1.2	4.0	5.1	5.5	5.4
Contributions to real GDP growth							
9. Final domestic demand			0.0	2.8	3.7	4.5	4.8
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		-0.9	0.2	0.3	0.5	0.4
11. External balance of goods and services	B.11		1.6	0.5	0.0	-0.3	-0.6

Table 11. Price developments

	ESA Code	2013 Level	2013 Rate of change	2014 Rate of change	2015 Rate of change	2016 Rate of change	2017 Rate of change
1. GDP deflator			0.9	0.9	2.1	2.5	2.3
2. Private consumption deflator			0.7	1.2	2.3	2.5	2.2
3. HICP			0.9	1.2	2.3	2.5	2.2
4 Public consumption deflator			0.9	1.2	2.2	2.5	2.2
5. Investment deflator			-1.6	1.0	2.6	2.8	2.3
6. Export price deflator (goods and services)			0.4	0.4	0.3	0.0	-0.1
7. Import price deflator (goods and services)			-0.9	1.1	0.7	0.0	-0.3

Table 12. Labour market developments

	ESA Code	2013 Level	2013 Rate of change	2014 Rate of change	2015 Rate of change	2016 Rate of change	2017 Rate of change
1. Employment (in thousands of persons)*		15568	-0.1	0.6	0.8	0.8	0.8
2. Employment (hours worked)**							
3. Unemployment rate (%)***		10.3	10.3	9.8	9.3	8.6	7.9
4. Labour productivity (in thousands of persons)****		104.8	1.7	2.7	3.0	3.4	3.4
5. Labour productivity (hours worked)*****		-	-	-	-	-	-
6. Compensation of employees (PLN billion)	D.1	600.6	3.2	4.3	5.4	5.9	6.3
7. Compensation per employee (PLN thousand)		49.4	2.6	3.8	4.6	5.0	5.5

* 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 13. Sectoral balances

% of GDP	ESA Code	2013	2014	2015	2016	2017
1. Net lending / borrowing vis-à-vis the rest of the world	B.9	-1.0	-1.4	-0.8	0.4	0.5
of which: - balance on goods and services		-1.9	-2.1	-1.9	-1.5	-1.0
- balance of primary incomes and transfers		3.2	3.0	3.3	3.7	3.6
- capital account		-2.3	-2.2	-2.2	-1.8	-2.0
2. Net lending/borrowing of the private sector	B.9	5.3	-4.4	3.3	1.4	0.7
3. Net lending/borrowing of general government	EDP B.9	-4.3	5.8	-2.5	-1.8	-1.2
4. Statistical discrepancy		-	-	optional	optional	optional

Table 14. Basic assumptions

	2013	2014	2015	2016	2017
Short-term interest rate (annual average)	3.0	2.7	3.1	3.9	3.9
Long-term interest rate (annual average)	3.5	4.2	4.3	4.4	4.5
Nominal effective exchange rate	0.3	-0.7	-4.6	-5.5	-5.2
Exchange rate vis-à-vis the € (annual average)	4.20	4.17	3.98	3.76	3.56
World, excluding EU, GDP growth*	3.6	4.1	4.4	-	-
EU GDP growth*	0.1	1.5	2.0	-	-
Growth of relevant foreign markets**	0.4	4.0	5.6	5.4	4.8
World import volumes, excluding EU*	3.5	5.4	6.1	-	-
Oil prices (Brent, USD/barrel)*	108.8	104.1	99.6	-	-

* Source: EC, *European Economic Forecast. Winter 2014*, February 2014

** EU imports taken as foreign markets indicator.

Table 15. General government

	ESA Code	2013 PLN billion	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP	2017 % of GDP
Net lending (EDP B9) by sub-sector							
1. General government	S.13	**-70.7**	**-4.3**	**5.8**	**-2.5**	**-1.8**	**-1.2**
2. Central government	S.1311	-59.9	-3.7	5.5	-2.6	-1.8	-1.4
3. State government	S.1312						
4. Local government	S.1313	-2.9	-0.2	-0.2	-0.1	-0.2	-0.1
5. Social security funds	S.1314	-7.8	-0.5	0.5	0.2	0.2	0.3
General government							
6. Total revenue	TR	613.9	37.5	46.9	37.9	37.5	37.5
7. Total expenditure	TE	684.6	41.9	41.1	40.4	39.3	38.7
8. Net lending/borrowing	EDPB.9	-70.7	-4.3	5.8	-2.5	-1.8	-1.2
9. Interest expenditure	EDP D.41	43.2	2.6	2.1	2.2	2.1	2.1
10. Primary balance		-27.5	-1.7	7.9	-0.3	0.4	0.9
11. One-off and other temporary measures		-	-	9.0	-	-	-
Selected components of revenue							
12. Total taxes (=12a+12b+12c)		322.0	19.7	19.7	19.6	19.6	19.3
12a. Taxes on production and imports	D.2	206.8	12.6	12.6	12.4	12.1	11.7
12b. Current taxes on income, wealth, etc	D.5	114.9	7.0	7.1	7.2	7.4	7.6
12c. Capital taxes	D.91	0.3	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	199.5	12.2	12.4	12.6	12.6	12.5
14. Property income	D.4	19.8	1.2	1.0	1.0	1.0	1.1
15. Other		72.6	4.4	13.8	4.7	4.4	4.6
16. Total revenue	TR	613.9	37.5	46.9	37.9	37.5	37.5
Tax burden (D.2+D.5+D.61+D.91-D.995)		519.6	31.8	32.0	32.1	32.0	31.7
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D1+P2	248.2	15.2	15.0	14.6	14.1	13.9
17a. Compensation of employees	D.1	152.5	9.3	9.2	9.0	8.8	8.6
17b. Intermediate consumption	P.2	95.7	5.8	5.8	5.6	5.4	5.3
18. Social payments		277.0	16.9	16.9	16.5	16.3	16.2
of which Unemployment benefits		4.7	0.3	0.3	0.2	0.2	0.2
18a. Social transfers in kind supplied via market producers	D.6311 D.63121 D.63131	38.3	2.3	2.4	2.4	2.4	2.4
Social transfers other than in kind	D.62	238.6	14.6	14.5	14.1	13.9	13.8
19. Interest expenditure	EDP D.41	43.2	2.6	2.1	2.2	2.1	2.1
20. Subsidies	D.3	5.7	0.4	0.3	0.3	0.3	0.3
21. Gross fixed capital formation	P.51	63.2	3.9	3.9	39	3.6	3.5
22. Capital transfers	D.9	9.3	0.6	0.6	0.5	0.5	0.5
23. Other		38.0	2.3	2.3	2.4	2.4	2.2
24. Total expenditure	TE	684.6	41.9	41.1	40.4	39.3	38.7

	ESA Code	2013 PLN billion	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP	2017 % of GDP
p.m.: government consumption (nominal)	P.3	295.2	18.0	17.9	17.5	17.0	16.7

Table 16. No-policy change projections

	2013 Level	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP	2017 % of GDP
1. Total revenue at unchanged policies	**613.9**	37.5	36.8	37.6	37.4	37.4
2. Total expenditure at unchanged policies		-	-	-	-	-

Table 17. Amounts to be excluded from the expenditure benchmark

	2013 Level	2013 % of GDP	2014 % of GDP	2015 % of GDP	2016 % of GDP	2017 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	**23.1**	1.4	1.4	1.5	1.3	1.4
2. Cyclical unemployment benefit expenditure	**3.7**	0.2	0.2	0.2	0.2	0.2
3. Effect of discretionary revenue measures	**3.5**	0.2	0.8	0.4	0.1	0.0
4. Revenue increases mandated by law		-	-	-	-	-