REPUBLIC OF POLAND

CONVERGENCE PROGRAMME

2012 UPDATE

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Summary

Each *Convergence Programme* update presents medium-term forecasts for Poland's economy and public finances. The document has been prepared in accordance with the guidelines on format and content of stability and convergence programmes of the EU Member States.

The main objectives and guidelines of the government's economic policy presented in the previous *Programme* update have been maintained.

The *Convergence Programme. 2011 Update* shall be subject to discussion by Polish parliamentary committees.

I. Overall policy framework and objectives

I.1. Introduction

The *Convergence Programme* contains information on measures taken by the government to implement Council recommendations for eliminating the excessive deficit in 2012(cf. section III.2).

In November 2011 the European Commission, on the basis of its autumn deficit forecasts for Poland, sent a letter in which Poland was asked to outline measures ensuring the correction of the excessive deficit in line with Council recommendations. In response to that letter, in December 2011 the Minister of Finance presented[1] information concerning measures taken to correct the excessive deficit within the time frame specified by the Council. These measures have been positively assessed by the Commission, which in January 2012 stated that Poland has taken effective action towards a timely and sustainable correction of the excessive deficit, in line with (Ecofin) recommendations.[2]

According to the European Council, continuation of growth-friendly fiscal consolidation is the first of five economic policy priorities of the EU Member States[3] for 2012. Restoring normal lending to the economy, the second priority specified by the European Council, is of limited importance to Poland: the current situation of the Polish financial system and current tendencies for lending to the economy do not pose a threat to the financial system nor to macroeconomic stability.

The remaining priorities of the EU Member States' economic policy refer to structural policies and have been taken into consideration in this year's update of the *National Reform Programme*, which Poland, under the *European Semester,* is bound to submit to the European Commission and to the Economic and Financial Affairs Council (Ecofin) along with the Convergence Programme in April 2012.

In 2012 institutional strengthening of public finances will be continued (cf. section VII); which will also support the implementation of Poland's commitments made within the *Euro Plus Pact*.

I.2. Integration with the euro area

Serious deterioration of the economic situation, in particular in the euro area but - as a consequence - also in Poland – has delayed the prospect of introducing the common currency. Against this background, the previous strategy for the integration of Poland with the euro area has been supplemented with an additional fourth pillar. The first pillar concerns targeting sustainable fulfilment of the convergence criteria in the Polish economic policy framework, with particular focus on fiscal discipline. Pillar two: undertaking other measures, including institutional measures, aimed at strengthening the potential of the Polish economy, to ensure the smooth functioning in the common currency area. Pillar three: early development of the *National Euro Changeover Plan* and subsequent appropriate updating of this document. The new, fourth pillar includes stabilisation of the situation in the euro

[1] Cf. letter from Minister of Finance Jan Vincent-Rostowski to Commissioner Olli Rehn: http://www.mf.gov.pl/dokument.php?const=1&dzial=153&id=280042&typ=news.

[2] Cf. European Commission communication: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/communication_to_the_council/2012-01-11_be_cy_hu_mt_pl_communication_en.pdf

[3] Cf. European Council conclusions of 1-2 March 2012: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/128520.pdf

area, especially its institutional strengthening. Such an integration strategy should permit the avoiding of the problems faced by some countries of the euro area and should provide suitable conditions to fully take advantage of membership of the currency union.

Due to the significant uncertainty about the time horizon in which the requirements for adopting the common currency would have been met and to the situation in the euro area, the government at present is not specifying a target date for euro adoption. However, preparatory activities are being pursued. This was reflected in 2011 in the development of the *National Euro Changeover Plan* which has been approved by the Committee for European Affairs of the Council of Ministers.

If practical adjustments are started early enough and if transparency of currency integration is ensured, then the process of Poland's integration with the euro area in the future should continue smoothly, as long as it is possible to acknowledge that the requirements specified in previous pillars have been met. Owing to such an approach, when requirements specified in the *Prerequisites for Implementation of the Next Stages of the Roadmap for Euro Adoption in Poland* concerning the inclusion of the Polish zloty in ERM II (the requirement of meeting the exchange rate criterion) are fulfilled, especially when it is highly probable that the other convergence criteria will have been met within a two-year window and when the situation in the euro area becomes stable, it will be possible to undertake measures aimed at introducing euro banknotes and coins in Poland, which is conditional upon the final date of euro adoption.

I.3. Economic policy objectives

The main medium-term economic policy objective of the government is to create conditions for fast and sustainable growth, while ensuring the optimum pace of public finance consolidation. This section presents the most important measures aimed at achieving this objective. These measures are consistent with the priorities of the *Europe 2020* strategy, reflected in this year's update of the *National Reform Programme.*

1) Fiscal consolidation

The government's objective is to correct the excessive deficit of general government in 2012 and to subsequently continue fiscal consolidation and achieve the medium-term budgetary objective in 2015 (cf. section III.4). In the long-term, the government's objective is to ensure the sustainability of public finances. The attainment of these goals requires, *inter alia,* a further strengthening of the institutional framework for fiscal policy. The key change, in comparison with the current fiscal framework, is that greater emphasis will be put on ensuring a sustainable balance of general government through the introduction of a permanent expenditure rule that will apply to the whole sector. Analytical work on developing a draft of such a rule, as well as proposed measures aimed at improving the budgetary process and its monitoring, which are essential for an efficient implementation of the permanent expenditure rule (cf. section VII), have almost been completed.

2) Increasing the labour force participation rate

Changes in the demographic structure of the population and the objective of maintaining balance in the social insurance system require the reform of the pension system. From 2013 onwards, the retirement age for men and women will be gradually raised and equalised at 67. The whole process will be completed by 2040. The pension system for the uniformed services will also undergo reforms – the employment period necessary to acquire pension entitlements will be lengthened and the age at which it will be possible to receive retirement benefits will be raised. Additionally, only front line workers directly engaged in extraction (cf. section III.7) will be entitled to receive miners' pensions. The increase in the level of employment will also be supported by strengthening the advantages of continued employment through a rationalisation of the benefit and social welfare system. For people over 60 a programme of pro-employment measures will be prepared.

3) Improving conditions for business activity and innovation

Measures undertaken to further eliminate barriers which impede entrepreneurship will above all cover reduction of the administrative burden and disclosure requirements, as well as streamlining procedures for registering new businesses. Draft guidelines for the third deregulation bill will be drawn up this year which will improve economic activity. Other measures include reform of the construction law, which will lead to an improvement in investment

processes, as well as changes in the functioning of courts aimed at increasing the efficiency of legal proceedings and significantly reducing the time necessary to complete such proceedings.

As announced by the Prime Minister Donald Tusk in his exposé on 18 November 2011, legislative work aimed at improving access to the regulated professions has also been undertaken. In Poland, restrictions apply to as many as 380 professions[4]. This work will proceed in 3 stages with the first stage planned at improving access to the 49 professions regulated by law and subsequent stages – to approx. 200 more professions.

The above-mentioned measures will support the creation of an innovation-friendly environment for business. However, the main challenge associated with boosting innovation is an increase in the overall expenditure on research and development, particularly private expenditure. In order to achieve this goal the following measures – apart from a reduction of the administrative burden – will be undertaken: improving the quality of business regulations, simplifying these regulations and adapting them to the needs of a modern economy, developing human competencies for innovative enterprises, supporting the science sector and its cooperation with business, and the coordination of innovative and pro-export policies.

4) Privatisation and improvement of State Treasury assets management

Measures in this area are aimed at streamlining and increasing the efficiency of the privatisation process, completing ownership transformations in some industries and sectors, as well as improving ownership supervision by the State Treasury. The role of the state will be reduced in those areas of the economy where the ownership supervision by the State Treasury is not indispensable. However, the ownership by the State Treasury cannot be excluded in companies of strategic importance for the state. These efforts will lead to the acceleration of growth and modernisation of enterprises and will contribute to the improved competitiveness of the Polish economy.

II. Economic outlook

II.1. Cyclical developments and current prospects

Economic activity throughout the world slowed markedly in 2011, due mainly to a slowdown in developed countries such as the USA, Japan and the euro area. Global trade and industrial production have grown at a slower pace. There are several factors that negatively influenced the economic situation during this period: a sharp increase in commodity prices, natural disasters in Asia and, above all, the ongoing debt crisis in the euro area, which led to increased risk aversion in global financial markets. This has been reflected in higher yields for treasury securities, mainly in countries with the largest debt, which often means further increases in the cost of servicing public debt. Tensions in the debt market translated into higher costs of financing for the banking sector, which – together with tighter capital requirements and higher risk aversion – contributed to a tightening of credit standards for non-financial sector entities, especially in Europe.

These factors along with the process of rebalancing of the financial and non-financial sectors after the financial crisis of 2008-2009, contributed to a decline in the growth rate of the EU economy in 2011, where approx. 80% of Polish exports are directed. In 2011, gross domestic product (GDP) in the EU increased by 1.5% compared to 2% in 2010 and was below the forecasts of the previous year. Even more significant was the decline in the rate of growth of domestic demand (both investment and consumption). As a result, EU imports, which are the key determinant of external demand for Polish products, increased by only 4% compared to 9.8% in the previous year. Although German imports (particularly important for the Polish economy) grew relatively faster, even here a slowing of the rate of growth was noticeable.

The weakening of economic activity has led to a deterioration in the growth of trade in the countries whose markets play a key role for Polish exports. Despite this, the performance of Polish exports, especially at the end of 2011, turned out to be surprisingly strong, especially after taking into account the contraction of GDP and EU imports (including Germany) in the fourth quarter of 2011 caused in part by a relatively significant weakening of the Polish zloty in the second half of the year, which helped to support the price competitiveness of Polish

[4] In the main government document concerning this domain 334 professions were mentioned, which is caused by the use of a different classification of medical specialties and positions within the medical profession than in the EU.

products. BIS data shows that in the period from May to December 2011 the Polish zloty's real effective exchange rate fell by 13% and reached its lowest level since March 2009. Another factor favouring an increase in external trade was a slight decline in relative unit labour costs in the manufacturing industry. These factors contributed to an increase in the share of Polish exports to the EU, which helped to offset the negative effects of economic and trade slowdown experienced by our main partners.

In 2011, industrial production expanded by almost 8%. In comparison to the beginning of the current recovery stage, i.e. to January 2009, in December 2011, industrial production was almost a third higher (seasonally adjusted). Relatively good export results and significant public investment supported production growth in those manufacturing industry sectors that rely on foreign markets and in the sectors associated with the construction industry.

Throughout 2011 investment growth remained robust. This was mainly caused by considerable general government infrastructure investment and an improvement of investment in the private (especially enterprise) sector, supported by companies' solid financial results and favourable financing conditions in the banking sector. In 2011, after two years of decline, gross fixed capital formation increased by 8.3% compared to 2010. The highest growth was observed in investment in buildings and structures. In 2011, a significant improvement was also recorded in transport equipment investment; however the investment outlays for machinery and equipment, as well as residential housing still grew at a very slow rate.

Improved economic activity, in particular the increase in investment and good corporate financial results, supported labour demand in 2011. Employment[5] increased by 170 000, i.e. 1.1%, mainly thanks to the strong labour demand in the industrial sector (2.5% growth). In 2011, both the number of self-employed and employees (mainly those with contracts of indefinite duration) increased. Despite growing labour demand, in 2011 the number of unemployed increased, but the average annual rate of unemployment stabilised at the level of 2010 (9.6%). The unemployment rate for the second time in a row was also equal to the average unemployment rate in the EU. The stabilisation of the unemployment rate in Poland resulted from a further increase in the participation rate (the participation rate increased by 0.3 percentage points to 56.1%), which was caused by an increased participation rate for people aged over 54. After two years of stabilisation, the employment rate increased slightly by 0.3 percentage points to 50.7%.

In 2011, the increase in employment was accompanied by limited wage pressure. Employees' bargaining positions in wage negotiations were limited by the still relatively high unemployment. The average gross wage and salary in the national economy increased in nominal terms by 5.4% in comparison to 2010, with 5% in the enterprise sector (in real terms by 1.1% and 0.6% respectively).

Sluggish growth of household disposable income and relatively high inflation hampered private consumption, in particular in the second half of 2011. Given the fairly low income dynamics, the increase in private consumption was possible thanks to a further reduction of the savings rate. The gross saving rate[6] of households and non-profit organizations declined to 1.7% in 2011, from 8.5% in 2010. In 2011, for the first time in history, a contraction in public consumption was also observed. This can be attributed to the fiscal consolidation aimed at correcting the excessive deficit in general government.

The high growth rate of investment activity and – in broader terms – of accumulation (the contribution of inventory to GDP growth remained positive), was insufficient to fully offset slower final consumption growth. As a result, the growth rate of domestic demand decelerated in 2011 compared to 2010. This in turn, along with the weaker Polish zloty exchange rate contributed to slower import growth. Unlike 2010, export growth outpaced import growth in 2011, which resulted in a positive contribution of net exports to GDP growth. External imbalances were also reduced by an improved current transfer surplus, related to the build up of EU transfers recorded on the current account. Robust direct investment corporate profits translated into a slight deterioration of the income balance. As a result, throughout 2011 the estimated current account deficit fell to 4.3% of GDP from 4.6% in 2010. It is worth noting that over 90% of this deficit was financed by an inflow of long-term capital, that is foreign direct investment and EU structural funds, most of which are classified on the capital account.

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[5] The average number of employed aged 15 and older. Data concerning the labour market presented in this section are based on LFS.

[6] Expressed as percentages of adjusted gross disposable income; calculated as a four-period moving average.

Throughout 2011, GDP grew on average at a relatively high and stable rate (1% q/q, sa). As a result, in 2011 Poland's GDP increased by 4.3%, i.e. by 0.4 percentage points higher than in the previous year. A high economic growth rate, observed from the second half of 2010, allowed the output gap to close (defined as the deviation of current economic activity from the long-term trend) at the turn of 2010 and 2011, assuming that the estimated potential GDP grew in 2010-2011 at a rate of approx. 3.5-3.7%. The estimated gap in 2011 was positive; however its scale (approx. 0.6%) was clearly lower than at its highest level in 2008 when it reached 2.0%.

The average annual increase in the price of consumer goods and services in 2011 reached 4.3%.[7] During the whole year, inflation measured y/y (for both CPI and HICP) was clearly above the NBP target of 2.5%. The main causes of price increases stemmed from external factors: high commodity prices in global markets and the weakening of the Polish zloty caused by increased global risk aversion. Core inflation (i.e. CPI excluding food and energy prices) in the period from January to July 2011 remained below the target and at the end of the year, due to the weakening of the Polish zloty, increased to 3.1% y/y. In the first two months of 2012 the CPI inflation was slightly above 4% and in March it dropped to 3.9%. During that period there was a clear decrease in core inflation, which reverted to a level close to target.

The risk of increased wage and inflationary pressure, connected with the progress of economic recovery in Poland, the increase in employment and a sharp increase in commodity prices on global markets resulted in a tightening of monetary policy in the first half of 2011. During that period the Monetary Policy Council raised the NBP interest rates four times, in total by 1 percentage point, with the reference rate increasing to a level of 4.5%. In the second half of 2011, despite inflation being significantly above the target level, the deteriorating outlook for economic growth persuaded the MPC to maintain interest rates at an unchanged level. Basic interest rates also remained unchanged in the first quarter of 2012.

In 2011, the Polish zloty exchange rate was to a large extent determined by global factors. After the strengthening of the Polish zloty in a period from March to June, the Polish currency once again weakened in the second half of 2011. The Polish zloty depreciated as a result of a large increase in risk aversion by global financial markets caused by the deteriorating outlook for world economic growth and the fear of the debt crisis spreading in the euro area. During that period the NBP intervened on the foreign exchange market on several occasions in order to reduce the excessive volatility of the Polish zloty. At the beginning of 2012, along with a growing "appetite for risk" on global financial markets and an increasingly positive perception of Poland as a country for investments, the Polish zloty gained significantly in value.

II.2. Medium-term scenario

In subsequent years, just as it has in the past year, the economic situation in Poland will depend on the situation in the European Union, on the path and structure of fiscal consolidation carried out in Poland and on observed demographic trends, particularly on a significant decrease in the population of working age and changes in the participation rate.

The current assessment and projections with regard to the situation of Poland's main trading partner are not optimistic. It seems that at the turn of 2011 and 2012 the economy of the European Union experienced a technical recession (negative dynamics q/q over two successive quarters). A gradual improvement is not expected until the second half of 2012. According to current projections, in 2012 the EU economy in real terms will remain at the same level as in 2011. This means a significant correction of projections in comparison to those presented in the 2011 *Convergence Programme* update when it was expected that in 2012 EU GDP would increase in real terms by 2.1%. Although the assumptions concerning 2011 proved to be close to what was actually achieved (EU GDP increased by 1.5% compared to a projected increase of 1.8%), the last quarter of 2011 showed that trends observed in the first part of the year were reversed. Together with the correction of projections for EU GDP growth, projections for the growth of imports in this economic area, which is an indicator of the demand for Polish exports, have also changed. At present, it is expected that after increasing by 4.0% in 2011, EU import will, in 2012, increase by 0.5% in real terms, which is significantly less than the 6.3% assumed in the previous *Convergence Programme* update. In subsequent years, as the European economy recovers from

[7] The Harmonised Index of Consumer Prices (HICP) reached 3.9%.

recession, we should expect that EU imports will accelerate to 3.9% in 2013 and its dynamics will be even greater in subsequent years (5.2% in 2015).

After a period of large increases in public investments in Poland, which in 2011 reached a record level in relation to GDP –being the highest in the whole EU[8] – it is expected that in subsequent years the share of investment to GDP will gradually decrease to EU average levels. This is linked with the significant use of EU funds in previous years. However, there will be less funding available in future years for Poland as a beneficiary within the current Financial Perspective. As a result, the predicted share of public investments to GDP decreases from 5.8% in 2011 to 2.8% in 2015. Due to the uncertainty about the form of the next financial perspective for the years 2014-2020, the medium-term scenario, as well as the general government forecast, does not take into consideration the inflow of EU funds nor the necessary co-financing within this perspective.

Public consumption will be determined by the path of public finance consolidation. It has been assumed that in the section referring to the compensation of employees, the nominal wage fund of the central government sub-sector in 2012 will not change and the average remuneration in the local government sub-sector will increase at a pace similar to the increase of remuneration in the market sector. In the following years the restrictions previously described will be maintained, except for the remuneration of individuals employed in state higher education schools which, in accordance with the decisions made by the Council of Ministers, is supposed to increase at a nominal pace of 9.14% a year, to rise in total by 30%[9] in the years 2013-2015. It was assumed within the forecast horizon that the actual increase in intermediate consumption financed from domestic resources will reach approx. 1% a year.

Another factor which significantly impacts the forecast is the decrease in the population of working age. When preparing the forecast it was assumed that measures undertaken by the government, consisting mainly of significantly limiting the possibilities of earlier retirement and increasing the retirement age, would allow – provided that current participation rate trends do not change – for the reduction of negative demographic effects on the labour market. As a result, labour supply within the forecast horizon will increase.

Export dynamics in 2012 are expected to decline due to a serious slowdown in the pace of external demand growth. The real pace of export growth, however, will remain at a higher level than the pace of export market growth, which is linked to the expected changes in the exchange rate of the Polish zloty and with a significant improvement of competitiveness based on unit labour costs of Polish manufacturers. In subsequent years the positive influence of the above-mentioned factors will decline and it is expected that from 2015 onwards the share of Polish exports as a percentage of total external demand will gradually stabilize.

The high competitiveness of Polish business compared to their trading partners and despite a relatively unfavourable situation in the external environment is reflected in their good financial results. It is expected that this situation will also persist this year, which will provide important support for the expected increase in private investment. After accelerating last year, an increase in this economic category is also expected in 2012, although it will be slightly lower, i.e. 7.5% compared to 7.8% in 2011. Further acceleration can be expected in subsequent years, in line with the improvement of the economic situation in the EU. Within the forecast horizon, the share of private investment to GDP will gradually recover to a level of above 17%, as was recorded in the years 2007-2008.

Lower growth of investment together with a predicted slowdown in the external environment will result in lower demand for labour. It is predicted that in the current year the number of employed persons will increase by 0.3% compared to 1.1% in the previous year. However, after taking into account the prospective participation rate increase, it can be expected that the growth in the number of employed persons will be too small to prevent a slight increase in the unemployment rate. According to the forecast, the unemployment rate[10] in 2012 will increase slightly to 9.9% compared to 9.7% in 2011. In the following years however, the increase in the number of employed persons will accelerate, which will allow for a gradual reduction of the rate of unemployment. It is expected that in 2015 the unemployment rate will decline to 8.9% while the participation rate will increase.

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[8] In accordance with the European Commission forecasts for 2011. *European Economic Forecast. Autumn 2011*.

[9] Cf. the Minister of Science and Higher Education regulation of 5 October 2011.

[10] Harmonised unemployment rate consistent with the Eurostat definition.

The high continuing rate of unemployment together with an increasing labour supply (expected to increase with a higher rate of participation) and the planned freeze of the wage fund for most units of government and social insurance sub-sectors, will significantly reduce the growth of remuneration in the economy. It is predicted that in 2012 real wage and salary growth will be 0.9%, compared to 1.1% in the previous year. It is also predicted that in the following years, along with the expected improvement of the situation on the labour market and decreasing unemployment rate, the growth of real wages and salaries will accelerate.

The situation in the labour market and the predicted low wage and salary increases will allow real growth of household disposable income not exceeding 1% in real terms in 2012, compared to 0.4% in 2011. Assuming a further decrease in the savings rate and taking into consideration the positive effects of EURO 2012 on private consumption, it can be expected that real private consumption growth in the current year will reach 2.1%. In the following years, the real growth in this economic category should be consistent with the estimated increase in income and should stabilize at the level slightly above 3%.

It is predicted that after a large increase in inventories in 2011, their contribution to GDP growth in the current year will be negative and will reach -0.2 percentage points. In subsequent years, along with the expected acceleration of final demand, the contribution of this economic category to GDP growth should be positive and it will reach its highest level in the years 2013-2014, when the greatest acceleration of final demand is expected.

Final demand, together with the exchange rate, will be the basic determinant of import growth in Poland. It is expected that in 2012 real import growth will be slower than export growth, which will allow the positive contribution of net export to GDP growth to be preserved, however, at a level slightly lower than in 2011. In subsequent years, along with the acceleration of domestic demand, import dynamics will increase. The structure of increasing demand, implying the accelerating growth of imports, will reduce the contribution of net exports to GDP growth and will negatively influence the balance of trade, which in turn will be an important factor influencing the current account balance in the balance of payments. Assuming a slight deterioration in the negative income balance in subsequent years, which is determined to a large extent by revenues from foreign direct investors, it is predicted that the current account deficit, after an decrease to 3.5% of GDP in 2012, will rise to 4.0% of GDP within the forecast period. It should be noted, however, that this rise will be mainly financed by the inflow of long-term capital, comprising foreign direct investments and funds classified on the capital account (mainly EU structural funds).

In summary, predictions regarding the development of GDP components indicate that economic growth in Poland in 2012 will be 2.5% which is 1.8 percentage points lower than in 2011. The basic factor responsible for slower growth in the current year is stagnation in the markets of our main trading partners. If economic recovery in the euro area, especially in Germany accelerates, e.g. as a result of relatively high economic growth in the United States, it could be expected that the scenario in Poland will also be more optimistic. In such a case, the forecast GDP growth for Poland described in this section should be regarded as conservative. It seems, however, that from the point of view of the sustainability of public finances, and in the face of the debt crisis in some of the euro area countries, fiscal policy must be conducted on the basis of conservative macroeconomic forecasts. In subsequent years, in line with the improvement of the economic situation in the EU, we can expect that the rate of GDP growth in Poland will accelerate. This acceleration will be faster after the completion of consolidation measures in Poland and after the reduction of the general government deficit to the level required in order to maintain long-term financial sustainability.

At the same time, it should be noted that the chosen period and method of conducting fiscal consolidation favour the mitigation of possible negative effects of the reduction of public demand on Poland's economic growth. Lowering personnel costs in public administration will reduce pressure on remuneration increases for the whole economy, which will help to preserve cost competitiveness and, as a result, will influence the increase of employment and acceleration of economic growth. Despite lowering the share of public investment to GDP to approx. 2.8% in 2015, which is at a level close to the European Union average (2.6% in 2011), a simultaneous predicted increase in private sector investments will allow, after allowing for efficiency factors, for an increase of domestic economic potential. In addition, a significant consolidation effort will be made during the period of expected accelerated growth in the markets of Poland's main trading partners. The combination of these factors will minimize the effects of any negative shock in the form of a reduction of public demand and maximization of the probability of so-called non-Keynesian effects, which increases the chances of successful completion of consolidation measures and of a permanent reduction of the fiscal imbalance. A good example could be the year

2011 when the general government deficit was reduced by as much as 2.7 percentage points of GDP, while economic growth rose to 4.3% (compared to 3.9% in 2010).

Inflation is also expected to remain at a high level in 2012. The average annual CPI in the current year will reach 4.0%, as compared to 4.3% in the previous year. This high level is associated with a dramatic increase at the end of 2011, partially as a result of the earlier depreciation of the Polish zloty. In subsequent years, assuming that raw material prices will stabilize, inflation pressure will decrease and the CPI will approach the NBP target. In 2014, due to the decrease in the rates of VAT, this index may temporarily decline to a level of below 2.5%, but should return to a level consistent with the NBP target in the following year.

Because the factors influencing inflation growth (i.e. high prices of raw materials and the weakening of the Polish zloty resulting from the situation on global financial markets) remain beyond MPC control and considering the limited inflation pressure from domestic demand, the baseline scenario for 2012 assumes that central bank interest rates will remain at an unchanged level. On the other hand, according to the MPC statement of April 2012, if there are no perspectives of inflation reverting to the target and if there are no signals indicating a significant slowdown of economic activity in Poland, there is a chance that monetary policy will be further tightened in 2012. In subsequent years, the pace and scale of changes made to NBP interest rates will be determined by the progress of economic recovery, consolidation of public finance, the improvement of the situation on the labour market as well as the exchange rate and inflation. The most important external factors will be decisions made by the world's main central banks concerning their monetary policy. It has been assumed that in 2015 the NBP reference rate will reach 4.5%.

Within the forecast horizon, it is expected that the appreciation trend for the Polish zloty will be maintained. An average annual depreciation in 2012 results from a dramatic weakening of the Polish zloty at the end of 2011 and from a relatively weak exchange rate of the Polish zloty at the beginning of 2012. The gradual strengthening of the Polish currency should be favoured by the strong foundations of the Polish economy, including a relatively small current account deficit, the inflow of foreign investments and the reduction in the risk premium which is associated with limiting the imbalance in public finances. An important risk factor for the Polish zloty exchange rate forecast is the uncertainty on global financial markets, in particular a potential sudden growth of risk aversion associated with the crisis in the euro area.

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

In his exposé of 18 November 2011 Prime Minister Donald Tusk presented a plan to gradually increase and equalise the retirement age of men and women at 67. For men this objective will be reached in 2020 while for women in 2040. The changes also include the introduction of a partial retirement benefit for those meeting the requirements of minimum age (62 years for women and 65 for men) and of contributions (35 years for women and 40 years for men). The partial pension would be paid until the official retirement age is reached and would amount to 50% of the pension calculated at the moment of application. Since the partial pensions are paid from accumulated pension capital, they will reduce the final pension paid after reaching the official retirement age.

In practice, a large number of people drop out of the labour market either on acquiring pension entitlements or shortly afterwards. Raising the retirement age should postpone the moment of their exit from the labour market and increase the size of the labour force. Simulations were run where it was assumed that future retirees will behave in a similar way to those who are currently close to retirement age. This showed that raising the retirement age would significantly increase the participation rate of persons aged 55-64, from 50.1% (men) and 27.3% (women) to 67.3% and 61.3% respectively. Partial pensions may encourage some people to exit the labour force early. On the other hand however, strict conditions (age - 62/65 and contribution period - 35/40), relatively low partial pensions and the prospect of a reduced final pension should reduce this effect, especially as eligibility for a partial pension is not conditional on the termination of employment or on employment income. The impact of partial pensions on the labour supply is therefore difficult to estimate and as a result has not been taken into consideration in the simulations.

Based on these assumptions concerning labour supply and taking into consideration technical assumptions concerning: the growth rate of total factor productivity (convergence to a level of 1.5% in 2060, i.e. to the historical average for the most developed economies), the growth rate of capital (in the long-term equal to the sum of the growth rate of labour productivity and labour supply) and an average number of weekly working hours (it was

assumed that the share of people working full time and part time would be at the same level as in 2010 and that the average number of working hours per week would be at the level of the average from the last 3 years), a path of GDP growth in the years 2011-60 was presented in the baseline scenario and in the policy-change scenario.

Simulations show that increasing the retirement age will lead to an increase in average GDP growth in the years 2013-2060 by 0.1 percentage points. The average GDP growth will be higher by 0.1 percentage points in the period from 2013 to 2020, by 0.2 percentage points in the years 2021-2030 and 2031-2040 and by 0.1 percentage points in the period from 2041 to 2050. In the last decade of the forecast period GDP growth will be slightly below (0.1 percentage point) the path presented in the no-policy-change scenario[11]. As a result, the level of GDP in 2060, after introducing the reform, will be 5.1% higher compared to the no-policy-change scenario. The GDP per capita level will increase accordingly.

III. General government balance and debt

III.1. Policy strategy and medium-term objectives

A high general government deficit has a negative impact on domestic savings, increases the country risk premium which leads to higher capital costs and the need to service a continuously rising debt. This hinders the accumulation of capital and results in limiting potential GDP growth. Disciplined public finances are the key element of macroeconomic stability and thus of the state's credibility, which is of particular importance in the current period of turbulence on financial markets, risk of sudden capital outflows and the accompanying uncertainty. Therefore, further reducing the imbalance of public finances is the government's main priority for the coming years.

The government's initial aim for 2012 is to reduce the excessive general government deficit and then to pursue fiscal consolidation achieving the medium-term budgetary objective (MTO) in 2015. The structure of the fiscal consolidation has the greatest impact on achieving these goals. When analysing the experiences of other countries, it is noticeable that the optimal scenario consists of consolidation focused on the expenditure side, as its effects are the most durable. This correlation is already visible in the measures undertaken by the government, leading to a significant reduction of expenditure in 2011. This trend will also continue in subsequent years, at least until the medium-term budgetary objective is achieved (cf. chart 4).

Maintaining a permanent fiscal regime will be enhanced by the introduction of the permanent expenditure rule which will ensure that the general government deficit in the medium-term will be at a level of approx. 1% of GDP. The introduction of the rule and its accompanying changes in the national fiscal framework will also allow the fulfilment of requirements arising from the directive, which is an element of the so-called "six-pack" and specifies the requirements for budgetary frameworks in EU Member States. Structural reforms will also play a very important role in safeguarding the effects of consolidation (more in section III.7).

Due to the steady fiscal consolidation, Poland's public debt will have already started to decline in 2012. This trend will continue in subsequent years.

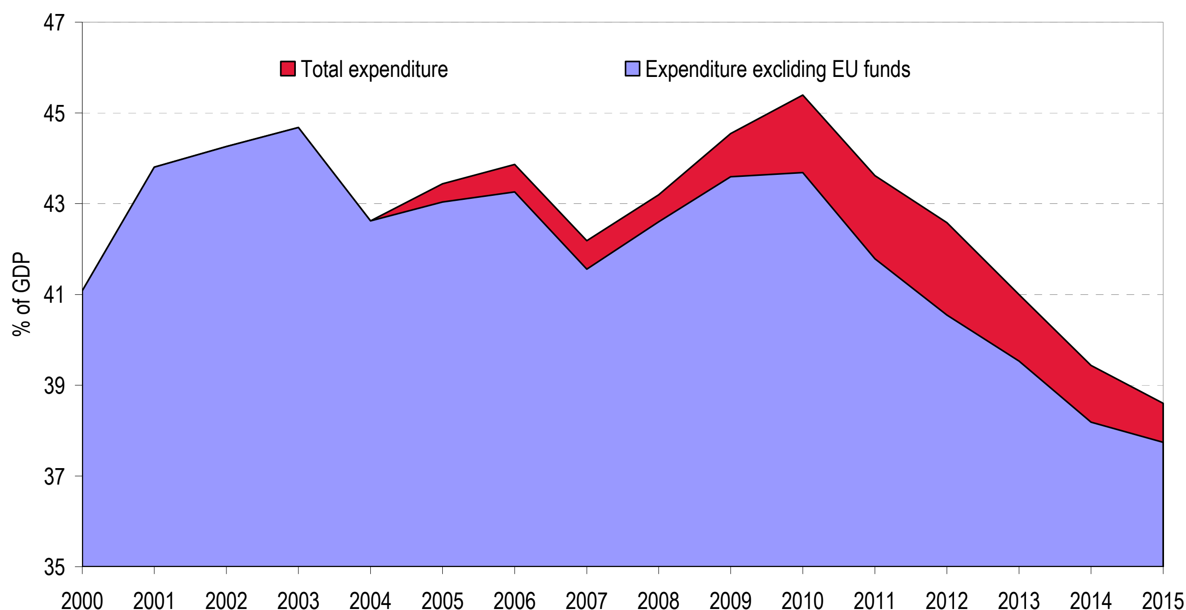
III.2. Measures taken to reduce the excessive deficit

The Council recommended that Poland, in a credible and sustainable manner, should put an end to the excessive deficit situation by 2012. In order to achieve this goal the government is undertaking and implementing appropriate measures, which have already contributed to a greater than planned reduction of the deficit in 2011. However, the worsening of global economic perspectives, particularly in the euro area – and by extension also in Poland – meant that the correction of the excessive deficit in 2012 would most probably be impossible without

[11] This results from lower labour supply dynamics in the years 2050-2060 which is a consequence of postponing retirement for those born in the 80s, i.e. the baby boom population. Due to the reform, this part of the population will postpone their exit from the labour force and will retire later with higher accumulated capital and higher payments. It also means that when they retire, the loss of labour supply in the decade will be faster than in the no-policy-change scenario. However, benefits (already achieved) from longer economic activity will prevail and the GDP level in 2060 will be significantly higher for the scenario introducing a higher retirement age.

additional measures. Therefore, the commitments made by the Polish government have had to be supplemented by additional measures for 2012. These were presented in the letter sent by the Minister of Finance to the European Commission in December 2011. These measures will ensure further reduction of the deficit, by both increasing revenues and by a tightening of expenditure discipline. It is emphasised that in 2012 the trend of reducing public expenditure in relation to GDP will continue. As a result, in 2012 this ratio should (after deducting deficit-neutral expenses financed from EU funds) reach the lowest level in the history of the Polish economy from the beginning of transformation (cf. chart 1).

Chart 1. General government expenditure



Source: AMECO, Ministry of Finance

The influence of measures undertaken in 2012 to reduce the excessive deficit is presented below. It should be emphasized that they do not take into consideration the reduction of the deficit achieved from expenditure discipline resulting from discretionary decisions (in addition to the effect of the temporary expenditure rule) that lead to a significant decrease in general government expenditure in relation to GDP (cf. chart 1 and 4).

Table 1. Government measures reducing the general government deficit

	ESA code	2012 % of GDP
Total taxes		
Taxes on production and imports, of which:	D.2	
- abolition of VAT refunds for company cars and fuel		0.03
- abolition of reduced excise duty on bio-fuels		0.03
- increase in excise duty on tobacco		0.04

	ESA code	2012 % of GDP
- increase in excise duty on fuel and in fuel fees		0.15
Current taxes on income and wealth, of which:	D.5	
- a freeze of PIT thresholds		0.09
- changes in the taxation of profits from bank deposits		0.02
- negative effect of the increase in disability pension contribution paid by employers (increase by 2 percentage points) on income taxes		-0.05
Property income, of which:		
- increase in dividends	D.42	0.13
- introduction of royalties on certain mineral resources (tax on the extraction of copper and silver)	D.45	0.09
Social contributions, of which:	D.61	
- higher disability pension contribution paid by employers (increase by 2 percentage points)		0.43
- changes to the funded pension scheme (lower contribution to OFE)		0.50
Current transfers, of which:	D.7	
- revenues from fines collected from the new speed enforcement camera system		0.07
Total impact on revenues		**1.53**
Compensation of employees + intermediate consumption + current transfers, of which:	D1+P2+D7	
- temporary expenditure rule (including a freeze of the nominal wage fund) and the effects of putting a ceiling on discretionary and new legally mandated spending		-0.11
- reduction of national direct payments to farmers		-0.10
Social transfers, of which:		
- implemented abolition of early retirement scheme		-0.33
- reduction in funeral benefits		-0.01
Interest expenditure, of which:	EDP D.41	
- reduction in debt-servicing cost due to changes in the funded pension scheme		-0.05
Total impact on expenditure*		**-0.60**
Total		**2.13**

* Assuming that higher expenditure of the central government sub-sector, resulting from paying higher disability pension contributions, will not lead to an increase in total expenditure of the central government sub-sector (due to the introduction of CPI+1 rule, which also covers expenditure on wages and salaries as well as derivatives of wages and salaries). In the case of additional local government expenditure, associated with paying higher disability pension contributions, it has been assumed that this would be compensated by a reduction in other current expenditure (due to the rule which has been in force from 2011, which obliges local government to balance at least the current element of their budgets).

Source*:* Ministry of Finance.

III.3. Actual balances

After increases in the general government deficit in the years 2008-2010, the year 2011 saw one of the greatest reductions of deficit since the transformation. Preliminary data indicates that the general government deficit in

2011 was 5.1% of GDP which is a decrease by 2.7 percentage points (from 7.8% of GDP) compared to 2010. It is important to note that this substantial reduction of deficit was mainly on the expenditure side. The ratio of domestic expenditure[12] to GDP in 2011 was lower by as much as 1.9 percentage points than that in 2010. Such a firm tightening was shown in the 2011 state budget expenditure, which was PLN 10.7 billion lower than predicted in the budget act.

Compared to 2010, in 2011 the greatest reduction in relation to GDP was in social expenditure (by 0.8 percentage points) and public consumption (also by 0.8 percentage points). In the case of expenditure for social allowances, the reduction was associated with the lower adjustment rate of retirement pay and pension benefits (3.1% as compared to 4.6% in 2010), with a reduction of the funeral benefit and with lower expenditure resulting from the abolition of the early retirement scheme implemented in 2009. In 2011 public consumption increased nominally by 2.9% (in comparison to an increase of 7.8% in the previous year). Such a significant decrease in the dynamics of public consumption was caused mainly by the reduction of intermediate consumption (i.e. the purchase of public sector goods and services) by 0.6%. For comparison, an increase in this category by as much as 15.5% was recorded in 2010. Furthermore, labour costs in general government increased nominally by 3.4% in 2011, while in the previous year they had increased by 4.2%.

In 2012, the trend of expenditure reduction with relation to GDP is continuing. As a direct result, by the end of 2012, this should (net of the EU funds) reach the lowest level in the history of the Polish economy since the beginning of transformation. At the same time it should be emphasized that this significant reduction of expenditure is not happening at the expense of investment outlays. On the contrary, in 2011 an increase in public investment expenditure was recorded – from 5.6% to 5.8% of GDP, i.e. to a record level, which was also the highest in the EU.[13] This was mainly caused by the acceleration of infrastructure expenditure within the framework of the *National road construction programme for the years 2011-2015,* as well as investment expenditure associated with preparations for EURO 2012. Such significant investment outlays would not however be possible without the efficient use of EU funds, supplemented by the necessary national co-financing.

So far, as the consolidation in the years 2011-2012 was concentrated mainly on reduction of expenditure, the deficit growth in Poland during 2008-2010 resulted mainly from changes in revenues. Among the factors responsible for the dramatic decrease in revenues in relation to GDP during this period were: effects of the earlier introduction of systemic changes to PIT and disability contributions (altogether reducing the tax wedge[14] from 39% in 2006 to 34.3% in 2010), relatively strong pro-cyclicality of tax revenue in Poland[15], mainly from business activity taxes (in the case of CIT revenues, having the greatest elasticity with regard to GDP, the relation of revenues to GDP declined from 2.7% in the years 2007-2008 to 2% in 2010), as well as the tax system which allows entrepreneurs to offset losses incurred in previous years thus reducing their taxable income.

In 2011, after three years of decline, the relation of domestic revenues (i.e. after deducting transfers from the EU) to GDP increased by 0.8 percentage points. This was the result of systemic changes associated with the reduction of a part of the retirement contribution transferred to the Open Pension Funds (OFE) (the share of the contribution base which is transferred to OFE was reduced as of May 2011 from 7.3% to 2.3%), the increase in VAT rates (from 22% to 23% and from 7% to 8% with a simultaneous decrease in rate from 7% to 5% for basic food products), abolition of tax preferences in excise duty on bio-fuels, increase in excise duty on tobacco,

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[12] Expenditure 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's revenues from the EU are shown in the amount of sector's 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 2011 the share of total expenditure in GDP in Poland decreased by 1.8 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 sector's results, revenues from national sources should be taken into account.

[13] In accordance with the European Commission forecasts for 2011. *European Economic Forecast. Autumn 2011.*

[14] The share of non-wage labour costs in gross remuneration.

[15] Pro-cyclicality of revenue from income tax is caused by the fact that during an economic revival it grows faster than would result from the GDP growth rate and in periods of slowdown, revenue from income taxes grows at a slower pace than GDP or may even decrease.

abolition of VAT deductions for certain types of vehicles, a freezing of tax thresholds and lump-sum tax deductible costs in PIT.

It is also worth mentioning that the structure of the VAT base has changed towards a higher share of public investments. This is important because entities within the public finance sector do not deduct VAT when purchasing goods and services. As a result, the expenses of these entities are effectively taxed at the highest rates of VAT. The effects of pro-cyclicality of revenues from income tax paid by individuals carrying out business activity (revenues from CIT increased by almost 14% y/y), though still quite restricted, were recorded in 2011. In addition to tax revenues, there was also an increase in property income, (dividend income from companies with State Treasury shareholding and profits of companies wholly owned by the State Treasury). The same entry (property income) of the state budget also includes revenues from the National Bank of Poland (NBP) profit for the previous year, which in 2011 amounted to PLN 6.2 billion. However, this payment has not reduced the sector's deficit because in accordance with ESA '95 methodology, payments from the central bank profit to the budget are treated as revenue only to the amount of the net position on operational activity, which in the case of the NBP was negative. A similar situation will occur in 2012, as the profit of the central bank in 2011 was not the result of operational activity.

The most important change, from the point of view of influence on the sector's revenue in 2012, is the increase by 2 percentage points – as of February 2012 – in the amount of disability pension contributions paid by employers (i.e. increasing the rate from 6% to 8%) which means that this part of the contribution has reverted to the level in force before 2008. In the years 2007-2008 the disability pension contribution decreased by 7 percentage points in total, of which 5 percentage points were on the part of the employee and 2 percentage points on the part of the employer. Another important factor, compared to 2011, are the increased revenues from pension contributions will result from the changes to the pension system introduced in 2011 and in force for the period of the whole year (reducing the amount of pension contribution transferred to the open pension funds - OFE).

A significant change to revenues is the introduction, as of 18 April 2012, of a new royalty on the mining of copper and silver. The rates of this tax are expressed in quotas and are specified per tonne of extracted copper and per kilogram of extracted silver. The rates depend on the average price of the raw material. Taxable entities can be legal persons, organisational units that do not have a legal personality and natural persons extracting copper and silver within the framework of their business activity. Revenues from the newly introduced tax will entirely benefit state budget revenue.

As of the beginning of 2012, a higher excise duty (by 14.1%) on diesel oil has also come into force. This increase is a direct result of the necessity to adapt the minimal rates for diesel oil to Community requirements. As in the previous year, an increase in excise duty on tobacco by on average 4% came into force from the beginning of 2012. This change, similarly to the tax on diesel oil, results from the necessity to adapt excise duty rates to Community requirements. Poland is obliged to reach the minimum level of tax on tobacco as specified in EU regulations by 2017.

Another, though less significant, source of expected additional revenues is the change to the *Tax Ordinance* introduced on 31 March 2012 which was designed to disallow tax avoidance on profits from bank deposits. Taxpayers can benefit (as of 2012) from relief on voluntary savings to an Individual Retirement Protection Account, which in turn will result in a slight reduction in revenues from PIT. This relief, introduced alongside recent changes to the pension system, is aimed at promoting additional individual retirement protection and thus at increasing private savings. The first results of this relief will, however, be visible only in the annual tax return for the year 2012, i.e. in 2013.

Revenues from VAT will mainly be determined by changes to macroeconomic indicators, including private consumption and public investment, whose increase in recent years has contributed to positive changes in the structure of the tax base for revenues from this type of tax (greater share of goods taxed at a higher than average VAT rate). In the current year the situation is different. The growth rate of private consumption is forecast to be lower, but the most dramatic slowdown will occur to nominal public investment dynamics – in real terms a decrease in public investment could even be expected. Revenues from VAT in 2012 will increase as a result of the abolition of VAT relief for company cars and fuel, introduced during 2011 and which was in force for the entire year. Additionally, compared to 2011, the rate for clothing and clothing accessories for babies and children's footwear was increased in 2012, as a result of Community regulations.

Very good corporate results in 2011[16] also have an influence on increases in the state and local budget revenues in 2012. This is reflected in high revenues from the annual income tax return for 2011 from individuals undertaking business activity and particularly concerns that group of taxpayers[17] who within last year chose a simplified form of making advance tax payments, i.e. equal monthly payment during the year, calculated on the basis of the amount of tax due for 2009 which was the year of the biggest economic slowdown in Poland. As a result, advance tax payments made by these taxpayers were often lower than should have resulted from their current profitability and these differences will have to be remitted in 2012, with the annual tax settlement for 2011.

Changes in the amount of current revenues from CIT and PIT from entrepreneurs additionally result from regulations concerning the settlement of losses incurred during the recent period of slowdown in the economy. In accordance with tax rules, losses from previous years may be deducted at most within five consecutive years, and in a given year it is possible to settle (reduce the taxable income) by up to 50% of cumulated losses which means that high income taxpayers may deduct losses (e.g. from 2009) within 2 years of having incurred these losses (during the years 2010-2011). Therefore 2012 should be the first year when negative budgetary effects associated with the deduction of losses incurred during the recent slowdown will begin to significantly decrease.

As a result of good corporate results in 2011, increased dividend payments from companies with State Treasury shareholding as well as profit pay-outs by companies wholly owned by the state treasury are also expected in 2012. An increase as of 2012, in non-tax revenues will result from the implementation of a system for automatic registration of traffic offences, managed by the Automatic Road Traffic Supervision Centre, which is part of the Main Inspectorate of Road Transport.

III.4. Medium-term budgetary outlook

The predicted situation of public finances within the *Programme* horizon indicates that government objectives will be met: after correcting the excessive deficit in 2012, fiscal consolidation will continue in subsequent years, which will result in the meeting of the medium-term budget objective in 2015. The main factors influencing revenues and expenditures in this period are listed below.

1) Factors determining general government revenues

The most important source of general government revenues is VAT, whose amount in subsequent years will be determined by changes to the macroeconomic situation. A predicted significant reduction of public investments post-2012, as a result of a decrease in grants from EU funds received within the framework of the current financial perspective (2007-2013), will be unfavourable to VAT revenues. The great majority of these funds have already been consumed in the previous years when public investments in relation to GDP reached a record level in Poland, and which at the time were the highest within the EU. The decrease in public investment will mean a reversal of the previous positive trend, when the share of investment assets (taxed at relatively high rates) in the VAT base structure was growing. However, a much more important factor, in fact fundamental for revenues from VAT and – in the broader perspective – for indirect taxes, will be private consumption. Based on the predicted increase in household disposable income, private consumption should increase starting in 2013 and growth should stabilise at a level slightly above 3% in real terms.

Another factor that will start to influence the macroeconomic situation from 2013 onwards will be the gradual rise of the retirement age for men and women, which will have a positive impact on the labour supply and thus on employment, production and economic growth. Although this effect will initially be marginal, it will gradually grow and the higher number of working Poles will also mean additional revenues from income tax and social insurance contributions.

Of all systemic changes which will influence general government revenues after 2012, the most important will be the reduction of VAT rates from 2014, from the current 23% to 22% and from 8% to 7%. The year 2013 will be the last year of VAT deductions for the purchase of certain vehicles and fuel. As far as revenues from direct taxes are

[16] According to the Central Statistical Office, in 2011 gross profit of non-financial enterprises increased by 17.2% y/y. In the banking sector the increase in the gross profit was even higher and exceeded 30% y/y.

[17] CIT and – to a lesser extent – taxable persons who run their own enterprises in accordance with the rules specified in PIT.

concerned, the following changes are suggested in the draft amendment to the PIT Act (which is expected to come into force in 2013):

- the introduction of an annual limit of 50% of tax deductible costs for taxpayers with income from copyrights, which will be equal to half of the amount specified as the upper limit of the first tax bracket, i.e. PLN 42 764; it means that a taxpayer with income from copyrights not exceeding PLN 85 528 will still benefit from preferential taxation without any limitations; for a taxpayer with higher income, lump sum costs will amount to a maximum of PLN 42 764 (the taxpayer will still have the right to deduct tax deductible costs actually incurred, provided that these are appropriately documented); this change will have a positive impact on tax revenues from 2013;
- the abolition of the Internet expense deduction; currently taxpayers may reduce their tax base by an amount not exceeding PLN 760 annually; this change will have a positive impact on revenues as of 2014 (when the annual PIT return for 2013 is filed);
- changes to childcare allowances consisting of:
  - an increase in the tax deductible amount for taxpayers with three or more children where allowances for the third and subsequent children will increase by 50%, which gives an amount of PLN 139.01 for every calendar month. Large families will be eligible to receive additional support from the state,
  - exclusion of taxpayers with only one child whose income exceeds PLN 85 528 (the upper level of the first tax bracket) from childcare allowances.

    For taxpayers with two children, the rules for deduction of the allowances remain unchanged, i.e. taxpayers will be entitled to the allowances regardless of their income. The introduction of changes to childcare allowances will result in a positive, although only slight, increase in revenues from 2014 (as a result of filing annual tax returns for 2013). The most important effect of this change will be a fairer reallocation of state aid.

Within the forecast horizon, there will be no changes to the two-tier scale for personal income tax which has been in force since 2009 with tax rates of 18% and 32%, one tax threshold of PLN 85528 and a basic tax-free allowance of PLN 556.02. This means a continuation of the slight increases in the effective PIT burden, from which the state budget and the local government benefit almost equally.

Factors serving to increase the state budget from 2013, include revenues from the introduction of the Emission Trading System as well as licence payments for radio frequencies to be made available in a reallocation from defence to civilian usage. Social insurance contribution revenues in 2013 will be increased as a result of the introduction at the beginning of 2012 of increased pension contributions paid by employers. The royalty tax on copper and silver mining will also have been in force for a whole year and will be the source of additional revenues in 2013. By 2017 Poland will have been obliged to reach the minimum level of excise duty on tobacco, as specified in EU regulations, which means that the excise duty on tobacco will be increased in subsequent years.

A gradual (from 2013 onwards) increase in the capital share of contributions transferred to OFE along with the total amount of pension contributions remaining at an unchanged level will in turn lead to a decrease in revenues from pension contributions, in accordance with the current legal situation.

2) Factors determining general government expenditure

Major factors influencing the level and the structure of expenditure within the forecast horizon include implemented (description in section III.2) as well as planned systemic changes, changes to public investment expenditure, including mainly infrastructural investments and decisions concerning the maintenance of expenditure discipline. These measures are aimed at ensuring an on-going reduction in general government expenditure in relation to GDP in the years to come.

After a period of sharp increases in the share of general government investments in GDP, which reached a record level of 5.8% in 2011, it is expected that in subsequent years this will gradually decrease to reach EU average levels. Causes for this to occur include:

- the absorption over the past few years of significant EU funds that Poland received within the framework of the current financial perspective – it should be emphasized that the consolidation path presented in the *Programme* is consistent with the full use of EU funds that Poland is entitled to receive;
- the reduction (from 2013 onwards) of investment expenditure financed from the National Road Fund (in accordance with the *National road construction programme for the years 2011-2015*)[18];
- the (conservative) assumption that savings in the local government sub-sector in the years 2012-2013 will not be made with regard to consumption, including labour costs, but by reducing investment expenditure (however, this excludes expenditures for the co-financing of projects financed from EU funds); these savings result in part from legal regulations already in force (*the Public Finance Act*), which require the basis for incurring liabilities by local governments to change by 2014, and put a requirement on these units to improve their financial situation in the interim period, (to 2013).
- In this scenario, the share of public investments to GDP should decrease from 5.8% in 2011 to 2.8% in 2015. If local governments make most of their savings by reducing consumption, including restraining labour costs, then their investment activity could remain at a higher level. It would not only mean higher public investment, but also additional revenues from the sector as the effective tax rate on public sector investment expenditure is higher than the tax rate on public sector consumption expenditure.

Labour costs in general government are another important factor contributing to expenditure. It has been assumed in the labour costs section that the nominal wage fund of the central and social security funds sub-sector in 2012 will be frozen (except for the uniformed services) and that wages in the local government sub-sector will increase in line with wage increases in the market sector. In subsequent years, these limits will be maintained in the central sub-sector, except for the remuneration of individuals employed in state higher education schools, which according to decisions made by the Council of Ministers is to rise at a nominal rate of 9.14% a year, increasing in total by 30% over the years 2013-2015.[19]

Within the forecast horizon, the effects of limiting the possibilities of earlier retirement will also impact the decrease in pension payments from social insurance. This reform, in force from 2009, limits the increase in the number of pensioners and at the same time increases the labour supply and improves the situation of public finances. Among other assumptions made for the purposes of the *Programme,* it is worth indicating the annual minimal indexation of old age pensions and other pensions according to the formula: CPI + 20% of the actual increase in remuneration in the national economy. Furthermore, it is predicted that funeral benefits will remain unchanged and the improvement of the situation in the labour market will allow for reduced expenditure of public funds on counteracting unemployment. Within the forecast horizon, decreasing expenditures intended for the implementation of the Common Agricultural Policy, resulting from financing supplementary area payments from the national budget will reduce state budget expenditure.

When preparing the forecast, it was assumed that when Ecofin abrogates the excessive deficit procedure for Poland by 2013, the temporary expenditure rule which reduces the increase in discretionary expenditure and new fixed expenditure to 1% annually in real terms will remain in force. This rule will be supported by additional measures reducing the growth of other expenditures not directly covered by legal regulations. It is important to note that expenditure discipline will also be maintained in subsequent years. As a result, it is expected that the general government deficit in 2012 will reach 2.9% of GDP and in the following years will be further reduced to 2.2% in 2013, 1.6% in 2014 and 0.9% in 2015. The achievement of the medium-term budgetary objective in 2015 will result primarily from the reduction of expenditure and not from an increase in general government revenues in relation to GDP (cf. chart 3). In reality, the share of national expenditure of general government to GDP, by 2012, should have reached its lowest level in Polish economy history since the beginning of the transformation. What is more, within the *Programme* horizon this share should decrease further in each subsequent year (cf. chart 1).

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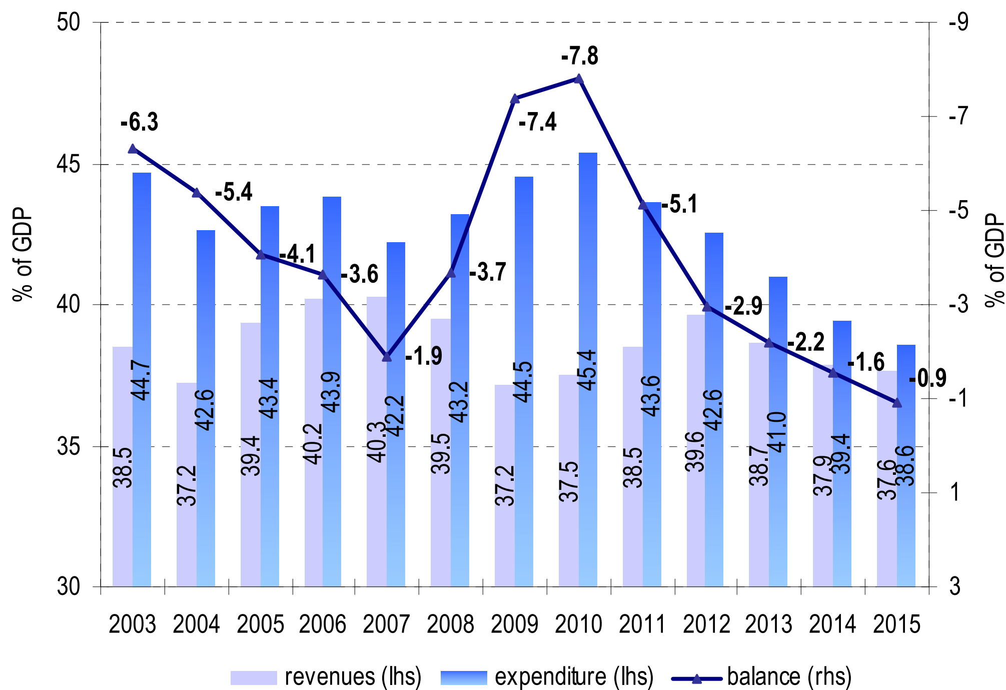
[18] The lack of information about new infrastructural programmes does not currently allow for the inclusion of such programmes in the public investment projection. It may be expected, however, that the path of investment expenditure will change if new investment programmes are accepted by the government. In addition, the disbursement (from 2014 onwards) of additional resources from EU grants will contribute an additional factor supporting economic growth, but with a limited negative influence on the general government deficit.

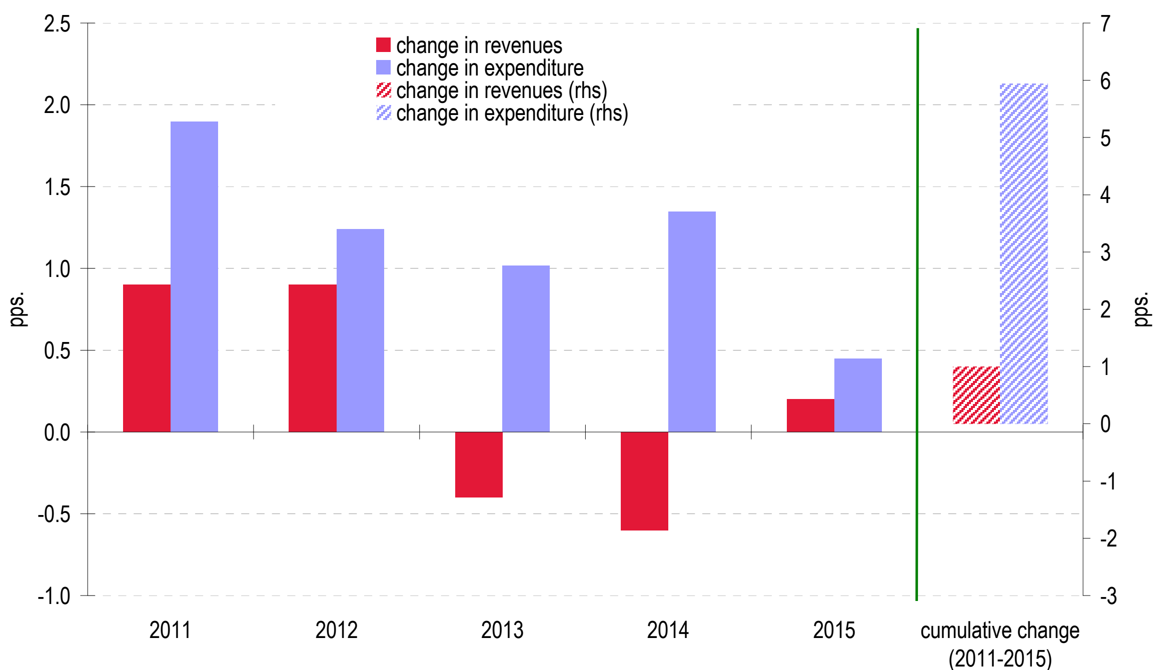
[19] Cf. the Ordinance of the Minister of Science and Higher Education of 5 October 2011.

Chart 2. Revenue, expenditure and balance of general government



Source: 2003-2010 – Eurostat, 2011-2015 – Ministry of Finance

Chart 3. 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 revenues to GDP between respective years, "minus" column – the decrease. Expenditure – "plus" column means the reduction of the share of national expenditure to GDP between respective years, "minus" column – the increase.

Source: Ministry of Finance

Table 2. General government balance and debt (EDP, % of GDP)

	ESA code	2011	2012	2013	2014	2015
General government balance (B.9)	S.13	**-5.1**	**-2.9**	**-2.2**	**-1.6**	**-0.9**
Central government	S.1311	-4.3	-2.7	-2.4	-1.8	-1.1
Local government	S.1313	-0.7	-0.4	-0.2	-0.2	-0.2
Social security funds	S.1314	-0.1	0.2	0.4	0.4	0.4
General government debt	**S.13**	56.4	53.7	52.5	50.6	49.7

Source*:* 2011 – Central Statistical Office, 2012-2015 – Ministry of Finance.

III.5. Structural balance

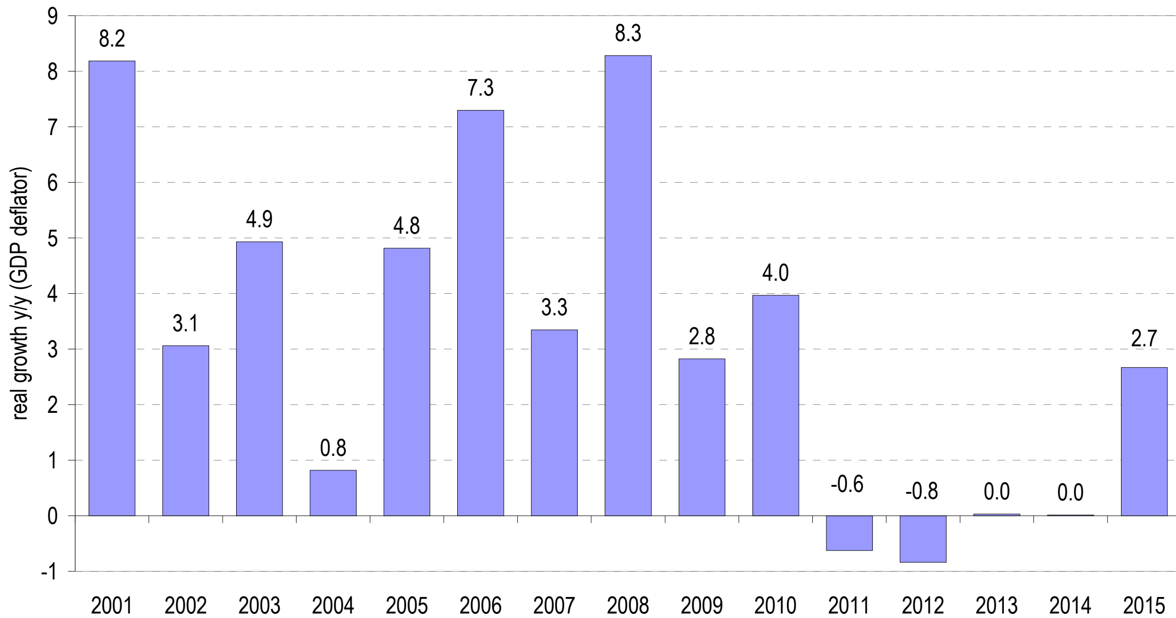
A significant decrease in the general government deficit in 2011 was caused by both an increase in revenue and to even greater extent, a decrease in expenditure in relation to GDP. The improvement in revenue resulted mainly from the introduction of systemic changes (see section III.3) and from the pro-cyclical effect of revenues from income tax. A significantly greater role in reducing the deficit in 2011 was played by adjustments associated with expenditures. The biggest decrease was noted in social expenditures (decreased by 0.8 percentage points in relation to GDP) and public consumption (also decreased by 0.8 percentage points).

Further fiscal tightening is scheduled for the current and subsequent years. If the measures on the revenue side play a significant role in reduction of the deficit in 2012 (cf. table 1), then starting from 2013 a significant majority of structural adjustments will result from a reduction of general government expenditure. Although systemic measures refer mainly to the revenue side in the current year, the contribution of expenditure limitation to the reduction of the sector deficit will be very significant (cf. chart 3). This is the result of discretionary measures undertaken by the government within the scope of continued expenditure discipline, resulting in an on-going decrease in domestic expenditure in relation to GDP. Maintaining discipline in subsequent years, and then introducing a target, permanent expenditure rule, will safeguard the achievements made during the consolidation and at the same time will not allow for an excessive "rebound" of expenditure increases e.g. in conditions of economic recovery. The reduction in expenditures achieved to date and also planned for subsequent years is thus of a structural nature, promoting the achievements and sustainability of sector results at the level of the medium-term budgetary objective.

Consolidation on the expenditure part is particularly important in a condition of the structural imbalance of public finances, which can still be seen in Poland. In a balanced scenario, the growth rate of expenditure should in principle correspond to the average GDP growth rate in the reference period. However if the country does not achieve MTO (medium-term budgetary objective), then expenditure increase should be limited to approx.1 percentage point less than the medium-term GDP growth rate. In Poland, the tightening of the expenditure side throughout the *Programme* period (including 2011) significantly exceeds the standards provided for in *the Stability and Growth Pact* (cf. chart 4).[20] As a result, the share of domestic expenditure (i.e. expenditure after deducting any expenditure co-financed with EU funds) in GDP should already this year achieve the lowest level in Polish economic history since the beginning of the transformation, and will continue to decrease in subsequent years (cf. chart 1).

[20] Expenditure dynamics growth in 2015, though still lower than the medium-term GDP growth rate, results mainly from a significant acceleration of domestic investment expenditure. What is important is that this growth does not threaten the achievement of the medium-term budgetary objective. In fact, in 2015 the sector deficit still reduces to the MTO level.

Chart 4. General government expenditure excluding EU funds, debt servicing costs and cyclical expenditure on unemployment benefits in Poland



Source: AMECO, Ministry of Finance

Further to the current forecast, the GDP level in 2012 should be similar to the potential, whereas in subsequent years it will be slightly below the potential, which means a negative output gap at a level of approx. 0.5% of GDP. Taking into consideration the OECD estimates concerning long-term tax elasticity, it is expected that the forecast cyclical part of the sector result in the years 2013-2015 will not exceed 0.2% of GDP.

Table 3. Structural balance

% of GDP	ESA Code	2011	2012	2013	2014	2015
1. Real GDP growth (%)		4.3	2.5	2.9	3.2	3.8
2. Net lending of general government	EDP B.9	-5.1	-2.9	-2.2	-1.6	-0.9
3. Interest expenditure	EDP D.41	2.8	2.8	2.8	2.6	2.5
4. One-off and temporary measures						
5. Potential GDP growth (%)		3.5	3.3	3.3	3.3	3.4
of which: contribution of labour						
capital						
TFP						
6. Output gap		0.6	-0.1	-0.5	-0.5	-0.2
7. Cyclical budgetary component		0.2	0.0	-0.2	-0.2	-0.1
8. Cyclically-adjusted balance (2-7)		-5.3	-2.9	-2.1	-1.4	-0.8
9. Cyclically-adjusted primary balance (8+3)		-2.6	-0.2	0.7	1.2	1.7

% of GDP	ESA Code	2011	2012	2013	2014	2015
10. Structural balance (8-4)		-5.3	-2.9	-2.1	-1.4	-0.8

Source: Ministry of Finance.

III.6. Debt levels and developments

Debt management in the period covered by the *Convergence programme* update 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 minimisation of long-term debt servicing costs subject to constraints at the level of risk.

Debt management will be carried out against a background of the gradual reduction of the general government deficit as well as uncertainty in financial markets caused by debt crises in some euro area countries. In the domestic market, measures aimed at reduction of the general government deficit should have a significant 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 debt to GDP ratio in 2012-2015 will result primarily from the state budget borrowing requirements (the State Treasury debt constitutes over 85% of the general government debt), the GDP growth rate and the Polish zloty exchange rate vis-à-vis other currencies, especially the euro. Apart from deficit reduction, a significant factor limiting the borrowing needs of the state budget will be the improvement of the budget balance of EU funds, which from 2013 will become a cash surplus. In the current year, the borrowing requirements will also be lower owing to the changes in the pension system introduced in 2011 and which will in 2012 be in force for the entire year (reduction of the part of the pension contribution transferred to OFE). Privatisation proceeds will also contribute to a reduction of the borrowing requirements, although it is assumed that their scale in subsequent years will decline.

The reduction of borrowing requirements in 2011 was significantly influenced by a systemic change consisting in introducing an obligation to deposit available funds from specified central public finance units in an account of the Minister of Finance. This change allowed the use of liquid financial assets from the public finance sector to decrease the borrowing needs of the state budget, thus decreasing the difference between the gross and net public debt in subsequent years by over PLN 20 billion.

The changes in the debt of other general government units will mainly be the result of a change in the debt of the National Road Fund and an increase in the debt of local government entities. The borrowing requirements of local governments will also result, to a great extent, from infrastructure projects, co-financed with the EU funds within the financial perspective 2007-2013. After a sharp increase through 2009-2011, local government debt is expected to rise at a slower pace in subsequent years, due in part to the introduction of new fiscal rules for local government units.

Within the timeframe of this update, the ratio of debt to GDP, according to the EU methodology, will fall below 50%. Whereas when calculated using the national methodology, the state public debt should decline in the same period to approx. 47% of GDP.

Table 4. General government debt developments (end of the year)

% of GDP	ESA Code	2011	2012	2013	2014	2015
1. Gross debt		56.3	53.7	52.5	50.6	49.7
2. Change in gross debt ratio		1.5	-2.7	-1.2	-1.9	-0.8
Contributions to changes in gross debt						
3. Primary balance		2.4	0.2	-0.5	-1.0	-1.6
4. Interest expenditure	EDP D.41	2.8	2.8	2.8	2.6	2.5
5. Stock-flow adjustment		-3.6	-5.7	-3.4	-3.5	-1.8

% of GDP	ESA Code	2011	2012	2013	2014	2015
of which: difference between cash and accruals		0.2	0.4	0.1	0.1	0.4
net accumulation of financial assets*		-1.9	-0.9	-0.5	0.2	1.0
of which: privatisation proceeds		-0.4	-0.2	-0.1	-0.1	0.0
valuation effects and other		-1.9	-5.2	-3.1	-3.8	-3.1
p.m.: Implicit interest rate on debt (%)		5.4	5.2	5.1	5.1	5.2
Other relevant variables						
6. Liquid financial assets		2.7	2.2	1.9	1.8	1.8
7. Net financial debt (=1-6)		53.6	51.5	50.6	48.7	48.0
8. Debt amortisation (existing bonds) since the end of the previous year**		8.5	7.6	6.2	4.0	5.2
9. Percentage of debt denominated in foreign currency (%)		30.9	29.3	29.2	28.8	29.2
10. Average maturity***		5.4	5.4-5.6	5.3-5.8	5.3-5.9	5.3-5.9

* Net accumulation of financial assets is the result of different variables. The most important include: the use of available funds from public finance sector units within the scope of consolidation of liquidity management (in 2011), privatisation proceeds and cash balance of the EU funds budget of the state budget.

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

*** Interval forecast for the State Treasury debt.

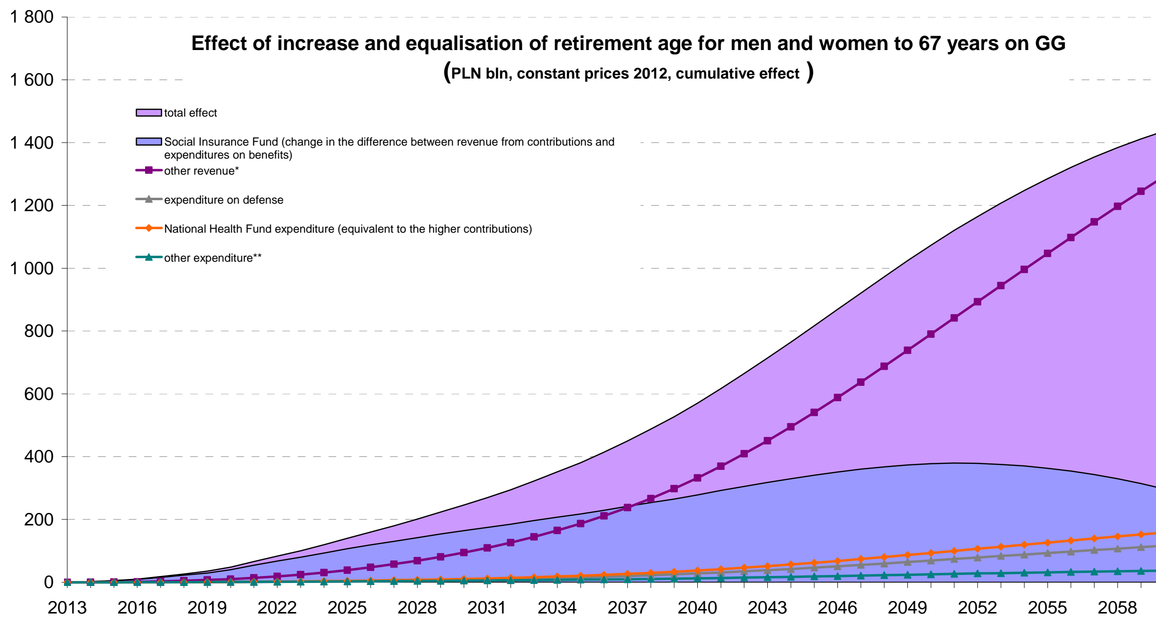
Source*:* Ministry of Finance.

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

A significant role in the strengthening of consolidation effects and long-term sustainability of public finances will be played by structural reforms. This refers in particular to a gradual increase and equalisation of the retirement age of men (at present 65) and women (60) at 67. The reform will contribute to an increase in long-term GDP in Poland by increasing the labour supply. Higher economic growth, a larger remuneration fund and longer occupational activity will be contributory factors to increasing pension capital, and thus also future pensions.

The increase in the number of people employed and rise in GDP as a result of the introduced reform will give an increase in the proceeds from taxation and social insurance contributions. Moreover, in the transition period (in the following several decades) expenditure from the Social Insurance Fund (SIF) on pensions will be reduced due to a smaller number of the retired (compared to the no-policy-change scenario). After the transition period; however, the number of persons who will retire at an older age (compared to the no-policy-change scenario) will increase. Due to a higher participation rate, these persons will however have accumulated higher pension capital. This will be reflected in increased SIF expenditures due to the higher pensions.

Chart 5. Impact of increasing and equalising retirement age on the public finance sector (accumulated effects)



* taxes, contributions to the Labour Fund, the Demographic Reserve Fund, Guaranteed Employee Benefits Fund, Social Security Fund income of refunds loss of contributions transferred to OPF.
** state budget expenditure on retirement benefits of judges and prosecutors and the teachers' compensation benefits, spending Labour Fund on early retirement and unemployment benefits

Source: Ministry of Finance.

Apart from the higher proceeds from contributions of all kinds of social insurance and higher tax proceeds, an increase of retirement age will result in an increase in some categories of expenditure. In particular, owing to higher GDP, expenditure on defence will increase, because pursuant to Article 7. (1) of the *Act on Reconstruction and Technical Modernisation as well as Financing of the Polish Armed Forces*, state budget defence expenditures must amount to at least 1.95% of GDP from the previous budget year and are allocated annually to finance the defence needs of the Republic of Poland. Also an increase in the state budget expenditure on compensation allowance for teachers and a reduction of the state budget expenditure on pensions for judges was taken into account.

The calculations presented in the chart do not take into account the expected improvement of finances of the Agricultural Social Insurance Funds (KRUS). A reduction of debt servicing costs due to a lowering of the state's borrowing needs and the expectation of a better assessment of Polish public finances by the financial markets was not incorporated in the forecast, though both should contribute to a reduction of yields of Polish treasury securities.

Another significant change in the social insurance system will be the limitation of retirement privileges for the uniformed services. In particular, starting in 2013 persons entering service will have earned their pension entitlements after 25 years of work, instead of 15 currently. The entitlements of other professional groups (including miners) to early retirement will be subject to review and suitable modifications.

Moreover, on 1 February 2012 the *Act on farmers health insurance contributions for 2012* came into force, by which farmers working agricultural farms with a surface area of 6 conversion hectares and bigger are obliged to pay health insurance contributions for all persons insured on their agricultural farms. The contribution is progressive and increases proportionally to the size of the agricultural farm. Ultimately, the introduction of new rules which will determine agricultural farm profitability is to be considered, which will make both the size of the health insurance contribution and value of tax paid by the farm, income dependent.

Increasing transparency is among the structural measures aimed at supporting fiscal consolidation, as well as rationalisation of the tax system, in particular the elimination or modification of some tax reliefs, which will promote broadening of the tax base and a fairer allocation of state aid (more in section III.4).

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 in Poland's major trade partners is a basic risk factor for the macroeconomic forecast presented in section II. The forecast was prepared on the basis of up-to-date data concerning the current and projected situation in the EU. The debt crisis in some of the euro area countries may however have a significant impact on the situation dynamics, and presents a basic risk to the forecast of economic growth in Poland. As a result, the main risk factor to Polish economic development stems from the situation in the external environment, which in turn depends to a large extent, on the effectiveness of measures taken by European institutions as well as the governments of the euro area countries, aimed at containing the crisis and ensuring a stable basis for economic recovery.

A relatively high economic growth rate in the USA, with prospects for acceleration in the current year may also trigger higher growth in the biggest economies of the euro area. This refers in particular to the German economy which is strongly linked with world trade. Taking into consideration the economic links between Poland and Germany, the acceleration of growth in our biggest trade partner would result in a faster improvement of the economic situation also in Poland, which would in turn lead to a higher than expected growth in exports, employment and investment, and consequently other components of domestic demand. In such a case, the macroeconomic forecast for Poland shown in section II should be considered conservative.

2) Implementation of 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 fields 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 dependency of the Polish energy sector on fossil fuels – over 90% of electricity in Poland comes from brown and black coal-fired power plants. Fulfilment of these objectives will require significant investments in those sectors of the economy having high levels of CO_2 emissions. In addition, as a result of an increase in electricity prices, a slowdown of the rate of economic growth may be expected, lowering 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.

Polish enterprises are characterised by low energy efficiency compared to the leaders in the EU. As a consequence, domestic enterprises operating in sectors having significant levels of energy consumption per production unit face the risk of a significant increase in operational costs and a loss of international competitiveness. Moreover, domestic entities are exposed to the risk of carbon leakage (transferring energy-consuming and high-emission production from the EU Member States implementing CO_2 emission reduction policy to countries with lower environmental standards).

3) Lower absorption of EU funds and other risk factors

The risk of incomplete utilisation of funds from the Polish allocation of structural funds and the Cohesion Fund as well as from the *Rural Development Programme* (RDP) results from an expected accumulation of payments from the current EU multiannual financial framework (2007-2013) in 2011-2013. The necessity of ensuring the availability of public funds for national co- and pre-financing of projects is another source of this risk. Moreover, failure to adopt the EU budget for 2012 and 2013 or adoption of the annual EU budget at a level that will be insufficient to implement the cohesion policy and RDP in Poland may lead to an accumulation and prolongation of pre-financing expenditures from the state and local government budgets as a result of delays in the reimbursement of funds.

In addition, the following risk factors may also be mentioned:

- limitations resulting from environment protection requirements and of NATURA 2000 areas,
- fixed tender criteria for obtaining EU funds and the significant volumes of documentation that are required from the beneficiaries of these funds,
- the long period from signing the co-financing agreement until the final project settlement by the European Commission.

Moreover, attention should be paid to the risks associated with negotiations for the next EU multiannual financial perspective (2014-2020), that may continue until 2013. Determining payment limits which are too low, in particular in the first 2-3 years of the next financial period, may threaten the timely reimbursement of incurred expenditures from the EU budget (refinanced from the state and local government budgets) according to the principle n+2/n+3, within the current EU multiannual financial framework.

4) Guarantees and other operations

Over the next years, a concentration of sureties and guarantees granted by the State Treasury on investments facilitating developments in the road and rail infrastructure, as well as environmental protection, workplace creation and regional development is anticipated. Sureties and guarantees will mainly be granted for investments utilizing EU funds (loans and bonds underwritten or guaranteed by the State Treasury should enable the obtaining of EU funds), as well as for other investment tasks 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 limit for 2012 in the budget act was determined at PLN 200 billion and apart from supporting the above projects may also be allocated to measures which may have to be undertaken should the global financial and economic crisis cause a worsening in the functioning of the Polish financial system.

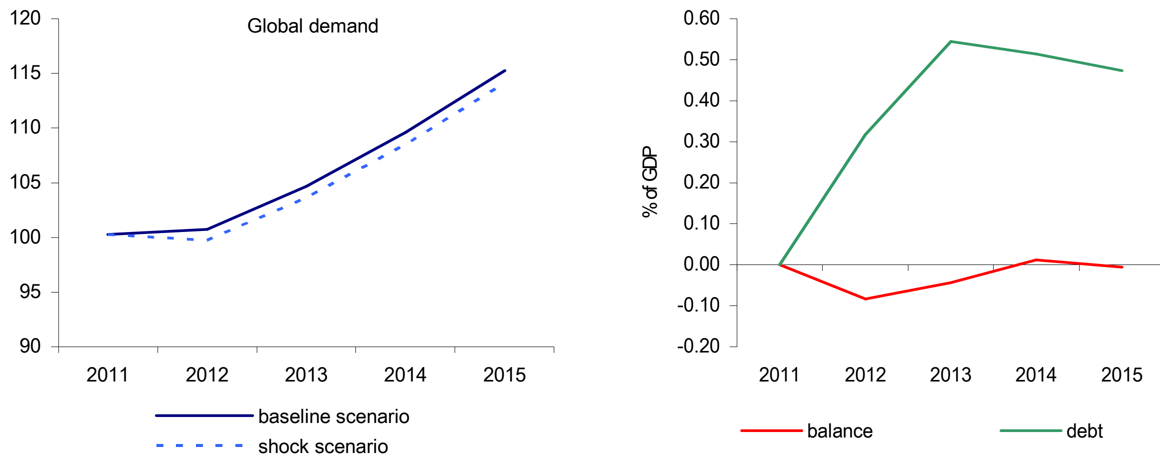
As of the end of 2011, the sum of potential obligations by the State Treasury for sureties and guarantees already issued amounted to about 6% of GDP. For the years 2012-2013 a further growth of this sum is predicted, but it is not expected to exceed 9% of GDP. The risk associated with the sureties and guarantees portfolio should not increase.

Transactions within the framework of public-private partnerships (PPP) are among the other operations which could increase the risk to public finances. The budget act for 2012 set a limit of PLN 1 billion for financial liabilities in relation to PPP agreements upon which the government administration can draw upon.

IV.2. Sensitivity analysis

The sensitivity of the general government balance and debt in the years 2012-2015 to a decrease in global demand, increase in public investments, depreciation of the exchange rate of the Polish 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 Finances (eMPF) developed by the Ministry of Finance.

Chart 6. Global demand (left chart) and its impact on general government balance and gross debt (right chart)

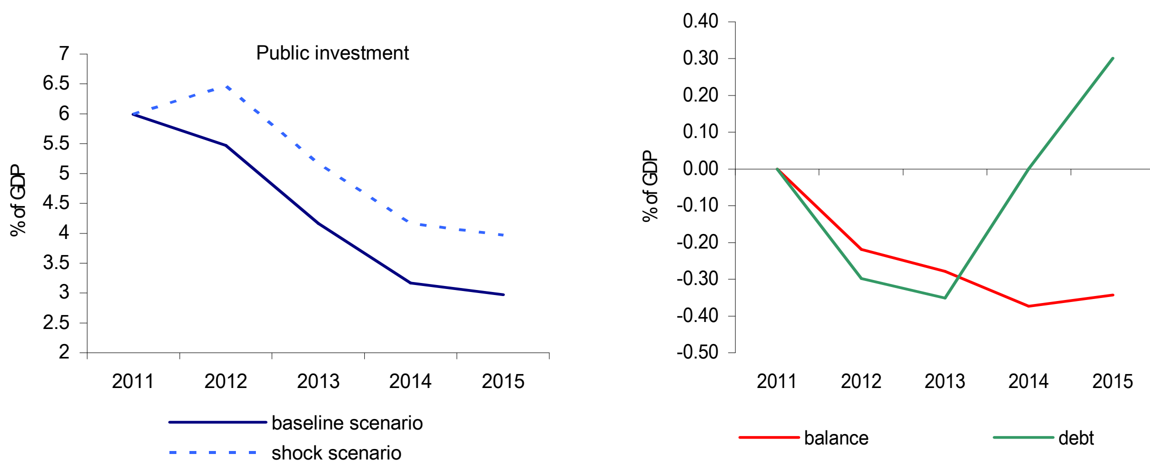


The impulse of the slowdown in global demand has been defined as a permanent 1% decrease in the global demand indicator as compared to the baseline scenario. A direct effect of disturbances in the external environment for the national economy is a reduction in foreign trade. In the first year from the occurrence of the shock, the volume of exports has declined by 0.6% against the baseline scenario, and in subsequent years its level remains lower by 0.2-0.4%. Due to the high import intensity of exports, the decrease in the export volume is accompanied by a decline in imports, additionally supported by depreciation of the national currency which is the result of worsening sentiments in the world economy. Imports decline more than exports (by 0.6-0.9%) and the trade balance improves.

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 approx. 1% compared to the baseline scenario), reducing employment and remuneration. Household disposable income goes down, which limits private consumption by 0.2-0.5%. As a result of these disruptions, GDP remains persistently lower by 0.2-0.4% in comparison to the non-shock scenario. A restriction of domestic demand is accompanied by the lowering of inflationary pressure and a decrease in interest rates.

Lower economic growth negatively affects the condition of public finances. The general government deficit increases (in the first year by 0.1% of GDP, and in subsequent years by a little less), as a result of which in 2015 the level of general government debt is 0.5% of GDP higher than in the baseline scenario.

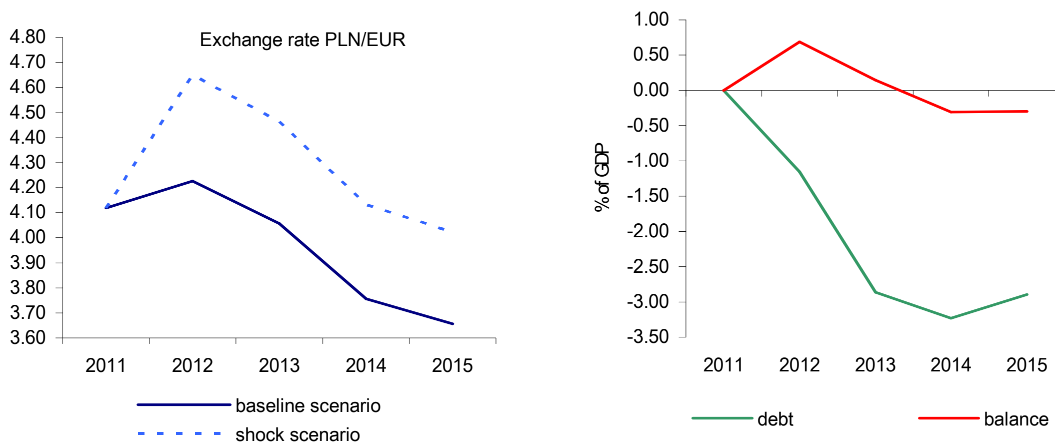
Chart 7. Volume of public investment (left chart) and its impact on general government balance and gross debt (right chart)



The fiscal impulse has been defined as a sustained increase in general government investments by 1% of GDP as compared to the baseline scenario (investments financed exclusively with domestic funds). The direct effect of an increase in public expenditures is an increase in the deficit, which during the analysed period remains at a level of 0.2-0.4% of GDP above the base path. Higher public expenditures also imply an increase in private demand (household consumption increases by 0.2-0.7%, and private investments by 0.8-2.0%), which results in an improvement of the condition of the labour market, an increase of inflationary pressure and worsening of the foreign trade balance. As a result of the introduced disruption, GDP will increase in the first year by 0.7% as compared to the base path and will remain 0.4-0.6% higher in subsequent years.

Higher economic growth partially neutralises the negative effects of the increase in public expenditure to general government debt, especially at the beginning of the simulation period. In subsequent years, amid a sustained worsening of the general government balance, the effects become the more and more visible and by 2015 the level of general government debt is 0.3% of GDP higher than in the no expenditure increase scenario.

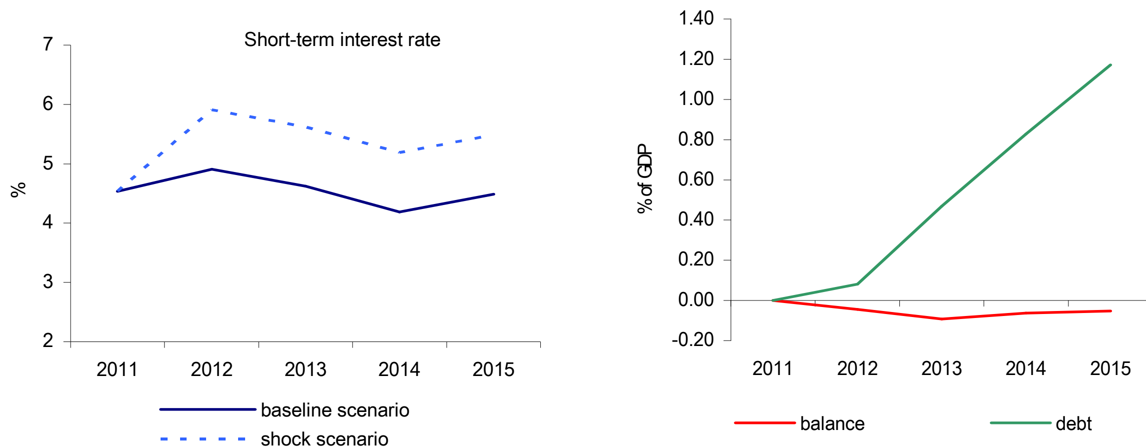
Chart 8. PLN/EUR exchange rate (left chart) and its impact on general government balance and gross debt (right chart)



The exchange rate impulse has been introduced as a sustained 10% depreciation of the PLN/EUR exchange rate. The weakening of the Polish zloty improves the competitiveness of domestic products, which results in an increase in exports of approx. 0.7-3% (the biggest increase is observed in the first two years). Due to the high import intensity of exports, at the beginning of the simulation period there is also an increase of imports in comparison to the baseline scenario path (though slower than exports). However, in the following years, a negative exchange rate effect starts to dominate and the import volume falls below the base path. An increase in demand for Polish goods also influences the improvement of labour market conditions and an acceleration of investment activity. As a result, in the first two years from the occurrence of the shock, GDP remains 1.8-2.8% higher than in the stronger exchange rate scenario.

Along with the increase in domestic prices, the positive effects of the Polish currency depreciation will gradually fade in subsequent years. The higher economic growth supports the growth of general government revenue which exceeds the growth of expenditures associated with the servicing of debt denominated in foreign currencies and in the first years after the shock the general government balance improves. In subsequent years, the significance of negative factors increases (bigger increase of expenditure than income), but in 2015 public debt still remains approx. 3% of GDP lower than in the baseline scenario.

Chart 9. 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 2015 are almost 8% 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 a tightened of conditions for obtaining loans, private consumption is also slightly lower (by 0.8% in 2015).

The tightening of monetary policy also restricts price growth. Higher domestic interest rates support a slight strengthening of the Polish zloty, though this effect is short-term, since along with the deepening decline of the GDP growth rate, the Polish zloty starts to lose its value in comparison to the baseline scenario path which does not assume a change of interest rates. As a result, the monetary impulse leads to a decrease in GDP volume of about 1% in the horizon forecast. The general government balance remains permanently lower by 0.1% of GDP and the general government debt in 2015 is 1.2% of GDP higher than in the baseline scenario.

IV.3. Comparison with the previous update

Compared with the previous *Convergence programme* update, the predicted path of real GDP growth has been lowered. The causes of this change include the change in the economic situation in the external environment and assumed greater adjustments in public sector investments. In the first case, the GDP growth path of Poland's major trade partners has been significantly corrected. When preparing macroeconomic assumptions to the previous update it was assumed that in subsequent years the economic growth in the EU would gradually improve. However, current forecasts indicate a stagnation of the European economy in 2012 and thus a significant lowering of the rate of demand growth in Polish export markets.

Changes to the predicted fiscal path arise mostly from measures that have already been taken and the planned consolidation of public finances (in particular with regard to expenditure) which limit the structural general government deficit, and fiscal tightening which exceeds that estimated in 2011. An additional factor, as compared to the last update of the Convergence Programme, is the assumption that in the area of labour costs, the nominal remuneration fund of the central sub-sector over the entire forecast horizon will not change in comparison to 2011, except for remunerations for part of the uniformed services and wages in public higher education schools. In the last case, wages as agreed by the Council of Ministers are planned to rise at a nominal rate of 9.14% per annum, to achieve a total increase of 30% during the years 2013-2015.

The difference in the relation of the general government debt to GDP in 2011 as compared to the forecast from the previous *Programme* update is a result primarily of last year's significant weakening of the Polish zloty. Whereas the differences in subsequent years are caused, among others, by a different assumed distribution of

state budget borrowing needs over time (in the present *Programme* lower needs for the years 2012-2013 are assumed, of which a significant role is played by the one-off factor payment in 2012 from NBP profit) and from the slower currently assumed (as compared to the previous *Programme*) nominal GDP increase. A resultant of the these factors is a relatively small difference between the present and previous *Programme* update within the scope of debt-to-GDP ratio post-2011.

Table 5. Divergence from previous update

	ESA Code	2011	2012	2013	2014	2015
Real GDP growth (%)						
2011 update		4.0	4.0	3.7	3.9	-
Current update		**4.3**	**2.5**	**2.9**	**3.2**	**3.8**
Difference		0.3	-1.5	-0.8	-0.7	-
General government balance (% of GDP)	EDP B.9					
2011 update		-5.6	-2.9	-2.5	-2.0	-
Current update		**-5.1**	**-2.9**	**-2.2**	**-1.6**	**-0.9**
Difference		0.5	0.0	0.3	0.4	-
General government gross debt (% of GDP)						
2011 update		54.9	54.1	52.4	50.8	-
Current update		56.3	53.7	52.5	50.6	49.7
Difference		1.4	-0.4	0.1	-0.2	-

Source*:* Ministry of Finance, Central Statistical Office.

V. Long-term sustainability of public finances

V.1. Policy strategy

Sustainable public finances support long-term economic growth and are a crucial element of macroeconomic stability. A high deficit of the public finance sector, through its negative influence on domestic savings, escalates the country risk premium, thus increasing the cost of capital and the cost of debt servicing, hampers capital accumulation and results in slower potential GDP growth.

The deadlines for the reduction of excessive deficit and the scale of the changes either already implemented or planned place Poland among the leaders in budgetary consolidation. Achieving those objectives does not complete the challenges associated with ensuring financial sustainability. Even though good economic results and a suitable consolidation strategy have restricted the growth of public debt, the current level of debt still increases the risk that should there be another recession in the EU, the effect on Polish public finances and the economy could be more intense. Therefore, ensuring long-term financial sustainability requires further reduction of the structural imbalance, including debt, and then the strengthening of the achievements of consolidation. Undertaking these measures will be particularly important, including the introduction of institutional solutions which after reduction of excessive deficit and its further lowering to the level of the medium-term budgetary objective, will minimise the risk of a reoccurrence of a public finance imbalance in Poland.

The achievement of this objective will be supported, in part, by the introduction of the permanent expenditure rule which is aimed at ensuring that the medium-term general government deficit stays at a level of approx. 1% of GDP, thus eliminating the risk of another excessive deficit procedure for Poland and the subsequent loss of funds from the Cohesion Fund which constitute a very important element of financing the development of our country. Apart from the permanent rule, structural reforms will play a significant role in the strengthening of consolidation effects and the long-term sustainability of public finances. This refers in particular to the gradual raising and equalising of the retirement age of men and women at 67 [cf. section III.7]. An important role will also be played by measures which rationalise and increase the transparency of the tax system, thus supporting a broadening of the tax base and a fairer allocation of state aid. In the future, the effects of these measures should allow for reducing the labour factor tax, which in turn should contribute to an increase in the participation rate of Poles, and

thus a long-term strengthening of economic growth, which is also a crucial determinant of the country's financial sustainability.

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

The projections presented in table 6 for the long-term sustainability of public finances were prepared by the Economic Policy Committee (EPC) Working Group on Ageing (AWG). The AWG findings will be published in 2012 in a European Commission report on the effects of ageing by the year 2060.

The projections were based on demographic assumptions prepared by Eurostat in 2011, the extrapolation of historic trends and technical assumptions on the convergence of basic economic growth factors, such as labour, capital and work efficiency. The calculations take into account the legal situation to 2011 and include those effects of the reform which are most significant to the sustainability of public finances, namely the reforms to the pension system which were introduced on 1 January 1999. The main component of these reforms was the replacement of the defined benefit system by a defined contribution system, which led to a reduction of the risk of long-term insolvency of the pension system by adapting it to demographic and social-economic changes.

The AWG projection does not take into account an increase in the employers contribution to the disability pension by 2 percentage points (from 4.5% to 6.5%) commencing on 1 February 2012, which improves the balance of the disability pension fund within the Social Insurance Fund. Also, the projection does not consider the estimated effects of increasing and equalising the retirement age.

However, the projections for the long-term sustainability of public finances already take into consideration the results of the changes mentioned in the *Convergence Programme. 2011 Update:*

1) Introduction of bridge pensions which, according to the objectives of the reform are intended to be a transitional solution and to replace early retirement. The significant reduction of entitlements to early retirees reduces the expenditures on pensions and also, through increasing the labour supply, should have a positive influence on economic growth and thus the long-term sustainability of public finances.

2) Introduction of compensation allowances for teachers which replace early retirement benefits and are financed from the state budget. These allowances are a temporary solution and have no significant impact on the long-term sustainability of public finances.

3) Launch of the Demographic Reserve Fund The main objective of launching the fund was to increase the security for having the ability to pay benefits from the pension fund. The Demographic Reserve Fund plays the role of a reserve fund for the pension fund separated within the Social Insurance Fund. The first transfer of resources from the Fund took place in 2010. The amount transferred to the Social Insurance Fund (SIF) was approx. PLN 7.5 billion, i.e. approx. 0.53% of GDP, whereas in 2011 it was PLN 4 billion, i.e. 0.27% of GDP. In the State Budget Act for 2012 the amount transferred from the Demographic Reserve Fund is planned to be at a level of PLN 2.88 billion, which represents 0.2% of GDP.

On the other hand, in 2009 the rules governing the transfer of privatisation funds to the DRF were also changed.[21] As a result of these changes, despite resources transfers from the fund, overall DRF assets increased. At the end of 2011 the resources of the Demographic Reserve Fund amounted to PLN 12.8 billion, i.e. 0.8% of GDP, while in 2010 the amount was PLN 10.2 billion, i.e. 0.7% of GDP. The long-term projection assumes a gradual increase of income of the Demographic Reserve Fund in relation to GDP.

4) Modifications to the pension system In May 2011 the Act amending the separation of pension contributions between the pay-as-you-go and the funded scheme came into force. The change will limit the transition costs of pension reform without a deterioration of the long-term sustainability of public finances, while leaving the expected pension level from the whole pension system unchanged. As a result and effective from May 2011 the contribution to OFE amounts to 2.3% of the contribution base and is intended to gradually increase to 3.5% from 2017, whereas the remaining part of the contribution, i.e. 5.0% of the contribution, is recorded in a subaccount maintained by ZUS within the account of the insured and this is due to decrease to 3.8% from 2017.

[21] Further to the Social Insurance Scheme Act, 40% of revenues from the total gross sum of proceeds transferred from the State Treasury property privatisation is submitted to DRF, reduced by amounts of obligatory deductions for the special fund, referred to in Article 56 (1) point 1 of the Act on Commercialisation and Privatisation.

Table 6. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure							
Of which **age-related expenditure**	20.5	21.3	20.5	21.2	20.9	21.2	21.6
Pension expenditure	11.6	11.8	10.9	10.9	10.3	10.0	9.6
Social security pension	11.6	11.8	10.9	10.9	10.3	10.0	9.6
Old-age and early pensions	9.8	10.2	9.8	9.9	9.1	9.0	8.7
Other pensions (disability, survivors)	1.7	1.7	1.1	1.0	1.1	1.1	0.9
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	6.5	6.6	6.7	6.8	6.8
Demographic Reserve Fund	0.3	0.7	1.9	3.2	4.9	7.3	10.5
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	0.7	1.2	1.3
Assumptions							
Labour productivity growth	3.0	2.5	2.3	2.1	2.1	1.8	1.5
Real GDP growth	5.9	4.3	2.0	1.5	1.2	0.5	0.6
Participation rate males (aged 20-64)	77.4	79.1	80.5	80.9	78.7	78.8	79.7
Participation rate females (aged 20-64)	62.2	64.1	65.4	66.6	63.0	63.1	65.3
Total participation rate (aged 20-64)	69.7	71.5	72.9	73.8	70.9	71.1	72.6
Unemployment rate (aged 15-64)	9.8	9.8	7.6	7.4	7.3	7.3	7.3
Population aged 65+ over total population	13.4	13.5	18.2	22.6	25.3	30.6	34.6

Source*: 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 as of the end of 2011 amounted to 6.4% of GDP, as compared to 5.4% of GDP at the end of 2010. A significant share comprised sureties and guarantees granted by the State Treasury. As of the end of 2011 they constituted 6.2% of GDP, as compared to 5.2% of GDP at the end of 2010. Within the State Treasury sureties and guarantees portfolio, guaranties granted for financial sector liabilities (excluding guarantees granted for supporting the National Road Fund at Bank Gospodarstwa Krajowego) were only approx. 0.2% of GDP.

Table 7. Contingent liabilities

% of GDP	2011	2012
Public guarantees	6.4	Optional
Of which those linked to the financial sector*	0.2	Optional

* Data on potential liabilities of other public finance sector entities on account of sureties and guarantees to the financial sector are not subject to reporting (only total potential liabilities are available). Therefore, the shown 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).

The State Treasury exposure with regard to sureties and guarantees does not impose a significant risk to public finances. At the end of 2011 almost 90% of contingent liabilities on account of sureties and guarantees granted by the State Treasury were classified as a low-risk group. The long-term risk ratio for the State Treasury sureties and guarantees portfolio decreased from approx. 8% as of the end of 2010 to approx. 6% at the end of 2011. 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 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 may be translated into a slight increase in the ratio of these liabilities to GDP.

VI. Quality of public finance

Many actions taken by the government to improve the fiscal framework within which fiscal policy is conducted are inter-related with the introduction of new regulations and solutions under *the Public Finance Act*, as well as with other planned measures, including the institutional changes described in section VII.

VI.1. Composition, efficiency and effectiveness of expenditure

The general government expenditure to GDP ratio is forecast to decrease from 43.6% in 2011 to 38.6% in 2015, so in comparison to 2010, the general government expenditure proportion of GDP will have decreased by as much as 6.8 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 have decreased as a proportion of GDP from 41.8% in 2011 to 37.7% in 2015.

The institutional changes, both planned and already implemented which are aimed at consolidating, rationalising and increasing the flexibility of expenditure, as well as additional measures aimed at the strengthening of public finance discipline will all affect the level and structure of expenditure. They are reflected in *general public services*, where a decrease of expenditure to GDP of 0.9 percentage points for the forecast horizon is expected. It should be mentioned that solutions promoting the rationalisation and effectiveness of public expenditure were included in the Polish legal system in 2009. In particular, under the *Public Finance Act* a new management control institution was introduced to the public finance sector, whose functions include ensuring the implementation of objectives and tasks in conformity with relevant law and in an effective, economical and timely manner. The institution covers all general government units. It is aimed in particular at ensuring:

- conformity of activity with the provisions of law and internal procedures;
- efficiency and effectiveness of operation;
- reliability of reporting;
- protection of resources;
- control and promotion of ethical rules of conduct;
- effectiveness and efficacy of information exchange;

— risk management.

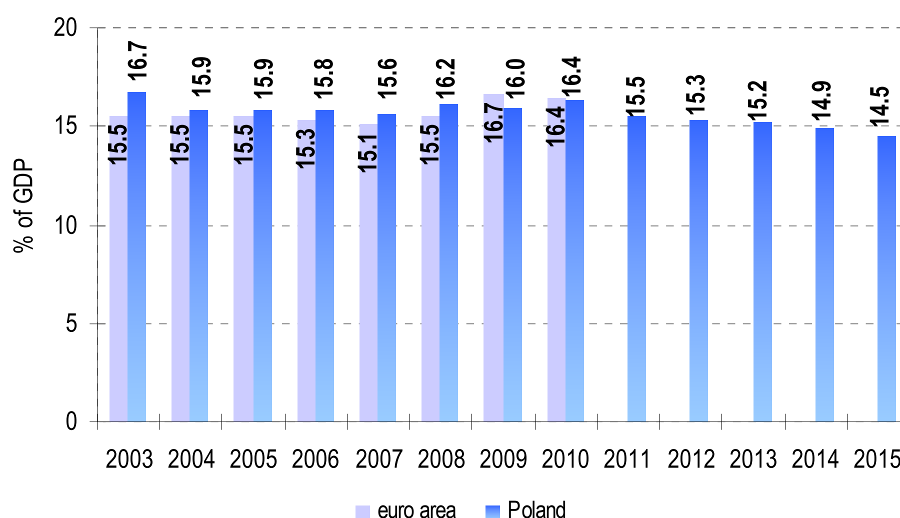
In addition, the *Public Finance Act* of 2009 entitled the Minister of Finance to carry out an assessment of the planning and management of public funds in both general and local government units.

In order to facilitate contact between citizens and the public administration, as well as to reduce the costs of government administration, an IT system was created which allows citizens to conduct most official matters via the Internet (*Electronic Platform of the Public Administration Services).* The computerisation of public administration is an example of the rationalisation of public expenditure and reduction of the costs of the administrative operation (including reduced transaction costs). Administration costs are also reduced through changes in the system of departmental procurement. The launch of the *Common Services Centre* in 2011 is an example of such measures. This unit functions as a central ordering facility for government administration units which prepares and conducts public procurement procedures and award procedures as well as concluding the necessary framework agreements.

It is worth emphasizing that in the last period legislative changes aimed at strengthening the financial discipline of general government units has been implemented, including the introduction of the following rules:

- Public institutions of higher education whose net loss over the previous five years exceeds 25% of the funding received from the state for performing their objectives (education of full-time students, doctoral candidates, teaching staff and upkeep of the institution) in the year before the current budgetary year, are obliged to prepare a remedial programme. The aim of this programme is to restore financial equilibrium by balancing planned operating expenses against income within a period not exceeding three years from the date of the resolution implementing the programme. The remedial programme should be accepted not later than three months from the time that the problem is identified;
- If an independent public health-care institution cannot cover any outstanding losses plus depreciation within three months of approving its financial results, then it has a year to change its legal-organizational structure or to start proceedings for winding up the institution;
- Budgetary entities must obtain the consent of their founding bodies to enter into liabilities exceeding 30% of their annual income.

Chart 10. Administration costs (as a sum of remuneration and indirect consumption)

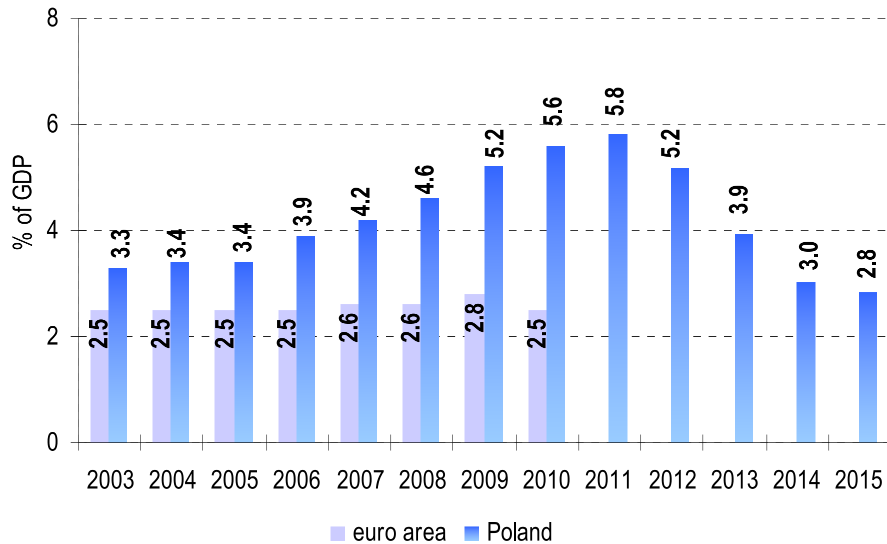


Source: Eurostat, Ministry of Finance.

The biggest decrease of expenditure is expected in the field of *economic affairs* - by 1.8% of GDP, which is associated with the assumed decrease in public investment, resulting mainly from the usage in previous years of

a significant amount of EU funds from which Poland has benefited within the framework of the current financial perspective and as a consequence, for the following years within this financial perspective there are less of these funds remaining. It is also worth underlining that the share of public investments to GDP will be reduced from the record level achieved in 2011 (5.8%), which was at the time, the highest in the whole EU.

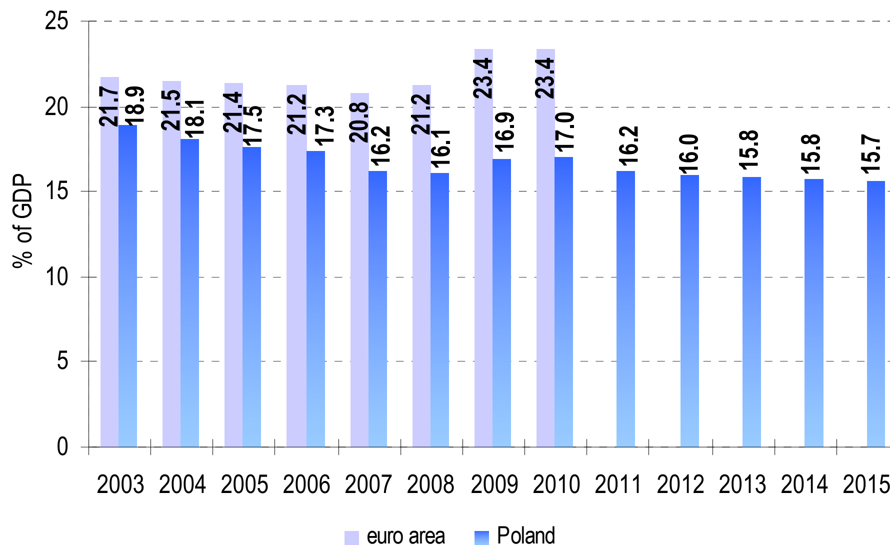
Chart 11. Gross fixed capital formation



Source: Eurostat, Ministry of Finance.

A significant decrease in social protection expenditure is also expected (by approx. 1.5 percentage points in relation to GDP). This will result partly from a reduction of entitlements (introduced in 2009) to early retirement, decreasing expenditure on some less effective forms of counteracting unemployment, and the reduction of other social benefits.

Chart 12. Social expenditure



Source: Eurostat, Ministry of Finance.

Moreover, within the framework of measures rationalising public expenditure, the reimbursement system for health-related services was changed by statute, to provide patients, within the financing available, maximum access to a supply of requisite drugs, special purpose food products and medical apparatus. Also the financial management of the National Health Fund was rationalised statutorily, by introducing regulations which limit the total budget for reimbursement to not more than 17% of the sum of public funds designated to finance guaranteed benefits within the Fund's financial plan (the ratio in OECD countries corresponds to the average ratio of cost of drugs to total cost of health benefits). The regulation will result in sustainability of the Fund's expenditure.

Table 8. General government expenditure by function

% of GDP	COFOG Code	2010	2015
1. General public services	1	5.9	5.0
2. Defence	2	1.4	1.2
3. Public order and safety	3	1.9	1.6
4. Economic affairs	4	5.6	3.8
5. Environmental protection	5	0.7	0.5
6. Housing and community amenities	6	1.0	0.8
7. Health	7	5.0	4.3
8. Recreation, culture and religion	8	1.3	1.0
9. Education	9	5.6	5.0
10. Social protection	10	16.9	15.4
Total expenditure	TE	**44.3**	**38.6**

Source*:* Ministry of Finance, Central Statistical Office.

VI.2. Structure and efficiency of revenue systems

The revenues of general government reached 38.5% of GDP in 2011. It is predicted that this will rise to 39.6% of GDP in 2012 and in subsequent years should decrease gradually to reach a level of 37.6% of GDP in 2015. 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-reimbursable EU aid), whose share in GDP should increase in the current year to 37.6% (from 36.7% in 2011), to decrease in the following years to a level of 36.8% in 2015.

Starting from 2013, the expected decrease in the income-to-GDP ratio will be caused by the planned reduction of proceeds on account of dividends from companies in which the State Treasury has a share, a reduction of VAT rates and the planned increase in the share of the capital part of the contribution transferred to OFE while maintaining the full amount of the pension contribution at the same level. In addition, as of 2014, a temporary reduction of VAT deductions for the purchase of certain vehicles and their fuel will expire.

In addition to the changes in the taxation system described in section III.2., other changes were introduced, which have a lesser influence on general government revenues, yet are still significant in terms of the quality of the revenue system.

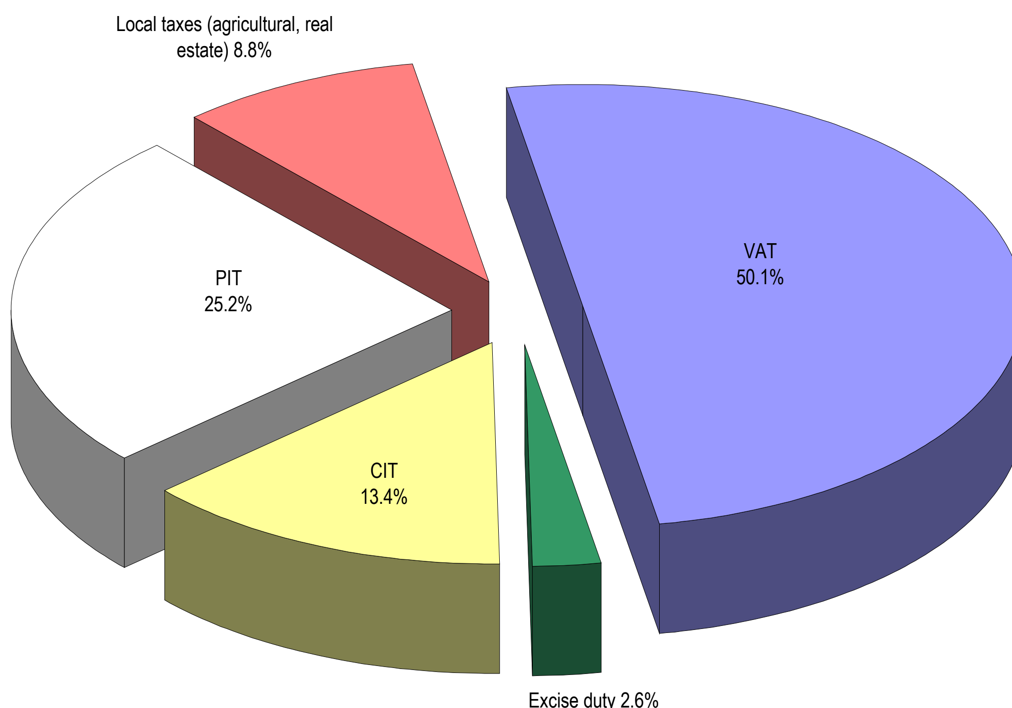
Within the framework of fiscal consolidation, the Ministry of Finance again launched an analysis of preferential taxation of taxes contributing to the state budget revenue, as well as local taxes contributing to the budgets of local government units. The report on *Preferential taxation treatment in Poland*[22] which by showing the values of reliefs and deductions functioning in the taxation system not only supports the transparency of public finances,

[22] The report entitled *Preferential taxation treatment in Poland* no. 2 (2010) is available on the Ministry of Finance website http://www.mofnet.gov.pl/_files_/podatki/system_podatkowy/raport/preferencje_podatkowe_w_polsce.pdf

but primarily serves to simplify and improve the effectiveness of the taxation system, in addition to making it tighter. As a result of the newest version of the report, 489 areas of preferential taxation were identified within the Polish taxation system. Within the area of income tax, 205 areas of preferential taxation were identified, of which the majority are related to personal income tax (145). 195 areas of preferential taxation encompass lower VAT rates on different kinds of goods and services. For state taxes, the smallest number of areas of preferential taxation was identified within excise tax (16). Within local taxes, a total of 70 areas of preferential taxation were identified.

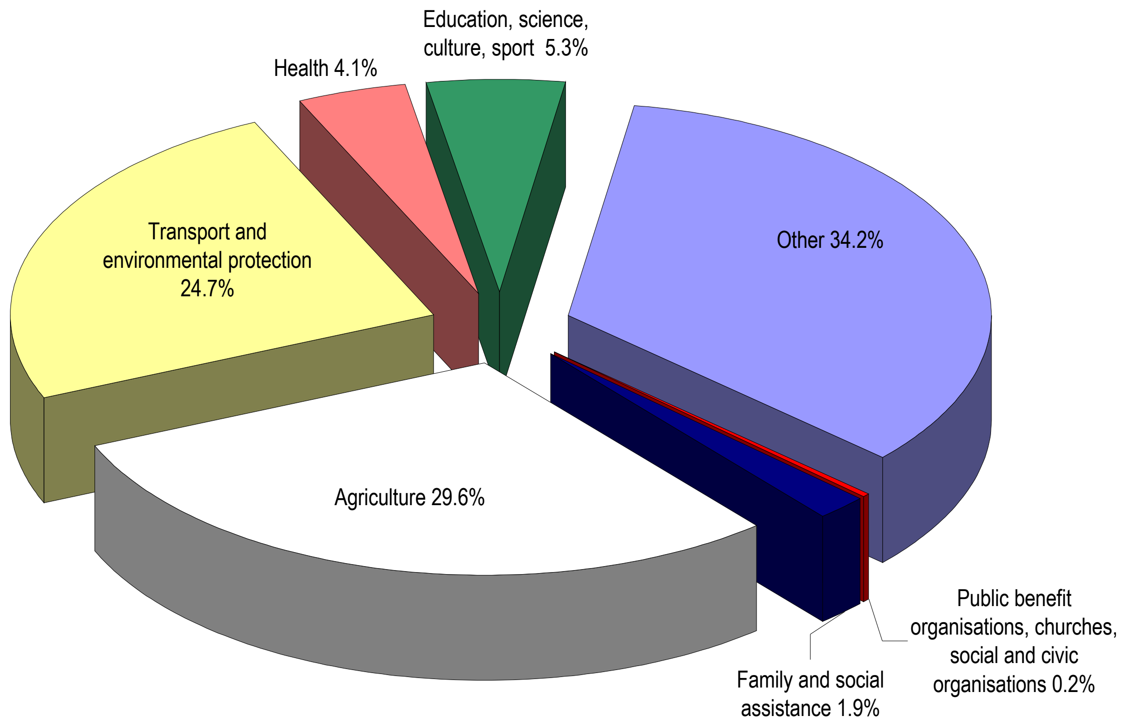
The estimated value in 2010 of the various areas of preferential taxation amounted to PLN 73.8 billion, which constituted 5.2% of GDP, whereas the 2009 report estimated the amount at PLN 65.9 billion, i.e. 4.9% of GDP. The regulations governing preferential taxation have not changed significantly from 2009, so the increase in the total value of preferential taxation resulted mainly from entrepreneurs' taking the opportunity to deduct losses in corporate income tax. Entrepreneurs can settle the loss incurred in a given year (reduce the tax base by the loss from the given year) during 5 consecutive years. The year 2010 was the first year in which taxable persons started to show the losses incurred during the period of the Polish economy slowdown in 2009 in their declarations.

Chart 13. Structure of preferential taxation in Poland in 2010 (as a share in the total value of preferential taxation)



Source: Ministry of Finance, *Preferential taxation treatment in Poland* no. 2 (2010), Warsaw 2011.

Chart 14. Structure of preferential taxation in local taxes by support areas (as a share in the total value of preferential taxation in local taxes)



Source: Ministry of Finance, *Preferential taxation treatment in Poland* no. 2 (2010), Warsaw 2011.

On 31 March 2012, regulations under the *Tax ordinance* entered into force, resulting in the elimination of tax evasion on profits earned from different sources of savings or capital investments.

The "e-Podatki Programme" is a complex and significant extension of the application of innovative technologies implemented by the Ministry of Finance which is focused on improving the operation of the Polish tax administration by centralising tax records. The programme includes three projects: *e-Deklaracje 2, e-Rejestracja* and *e-Podatki* whose implementation will contribute to improving the conditions of running business activity in Poland by simplifying registration obligations and tax declaration rules. Electronic communications using the tax portal are being introduced, which will allow:

- real-time access to information on current accounts and on-going tax cases;
- e-certificates
- on-line access to tax statements and submitted annual returns for persons not engaged in business activity.

In January 2012, a tender for the *Construction, Implementation and Maintenance of the e-Podatki System* was announced.

Another programme, which consistently improves the effectiveness of public administration, is the *e-Cło Programme* project. It is a package of legislative, organisational, financial and technical solutions, aimed at an e-implementation of public services for businesses involved in international trade in goods and payment of the relevant duties and taxes. The implementation of this project will allow for more efficient risk management, monitoring of international trade and movement of goods subject to excise duty. In particular, this will make the collection system tighter and increase proceeds from customs related activities.

Full implementation of the *e-Cło* project will provide social as well as economic benefits:

- acceleration in issuing permits and improvements as well as cost reductions in the servicing of applications,
- reduction of transaction costs incurred by entrepreneurs in completing customs formalities,

- cost rationalization in the maintenance of customs service information technology as well as improvement of data quality by having one common system of reference data.

VII. Institutional features of public finances

VII.1. Fiscal rules

1) Introduction

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. The most important of these is the debt rule, enshrined in two legal acts – the *Constitution of the Republic of Poland* and *the Public Finance Act,* whose main objective is to constrain public debt (calculated according to the Polish methodology) to certain defined limits (as % of GDP).

A new rule, in force from 2011, is the temporary expenditure rule. It limits the growth rate of discretionary and new legally mandated expenditure, which also covers current legally mandated expenditure, if the act defining them is modified. Any draft act resulting in a rise of this expenditure will require the inclusion of the total amount of discretionary expenditure and the new legally mandated expenditure, and which may not rise by more than 1% annually in real terms. The temporary expenditure rule shall be binding until the Ecofin Council abrogates the excessive deficit procedure for Poland.

A regulation was applied from 2011 which prohibits the Council of Ministers from adopting certain draft acts while Poland is subject to the excessive deficit procedure. These include:

- stipulating exemptions, reliefs and deductions whose financial outcome may be a reduction in the income of general government units in relation to the amounts resulting from applicable regulations;
- causing an increase in state budget expenditure which is not covered by the temporary rule (CPI+1)

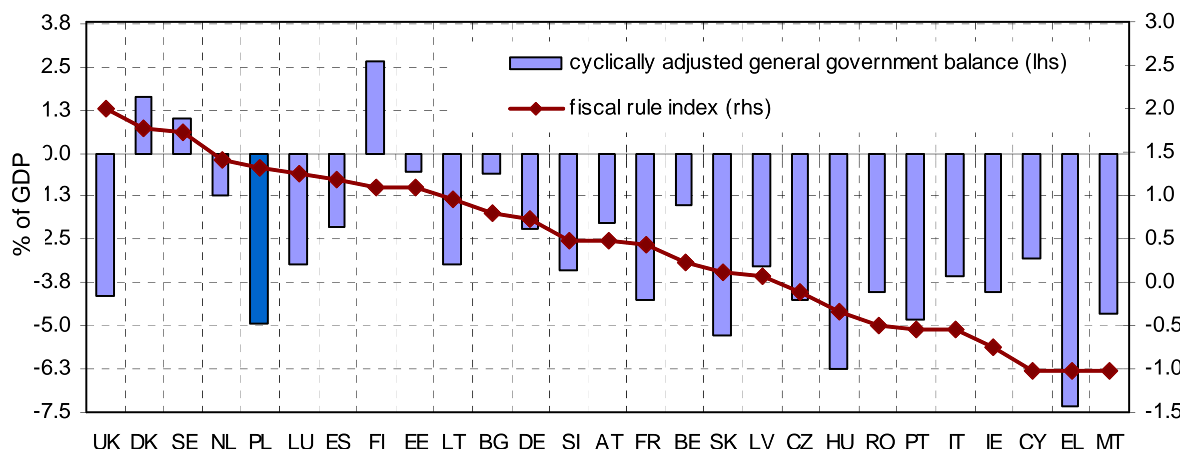
Fiscal self-discipline has been strengthened for ministries which are responsible for draft legislation which has financial consequences. In draft acts adopted by the Council of Ministers, whose financial consequences may cause a change in the level of general government expenditure in relation to the amounts resulting from present regulations, the limits of these expenditures have to be determined, expressed as a value, for a period of 10 budget years from the execution of the act, separately for each year, starting from the first year when the act enters into force. This requirement will remain in effect even when Poland will not be subject to the excessive deficit procedure. In addition, such a draft has to determine:

- corrective mechanisms when the maximum limit of expenditures adopted for a given budget year is exceeded or is in danger of being exceeded;
- a competent authority which monitors the use of the expenditure limit for performance of public tasks by general government units;
- a competent authority responsible for the implementation of corrective mechanisms.

Fiscal rules in Poland are relatively highly regarded which is expressed by the fiscal rule index (cf. the chart below). A recent re-assessment has improved Poland's position which is now at the 5th position in the EU[23].

[23] In the fiscal rule rankings (years 2000-2010) Poland moved from the seventh (years 2000-2008) to fifth place. This was due to additional points for the rule which was applicable to LGUs in the years 2009-2010 and a deduction (though less) of points for the "anchor budget" which ceased to be effective in 2008. Next year an increase in the points for Poland is expected when the temporary expenditure rule which entered into force in 2011 is taken into consideration.

Chart 15. Fiscal rule index and the level of the cyclically-adjusted general government balance (average for 2000-2010)



Source: AMECO, European Commission, Ministry of Finance's own calculations.

Historic data clearly shows a general government balance with regular excessive deficit, whose level over the last decade has been among the highest in the EU. Therefore, the rules did not prevent a deep imbalance of public finances. Therefore, a further strengthening of the fiscal framework is necessary, in particular by addressing current weaknesses. An important element of these changes will be the introduction of a permanent (target) expenditure rule which after reducing the deficit to the MTO level will stabilise the general government balance at the level of the medium-term budgetary objective.

2) Permanent expenditure rule

The Council Directive on requirements for budgetary frameworks stipulates that EU Member States should have strong numerical fiscal rules. Such rules should be used in their annual budget acts, as well as in a multiannual perspective of budgetary planning. They are aimed at keeping the general government balance over the average period at the level of the medium-term budgetary objective (MTO)[24], which for Poland amounts to -1% of GDP (calculated according to ESA'95). The fiscal rules should have a specific objective and scope, prevent pro-cyclical budgetary policy and be subject to efficient and timely monitoring. The Directive also requires a precise definition of escape clauses (permitting temporary suspension of rules) and the consequences of disregarding the rules along with the mechanisms for their effective execution. Poland is obliged to implement this Directive by the end of 2013 and submit the details of all regulations necessary for execution to the European Commission. The Commission will submit a report on progress in implementing the main provisions of the Directive by Poland and other countries to the European Parliament in December 2012.

At present, analytical works on the permanent expenditure rule which, after the reduction of the deficit to the level of MTO will ensure the sustainability of the general government balance in the medium-term at a level of -1% of GDP[25] is being completed. The implementation of the rule will be preceded by a transition period, defining a consolidation path compliant with the one presented in the present *Programme.* The path will ensure the reduction of the general government deficit to the level of the medium-term budgetary objective in 2015.

The permanent expenditure rule should reduce the maximum increases in general government expenditure, excluding the expenditures of the local government sub-sector (covered by different rules) and expenditures

[24] Article 5 of *Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States* stipulates *inter alia* that: "Each Member State shall have […] numerical fiscal rules which [..] promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multiannual horizon for the general government as a whole. […] in particular: […] adherence to the Member State's medium-term budgetary objective".

[25] In the case of changing the MTO level, the deficit level shall also be suitably changed, the achievement of which in the medium term would be ensured by the permanent expenditure rule.

financed with non-returnable EU funds of which the general government units are the final beneficiaries. This is justified by the fact that the influence of the EU funds on the deficit (calculated according to ESA'95) is neutral, i.e. the revenues from the EU are always shown as expenditures financed from EU funds, irrespective of cash flows. An additional category of expenditure whose exclusion from the scope of the rule is being considered, is the cost of public debt servicing. According to the permanent rule, an increase in general government expenditures ("adjusted" for the above categories) may not exceed the medium-term GDP growth rate.

It is recommended that the limit of expenditure should be corrected down, if the deviations from MTO of the nominal result of the general government account accumulated on the control account exceed the assigned threshold expressed in % of GDP. The correction could be suspended in times of deep recession, defined e.g. as an excessive deviation of the forecast dynamics of real GDP for a given year from the medium-term growth rate. The limit of expenditures would also be corrected by a discretionary systemic change of revenue. In particular, the reduction of taxes or introduction of tax reliefs would be possible provided that the loss in revenue on this account is compensated with a suitable reduction of expenditures.

Reduction of the growth rate of expenditure (excluding those under limited government influence) to the medium-term GDP growth rate would be compliant with the requirements of the preventive arm of the *Stability and Growth Pact*[26]. At the same time, it has to be emphasized that the limit of expenditure would not refer to each entity or transaction equally but would be of an aggregate nature, and would thus reduce the total increase in expenditures. This means that some expenditures could increase faster, provided that they are balanced by equally slower increases (or decreases) of other expenditures covered by the rule.

Moreover, it has to be mentioned that for control account deviations from the MTO the nominal result of the entire sector would be accumulated, not only of the part covered directly by the expenditure limits. The rule designed in this way would ensure the sustainability of public finances by stabilizing the general government result in the medium-term at the level of -1% of GDP. In addition, the maximum expenditure growth rate defined according to the suggested rule, along with a reduction of the local government sub-sector deficit (see the following sub-section), would favour the minimisation of the risk of exceeding the sector deficit threshold of 3% of GDP, at the same time reducing the risk of another excessive deficit procedure for Poland and consequent loss of funds from the EU Cohesion Fund which constitute a significant element of financing for Poland's development.

The introduction of the permanent expenditure rule would therefore allow the fulfilling of obligations resulting from the six-pack, i.e. six legal acts, binding from December 2011, which strengthen the coordination of economic policies in the EU. The introduction of the rule and associated changes within national fiscal rules would allow the requirements of the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union,* which was signed by Poland, along with 24 other EU countries, at the European Council meeting held on 1-2 March 2012, to be met. The details of the legal act introducing the permanent expenditure rule is planned to be submitted to the Council of Ministers in the third quarter of 2012.

3) Rules in the local government sub-sector

Starting in 2009 changes began to be introduced to the budgeting rules of local government units which are aimed at increasing financial discipline, including making specific local government units liable for penalties dependent on their economic strength and individual financial situation. Due to the heterogeneity of local government units, the process is being implemented gradually. The *Ministry of Finance regulation on detailed classification of debt instruments included in the public debt* (of 23 December 2010) is an example of the changes being introduced, as a result of which the possibility of circumventing the debt limit (60% of revenue) by local government units was effectively reduced (*de facto*, introduction of economic criteria of debt classification[27]).

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[26] Article 9(1) of *Regulation (EU) no. 1175/2011 of the European Parliament and the Council of 16 November 2011 amending Council Regulation (EC) no. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies* stipulates *inter alia* that: "[…] The Council and the Commission shall assess whether […] for Member States that have achieved their medium-term budgetary objective, annual expenditure growth does not exceed a reference medium-term rate of potential GDP, unless the excess is matched by discretionary revenue measures".

[27] For example, before the changes were introduced, trade credits taken for any period in excess of 12 months were not included in the public debt total. At present the debt category of „credits and loans" includes *inter alia*: in nominate contracts

According to (legally) binding regulations (the *Public Finance Act*) the rules for incurring liabilities by local governments units will be changed in 2014. The present limits to debt levels and levels of debt servicing costs will be replaced by a system of individual constraints reflecting the economic capacity of local governments units to repay debt. This new limit will depend on the ability of local government units to run at a current account surplus as well as on the revenues earned from property sales. An additional rule for local government units obliges them to balance the current account parts of their budgets starting from 2011.

A proposal to amend the *Public Finance Act*, introducing a legally binding limit for the local government sub-sector deficit and keeping the debt limit relative to revenue is now at the stage of interdepartmental discussions and social consultations. The rule will be an important enhancement of the planned permanent expenditure rule (described in section VII.1.2). This will result in stabilising the general government deficit at the level of MTO. Due to a significant heterogeneity of local government units and the institutional and legal environments in which local government units operate, a gradual movement towards the implementation of this rule is planned. The proposal in the *Public Finance Act* amendment also envisages the introduction of regulations defining the rules for monitoring and applying correction mechanisms and mechanisms protecting against uncontrolled deficit growth in the local government sub-sector.

The review of current rules applicable to the local government sub-sector is shown in table 9.

Table 9. Fiscal rules concerning local government units in the current legal state

	2009	2010	2011	2012	2013	2014	2015	2016
Debt rule* liabilities to revenue ratio	60%					none		
Exclusions from the rule of debt servicing costs	Repayment (principal instalments t + interest) of securities and credits or loans contracted in conjunction with the use of funds defined in an agreement signed with an entity having at its disposal European Union funds					Servicing (principal only) of securities and credits or loans contracted in conjunction with the use of funds defined in an agreement signed with an entity having at its disposal European Union funds (**excluding interest**)		
Exclusions from the debt rule	Securities and credits or loans contracted in conjunction with the use of funds defined in an agreement signed with an entity having at its disposal European Union funds (for financing and co-financing)							
Debt servicing costs rule debt servicing costs (principal instalments t + interest) to revenue ratio	15% (12%)**					System of individual constraints		
Rule of balanced budget for local government units	None		Yes					

* From December 2010, the criteria defining instruments included in public debt has been tightened.

** 12% should public debt exceed the threshold of 55% of GDP.

Source: Ministry of Finance.

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with the date of payment exceeding one year, associated with financing services, deliveries, construction works, which have economic effects similar to those of loan or credit contracts.

VII.2. Budgetary procedures, incl. governance of public finance statistics

For efficient implementation of the permanent expenditure rule, the national fiscal framework will be further strengthened. This process will support the fulfilment of the provisions of the Council Directive mentioned in section VII.1 which imposes an obligation on Member States to submit quarterly reports on cash-based fiscal data for the local government sub-sector (prior to the end of the following quarter) and monthly reports for units from other sub-sectors (prior to the end of the following month).

Measures introduced so far, mainly in the areas of multiannual planning, performance budgeting and fiscal rules, will be supplemented with increased *top-down budgeting*, which highlights its binding character, stresses the importance of meeting deadlines for the submission of financial plans by general government units, provides more complete monitoring of budget implementation by general government units and further shortening of deadlines and increasing the frequency of budgetary reporting (mainly by those units which currently submit reports less frequently than on a monthly basis) as well as changes in the budgetary classification for the needs of economic analysis within the framework of expenditure review.

The heads of individual general government units are responsible for the execution of their financial plans. Current monitoring (*interim reports*) is undertaken by the Minister of Finance on the basis of information submitted to him by the biggest units. Current legal regulations give the Minister of Finance access to monthly data covering approx. 66% of the public finance sector[28], and after the introduction of planned changes (fiscal data of local government units will be available on a monthly basis) this share will increase to approx. 86% of the sector. Nevertheless, apart from collecting and analysing information, the Minister of Finance has restricted means of effectively controlling budgetary execution within many sector units.

In addition to the central budget, the budgetary process currently incudes selected units whose financial plans, are based on the macroeconomic assumptions adopted by the Council of Ministers, and which are included as annexes to the budget act (executive agencies, special funds, budget institutions and some state legal entities).

Within the framework of the budgetary process, subsidies to local governments are determined, and their share of PIT and CIT are estimated (total mean share of revenues from these sources as a function of total revenues amounted to approx. 70% for the years 2005-2010). The Minister of Finance is obliged to inform individual local governments of planned annual subsidies, grants and income from their share of PIT. However, further support for the medium-term budgetary framework is required through its closer correlation with the annual budgetary planning process as well as the strengthening of cooperative mechanisms between public finance sub-sectors. At present, the *Multiannual State Financial Plan* (MYSFP) is binding only in relation to the balance of the state budget. In turn, the *Multiannual Financial Forecast* of local governments – despite being compulsory while determining the local government budget – may be relatively easily changed.

High-quality statistical data on public finance, calculated according to ESA'95 rules, will indirectly reinforce the effective functioning of the permanent expenditure rule, which serves to stabilize the general government balance at the MTO level, and thus the balance calculated according to ESA'95.

The Group for General Government Statistics appointed by the President of the Central Statistical Office has been in continuous operation since 2004. The Group was responsible for the publication in 2010 of a report entitled *General Government Statistics* which presents the list of units included in the sector, the data sources used for the compilation of statistics, the methodological rules and the tables used to convert data coming from budgetary and financial reports to data based on the ESA'95 standards. Further adjustments to budgetary classification and reporting have been made since 2010 (scope, frequency and deadlines for data availability) to satisfy international requirements and the work is on-going.

Administrative data are commonly recognized as being the most reliable source of basic data for the compilation of general government statistics. Budgetary reporting is subject to statutory fiscal discipline and is supervised by independent entities, namely the Supreme Audit Office for all public finance sector units and the Regional Accounting Chambers for local government units.

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[28] The share of selected public finance units in the entire sector have been calculated as the average share of the sum of non-consolidated expenditure in total non-consolidated expenditure of the public finance sector in the years 2005-2010.

The distribution of tasks and responsibilities for particular offices involved in the process of compiling general government statistics as well as the independence of the statistical services, protected by law, is the guarantee of the reliable and objective presentation of statistics which are published by the President of the CSO in the form of communiques (for the main categories) and in the generally accessible database maintained by Eurostat (detailed data).

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

Since the beginning of 2011, additional procedures have been introduced under *the Public Finance Act* for cases where public debt (PD) exceeds the safety thresholds of 55% and 60% of GDP. In particular, exceeding the 55% of GDP threshold of would trigger an automatic increase in VAT for the subsequent 3 years and restrict government administration authorities from incurring liabilities for new investments except where at least 50% of costs are co-financed with EU funds. Any breach of these thresholds would therefore mean that the fiscal rules had not been enforced.

Work is currently under way on further modification of the safety mechanisms and remedial procedures to be adopted should the 50% or 55% of GDP thresholds be crossed. The objective of these modifications is to reduce the effects associated with sudden exchange rate changes as well as pre-financing procedures (which incur commitments to finance the borrowing needs of the next budget year). At present, foreign debt is converted into PLN based on the exchange rates of the last business day of the calendar year. Changes in foreign exchange rates, often resulting from external conditions on that day (significant changeability on the main foreign exchange markets, speculative attacks on the Polish zloty) may cause the safety threshold to be exceeded and trigger changes in fiscal policy, which may not be justified by the performance of the economy. In addition it is customary for State Treasury debt management, that in the fourth quarter of the budgetary year liabilities are incurred to finance the borrowing needs of the next year, thus reducing the risk of refinancing public debt. However this also causes an increase of gross debt and could cause the safety thresholds to be crossed.

To reduce this risk of exceeding the 50% or 55% threshold of public debt to GDP, the exchange rate would be calculated as the mean of the exchange rates for the whole year.to which it pertains. The sum would also be reduced by any liabilities entered into by the Minister of Finance to finance the borrowing requirements for the following budgetary year. If as a result the 50% and 55% debt to GDP thresholds are not exceeded then no remedial action would triggered.

This modification of the safety procedures will reduce the risk of abrupt changes in fiscal policy, which are caused by factors which are not related to the true economic fundamentals, and thus will serve to increase macroeconomic stability.

Annex

Table 10. Macroeconomic prospects

	ESA Code	2011 Level	2011 Rate of change	2012 Rate of change	2013 Rate of change	2014 Rate of change	2015 Rate of change
1. Real GDP* (PLN billion)	B1*g	1 291.9	4.3	2.5	2.9	3.2	3.8
2. Nominal GDP (PLN billion)	B1*g	1 524.7	7.6	5.8	5.1	5.5	6.3
Components of real GDP*							
3. Private consumption expenditure	P.3	787.7	3.0	2.1	2.7	3.1	3.3
4. Government consumption expenditure	P.3	220.2	-1.3	0.9	1.5	1.8	1.6
5. Gross fixed capital formation	P.51	283.5	8.3	2.8	0.8	2.9	6.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	18.9	1.5	1.3	1.8	2.3	2.4
7. Exports of goods and services	P.6	548.4	7.5	3.0	6.5	7.4	5.3
8. Imports of goods and services	P.7	565.8	5.8	1.8	6.1	7.6	5.1
Contributions to real GDP growth							
9. Final domestic demand		-	3.7	1.9	2.8	3.4	3.7
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.4	-0.2	0.6	0.6	0.2
11. External balance of goods and services	B.11	-	0.6	0.5	0.1	-0.1	0.1

* In 2005 prices.

Table 11. Price developments

	ESA Code	2011 Level	2011 Rate of change	2012 Rate of change	2013 Rate of change	2014 Rate of change	2015 Rate of change
1. GDP deflator		-	3.2	3.2	2.2	2.2	2.5
2. Private consumption deflator		-	4.4	3.8	2.7	2.3	2.5
3. HICP		-	4.3	4.0	2.7	2.3	2.5
4 Public consumption deflator		-	4.3	3.8	2.6	2.1	2.5
5. Investment deflator		-	1.2	3.6	2.2	2.4	2.4
6. Export price deflator (goods and services)		-	6.3	3.2	-1.7	-1.2	1.5
7. Import price deflator (goods and services)		-	7.6	4.2	-0.7	-0.9	1.4

Table 12. Labour market developments

	ESA Code	2011 Level	2011 Rate of change	2012 Rate of change	2013 Rate of change	2014 Rate of change	2015 Rate of change
1. Employment (in thousands of persons)*		16130.8	1.1	0.3	0.6	0.8	0.9
2. Employment (hours worked)**		-	-	-	-	-	-
3. Unemployment rate (%)***		9.7	9.7	9.9	9.7	9.3	8.9
4. Labour productivity (in thousands of persons)****		80.1	3.2	2.2	2.3	2.4	2.8
5. Labour productivity (hours worked)*****		-	-	-	-	-	-
6. Compensation of employees (PLN billion)	D.1	563.6	5.6	6.7	6.3	5.8	6.8
7. Compensation per employee (PLN thousand)		45.2	4.2	6.4	5.7	5.1	6.0

* Average employment based on LFS (aged 15 and older).

** National accounts definition.

*** Harmonised definition, Eurostat; levels.

**** Real GDP per person employed.

****** Real GDP per hour worked.

Table 13. Sectoral balances

% of GDP	ESA Code	2011	2012	2013	2014	2015
1. Net lending / borrowing vis-à-vis the rest of the world	B.9	2.1	1.2	1.8	2.3	2.7
of which: - balance on goods and services		1.6	1.3	1.5	1.7	1.5
- balance of primary incomes and transfers		2.8	2.2	2.2	2.3	2.5
- capital account		-2.2	-2.3	-2.0	-1.7	-1.3
2. Net lending/borrowing of the private sector	B.9	3.0	1.7	0.4	-0.7	-1.8
3. Net lending/borrowing of general government	EDP B.9	-5.1	-2.9	-2.2	-1.6	-0.9
4. Statistical discrepancy		-	-	optional	optional	optional

Table 14. Basic assumptions

	2011	2012	2013	2014	2015
Short-term interest rate (annual average)	4.22	4.50	4.28	4.03	4.20
Long-term interest rate (annual average)	5.9	5.6	5.6	5.5	5.4
Nominal effective exchange rate	1.9	2.6	-5.3	-4.6	-3.9
Exchange rate vis-à-vis the € (annual average)	4.12	4.17	3.95	3.77	3.62
World, excluding EU, GDP growth*	4.2	4.1	4.3	–	–
EU GDP growth**	1.5	0.0	1.2	1.6	1.8
Growth of relevant foreign markets***	4.0	0.5	3.9	4.7	5.2
World import volumes, excluding EU*	7.4	6.2	6.8	–	–
Oil prices (Brent, USD/barrel)**	111.0	113.1	109.0	110.4	110.4

* Source: EC, *Common external assumptions*, March 2012

** Forecast for 2012 based on EC projections, *Interim forecast,* February 2012

*** EU imports taken as foreign markets indicator.

Table 15. General government

	ESA Code	2011 PLN billion	2011 % of GDP	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP
Net lending (EDP B9) by sub-sector							
1. General government	S.13	-78.0	-5.1	-2.9	-2.2	-1.6	-0.9
2. Central government	S.1311	-65.2	-4.3	-2.7	-2.4	-1.8	-1.1
3. State government	S.1312						
4. Local government	S.1313	-11.2	-0.7	-0.4	-0.2	-0.2	-0.2
5. Social security funds	S.1314	-1.5	-0.1	0.2	0.4	0.4	0.4
General government							
6. Total revenue	TR	587.1	38.5	39.6	38.7	37.9	37.6
7. Total expenditure	TE[1]	665.0	43.6	42.6	41.0	39.5	38.6
8. Net lending/borrowing	EDPB.9	-78.0	-5.1	-2.9	-2.2	-1.6	-0.9
9. Interest expenditure	EDPD.41	41.9	2.7	2.8	2.8	2.6	2.5
10. Primary balance		-36.1	-2.4	-0.2	0.5	1.0	1.6
11. One-off and other temporary measures							
Selected components of revenue							
12. Total taxes (=12a+12b+12c)		317.1	20.8	21.0	21.1	20.6	20.7
12a. Taxes on production and imports	D.2	209.6	13.7	13.7	13.6	12.9	12.7
12b. Current taxes on income, wealth, etc	D.5	107.2	7.0	7.3	7.5	7.7	8.0
12c. Capital taxes	D.91	0.3	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	174.3	11.4	12.3	12.5	12.6	12.6
14. Property income	D.4	16.8	1.1	1.3	0.9	0.9	0.8
15. Other		78.9	5.2	5.1	4.2	3.8	3.5
16. Total revenue	TR	587.1	38.5	39.6	38.7	37.9	37.6
Tax burden (D.2+D.5+D.61+D.91-D.995)		489.8	32.1	33.2	33.5	33.1	33.2
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D1+P2	236.7	15.5	15.3	15.2	14.9	14.5
17a. Compensation of employees	D.1	149.0	9.8	9.6	9.6	9.4	9.2
17b. Intermediate consumption	P.2	87.7	5.7	5.8	5.7	5.5	5.3
18. Social payments		247.5	16.2	16.0	15.8	15.8	15.7
of which Unemployment benefits		3.1	0.2	0.2	0.2	0.2	0.2
18a. Social transfers in kind supplied via market producers	D.6311 D.63121 D.63131	32.6	2.1	2.1	2.1	2.1	2.2
Social transfers other than in kind	D.62	214.9	14.1	13.8	13.7	13.6	13.4
19. Interest expenditure	EDP D.41	41.9	2.7	2.8	2.8	2.6	2.5
20. Subsidies	D.3	7.0	0.5	0.4	0.4	0.4	0.4
21. Gross fixed capital formation	P.51	88.4	5.8	5.2	3.9	3.0	2.8
22. Capital transfers	D.9	11.6	0.8	0.6	0.6	0.6	0.6
23. Other		32.0	2.1	2.2	2.1	2.1	2.1
24. Total expenditure	TE	665.0	43.6	42.6	41.0	39.4	38.6

	ESA Code	**2011** PLN billion	**2011** % of GDP	**2012** % of GDP	**2013** % of GDP	**2014** % of GDP	**2015** % of GDP
p.m.: government consumption (nominal)	P.3	276.2	18.1	17.9	17.8	17.5	17.1

Table 16. Breakdown of revenue

	2011 Level	2011 % of GDP	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP
1. Total revenue at unchanged policies	587.2	38.5	39.6	38.4	37.9	37.6
2. Discretionary revenue measures				0.30	-0.06	0.03

The table above uses 2012 as the base year. A positive balance of discretionary measures means that in a given year sector revenue was increased compared to the revenues if government policies had remained unchanged.

The following discretionary measures were considered: change of VAT rates starting from 2014, restrictions in VAT reimbursement for fuel for certain vehicles, revenue from the sale of CO_2 emission rights, revenue from the royalty charge on mineral resource extraction, increase in excise duty on tobacco, increase in the disability pension contribution (effect on SIF and CIT), abolition of tax relief for Internet usage and changes in childcare reliefs, consequences of freezing PIT thresholds, effect of PIT relief on account of collecting savings within the framework of Individual Retirement Protection Accounts (IRPA) and increase (starting from 2013) in the capital portion of the contribution transferred to OFE while maintaining the total level of the pension contribution.

Table 17. Expenditure to be excluded from the expenditure benchmark

	2011 Level	2011 % of GDP	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue*	28.0	1.8	2.0	1.5	1.3	0.9
2. Expenditure fully matched by mandated revenue increases	-	-	-	-	-	-
3. Non-discretionary changes in unemployment benefit expenditure**	3.1	0.2	0.2	0.2	0.2	0.2

* The general government expenditure does not take into account the inflow of EU funds within the framework of the new financial perspective 2014-2020.

** The values provided for the years 2011-2015 reflect the level of non-discretionary unemployment benefit expenditure.