COUNCIL OPINION

on the updated convergence programme of Poland, 2009-2012

(2010/C 143/04)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 26 April 2010 the Council examined the updated convergence programme of Poland, which covers the period 2009 to 2012.

(2) With real GDP estimated to have increased by 1,7 %, Poland was the only EU country that recorded positive growth in 2009. This performance reflects a constellation of favourable factors including sound fundamentals at the outset of the crisis, a well capitalised and sound financial sector, the relatively low degree of openness of the economy, a sizeable depreciation of the Polish currency at an early stage of the crisis, as well as timely accommodative monetary and fiscal policies.

While some of the factors that supported growth are of temporary nature — the margin for supportive fiscal policy has largely disappeared and the exchange rate is now appreciating — Poland's economic outlook has improved significantly in recent months. Key challenges for the years ahead will be to bring government finances back to a sustainable position and secure a sustained catching-up process without compromising fiscal and macroeconomic stability. Poland did not use the good economic times (2006-2008) to consolidate its public finances, and the structural government deficit (i.e. the cyclically-adjusted balance net of one-off and other temporary measures calculated in accordance with the commonly agreed method on the basis of the data in updated programme) is estimated to have reached 7 % of GDP in 2009. Based on the April 2009 EDP notification by the Polish authorities of a 2008 government deficit of 3,9 % of GDP, on 7 July 2009 the Council decided on the existence of an excessive deficit and recommended its correction by 2012.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, the level of potential has also been negatively affected. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment, though the effects should be less severe in Poland because of the lower scale of capital destruction and Poland's flexible labour market. Moreover, the impact of the economic crisis compounds the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, in view of Poland's low employment rate and the need for reforms in support of the ongoing catching up process, it will be important to take further measures that foster labour market participation, improve the business environment, and stimulate private R&D spending.

(4) The baseline macroeconomic scenario underlying the budgetary projections in the programme envisages that real GDP growth will accelerate from 1,7 % in 2009 to 3 % in 2010, 4,5 % in 2011 and 4,2 % in 2012. Assessed against currently available information [2] the assumption for real GDP growth in 2010 appears slightly favourable and the assumptions for 2011 and 2012 seem favourable. The programme presents an alternative, 'risk scenario' with lower real GDP growth, at 2,7 % in 2010, 3,7 % in 2011 and 3,5 % in 2012, which appears more plausible. Taking into account recent information, the projection in the programme of a gradual recovery in employment over the period 2010-2012 is plausible, especially as the swift adjustment of real wages seems to be cushioning the effects of the downturn on employment. The programme's projections for inflation, showing a decline to around 2 % in 2010 on the back of appreciating currency and contained wage pressure followed by a moderate rebound thereafter in line with improving economic situation, are realistic.

(5) The programme estimates the general government deficit in 2009 at 7,2 % of GDP. The significant deterioration from a deficit of 3,6 % of GDP in 2008 reflects to a

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/sgp/index_en.htm

[2] The assessment notably takes into account the Commission services' Autumn 2009 forecast, but also other information that has become available since then, in particular Commission services February 2010 interim forecast.

large extent the impact of the crisis on government finances, but was also brought about by stimulus measures amounting to about 2 % of GDP which the government implemented in 2009 in line with the European Economic Recovery Plan (EERP). A personal income tax cut (decided in 2007), an increase of public investment, and an indexation of social transfers were the main elements of the stimulus. On the other hand, the deficit outturn in 2009 would have been even worse if deficit-reducing measures estimated at about 1,5 percentage point had not been implemented (reduction of administrative expenditure and increase of dividends from State-owned enterprises). Despite these measures, the structural balance deteriorated by more than 2 percentage points of GDP in 2009, also reflecting over spending in some general government subsectors [1] and unfavourable growth composition.

Despite the high level reached by the structural deficit and projected sharp rebound in economic activity, the programme foresees a gradual exit strategy, with moderate fiscal consolidation planned in 2010-2011.

(6) The programme projects a slight decline in the government deficit to 6,9 % of GDP in 2010. This is to be achieved through a large increase in the revenue ratio (by 2,2 percentage point) which would more than offset a pronounced increase in the expenditure ratio (by 1,9 percentage point), mainly due to an increase in capital spending (partly financed by EU funds). The main consolidation measures are an increase of some excise and quasi-excise duties (about 0,2 % of GDP) and a reduction of wage and salary growth in the central budget (0,3 % of GDP) totalling 0,5 % of GDP. The improvement in the structural balance is estimated at 0,8 percentage point of GDP, and would also reflect favourable growth composition leading to higher than usual tax elasticity. The fiscal effort implied by current plans is smaller than the annual average recommended by the Council in July 2009 for the period 2010-2012 (at least 1,25 percentage point of GDP).

(7) The main goal of the programme's medium-term budgetary strategy is to reduce the deficit below the 3 % of GDP deficit reference value by 2012, in line with the Council recommendation under Article 104(7) TEC. However, the planned adjustment is considerably back-loaded: the headline balance is projected to improve by 0,3 percentage point of GDP in 2010, 1 percentage point of GDP in 2011 and 3 percentage points of GDP in 2012. The structural balance would improve by 0,8-0,9 percentage point of GDP per year in 2010-2011, and by 3 percentage points of GDP in 2012. To compensate for the worse starting position for the headline deficit in 2009 than assumed at the time of the Council recommendation, the average annual structural effort for the period 2010-2012 would be around 1½ percentage of GDP, slightly higher than recommended in the Council recommendation under the excessive deficit procedure. Consolidation in the years 2011-2012 is predominantly expenditure-based but is not supported by sufficiently concrete measures. The total net impact of announced measures, i.e. those included in 'The Plan for the Development and Consolidation of Finances' of 29 January 2010 to which the convergence programme refers extensively, does not exceed 0,5 % of GDP over the 2011-2012 period [2]. The programme confirms the commitment to the medium term objective (MTO) of a government balance of – 1 % of GDP in structural terms. Given the most recent projections and debt level, the MTO more than adequately reflects the objectives of the Pact. However, the programme does not envisage achieving it within the programme period.

(8) The budgetary outcomes could turn out worse than projected in the programme over the whole programme period. Firstly, real GDP growth could turn out to be less favourable than projected, which would translate into lower than expected tax revenue. According to the programme, if the alternative, more cautious and plausible scenario materialises, the deficit in 2012 would be close to 5 % of GDP, and the excessive deficit would not be corrected within the deadline set by the Council. Secondly, the fiscal targets for 2011 and 2012 are not supported by concrete measures. The heavy electoral calendar for the coming two years (presidential and local elections in autumn 2010, parliamentary elections in autumn 2011) raises questions on when such measures will be specified and implemented. Thirdly, Poland has a mixed track record in achieving its general government expenditure targets specified in the subsequent Convergence Programmes updates, and new initiatives to strengthen the fiscal framework may not be sufficient to change this pattern in the time span covered by the programme. The proposed new 'temporary' expenditure rule to be implemented until the 'target' expenditure rule is introduced, covers a very small part of government expenditure (less than 15 %) and will result in a small annual adjustment even if fully implemented (less than 0,2 % of GDP per year in 2011-2012) [3]. Overall, the budgetary outcomes could turn out worse than projected in the programme.

(1) This excludes the central government subsector where spending was under executed in spite of higher revenues.

(2) The 0,5 % of GDP includes the impact of the expenditure rule as specified in the first package of reforms presented to the President.

(3) The programme plans the introduction of two expenditure rules: first a 'temporary' rule covering only a small part of general government expenditure. This rule will be in force until the structural general government deficit reaches the MTO (deficit of 1 % of GDP). Then, the authorities plan to introduce a 'target' expenditure rule (the objective would be to keep the structural deficit at 1 % of GDP), which would cover a larger share of government expenditure

(9) Government gross debt is estimated to have reached 50,7 % of GDP in 2009, up from 47,2 % in 2008. This ratio is projected to increase by 5 percentage points over the programme period reaching the level of around 56 % of GDP in 2012 but remaining below the Treaty reference value, mainly driven by high government deficits. Important privatisation receipts planned for 2010 are projected to contain the increase in the debt ratio. However, in light of still weak market conditions and underperformance of past privatisation plans, receipts may be lower than expected. Under a different macro-economic scenario and unchanged policies, the Commission services foresaw in their autumn 2009 forecast the debt ratio breaching the 60 % of GDP threshold in 2011. While in view of recent data this forecast appears to be on the high side, the debt ratio in the coming years may be higher than foreseen in the programme.

(10) Medium-term debt projections until 2020 assuming that GDP growth rates will gradually recover to the values projected before the crisis, tax ratios will return to pre-crisis levels and that include the projected increase in age-related expenditure show that the budgetary development envisaged in the programme, taken at face value and with no further policy change, is more than sufficient to stabilise the debt ratio by 2020. The programme refers to reforms supporting the long-term sustainability of public finances (inclusion of uniformed professions in the reformed general pensions, retirement age, farmers' social security fund, and reduction in disability benefits). While very important for government balance and labour market developments in the long-term, these measures are intended to be implemented gradually and, thus, will not have significant effects for the government balance in the programme period.

(11) The long-term budgetary impact of ageing is significantly below the EU average, reflecting the projected decrease in public pension spending. However, the budgetary position in 2009 causes a marked sustainability gap over the long term. Ensuring higher primary surpluses over the medium term, as already foreseen in the programme, would contribute to reducing risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report [1] as medium.

(12) There is scope to improve Poland's fiscal framework. Poland has one type of fiscal rule, based on three debt thresholds (50 %, 55 % and 60 % of GDP, the last one enshrined in the Constitution), the breach of which would trigger increasingly large fiscal consolidation measures. On the expenditure side, the institutional framework does not ensure sufficient expenditure control and results in recurring expenditure slippages. The authorities took action to improve the fiscal framework in 2009. They made the existing debt rule more restrictive, by introducing additional specific provisions on the type of measures to be implemented once public debt exceeds 55 % of GDP (national definition, non-ESA95). The fiscal planning horizon for the central State budget was extended from three to four years. Some reorganisation of the general government took place, aimed at increasing the transparency of public accounts. Finally, the authorities are planning the strengthening of the fiscal framework, which includes 'temporary' and 'target' expenditure rules. However the 'temporary' rule would cover only the non-mandatory part of the central State budget (excluding public investment), which is currently less than 15 % of general government expenditure. While these actions will facilitate future consolidation efforts they are not substitutes for measures needed to support the consolidation path included in the programme.

(13) Looking at the composition of public expenditure, Poland has a relatively large share of public expenditure allocated to social protection at the cost of relatively low spending in some growth-enhancing categories (innovation, R&D) and healthcare. Moreover, there seems to be scope to improve the efficiency of public expenditure in areas such as healthcare and education. As far as the revenue side is concerned, the tax burden is close to the EU average, but the complex system of taxation and tax collection would benefit from further simplification. Since 2005, the Polish authorities have gradually designed and implemented performance budgeting, which is expected to improve both efficiency and effectiveness of government expenditure in the coming years. The 2010 budget has extended the scope of performance budgeting, since additional parts of the general government sector are covered and additional expenditure categories included. The first central budget to be fully covered by performance budgeting is supposed to be implemented in 2013.

(14) Overall, in 2010 the budgetary strategy set out in the programme is broadly consistent with the Council recommendations under Article 104(7) TEC of 7 July 2009. However, taking into account the risks, the budgetary strategy, from 2011, would not seem consistent with the Council's recommendations. The average annual structural

[1] In the Council conclusions from 10 November 2009 on sustainability of public finances 'the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes' and further 'invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report', which is foreseen in 2012.

effort planned for the period 2010-2012 is 1½ percentage of GDP, slightly higher than recommended in the Council recommendation under the excessive deficit procedure. However, fiscal consolidation is considerably back-loaded, deficit targets are based on favourable growth assumptions, and the planned expenditure savings are not supported by sufficiently concrete measures. In view of Poland's good economic performance during the crisis, the recovery projected by the authorities from 2010, the large structural government deficit, and the authorities' objective to correct the excessive deficit by 2012, a more frontloaded fiscal consolidation strategy would be appropriate. In 2010, the budget should be rigorously implemented, primary current expenditure plans under-executed wherever possible and windfall revenue allocated to deficit reduction. The government deficit targets for 2011-2012 would have to be backed up by sizeable additional measures, which should also ensure an adequate margin in case the baseline macroeconomic scenario included in the programme does not materialise.

(15) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data [1]. In its recommendations under Article 104(7) TEC of 7 July 2009, the Council also invited Poland to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the convergence programmes. Poland partly complied with this recommendation. In particular, the detailed measures that are necessary to bring the deficit below the reference value by 2012 and reforms to contain primary current expenditure over the coming years have not been sufficiently spelled out.

The overall conclusion is that while Poland is planning to correct its excessive deficit by 2012 in line with the Council recommendation under the excessive deficit procedure, the fiscal adjustment is considerably backloaded, most of the deficit reduction being projected to take place in 2012, and deficit targets in the programme are subject to significant downside risks, both on the revenue and expenditure side. In view of the recovery projected by the authorities from 2010 and the large structural government deficit a more frontloaded fiscal consolidation strategy would be appropriate. Risks to fiscal targets reflect favourable real GDP growth assumptions, the lack of sizeable sufficiently concrete measures in support of fiscal targets from 2011 on, a history of current expenditure slippages compared to plans and impact of the electoral cycle. Intentions to strengthen the fiscal framework, in particular backed by expenditure rules, are welcome. With respect to the 'temporary' expenditure rule a higher degree of ambition would be appropriate, notably in terms of the share of government finances covered by the rule.

In view of the above assessment and also in the light of the recommendation under Article 104(7) TEC of 7 July 2009 and also given the need to ensure sustainable convergence, Poland is invited to:

(i) implement the 2010 budget rigorously, under-executing primary current expenditure plans wherever possible and allocating windfall revenue to deficit reduction;

(ii) strengthen the planned budgetary adjustment in 2011 in order to achieve the recommended average annual fiscal effort of 1,25 % of GDP in line with the Article 104(7) Recommendation and stand ready to adopt further consolidation measures in 2011 and 2012 in case risks related to the fact that the programme scenario is more favourable than the scenario underpinning the recommendation under Article 104(7) TEC materialise;

(iii) proceed with strengthening the fiscal framework, including through introduction of an expenditure rule covering a larger share of the general government primary expenditure than the 'temporary' rule presented in the Convergence Programme, with appropriate monitoring and enforcement mechanisms. This would require to reduce the share of statutory spending in total expenditures.

Poland is also invited to add, in its next update of the convergence programme, more precise information in the separate chapter on progress made to bring the excessive deficit situation to an end, as requested by the Council in its recommendations under Article 104(7) of 7 July 2009.

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	**CP Feb 2010**	**5,0**	**1,7**	**3,0**	**4,5**	**4,2**
	COM Nov 2009	5,0	1,2	1,8	3,2	n.a.
	CP Dec 2008	*5,1*	*3,7*	*4,0*	*4,5*	*n.a.*

[1] In particular, the estimates of the contributions from individual production factors to potential growth and long-term projections for some data series are not provided.

		2008	2009	2010	2011	2012
HICP inflation (%)	**CP Feb 2010**	**4,2**	**4,0**	**2,1**	**2,7**	**3,2**
	COM Nov 2009	4,2	3,9	1,9	2,0	n.a.
	CP Dec 2008	*4,2*	*2,9*	*2,5*	*2,5*	*n.a.*
Output gap (1) (% of potential GDP)	**CP Feb 2010**	**2,4**	**– 0,4**	**– 1,7**	**– 1,5**	**– 1,5**
	COM Nov 2009 (2)	2,6	– 0,4	– 2,2	– 2,3	n.a.
	CP Dec 2008	*1,0*	*– 0,1*	*– 0,6*	*– 0,5*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Feb 2010**	**– 4,0**	**– 0,1**	**– 1,1**	**– 0,0**	**– 0,8**
	COM Nov 2009	– 4,0	– 0,2	– 0,3	– 0,7	n.a.
	CP Dec 2008	*– 4,0*	*– 1,8*	*– 1,3*	*– 1,5*	*n.a.*
General government revenue (% of GDP)	**CP Feb 2010**	**39,6**	**37,4**	**39,6**	**40,3**	**40,3**
	COM Nov 2009	39,6	37,6	38,6	38,3	n.a.
	CP Dec 2008	*39,8*	*40,7*	*40,0*	*39,7*	*n.a.*
General government expenditure (% of GDP)	**CP Feb 2010**	**43,3**	**44,6**	**46,5**	**46,2**	**43,3**
	COM Nov 2009	43,3	44,0	46,1	45,9	n.a.
	CP Dec 2008	*42,6*	*43,2*	*42,4*	*41,7*	*n.a.*
General government balance (% of GDP)	**CP Feb 2010**	**– 3,6**	**– 7,2**	**– 6,9**	**– 5,9**	**– 2,9**
	COM Nov 2009	– 3,6	– 6,4	– 7,5	– 7,6	n.a.
	CP Dec 2008	*– 2,7*	*– 2,5*	*– 2,3*	*– 1,9*	*n.a.*
Primary balance (% of GDP)	**CP Feb 2010**	**– 1,4**	**– 4,8**	**– 4,2**	**– 3,1**	**– 0,2**
	COM Nov 2009	– 1,4	– 3,8	– 4,6	– 4,6	n.a.
	CP Dec 2008	*– 0,3*	*0,1*	*0,2*	*0,5*	*n.a.*
Cyclically-adjusted balance (1) (% of GDP)	**CP Feb 2010**	**– 4,6**	**– 7,0**	**– 6,2**	**– 5,3**	**– 2,3**
	COM Nov 2009	– 4,7	– 6,3	– 6,6	– 6,7	n.a.
	CP Dec 2008	*– 3,1*	*– 2,5*	*– 2,1*	*– 1,7*	*n.a.*
Structural balance (3) (% of GDP)	**CP Feb 2010**	**– 4,6**	**– 7,0**	**– 6,2**	**– 5,3**	**– 2,3**
	COM Nov 2009	– 4,7	– 6,4	– 6,6	– 6,7	n.a.
	CP Dec 2008	*– 3,1*	*– 2,5*	*– 2,3*	*– 1,7*	*n.a.*
Government gross debt (% of GDP)	**CP Feb 2010**	**47,2**	**50,7**	**53,1**	**56,3**	**55,8**
	COM Nov 2009	47,2	51,7	57,0	61,3	n.a.
	CP Dec 2008	*45,9*	*45,8*	*45,5*	*44,8*	*n.a.*

Notes:

(1) Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.
(2) Based on estimated potential growth of 5,0 %, 4,2 %, 3,7 % and 3,3 % respectively in the period 2008-2011.
(3) Cyclically-adjusted balance excluding one-off and other temporary measures.There are no one-off measures according to the most recent programme and 0,1 % of GDP in 2009, deficit-reducing, in the Commission services' Autumn 2009 forecast.

Source:

Convergence programme (CP); Commission services' autumn forecast (COM); Commission services' calculations.