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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels,
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Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/183/EC on the existence of an excessive deficit in Poland

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. BACKGROUND

Article 104 of the Treaty establishes that Member States should avoid excessive deficits and lays down a procedure for their identification and correction. The excessive deficit procedure (EDP) is further specified in Council Regulation (EC) No 1467/97 on "speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the planned or actual government deficit exceeds the reference value of 3% of GDP (unless either the deficit ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether government debt exceeds the reference value of 60% of GDP (unless the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the EDP. As part of the application of this Protocol, Member States have to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93[2,3]. As explained in the box below, Poland was among the countries which benefited from a transition period for implementing the Eurostat decision of 2 March 2004 on the classification of funded pension schemes and as a result notified deficit and debt figures without the net cost of the 1999 pension reform (currently amounting to around 2% of GDP annually) until March 2007. Since then, deficit and debt figures have been notified in accordance with the Eurostat decision. Unless mentioned explicitly, all figures quoted in this document are in accordance with the Eurostat decision.

Box: The classification of pension schemes

There are typically different pillars within a country's pension system, such as pay-as-you-go or unfunded systems and funded systems; furthermore, pension schemes can be of the defined-benefit (DB) or defined-contribution (DC) variety.

If a pension scheme is classified in the government sector, contributions collected and benefits paid by the scheme are government revenue and expenditure and contribute to the government balance. If a pension scheme is classified in a sector other than government, its contributions and benefits do not contribute to the government balance. The ESA95 accounting rules state that pension schemes classified within government are those which are "imposed, controlled and financed by government".

On 2 March 2004, Eurostat clarified that funded DC pension schemes do not fulfil these criteria because pensions paid by such schemes (i) depend primarily on financial markets performance (i.e. not under government control) and (ii) are financed by reserves that are not economically owned by

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1 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

2 OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

3 The most recent notification of Poland can be found at: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal.

government. Even if they are mandatory or if they are managed by government (for example, managed by the same government agency in charge of the pay-as-you-go pillar) or if there is some government guarantee of a minimum pension, funded DC schemes should not be classified within government (*).

A transition period, expiring in spring 2007 (first notification of 2007), was granted to implement this decision (**).

(*) Eurostat News Release No 30/2004 of 2 March 2004.
(**) Eurostat News Release No 117/2004 of 23 September 2004.

On 12 May 2004, the Commission initiated the EDP for Poland with the adoption of a report under Article 104(3), based on a general government deficit of 4.1% of GDP (excluding pension reform cost) in 2003[4]. On 5 July 2004, the Council decided, on a recommendation from the Commission, that Poland was in excessive deficit according to Article 104(6)[5]. The Council decision stated that the deficit and the debt figures would have to be adjusted upward if the funded pension schemes were excluded from the general government sector following the Eurostat decision on the classification of the funded pension schemes (see box). At the same time, and also based on a Commission recommendation, the Council addressed recommendations under Article 104(7) to Poland with a view to bringing the situation of an excessive government deficit to an end, by 2007 at the latest[6]. On 28 November 2006, the Council decided under Article 104(8), on a recommendation from the Commission, that action taken until then by the Polish authorities was inadequate[7]. On 27 February 2007, the Council issued new recommendations under Article 104(7) based on a recommendation by the Commission.

In its second recommendation under Article 104(7), the Council recommended that the Polish authorities put an end to the excessive deficit situation by the original deadline of 2007 and reduce the general government deficit in a credible and sustainable manner and to this end ensure an improvement of the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) by at least 0.5 percentage points of GDP between 2006 and 2007. The Council established the deadline of 27 August 2007 for the Polish authorities to take effective action. In addition, the Council invited Poland to ensure that budgetary consolidation towards its medium-term objective of a structural deficit of 1% of GDP was sustained after the excessive deficit would have been corrected.

4 SEC(2004) 826.
5 OJ L 62, 9.3.2005, p. 18.
6 All EDP-related documents for Poland can be found at the following website: http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.
7 OJ L 414, 30.12.2006, p. 81.

Table 1: Adjustment endorsed by the Council on 27 February 2007

% of GDP, unless indicated otherwise	**2006**	**2007**
General government balance	−3.9	deficit close to 3[8]
change in structural balance		*at least +0.5*
p.m.: Real GDP growth (%)	5.4	5.1

Note: Structural balance = cyclically-adjusted balance excluding one-off and other temporary measures.

Source: Council recommendation under Article 104(7) and, for real GDP growth, Council opinion on the November 2006 update of the convergence programme, both adopted on 27 February 2007.

On 20 November 2007, i.e. after the expiry of the deadline for taking action set in the Council recommendation, the Commission adopted a communication to the Council, which concluded that the action taken by Poland in response to the Council recommendation was consistent with the recommendation. While the Commission expressed concern about the durability of the correction of the excessive deficit in 2008 and 2009, no further steps under the EDP were recommended at that stage[9]. In its meeting of 4 December 2007, the Council concurred with this assessment. Both the Commission and the Council invited the Polish authorities to submit as soon as possible an updated convergence programme describing their medium-term strategy for the whole legislature, consistent with a durable correction of the excessive deficit and further progress towards the medium-term objective. A new programme was submitted at the end of March 2008. The Commission is recommending a Council opinion on this programme together with this recommendation for a Council decision.

According to Article 104(12), a Council decision on the existence of an excessive deficit is to be abrogated, on the basis of a Commission recommendation, when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

2. RECENT DEFICIT DEVELOPMENTS

Since peaking at 6.3% of GDP in 2003, the general government deficit declined by more than 1 percentage point annually on average to reach 2% of GDP in 2007, based on the data provided by the Commission (Eurostat) following the reporting by Poland before April 2008[10, 11,12]. The outturns were generally better than targeted thanks to positive growth

8 In its recommendation, the Council referred to the November 2006 update of the convergence programme, which targeted a deficit of 3.4% of GDP in 2007 and which "*assumes that, for the purpose of abrogating the decision on the existence of an excessive deficit under Article 104(12), the Commission and the Council could, as foreseen in Article 2(7) of Regulation (EC) No 1467/97, consider the cost to the budget of the 1999 pension reform [estimated at around 2% of GDP in 2007] according to a linear degressive scale amounting to 60 % in 2007. The Council recalls that for Poland to benefit from this provision, the deficit should have declined substantially and continuously and have reached a level that comes close to the reference value. As the deficit has declined substantially and continuously over the period 2004-2006, the outcome for the 2007 deficit and the outlook thereafter will determine whether this provision can be applied to Poland*".

9 SEC(2007) 1543.

10 Eurostat News Release No 54 of 18 April 2008.

11 Deficit ratios are usually revised – upwards or downwards – after the publication of the first outcome in the spring notification. For the EU Member States as a whole, the revisions are usually relatively small and on average insignificantly different from zero. In view of the distance between the currently

surprises resulting in windfall revenues as well as the incomplete execution of expenditure plans.

The 2007 general government deficit outturn was 2.0% of GDP, compared to 3.4% projected in the November 2006 convergence programme. Much higher real and nominal GDP growth than assumed in November 2006 was the main reason, but also expenditure was restrained. In particular, high profitability of companies allowed for growth in subsidies to be contained, while the rapid fall in unemployment and the lack of indexation imposed by the Hausner plan[13] curtailed growth in social transfers. In addition, compensation of public sector employees was lower than planned. Finally, government investment was lower than projected because of a slower absorption of EU funds than planned. Overall, the expenditure-to-GDP ratio was 1.5 percentage point lower than projected in November 2006. On the revenue side, revenue from indirect taxes and social contributions turned out better than envisaged in November 2006, mainly thanks to a much higher employment and wage growth. These positive surprises were offset by a lower performance of other revenue items (direct taxes due to an increase in tax brackets). Overall, this led to a revenue ratio slightly below the planned one.

3. DEFICIT PROJECTIONS FOR 2008-2009 AND BEYOND

For 2008, the Commission services' spring 2008 forecast projects that the general government deficit will increase to 2.5% of GDP, in line with the target in the March 2008 convergence programme. GDP is expected to grow by 5.3% and 5% in 2008 and 2009, respectively. The Commission services foresee that private consumption accelerates in 2008 to 5.6% supported by the social contributions cuts and decelerates to 4.7% in 2009 because of a deteriorating external environment weighing on consumers' confidence.

The increasing general government deficit results from the Polish 2008 budget, which targets a worsening of the central state balance (non ESA95) by about 0.8% of GDP in 2008 compared to the 2007 outturn because of a number of deficit-increasing measures adopted before the parliamentary elections of October 2007. Most of them will reduce government revenues: a second cut in social contributions and personal income tax relief for families. On the expenditure side, the 2008 budget envisages higher public investment and restores the generous (inflation plus wage growth) annual indexation of pensions and disability benefits. The deficit-increasing measures will be partly offset by improved tax compliance, higher taxable income, and excise duty hikes related to the EU tax harmonisation.

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reported deficit for 2007 and the deficit reference value, there is a very low probability that potential future revisions in government accounts would raise the 2007 deficit ratio in excess of 3% of GDP.

12 In accordance with Article 2(7) of Regulation (EC) No 1467/97, a decision to abrogate a decision on the existence of an excessive deficit should take into account the net cost of a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar if the deficit has declined substantially and continuously and has reached a level that comes close to the reference value. Since the 2007 general government deficit was below the 3%-reference value there is no need to consider the application of this Article.

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

In 2009, the general government deficit ratio is expected to rise marginally to 2.6% of GDP according to the spring 2008 Commission forecast, which is based on the no-policy-change assumption. The March 2008 convergence programme, which assumes the implementation of some deficit-decreasing measures that remain to be specified, envisages a general government deficit of 2.0% of GDP.

The spring forecast projects the structural deficit to widen by approximately ¼ percentage point of GDP in 2008 but to narrow by about ⅓ percentage point in 2009, resulting from the improvement in the labour market stimulated by the cuts in the tax wedge[14].

The main goal of the budgetary strategy presented in the March 2008 convergence programme is to reach the MTO, a structural deficit of 1% of GDP, by 2011, i.e. one year after the end of the programme period. The budgetary adjustment is expenditure-based and back-loaded to 2009 and 2010.

4. DEBT DEVELOPMENTS AND PROJECTIONS

After having reached its peak of 47.6% of GDP in 2006, the debt ratio appears to be on a declining path. Significant debt reduction was achieved in 2007, when the ratio decreased by almost 2½ percentage points to 45.2% of GDP mainly thanks to high nominal GDP growth but also to the appreciation of the złoty. Gross debt is projected to fall more slowly this year and next to about 44% of GDP in 2009, according to the spring 2008 forecast under the no-policy-change assumption.

5. CONCLUSIONS

The general government deficit decreased from 6.3% of GDP in 2003 to 2.0% in 2007, below the 3% of GDP reference value. The deficit reduction in 2007 mainly reflected higher economic growth, which together with expenditure restraint (partly due to an incomplete execution of investment plans) reduced the expenditure ratio compared to budget plans. The revenue ratio came in close to target, with windfall revenues from favourable economic conditions offset by direct tax cuts and underperformance in other revenue categories. The structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, improved by about 1½ percentage point of GDP, well above the fiscal effort of at least 0.5 percentage point recommended by the Council. According to the Commission services' spring 2008 forecast, the headline deficit is expected to increase to 2.5% of GDP in 2008 and, on a no-policy change basis, to 2.6% in 2009. This indicates that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner.

General government gross debt declined from 47.6% of GDP in 2006 to 45.4% in 2007, below the 60% of GDP reference value. According to the Commission services' spring 2008

[14] There seems to be a particularly high potential for reducing the shadow economy and stimulating labour activity in Poland, as suggested by the significant difference between the registered unemployment rate and the unemployment rate from labour force surveys (about 3 percentage points in the beginning of 2008). Furthermore, Poland has one of the lowest activity rates in the EU (63½% compared to almost 71% in the EU in the second half of 2007), especially for those aged 55+. Moreover, the steep increase in corporate-income and small-business personal-income tax revenues in the recent years in Poland may be partly explained with a better compliance following a reduction of initially high tax rates.

forecast, the debt ratio is expected to fall further to around 44% of GDP by 2009 (on a no-policy change basis).

From an overall assessment, it follows that the excessive deficit situation in Poland has been corrected. Accordingly, the Commission recommends to the Council to abrogate its decision on the existence of an excessive deficit in Poland.

Table 2: Budgetary developments, 2003-2009

% of GDP, unless indicated otherwise	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**		**2009**	
						COM	**CP**(2)	**COM**(3)	**CP**(2)
General government balance	**−6.3**	**−5.7**	**−4.3**	**−3.8**	**−2.0**	**−2.5**	**−2.5**	**−2.6**	**−2.0**
Total revenues	38.4	36.9	39.0	40.0	40.4	40.1	40.0	39.7	39.2
Total expenditure	44.6	42.6	43.3	43.8	42.4	42.6	42.5	42.3	41.2
Of which: − interest expenditure	*3.0*	*2.8*	*2.8*	*2.7*	*2.6*	*2.7*	*2.3*	*2.7*	*2.3*
– gross fixed capital formation	*3.3*	*3.4*	*3.4*	*3.9*	*4.1*	*4.5*	*5.2*	*4.8*	*5.0*
Primary balance	**−3.3**	**−2.9**	**−1.5**	**−1.1**	**0.6**	**0.2**	**−0.2**	**0.1**	**0.3**
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance(1)	**−5.9**	**−5.9**	**−4.2**	**−4.0**	**−2.5**	**−2.7**	**−2.8**	**−2.3**	**−1.9**
Structural primary balance(1)	−2.9	−3.1	−1.4	−1.3	0.1	0.0	−0.5	0.3	0.4
Pm Real GDP growth (%)	*3.9*	*5.3*	*3.6*	*6.2*	*6.5*	*5.3*	*5.5*	*5.0*	*5.0*
Pm Output gap	*−1.0*	*0.4*	*−0.4*	*0.6*	*1.2*	*0.5*	*0.7*	*−0.7*	*−0.2*

(1) Cyclically-adjusted (primary) balance excluding one-off and temporary measures.
(2) Cyclically-adjusted and structural balances and output gaps according to the programme as calculated by Commission services on the basis of the information in the programme.
(3) No-policy change assumption.
Sources: Commission services' spring 2008 forecast (COM) and March 2008 update of the convergence programme (CP).

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/183/EC on the existence of an excessive deficit in Poland

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(12) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) By Council Decision 2005/183/EC of 5 July 2004[15], following a recommendation from the Commission in accordance with Article 104(6) of the Treaty, it was decided that an excessive deficit existed in Poland. The Council noted that the general government deficit was 4.1% of GDP in 2003, above the 3% of GDP Treaty reference value, while general government gross debt stood at 45.4% of GDP, below the 60 % of GDP Treaty reference value. The Council decision stated that the deficit and the debt figures would have to be adjusted upward if the funded pension schemes were excluded from the general government sector following the Eurostat decision on the classification of the funded pension schemes[16].

(2) On 5 July 2004, in accordance with Article 104(7) of the Treaty and Article 3(4) of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[17], the Council made, based on a recommendation from the Commission, a recommendation addressed to Poland with a view to bringing the excessive deficit situation to an end by 2007 at the latest. The recommendation was made public.

(3) On 28 November 2006, the Council decided under Article 104(8), on a recommendation from the Commission, that action taken until then by the Polish authorities was inadequate[18]. On 27 February 2007, the Council issued a new recommendation under Article 104(7), on a recommendation from the Commission, confirming the 2007 deadline for the correction. The recommendation was made public.

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15 OJ L 62, 9.3.2005, p. 18.

16 Eurostat News Releases No 30/2004 of 2 March 2004 and No 117/2004 of 23 September 2004.

17 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

18 OJ L 414, 30.12.2006, p. 81.

(4) In accordance with Article 104(12) of the Treaty, a Council Decision on the existence of an excessive deficit is to be abrogated when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

(5) In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the procedure. As part of the application of this Protocol, Member States are to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community[19].

(6) Based on data provided by the Commission (Eurostat) in accordance with Article 8g(1) of Regulation (EC) No 3605/93 following the notification by Poland before 1 April 2008 and on the Commission services' spring 2008 forecast, the following conclusions are warranted:

– the general government deficit was reduced from 3.8% of GDP in 2006 to 2.0% of GDP in 2007, which is below the 3% of GDP deficit reference value. This compares with a target of 3.4% of GDP set in the November 2006 update of the convergence programme,

– the much better 2007 deficit outturn compared to the target was supported by much higher real GDP growth than assumed in the November 2006 convergence programme. In addition, relative to GDP, the government spent less on social transfers (due to lack of indexation in 2007), subsidies, investment and compensation of employees. Overall, total expenditure was by 1.5 percentage point lower than planned in the November 2006 convergence programme. The improvement in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is estimated at 1½ percentage point of GDP in 2007,

– with lower GDP growth than in 2007, the spring 2008 forecast projects the deficit to increase in 2008 to 2.5% of GDP, but remain below the reference value, driven mainly by cuts in social contributions, personal income tax relief and an increase of social transfers together with higher investment. This is the same as the official deficit target set in the March 2008 update of the convergence programme. For 2009, the spring forecast projects the deficit to broadly stabilise on a no-policy change basis. This indicates that the deficit has been brought below the 3% of GDP reference value in a credible and sustainable manner,

– nonetheless, the structural balance is projected to deteriorate slightly by ¼ percentage point of GDP in 2008 and, on a no-policy change basis, improve by about ⅓ percentage point in 2009. This has to be seen against the need to make

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[19] OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

progress towards the medium-term objective (MTO) for the budgetary position, which for Poland is a structural deficit of 1% of GDP,

– government debt declined from 47.6% of GDP in 2006 to 45.2% in 2007. According to the spring 2008 forecast, the debt ratio is projected to remain well below the 60% of GDP threshold and fall further to around 44% by end-2009.

(7) In the view of the Council, the excessive deficit in Poland has been corrected and Decision 2005/183/EC should therefore be abrogated.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that the excessive deficit situation in Poland has been corrected.

Article 2

Decision 2005/183/EC is hereby abrogated.

Article 3

This Decision is addressed to the Republic of Poland.

Done at Brussels,

For the Council
The President