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# REPORT FROM THE COMMISSION

## Poland

## Report prepared in accordance with Article 104(3) of the Treaty

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## 1. 1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever the deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

## 2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Poland and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure 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 ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the 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 the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

An EDP for Poland was initiated by the Commission in May 2004 with the adoption of a report under Article 104(3) in view of a deficit of 4.1% of GDP in 2003, i.e. above the reference value. On the Commission's recommendation, the Council decided in July 2004, in conformity with Article 104(6), that an excessive deficit existed in Poland and consequently, pursuant to Article 104(7), issued a recommendation to the Polish authorities for its correction. 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. On 27 February 2007, the Council issued a new recommendation under Article 104(7) confirming the 2007 deadline for the correction. After assessment of the measures taken, on 8 July 2008, the Council issued a decision under Article 104(12), abrogating Decision 2005/183/EC on the existence of an excessive deficit in Poland[2].

According to data notified by the authorities in April 2009[3] and subsequently validated by Eurostat[4], the general government deficit in Poland reached 3.9% of GDP in 2008, thus exceeding the 3% of GDP reference value, while general government gross debt stood at 47.1% of GDP, below the 60% of GDP reference value and on a rising trend.

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1 OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2 http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm

3 According to Council Regulation (EC) No 3605/93, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. 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.

4 Eurostat news release No 56/2009 of 22 April 2009.

**Table 1: General government deficit and debt** [a]

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|
| General government balance | −6.3 | −5.7 | -4.3 | -3.8 | -1.9 | -3.9 | -6.6 | -7.3 |
| General government gross debt | 47.1 | 45.7 | 47.1 | 47.7 | 44.9 | 47.1 | 53.6 | 59.7 |

Note:
[a] In percent of GDP.

*Source: Eurostat and Commission services' spring 2009 forecasts.*

The figure for the 2008 deficit provides *prima facie* evidence on the existence of an excessive deficit in Poland in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Poland with the adoption of this report. Section 3 of the report examines the deficit criterion. Section 4 deals with public investment and other relevant factors. The document takes into account the Commission services' spring 2009 forecasts, released on 4 May 2009.

## 3. DEFICIT CRITERION

In 2008, the general government deficit reached 3.9% of GDP.

Well in excess of 3% of GDP, the deficit is not close to the Treaty reference value.

The excess over the 3% of GDP reference value cannot be regarded as exceptional. In particular:

– it does not result from an unusual event in the sense of the Treaty and the Stability and Growth Pact. This definition is to be applied narrowly to cover events such as wars or natural disasters.

– it does not result from a severe economic downturn in 2008 in the sense of the Treaty and the Stability and Growth Pact. Despite growth slowing down to 3.1% y-o-y in the last quarter of 2008, which affected revenue collection in the last quarter of the year and added to the worse-than-expected deficit outcome, overall GDP growth was still relatively robust at 4.8% in 2008. Potential GDP is estimated to have grown by 4.6% and the output gap to have reached 3.5% of potential GDP, indicating favourable cyclical conditions. In 2009, GDP is forecast to contract by 1.4%, and the output gap is set to turn negative and reach -1.5 % of potential GDP, pointing to a significant worsening of the economic situation.

**Table 2: Macroeconomic and budgetary developments** [a]

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|
| Real GDP (% change) | 3.9 | 5.3 | 3.6 | 6.2 | 6.6 | 4.8 | -1.4 | 0.8 |
| Potential GDP (% change) | 3.1 | 3.6 | 4.1 | 4.6 | 4.9 | 4.6 | 3.7 | 3.2 |
| Output gap (% of potential GDP) | -1.0 | 0.6 | 0.1 | 1.7 | 3.4 | 3.5 | -1.5 | -3.8 |
| General government balance | -6.3 | -5.7 | -4.3 | -3.8 | -1.9 | -3.9 | -6.6 | -7.3 |
| Primary balance | -3.3 | -2.9 | -1.5 | -1.2 | 0.4 | -1.7 | -3.7 | -4.4 |
| One-off and other temporary measures | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.2 |
| Government gross fixed capital formation | 3.4 | 3.4 | 3.5 | 3.9 | 4.2 | 4.6 | 5.5 | 6.0 |
| Cyclically-adjusted balance | -5.9 | -5.9 | -4.4 | -4.6 | -3.2 | -5.3 | -6.0 | -5.8 |
| Cyclically-adjusted primary balance | -2.9 | -3.2 | -1.6 | -1.9 | -0.9 | -3.1 | -3.1 | -2.9 |
| Structural balance [b] | -5.9 | -6.0 | -4.4 | -4.6 | -3.2 | -5.3 | -6.0 | - 5.6 |
| Structural primary balance | -2.9 | -3.2 | -1.6 | -1.9 | -0.9 | -3.1 | -3.1 | -2.7 |

Notes:

[a] In percent of GDP unless specified otherwise.

[b] Cyclically-adjusted balance excluding one-off and other temporary measures.

*Source: Eurostat, Ameco and Commission services' spring 2009 forecast*

The excess over the 3% of GDP threshold from 2008 is to a large extent a reflection of the fact that the recent good times were only to a certain extent used as an opportunity to consolidate public finances and undertake deep reforms on the expenditure side, especially in the area of social protection. The reduction of social contributions, an increase in personal income tax reliefs for families, a generous indexation of pensions and of social benefits increased the deficit in 2008. Higher-than-planned intermediate consumption and , investment, as well as the drop in revenues at the end of the year due to the economic slowdown, all resulted in a higher than expected deficit both at the central and local government level.

The excess over the 3% of GDP reference value cannot be regarded as temporary in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services spring 2009 forecast, the general government deficit is forecast to reach 6.6% of GDP in 2009 and 7.3% in 2010 against a GDP contraction of 1.4% in 2009 and GDP growth of 0.8% in 2010. Also according to the most recent fiscal notification by the Polish authorities the deficit will expand to 4.6% in 2009. Thus, in the absence of countervailing measures, it is unlikely that the deficit could be brought below the 3% of GDP threshold by the end of the forecasting period (2010).

In sum, the deficit is not close to the 3% of GDP reference value and the excess over the reference value is neither exceptional nor temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

## 4. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State”. These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that “any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council” need to be given due consideration. Finally, Article 2(5) of the Regulation provides that the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar should be considered in all assessments in the framework of the excessive deficit procedure. In 1998, Poland has adopted such a reform, which was implemented in 1999.

In view of the above provisions, the following five subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; (4) other factors considered relevant by the Commission and (5) pension reforms as mentioned above.

### *4.1. Medium-term economic position*

**Cyclical conditions and potential growth.** Between 2004 and 2008, Poland's GDP grew by 5.3% per year. This above-potential performance was driven by inflows of external funds fuelling investment and by favourable developments in the labour market boosting private consumption. In 2009, GDP is estimated to contract by 1.4%, the first time since the transition, with a negative contribution of domestic demand as investment will contract sharply. On the back of a worsening labour market situation and falling investment, the output gap will turn negative and reach -1.5% of potential GDP.[5] In 2010, GDP growth is expected to rebound only slightly to 0.8%, mainly thanks to exports, while the negative output gap will widen further to -3.8% of potential output. All-in-all, this clearly indicates poor economic conditions in the years ahead.

**Recent structural reforms.** The government implemented several structural reforms, which are expected to have a positive impact on the potential growth of the economy. In the area of labour markets, measures to boost employment included *inter alia* a cut in social contributions over 2007-2008 and a personal income tax reform in 2009. They had a negative impact on the budget (about 2% of GDP less revenue from social contributions in 2007-2008, about ½% of GDP lost revenue in 2009 from tax cuts). Early retirement pensions were replaced with less-costly "bridge pensions", which should contribute to both higher labour participation and lower public expenditure. With respect to health care, the government aims at gradually introducing some competition in healthcare insurance and harder budget constraints for hospitals by transforming them into companies (rather than prolonging soft budget constraints leading to the accumulation of debt) while allocating more resources to public healthcare. In the medium term these measures (both in the area of healthcare and "bridge pensions") should result in a more efficient use of public resources and lower public expenditure, but in the short term they may weigh marginally on public finances. As set out in the Council's country-specific recommendations on the implementation of the Lisbon strategy,[6] further urgent measures are needed to enhance expenditure control, review the

5 Output gap figures in general must be interpreted with special caution in the case of an economy such as Poland, as potential growth is difficult to determine for an economy subject to rapid structural change.

6 As laid down in the draft report No 6638/09 from the ECOFIN Council to the European Council.

benefit system, boost R&D performance (through reallocation of resources to this growth enhancing expenditure), and increase participation in lifelong learning.

### *4.2. Medium-term budgetary position*

**Structural deficit and fiscal consolidation in good times.** The fiscal stance appears to have been restrictive over 2004-2007, and expansionary in 2008. The structural deficit (cyclically-adjusted deficit net of one-offs) decreased from around 6% of GDP in 2004 to 3¼% of GDP in 2007 and widened again to 5¼% of GDP in 2008.[7] This has to been seen against an increasingly positive output gap (from slightly above ½% in 2004 to 3½% in 2008). Looking forward, the Commission services' spring 2009 forecast project that the structural government deficit in 2009 would continue deteriorating by almost ¾ percentage points of GDP to attain a deficit of 6% of GDP. In 2010, the structural deficit is projected to narrow slightly, to around 5¾% of GDP.

**Public investment.** The general government deficit ratio has been lower than the government investment-to-GDP ratio over 2006-2008. Government investment (as a share of GDP) grew by 0.7 percentage points between 2006 and 2008, while the deficit increased by 0.1 percentage points over the same period. In 2008, the general government gross fixed capital formation, at 4.3% of GDP, was higher than the deficit outturn. According to the Commission services' Spring 2009 forecasts, public investment will increase within the forecast horizon, but at a lower pace than the deficit, which would exceed the public investment ratio in 2009 as well as in 2010.

**Quality of public finances.** General government expenditure remained relatively stable over recent years, rising slightly from 42.6% of GDP in 2004 to 43% of GDP in 2008. Looking at the composition, efficiency and effectiveness of public expenditure, Poland has a relatively large share of public expenditure allocated to social protection at the cost of underspending in growth-enhancing categories (infrastructure and R&D) or those improving the quality of living (healthcare), though the situation has improved somewhat in recent years. As indicated in the December 2008 convergence programme, the government intends to improve the composition of public expenditure and spend relatively more on education, R&D, infrastructure and healthcare in parallel with increasing the efficiency and effectiveness of spending in these areas. As far as the revenue side is concerned, the level of taxation is around the EU average, but the tax system is comparatively complex. On the expenditure side, the current institutional framework does not ensure adequate expenditure control. The planned amendment of the public finance law includes a reduction of the amount of autonomous public funds not directly controlled by central or local authorities, obligatory multiannual budgetary plans for the central state budget and local authorities as well as modified fiscal rules on public debt. Lastly, gradual implementation of performance budgeting is to be finalised by 2013.

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7 Structural balance calculations are dependent on calculated output gaps and thus also subject to particular uncertainty for an economy such as Poland – see footnote 5.

**Long-term sustainability of public finances.** In its opinion of 10 March 2009 on the most recent convergence programme, the Council assessed the long-term sustainability of Poland's public finances as follows. Although, "the budgetary position in 2008 includes a small structural primary deficit, the long-term budgetary impact of ageing is among the lowest in the EU according to the projections made in 2005, which are based on the commonly agreed methodology. Recent reforms, however, tend to raise expenditure in the long-term. Maintaining high primary surpluses over the medium term would contribute to limiting the risks to the long-term sustainability of public finances, which are currently at a low level"[8].

### *4.3. Other factors put forward by the Member State*

In a letter of 30 April 2009, the authorities of Poland listed some factors which they found relevant in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above and below already covers some of the items put forward by the authorities. The remaining items on the list, and their relevance for the purpose of this report, are as follows.

The Polish authorities refer in the letter to the world economic crisis and its impact on the macroeconomic performance of the Polish economy, especially in the last quarter of 2008, and thus the general government balance (decrease in revenues, especially indirect taxes). The global crisis did affect Poland in 2008Q4, but revenues from indirect taxes turned out lower by only 0.1% of GDP compared to the December 2008 convergence programme.

A deeper budgetary impact of the tax wedge reform (reduction of social contributions) and personal income tax reliefs is also mentioned in the letter. However, the reduction of social contributions and family reliefs were adopted long ago and the actual budgetary cost was similar to that expected by the Polish authorities. The revenues from direct taxes were as projected in the programme and social contributions yielded more revenues by 0.4% of GDP than foreseen in the programme.

The Polish authorities describe the differences between the convergence programme projections for public consumption (notably on military equipment), public investment and capital injections, and the outturn, which was significantly higher. Moreover, the authorities explain significant differences between the cash and the accrual data (since the cash spending limits "did not prevent general government entities from incurring liabilities on accrual basis") and refer to missing up-to-date information from different spending entities. No additional relevant factors are identified beyond those presented above.

### *4.4. Other factors considered relevant by the Commission*

In the Polish Stability and Development Plan announced on 30 November 2008 the government intends to additionally increase public investment by about 0.3% of GDP, on the top of higher public investment (by more than 1% of GDP) and personal income tax cuts which were planned well ahead of the financial crisis. Most of the specific anti-crisis measures will not have any direct impact on the budget, as they are guarantees for inter-bank or corporate loans. The maximum limit for such guarantees was increased by almost 2 percentage points to about 3% of GDP. The guarantees will have an impact on the

8 The December 2008 convergence programme estimated the 2008 primary balance at −0.3% of GDP and projected that it would increase from 0.1% in 2009 to 0.5% in 2011.

government balance only when they are called. In addition, a capital injection (about 0.15% of GDP) to the state-owned BGK bank is planned, with the intention to increase loans to small and medium-sized enterprises. The measures are targeted towards the source of the economic challenges, as they attempt to restore confidence in the banking sector. Most of these actions are of a temporary nature (additional guarantees to expire at the end of 2009, but may be extended if necessary). They will have both positive short-term (demand side) and long-term (supply side) effects, such as additional public investment in infrastructure.

### *4.5. Systemic pension reforms*

As regards "pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar", Poland introduced in 1999 a fully funded second-pillar. The pension reform is based on defined contributions rather than defined benefits. The reform split the old-age social contribution (19.52% of gross wage) into two components: one (12.22% of the gross wage) retained by the public pay-as-you go system, the so called 1st pillar, and the second part (7.30%) allocated to the private funded system, the so called 2nd pillar, with "open pension funds".. The reform was based on the assumption that the projected low replacement ratios (the ratio of pension to the last wage) under a no-change scenario would encourage people to (i) save some additional amounts in non-mandatory private funds (3rd pillar) and (ii) increase their effective retirement age.

**Table 3: Illustration of the impact of the net cost of pension system reform in Poland**

| % of GDP, excl lines for d. scale | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** |
|---|---|---|---|---|---|---|---|---|
| **Government Balance*** | -4.3 | -3.8 | -1.9 | -3.9 | -6.6 | -7.3 | -- | -- |
| Cost of pension reform (total)** | 2.6 | 2.8 | 2.7 | 2.9 | 3.2 | 3.2 | 3.4 | -- |
| Cost (stage1) | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| Cost (stage2) | | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Cost (stage3) | | | | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Cost (stage4) | | | | | 0.3 | 0.3 | 0.3 | 0.3 |
| Cost (stage5) | | | | | | | 0.2 | 0.2 |
| Degressive scale (stage 1) | 100% | 80% | 60% | 40% | 20% | 0% | 0% | 0% |
| Degressive scale (stage 2) | | 100% | 80% | 60% | 40% | 20% | 0% | 0% |
| Degressive scale (stage 3) | | | | 100% | 80% | 60% | 40% | 20% |
| Degressive scale (stage 4) | | | | | 100% | 80% | 60% | 40% |
| Degressive scale (stage 5) | | | | | | | 100% | 80% |
| Cost to be considered (stage 1) | 2.6 | 2.08 | 1.56 | 1.04 | 0.52 | 0 | 0 | 0 |
| Cost to be considered (stage 2) | | 0.2 | 0.08 | 0.12 | 0.08 | 0.04 | 0 | 0 |
| Cost to be considered (stage 3) | | | | 0.1 | 0.08 | 0.06 | 0.04 | 0.02 |
| Cost to be considered (stage 4) | | | | | 0.3 | 0.24 | 0.18 | 0.12 |
| Cost to be considered (stage 5 ) | | | | | | | 0.2 | 0.16 |
| Cost to be considered (total) | 2.6 | 2.28 | 1.64 | 1.26 | 0.98 | 0.34 | 0.46 | 0.32 |
| **Adjusted government balance***** | -1.7 | -1.5 | -0.3 | -2.6 | -5.6 | -7.0 | | |

* according to the Commission services' spring 2009 forecast
** estimates provided by the Member State
*** government balance adjusted for the costs of the pension reform to be considered

Notes:
Table 3 is only illustrative as the degressive scale clause is not applicable when the deficit is not close to 3% of GDP.
The reform was implemented in 1999, while the costs are calculated as from 2005 in line with the Code of Conduct.

*Source: Commission services' spring 2009 forecast, December 2008 Update of the Convergence Programme*

According to the Polish authorities, the net cost of the pension reform amounts to 2.9% of GDP in 2008, rising to 3.2% of GDP in 2009. However, the cost of the systemic pension reform according to the Pact[9] should only be considered in view of adjusting the government balance in the case where the deficit exceeds the reference value, while remaining close to it. This does not apply therefore to Poland's case.

## 5. CONCLUSIONS

The general government deficit in Poland reached 3.9% of GDP in 2008, above and not close to the 3% of GDP reference value. The breach of the threshold mainly reflects the fact that recent good times were only to a certain extent used as an opportunity to consolidate public finances and undertake deep reforms on the expenditure side, especially in the area of social protection. The reduction of social contributions, an increase in personal income tax reliefs for families, a generous indexation of pensions and of social benefits increased the deficit in 2008. Higher-than-planned intermediate consumption and investment, as well as the drop in revenues at the end of the year due to the economic slowdown, all resulted in a higher than expected deficit both at the central and local government level. The excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. Furthermore, it cannot be considered temporary. This suggests that the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains below the 60% of GDP reference value.

In line with the Treaty, this report has also examined “relevant factors”, which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the case of Poland, on balance, present a mixed picture.

The existence of a severe economic downturn, with potential public finance implications, increases the need to undertake enhanced surveillance under the EDP.

9 EC No 1467/97, Article 2(7), see also the 2007 Public Finance Report (pages 124-129).