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**Assessment of the 2018 Convergence Programme for
Poland**

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION.....	3
2. MACROECONOMIC DEVELOPMENTS	3
3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS.....	5
3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018.....	5
3.2. MEDIUM-TERM STRATEGY AND TARGETS	5
3.3. MEASURES UNDERPINNING THE PROGRAMME.....	8
3.4. DEBT DEVELOPMENTS.....	9
3.5. RISK ASSESSMENT	11
4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT	12
5. FISCAL SUSTAINABILITY	16
6. FISCAL FRAMEWORK	18
7. SUMMARY	19
8. ANNEXES	20

1. INTRODUCTION

On 26 April 2018, Poland submitted its 2018 Convergence Programme (hereafter called Convergence Programme), covering the period 2018-2021. The government approved the Convergence Programme on 23 April 2018.

Poland is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its Medium-Term Budgetary Objective (MTO).

This document complements the Country Report published on 7 March 2018 and updates it with the information included in the Convergence Programme

Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Convergence Programme. In particular, it includes an overview on the medium-term budgetary plans, an assessment of the measures underpinning the Convergence Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long-term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

In 2017, real GDP growth reached 4.6%. The scenario presented in the Convergence Programme assumes a stabilisation of the real GDP growth rate over the Convergence Programme horizon, between 3.8% in 2018 and 3.6% in 2021. Private consumption and investment are projected to be the main growth drivers. Having increased by 4.7% in 2017, private consumption growth is expected to moderate to 3.8% in 2018 and thereafter stabilise at 3.5% per year until 2021 (Table 1). Increasing employment (by 0.7% in 2018 and up to 0.2% in the following years), continuously falling unemployment rate (from 4.9% in 2017 to 3.3% in 2021) and increasing wages (in real terms on average by 3.1% annually during the Convergence Programme horizon) are expected to support private consumption growth. Investment, after its sharp decline in 2016, increased only moderately in 2017 (by 3.4%). According to the Convergence Programme, its growth is expected to reach 9.1% in 2018 and then gradually moderate to 5.7% in 2021. EU funds are set to be an important driver of investment, in particular its public part. Net exports are set to have a negative contribution to GDP growth in 2018 (-0.5 percentage point). However, the growth contribution from net exports is expected to become neutral towards the end of the Convergence Programme horizon. Exports are set to rise in real terms by 6.2% in 2018 and on average by 5.3% annually in the following years. At the same time, imports are expected to increase by 7.6% in 2018 and on average by 5.8% annually afterwards.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	4.6	4.6	4.3	3.8	3.7	3.8	3.7	3.6
Private consumption (% change)	4.7	4.7	4.1	3.8	3.4	3.5	3.5	3.5
Gross fixed capital formation (% change)	3.4	3.4	8.7	9.1	5.3	8.4	6.4	5.7
Exports of goods and services (% change)	8.2	8.2	7.3	6.2	6.2	6.0	5.0	5.0
Imports of goods and services (% change)	8.7	8.7	8.4	7.6	6.3	6.9	5.2	5.2
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	4.0	4.0	4.6	4.3	3.5	4.0	3.7	3.5
- Change in inventories	0.6	0.6	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.1	0.1	-0.3	-0.5	0.2	-0.3	0.0	0.0
Output gap ¹	0.7	0.9	1.5	1.1	1.5	1.1	1.1	1.1
Employment (% change)	1.4	1.4	0.8	0.7	0.3	0.2	0.2	0.0
Unemployment rate (%)	4.9	4.9	4.1	4.2	3.9	3.9	3.6	3.3
Labour productivity (% change)	3.2	3.2	3.5	3.1	3.4	3.5	3.5	3.5
HICP inflation (%)	1.6	1.6	1.3	2.0	2.5	2.3	2.5	2.5
GDP deflator (% change)	1.9	1.9	1.7	2.3	2.4	2.3	2.5	2.5
Comp. of employees (per head, % change)	4.0	6.0	6.8	6.0	7.4	5.4	5.3	5.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.5	1.6	1.5	1.1	1.5	0.8	1.0	0.6
<u>Note:</u>								
¹ In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
<u>Source :</u>								
Commission 2018 spring forecast (COM); Convergence Programme (CP).								

The macroeconomic scenario underpinning the Convergence Programme is marginally more pessimistic than in the 2017 edition of the Convergence Programme. The projected real GDP growth in 2018 is unchanged from the previous Convergence Programme. At the same time, in 2019 and 2020 real GDP is set to grow slower by 0.1 and 0.2 percentage points respectively. According to the previous Convergence Programme, the GDP growth in 2018 was expected to be driven by domestic demand with the change in inventories and net exports having a neutral contribution. In the current version, significantly stronger domestic demand is counterbalanced by a negative contribution of net exports in 2018. In turn, the marginal differences for 2019 and 2020 are the result of a slightly positive contribution of net exports that was foreseen in the previous Convergence Programme, while the current Convergence Programme projects net exports having a neutral contribution to real GDP growth.

While the 2018 real GDP growth rate forecast in the Convergence Programme is lower than that in the Commission forecast, the two are broadly in line for 2019. The difference in 2018 results mainly from a lower (0.3 percentage point) growth projection for domestic demand in the Convergence Programme.

The output gap, as recalculated by the Commission based on the information in the Convergence Programme following the commonly agreed methodology, was 0.9 % of potential GDP in 2017. The output gap increases in 2018 to 1.1 % of potential GDP and then

remains stable over the Convergence Programme horizon. It is lower by 0.1% - 0.3 % of potential GDP than the output gap provided in the actual Convergence Programme, without recalculation.

Consequently, overall the macroeconomic scenario of the Convergence Programme is cautious in 2018 and plausible thereafter.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018

In 2017, the headline general government deficit decreased to 1.7% of GDP from 2.3% of GDP in 2016. This was a significantly better outcome than a deficit of 2.9% of GDP foreseen in the 2017 Convergence Programme. In relation to GDP, both revenue and expenditure were lower than expected in the 2017 Convergence Programme, with expenditure being significantly below the level expected in 2017¹. On the revenue side, the difference of 0.8% of GDP is mainly driven by lower other revenue items; while on the expenditure side, the difference of 2.1% of GDP results mostly from lower investment, social expenditure and intermediate consumption. In 2017, Poland did not implement any significant temporary or one-off measures to meet the fiscal targets.

The Convergence Programme projects the headline general government deficit to reach 2.1% of GDP in 2018. This is below the projection of a 2018 deficit of 2.5% of GDP presented in the 2017 Convergence Programme. As a share of GDP, both 2018 revenue and expenditure are set to be lower than projected in the 2017 Convergence Programme. The difference amounts to 0.6% of GDP and 1.1% of GDP, respectively, for revenue and expenditure. On the revenue side, current taxes on income and wealth are now expected to be higher than foreseen a year ago, driven by a stronger labour market forecast. This is, however, more than offset by a lower forecast of other revenue and of taxes on production and imports, mostly driven by an assumption of slower increases in consumption and public investment compared with the assumption a year ago. On the expenditure side, most major items are currently set to be lower than expected a year ago, with the biggest difference (0.5% of GDP) for social expenditure, driven by labour market developments, and investment. In turn, compensation of employees and other expenditure are currently forecast to be higher as a share of GDP than expected a year earlier. The Convergence Programme does not include any significant temporary or one-off measures that would help meeting the fiscal targets in 2018.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The main objective stated in the Convergence Programme is "*maintaining the stability of public finances while supporting inclusive growth*". This translates into a continuation of major social policies, counterbalanced by further efforts to increase tax collection. The Convergence Programme targets a gradual reduction of the headline general government

¹ The 2017 Convergence Programme included for 2017 a transaction of 2% of GDP related to the cancellation of debt granted to the Social Security Fund between 2009 and 2014. This transaction was neutral for the general government balance as the debtor and the creditor were parts of the general government. Thus, it should have been cancelled out. However, the transaction was presented in the Convergence Programme separately on both – revenue and expenditure – sides, artificially increasing them. For the sake of clarity and factual correctness, in the present comparative analysis, this transaction is treated as if it had been cancelled out already in the 2017 Convergence Programme.

deficit from 2.1% of GDP in 2018 to 0.7% of GDP in 2021 (Table 2). The general government structural balance assumed in the Convergence Programme is set to improve from -2.8% of GDP in 2018 to -1.3% of GDP in 2021. Simultaneously, the general government structural balance recalculated by the Commission on the basis of the information in the Convergence Programme according to the commonly agreed methodology (hereafter called recalculated structural balance) is set to improve from -2.7% of GDP in 2018 to -1.3% of GDP in 2021. There are no major differences between the structural balance cited in the Convergence Programme and the recalculated structural balance.

In order to achieve the budgetary targets, the Convergence Programme specifies measures, such as measures to further increase tax compliance (see section 3.3).

According to the Convergence Programme, the MTO of a structural balance of -1% of GDP will not be reached by 2021. Postponing the achievement of the MTO to the period beyond the Convergence Programme horizon has been a common practice since 2005. Poland would already have reached its MTO, if it had implemented the repeated recommendations of the Council in this respect. The MTO reflects the requirements of the SGP.

The Convergence Programme forecasts the headline general government balance improvement to be faster than its previous edition. The headline general government deficit consolidation path projected in the Convergence Programme that is from 0.1% to 0.6% of GDP faster than expected last year. In relation to GDP, both revenue and expenditure are set to be lower than assumed in the 2017 Convergence Programme, with expenditure expected to be significantly below the levels assumed in 2017.

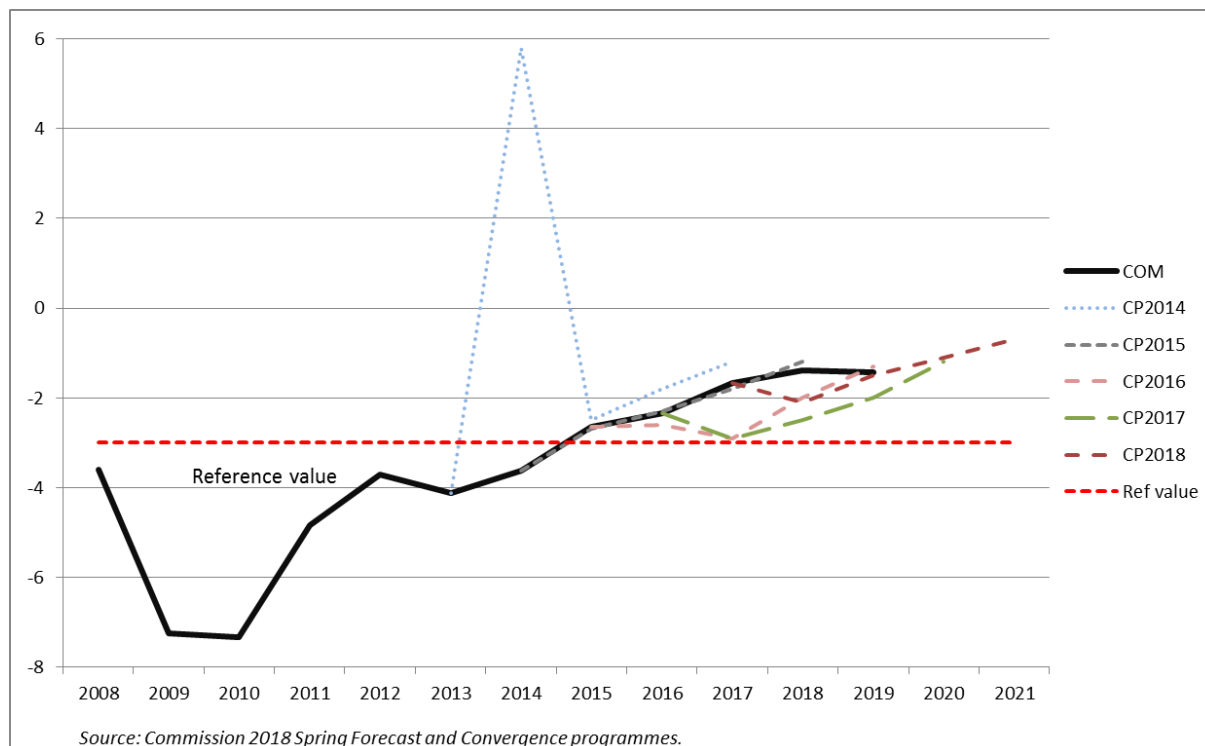
Revenue as a share of GDP is set to grow until 2019, and then to decrease by 2021 to a lower level than recorded in 2017 as a share of GDP. In recent years, Poland has implemented a number of measures to improve tax collection, in particular in the area of indirect taxes. Further measures are set to enter into force in 2018. They partly explain an increase in income from indirect taxes as compared to 2016. The level of income from indirect taxes as a share of GDP is expected to remain broadly stable in the Convergence Programme horizon. At the same time, revenue from direct taxes on income and wealth is expected to increase as a share of GDP, reflecting labour market developments and measures to improve tax collection. In nominal terms, social security contributions are expected to rise slower than GDP towards the end of the Convergence Programme horizon, being – together with other (residual) revenue – the main source of falling revenue-to-GDP ratio.

Expenditure as a share of GDP is set to increase strongly in 2018 driven by rising public investment. Over the period 2019-2021, total expenditure – including public investment – is expected to fall as percentage of GDP, so that by 2021, total expenditure is projected to be significantly lower as a share of GDP than in 2017.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018		2019		2020	2021	Change: 2017-2021
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	39.6	40.3	40.2	40.5	40.3	39.9	39.2	-0.4
<i>of which:</i>								
- Taxes on production and imports	13.7	13.9	14.0	13.6	14.0	13.9	13.8	0.1
- Current taxes on income, wealth, etc.	7.4	7.4	7.5	7.4	7.6	7.7	7.8	0.4
- Social contributions	13.9	14.1	13.8	14.3	13.8	13.6	13.5	-0.4
- Other (residual)	4.6	4.9	4.9	5.1	4.9	4.7	4.1	-0.5
Expenditure	41.2	41.7	42.3	41.9	41.8	41.0	39.8	-1.3
<i>of which:</i>								
- Primary expenditure	39.6	40.2	40.9	40.4	40.3	39.5	38.3	-1.2
<i>of which:</i>								
Compensation of employees	10.1	10.0	9.9	10.1	9.7	9.4	9.2	-0.9
Intermediate consumption	5.7	5.7	5.8	5.7	5.8	5.7	5.7	0.0
Social payments	17.0	17.2	17.1	17.1	16.7	16.4	16.2	-0.8
Subsidies	0.5	0.5	0.6	0.5	0.6	0.6	0.6	0.1
Gross fixed capital formation	3.7	4.4	4.5	4.5	4.6	4.3	3.9	0.2
Other (residual)	2.6	2.4	2.9	2.5	3.0	2.9	2.7	0.3
- Interest expenditure	1.6	1.5	1.4	1.5	1.5	1.5	1.5	-0.1
General government balance (GGB)	-1.7	-1.4	-2.1	-1.4	-1.5	-1.1	-0.7	0.8
Primary balance	-0.1	0.1	-0.6	0.1	0.0	0.4	0.9	0.8
One-off and other temporary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	-1.7	-1.4	-2.1	-1.4	-1.5	-1.1	-0.7	0.8
Output gap ¹	0.7	1.5	1.1	1.5	1.1	1.1	1.1	0.1
Cyclically-adjusted balance ¹	-2.0	-2.2	-2.7	-2.2	-2.1	-1.7	-1.3	0.9
Structural balance²	-2.0	-2.2	-2.7	-2.2	-2.1	-1.7	-1.3	0.9
Structural primary balance ²	-0.5	-0.7	-1.3	-0.7	-0.6	-0.2	0.2	0.8
<u>Notes:</u>								
¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.								
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<u>Source:</u>								
Convergence Programme (CP); Commission 2018 spring forecasts (COM); Commission calculations.								

Figure 1: Government balance projections in successive programmes (% of GDP)



3.3. MEASURES UNDERPINNING THE PROGRAMME

The main objective stated in the Convergence Programme is to maintain the stability of public finances and support inclusive growth. The Convergence Programme aims also at further increasing tax collection. To achieve the above, the Convergence Programme lists several measures to be implemented over the Convergence Programme horizon. Achieving the agenda presented in the Convergence Programme requires an effective implementation of these measures.

As in the 2017 edition, the main focus of the Convergence Programme on the revenue side is placed on increasing tax compliance and revenue. A number of measures are set to be implemented in the area of VAT in 2018. They will complement those that entered into force in previous years, in particular in 2016 and 2017. For instance, an analysis of banking information and an implementation of the split payment scheme are expected to increase compliance in the area of indirect taxes. An extension of the already implemented measures (standard audit file) is set to further raise VAT revenue. Additionally, the Convergence Programme assumes a further extension of the temporary application of higher VAT rates, which according to the current legislation in force are set to expire at the end of 2018. Other measures aim at increasing revenue from direct taxes, in particular by changing the rules used to optimise taxes. The authorities expect that the planned and already implemented measures to increase compliance will generate additional revenue amounting to some 0.5% of GDP in 2018 and an additional 0.3% of GDP in 2019. The Convergence Programme also lists a number of other measures, aiming for instance at improving compliance in the area of social security contributions, but without a precise estimation of their impact.

The principal measures on the expenditure side concern the continuation of the main recent social policies of the government (as the child benefit in force since early 2016 and lowering of the statutory retirement age since October 2017). The Convergence Programme also explicitly lists an introduction of the employees savings schemes, which is set to cost up to 0.1% of GDP in 2019 and 2020. At the current stage, however, the relevant laws were not adopted.

The programme assumes that the currently binding expenditure rule will remain in force and will be respected. The expenditure planned in the programme for the period 2019 – 2021 reaches the maximum expenditure level allowed by the rule.

The Commission forecast for 2019 was prepared under the no-policy-change assumption. As a result, it does not include the expected effects of any non-legislated fiscal measures which have not yet been specified in sufficient detail.

3.4. DEBT DEVELOPMENTS

General government debt, after its increase to 54.2% of GDP in 2016, declined strongly to 50.6% of GDP in 2017. According to the Convergence Programme, general government debt is expected to further gradually decrease to 46.0% of GDP at the end of 2021 (Figure 2). The main driving forces of the debt dynamics are the headline deficit improvement and nominal GDP growth.

Previous editions of the Convergence Programme have had a tendency to underestimate the developments in general government debt, in particular in timeframes longer than one year. Around one third of the Polish sovereign debt is denominated in foreign currencies. As a consequence, the long-term forecasts of the debt level are subject to significant uncertainty. With the assumption of the PLN being stronger against the EUR by around 1% in the scenario underlying the Convergence Programme, the Convergence Programme assumption on the PLN/EUR exchange rate are broadly in line with the Commission forecast.

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021
			COM	CP	COM	CP	CP	CP
Gross debt ratio¹	53.0	50.6	49.6	50.4	49.1	50.4	48.7	46.0
Change in the ratio	0.0	-3.5	-1.0	-0.2	-0.6	0.0	-1.7	-2.7
<i>Contributions² :</i>								
1. Primary balance	1.2	0.1	-0.1	0.6	-0.1	0.0	-0.4	-0.9
2. “Snow-ball” effect	0.4	-1.8	-1.4	-1.4	-1.4	-1.4	-1.4	-1.2
<i>Of which:</i>								
Interest expenditure	2.1	1.6	1.5	1.5	1.5	1.5	1.5	1.6
Growth effect	-1.3	-2.4	-2.1	-1.8	-1.7	-1.8	-1.8	-1.7
Inflation effect	-0.4	-1.0	-0.8	-1.1	-1.1	-1.1	-1.1	-1.1
3. Stock-flow adjustment	-1.5	-1.8	0.5	0.6	0.9	1.4	0.1	-0.6
<i>Of which:</i>								
Cash/accruals diff.				0.3		0.6	-0.2	-0.6
Acc. financial assets				0.4		0.8	0.3	0.0
<i>Privatisation</i>				0.0		0.0	0.0	0.0
Val. effect & residual				-3.0		-2.8	-2.9	-2.8

Notes:

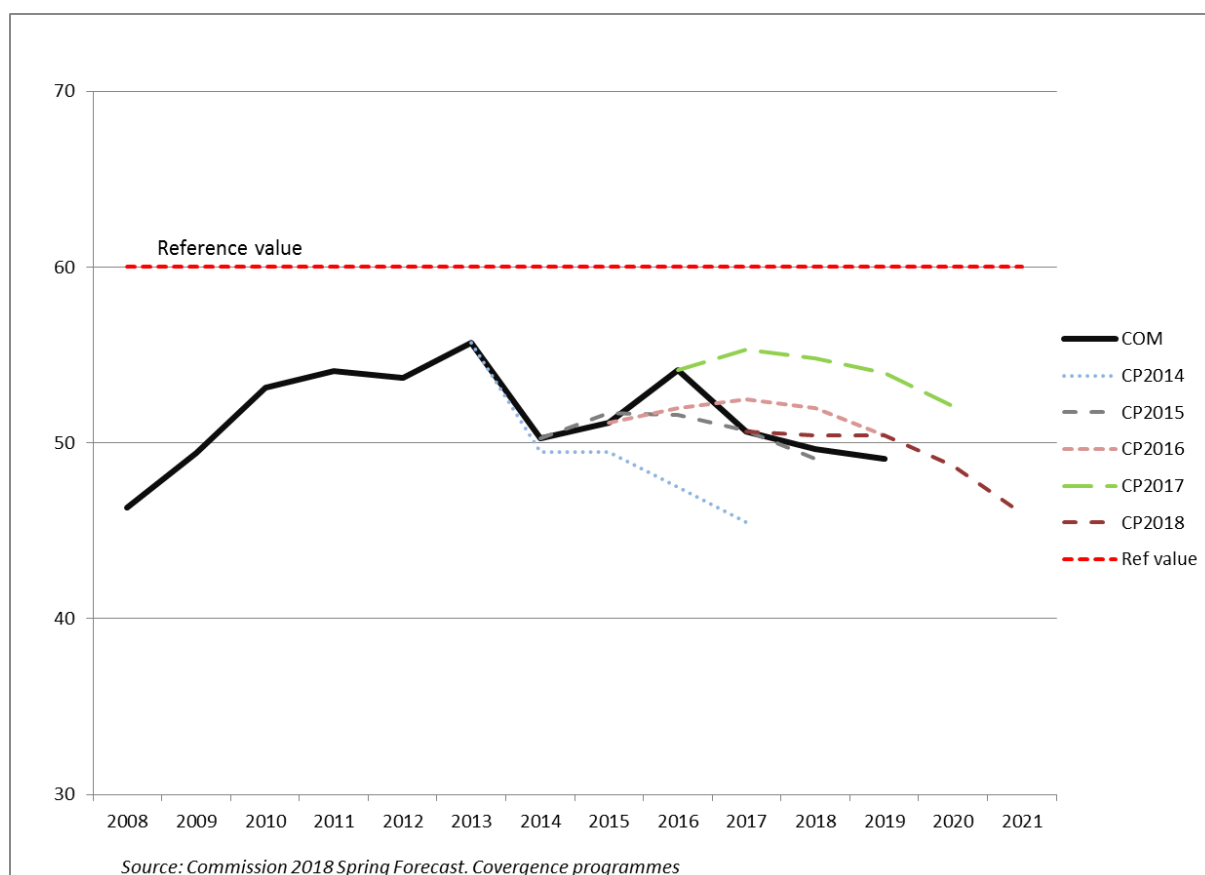
¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Commission 2018 spring forecast (COM); Convergence Programme (CP), Commission calculations.

Figure 2: Government debt projections in successive programmes (% of GDP)



3.5. RISK ASSESSMENT

As mentioned in the section 2, the Convergence Programme assumes a lower 2018 real GDP growth rate than the Commission forecast. Similarly, the deficit reduction path in the Convergence Programme is slower than in the Commission forecast, particularly in 2018. The difference amounts to 0.7% of GDP in 2018 and 0.1% of GDP in 2019. Cautious macroeconomic projections in the Convergence Programme for 2018 and the assumed full execution of central government expenditures imply that the 2018 headline general government deficit may turn out to be lower than the target laid down in the Convergence Programme.

For 2019, the macroeconomic scenario of the Convergence Programme is plausible. Lower economic growth constitutes a key downside risk to the headline general government deficit targets as laid down in the Convergence Programme. On the revenue side, the higher tax collection projected in the Convergence Programme requires effective implementation of several already introduced measures, as well as some new ones. The details of some of the specific measures are yet to be worked out and the size of their impact on tax collection remains uncertain. On the expenditure side, the Convergence Programme envisages higher public investment in 2019 than projected in the Commission forecast. At the same time, the Convergence Programme assumes lower spending on social transfers and on compensation of employees than the no-policy-change Commission forecast. Overall, the general government headline deficit assumed in the Convergence Programme (1.5% of GDP) is in line with the deficit forecast by the Commission (1.4% of GDP).

In general, fiscal risks appear very low in 2018 and limited thereafter.

The Commission forecast shows a lower debt by 0.8% of GDP and 1.3% of GDP in 2018 and 2019 respectively. The risks to the debt scenario presented in the Convergence Programme are mainly related to the significant share of debt denominated in foreign currencies. As a result, future debt to GDP ratio will be affected by exchange rate fluctuations.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council Recommendations addressed to Poland

On 11 July 2017, the Council addressed recommendations to Poland in the context of the European Semester. In particular, in the area of public finances the Council recommended to Poland to "pursue a substantial fiscal effort in 2018, in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Poland's public finances."

The Council noted that "in 2018, in light of its fiscal situation, Poland is expected to further adjust towards its medium-term budgetary objective of a structural deficit of 1 % of GDP. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure² that does not exceed 3.7 % in 2018. It would correspond to a structural adjustment of 0.5 % of GDP. (...) As recalled in the Commission Communication on the 2017 European Semester accompanying these country-specific recommendations, the assessment of 2018 budget outcomes will need to take due account of the goal to achieve a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of Poland's public finances."

Poland is subject to the preventive arm of the SGP.

For 2017, Poland was recommended to achieve an annual fiscal adjustment of 0.5% of GDP towards the MTO. This corresponds to a real growth rate of net primary government expenditure that does not exceed 1.8%. In 2017, based on outturn data, the real growth rate of net primary government expenditure exceeded the expenditure benchmark by almost 0.5% of GDP. This points to some deviation. At the same time, the structural balance remained broadly at an unchanged level as compared to 2016. Therefore, the reading of the structural balance also points to a deviation of 0.5% from the recommended adjustment path towards the MTO. However, the reading of this indicator shows a deviation marginally (by less than 0.02% of GDP) above 0.5% of potential GDP. Overall, there is no material difference in the reading between both indicators – the difference is significantly below 0.1% of GDP. Over 2016 and 2017 taken together, while the average deviation based on the structural balance points to significant deviation, the expenditure benchmark pillar points to some deviation. The different reading of both indicators is driven by the 2016 difference, in particular the differences in inflation used for the calculation of indicators, different potential growth and impact of investment developments. Considering the above, the overall assessment over two years points to some deviation. Considering the above, based on the outturn data and the

² Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

Commission 2018 forecast, the ex-post assessment suggests some deviation from the adjustment path towards the MTO in 2017.

For 2018, Poland was recommended to adjust towards the MTO. This adjustment translates into a requirement of a nominal growth rate of net primary government expenditure that does not exceed 3.7%³ in 2018. This would correspond to a structural adjustment of 0.5% of GDP. Based on the information provided in the Convergence Programme, the nominal growth rate of net primary government expenditure is expected to exceed in 2018 the applicable expenditure benchmark, leading to a negative impact of 1.0% of GDP on the underlying fiscal position. At the same time, according to the Convergence Programme, the recalculated structural balance is set to worsen by 0.6% of GDP. This would lead to a deviation by 1.1% of GDP. Simultaneously, based on the Commission forecast, the nominal growth rate of net primary government expenditure is set to exceed the expenditure benchmark by 0.5% of GDP, pointing to a risk of some deviation. In turn, the structural balance points to a risk of a significant deviation (0.6% of GDP). There are no major differences in the reading between both indicators according to the Commission forecast. The difference between the indicators calculated based on the Commission forecast and based on the Convergence Programme results mainly from an assumption of a higher deficit and expenditure made in the Convergence Programme (as mentioned above, the Convergence Programme scenario is based on an assumption of a full execution of allowable expenditure limits). Considering the two-year averages, both the expenditure benchmark and the structural balance point to a risk of a significant deviation based on the Commission forecast. Thus, following an overall assessment, a significant deviation from the adjustment path towards the MTO is to be expected in 2018 putting at risk compliance with the requirements of the preventive arm of the Pact.

In 2019, in view of Poland's projected output gap of 1.5% and the projected GDP growth equalling the potential GDP growth, the commonly agreed adjustment matrix under the Stability and Growth Pact requires that the nominal growth rate of net primary government expenditure does not exceed 4.2%, corresponding to an annual structural adjustment of 0.6% of GDP. According to the Convergence Programme, the nominal growth rate of net primary government expenditure would be lower in 2019 than the applicable expenditure benchmark, leading to a positive impact of 0.3% of GDP on the underlying fiscal position. Simultaneously, the structural balance would improve by 0.6% of GDP. This change would be exactly in line with the required adjustment. Following the no-policy-change assumption, based on the Commission forecast, in 2019, both indicators point to a risk of a significant deviation. The deviation from the recommended path towards the MTO as measured by the expenditure benchmark is of 1.1% of GDP, while the deviation as measured by the structural benchmark amounts to 0.6% of GDP. The difference in the reading between both indicators results mainly from the revenue windfalls and the difference in the growth potential estimations underlying the two indicators. The difference between the calculations based on the Commission forecast and the Convergence Programme results from the fact that the Commission forecast for 2019 is based on the no-policy-change assumption and from the fact that the Convergence Programme assumes a very strong fiscal adjustment between 2018 and 2019. Considering the two-year averages, both the expenditure benchmark and the structural

³ As part of the agreement on the EFC Opinion on "*Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm*", which was adopted by the Economic and Financial Committee on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

balance point to a risk of a significant deviation based on the Commission forecast. Overall, following an overall assessment, a significant deviation from the adjustment path towards the MTO is to be expected in 2019 putting at risk compliance with the requirements of the preventive arm of the Pact.

The Country-Specific Recommendation adopted by the Council on 11 July 2017 mentioned that the assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances.

The Commission has carried out a qualitative assessment of the strength of the economic conditions in Poland while giving due consideration to its sustainability challenges. Poland does not face short-term sustainability challenges. Moreover, government debt was at 50.6% of GDP in 2017 and sustainability risks are considered to be low in the medium term. Poland did not undergo a recession during the global financial crisis and experienced sustained and strong economic growth over recent years. Its GDP grew by nearly 33% in real terms between 2008 and 2017. Since 2013, the output gap has been gradually closing. It turned positive in 2017 and is expected to grow by additional 0.8 percentage point in 2018. On spare capacity, between 2007 and 2017, Poland was one of two countries with the strongest decline in the unemployment rate in the EU. In the same period, employment rate growth was among the fastest in the EU. Currently, Poland has one of the lowest unemployment rates in the EU, while its employment rate is gradually catching up to the EU average. Between the years preceding the crisis outbreak and 2016, the rate of capacity utilisation in manufacturing and the Economic Sentiment Indicator (ESI) in construction increased much more strongly than in most other EU countries. However, in the same period, the ESI in services and gross fixed capital formation declined (although the decline was moderate in comparison to other EU countries). The decline of the latter indicators could result from their relatively high levels in the years preceding and immediately following Poland's EU accession. In terms of price stability, following a period of deflation, Poland's headline inflation has turned positive since late 2016. Annual inflation has remained below the target of the National Bank of Poland. Looking ahead, however, inflation is expected to gradually rise. Core inflation is projected to follow a similar trend.

Overall, the framework indicates that the economic conditions in 2018 appear strong. On this basis, it is concluded that no additional elements in that regard need to be taken into account.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2017	2018		2019	
Initial position¹					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance ² (COM)	-2.0	-2.2		-2.2	
Structural balance based on freezing (COM)	-2.1	-2.2		-	
Position vis-a-vis the MTO³	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	2017	2018		2019	
	COM	CP	COM	CP	COM
Structural balance pillar					
Required adjustment ⁴	0.5	0.5		0.6	
Required adjustment corrected ⁵	0.5	0.5		0.6	
Change in structural balance ⁶	0.0	-0.6	-0.1	0.6	0.0
<i>One-year deviation from the required adjustment⁷</i>	-0.5	-1.1	-0.6	0.0	-0.6
<i>Two-year average deviation from the required adjustment⁷</i>	-0.4	-0.8	-0.6	-0.5	-0.6
Expenditure benchmark pillar					
Applicable reference rate ⁸	1.8	3.7		4.2	
One-year deviation adjusted for one-offs ⁹	-0.5	-1.0	-0.5	0.3	-1.1
Two-year deviation adjusted for one-offs ⁹	-0.2	-0.7	-0.5	-0.4	-0.8
<i>PER MEMORIAM: One-year deviation¹⁰</i>	-0.5	-1.0	-0.5	0.3	-1.1
<i>PER MEMORIAM: Two-year average deviation¹⁰</i>	-0.2	-0.7	-0.5	-0.4	-0.8
Notes					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.					
² Structural balance = cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1. Ex post assessment (for 2017) is carried out on the basis of Commission 2018 spring forecast.					
⁷ The difference of the change in the structural balance and the corrected required adjustment.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
¹⁰ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<i>Source:</i>					
<i>Convergence Programme (CP); Commission 2018 spring forecast (COM); Commission calculations.</i>					

5. FISCAL SUSTAINABILITY

Poland does not appear to face fiscal sustainability risks in the short run.⁴

Based on Commission 2018 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 50.6% of GDP in 2017, is expected to rise (to 53.5% in 2028, thus remaining below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2028. The sensitivity analysis indicates similar risks.⁵ Overall, this highlights low risks from the debt sustainability analysis for Poland in the medium term. The full implementation of the Convergence Programme would put debt on a slightly decreasing path, reaching 45.9% of GDP by 2028 and remaining below the 60% of GDP reference value.

The medium-term fiscal sustainability risk indicator S1⁶ at 0.0 percentage points of GDP, shows that no upfront fiscal adjustment effort is required to bring the debt-to-GDP ratio to 60 % by 2032. Thus, it indicates low risks in the medium term. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -1.4 percentage points of GDP, leading to a similar medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, low. Fully implementing the fiscal plans in the Convergence Programme would decrease those risks further.

The long-term fiscal sustainability risk indicator S2 is at 2.6 percentage points of GDP. In the long-term, Poland therefore appears to face medium fiscal sustainability risks, primarily related to the initial budgetary position and the projected ageing costs, contributing with 1.5 percentage points of GDP and 1.1 percentage points of GDP respectively. Full implementation of the programme would nonetheless put the S2 indicator at 1.7 percentage points of GDP, leading to a lower long-term risk.⁷

These assessments assume unchanged policies, including concerning the pension system. However, also in light of the recent reduction of the statutory retirement age, the current pension system implies that pension adequacy will be falling significantly. Depending on policy choices concerning minimum pensions an increasing proportion of pensioners might receive only minimum pensions, currently standing at 1,030 PLN per month. These developments might create pressure to put additional fiscal means into the pension system, increasing fiscal sustainability risks.

⁴ This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 5 for a definition of the indicator.

⁵ Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).

⁶ See the note to Table 5 for a definition of the indicator.

⁷ The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

Table 5: Sustainability indicators

<i>Time horizon</i>	Commission Scenario		Convergence Programme Scenario	
Short Term	LOW risk			
S0 indicator ^[1]	0.2			
Fiscal subindex	0.1	LOW risk		
Financial & competitiveness subindex	0.3	LOW risk		
Medium Term	LOW risk			
DSA ^[2]	LOW risk			
S1 indicator ^[3]	0.0	LOW risk	-1.4	LOW risk
<i>of which</i>				
Initial Budgetary Position	0.5		-0.4	
Debt Requirement	-0.8		-1.3	
Cost of Ageing	0.3		0.3	
<i>of which</i>				
Pensions	0.1		0.0	
Health-care	0.1		0.1	
Long-term care	0.1		0.1	
Other	0.1		0.1	
Long Term	MEDIUM risk		LOW risk	
S2 indicator ^[4]	2.6		1.7	
<i>of which</i>				
Initial Budgetary Position	1.5		0.6	
Cost of Ageing	1.1		1.1	
<i>of which</i>				
Pensions	-0.3		-0.5	
Health-care	0.6		0.6	
Long-term care	0.5		0.5	
Other	0.3		0.4	

Source: Commission services; 2018 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2018 forecast covering until 2019 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.

6. FISCAL FRAMEWORK

Based on the information provided in the Convergence Programme, the past and planned fiscal performance in Poland appears to comply with the requirements of the applicable national numerical fiscal rules.

The 2017 budget was the third consecutive budget for which Poland applied an expenditure rule covering nearly the entire general government sector. The Public Finance Act requires an ex-post compliance assessment to be included in the report on the execution of the budget law that is to be submitted by the Government to the Parliament and the Supreme Audit Office by 31 May. This assessment will be discussed in the Supreme Audit Office report on budget implementation. There is no assessment of the ex-post compliance with the expenditure rule in the Convergence Programme. Given that the expenditure rule does not cover the entire general government sector (although its coverage is close to this aggregate), it is not possible to provide an assessment for 2017 without the information to be published by the end of May.

The applicable debt ceilings defined in the Constitution and in the Public Finance Act have been respected in 2017. In addition, the 2017 central government deficit was lower than the limit defined in the 2017 budget law. Both the 2017 headline and the structural general government deficits (1.7% of GDP and 2% of potential GDP respectively) were also lower than projected in the previous year's Convergence Programme.

According to the Convergence Programme, the 2018 fiscal plans and the targets for the outer years are consistent with the limits defined by the expenditure rule. The expenditure rule was also respected in the 2018 budget law. The evolution of the debt-to-GDP ratio in the Convergence Programme also respects the debt ceilings defined in the Constitution and in the Public Finance Act.

Poland is the only EU Member State that has not established and does not have plans to establish an independent fiscal council. While some functions typically assigned to fiscal councils are performed by several other institutions, this scattered approach may undermine their impact. A fiscal council could be involved in the preparation or endorsement of macroeconomic forecasts and the analysis of the long-term sustainability of public finances. Currently, the macroeconomic forecasts underpinning the Convergence Programme are produced by the government without the involvement of independent stakeholders. Also, there is no analysis of the long-term sustainability of public finances. However, external assessments take place in the case of the macroeconomic forecasts underpinning annual budgets. Ex-ante this is carried out by the Monetary Policy Council and ex-post by the Supreme Audit Office.

7. SUMMARY

In 2017, Poland did not achieve the MTO. The structural balance of 2% of GDP remained unchanged as compared to 2016, which is not in line with the required adjustment towards the MTO. On the other hand, the growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark rate by nearly 0.5% of GDP. Following an overall assessment, this points to some deviation from the recommended adjustment path towards the MTO.

Poland plans a growth rate of government expenditure, net of discretionary revenue measures, which exceeds the applicable expenditure benchmark rate in both 2018 and 2019. Based on the Commission forecast, Poland also plans a slight worsening and then stabilisation of the structural balance in 2018-2019. Poland doesn't plan to reach the MTO in the Convergence Programme horizon. This path would imply a significant deviation from the required adjustment path towards the MTO in both 2018 and 2019.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	3.3	4.8	3.0	3.8	3.0	4.6	4.3	3.7
Output gap ¹	-2.9	0.7	0.2	-0.6	-0.6	0.7	1.5	1.5
HICP (annual % change)	4.3	2.8	2.2	-0.7	-0.2	1.6	1.3	2.5
Domestic demand (annual % change) ²	2.5	4.8	2.4	3.3	2.2	4.7	4.8	3.6
Unemployment rate (% of labour force) ³	18.7	11.3	9.8	7.5	6.2	4.9	4.1	3.9
Gross fixed capital formation (% of GDP)	19.8	21.3	19.9	20.1	18.0	17.7	18.5	18.8
Gross national saving (% of GDP)	16.9	17.6	17.9	20.7	20.4	20.4	20.6	20.6
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-4.7	-4.0	-4.7	-2.6	-2.3	-1.7	-1.4	-1.4
Gross debt	41.4	46.7	53.4	51.1	54.2	50.6	49.6	49.1
Net financial assets	-21.2	-19.1	-34.4	-42.0	-43.1	n.a	n.a	n.a
Total revenue	39.6	40.3	38.8	38.9	38.8	39.6	40.3	40.5
Total expenditure	44.4	44.3	43.5	41.6	41.1	41.2	41.7	41.9
<i>of which: Interest</i>	2.9	2.3	2.4	1.8	1.7	1.6	1.5	1.5
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-2.1	2.2	6.7	8.0	5.7	6.1	5.9	6.1
Net financial assets; non-financial corporations	-73.8	-84.4	-79.7	-82.2	-84.8	n.a	n.a	n.a
Net financial assets; financial corporations	8.6	-7.5	-4.1	1.5	1.7	n.a	n.a	n.a
Gross capital formation	12.9	12.4	10.9	11.6	11.8	11.7	11.7	11.8
Gross operating surplus	18.0	22.8	24.6	25.9	24.8	24.9	24.6	24.8
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	3.3	-2.2	-3.0	-2.8	-1.5	-3.0	-3.0	-3.2
Net financial assets	47.6	55.5	52.0	60.6	65.4	n.a	n.a	n.a
Gross wages and salaries	34.0	32.6	31.9	31.2	31.8	31.9	32.5	33.1
Net property income	5.4	3.6	3.1	2.5	2.6	2.3	2.1	2.0
Current transfers received	20.2	17.4	16.9	16.7	17.6	17.4	17.4	17.3
Gross saving	8.1	3.2	1.6	1.4	2.7	1.0	1.1	0.8
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-3.6	-4.0	-1.0	2.6	1.7	1.5	1.5	1.5
Net financial assets	39.3	56.2	67.0	62.9	61.8	n.a	n.a	n.a
Net exports of goods and services	-3.7	-2.5	-0.2	3.1	4.0	4.1	3.8	3.8
Net primary income from the rest of the world	-1.0	-2.4	-3.6	-3.6	-3.7	-4.0	-4.1	-4.2
Net capital transactions	0.0	0.8	1.9	2.4	0.8	0.8	1.2	1.5
Tradable sector	50.9	50.8	51.1	51.3	51.6	52.0	n.a	n.a
Non tradable sector	37.5	37.1	37.3	37.4	36.8	36.0	n.a	n.a
<i>of which: Building and construction sector</i>	6.7	7.0	7.1	7.1	6.2	6.5	n.a	n.a
Real effective exchange rate (index, 2000=100)	100.2	100.6	96.0	91.6	89.5	92.1	96.1	98.2
Terms of trade goods and services (index, 2000=100)	95.2	99.2	98.8	102.5	103.0	103.3	103.5	103.5
Market performance of exports (index, 2000=100)	76.1	88.5	106.2	114.8	120.1	123.5	125.7	127.6
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source:								
AMECO data, Commission 2018 spring forecast								