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Assessment of the 2015 Convergence Programme for

POLAND

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Poland's April 2015 Convergence Programme (hereafter called Convergence Programme), which was submitted to the Commission on 30 April and covers the period 2014-2018. It was approved by the government and presented to the national parliament for a debate without a vote.

Poland is currently subject to the corrective arm of the Stability and Growth Pact. The Council opened the Excessive Deficit Procedure for Poland on 7 July 2009. The country is recommended to correct the excessive deficit by 2015. The year following the correction of the excessive deficit, Poland will be subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO.

This document complements the Country Report published on 26 February 2015 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 2015 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 Stability and Growth Pact, 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 and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

The 2015 Convergence Programme presents a macroeconomic scenario where real GDP growth gradually increases from 3.4% in 2015 to 4% in 2018. The main driver of the projected growth path is domestic demand, in particular private consumption and investment. The projected solid growth rate of private consumption reflects favourable developments in households' disposable income on the back of increasing employment (1.1% in 2015 and just above or at 0.5% afterwards) and real compensation of employees (3.6% in 2015 and around 2% in the outer years). As employment is expected to grow faster than the labour force, the rate of unemployment is expected to decrease from 8.2% in 2015 to 6.5% in 2018. Real unit labour costs are projected to increase by more than 2% in 2015 as wage costs are set to exceed gains in labour productivity. However, this loss in cost competitiveness is projected to be counterbalanced by improvements of around 0.7% in 2016 and beyond. The 2015 Convergence Programme expects private investment to strongly increase (by 6-7%) over the programme period, partly on account of favourable financial conditions. These domestic factors leading to enhanced economic growth are expected to be partly offset by trade developments, mainly in 2015.

Regarding the cyclical position of the economy, the output gap, as recalculated by Commission based on the information in the programme, following the commonly agreed

methodology, is slightly negative in 2015-2017 – when it is estimated to narrow from -0.9% to -0.3% – and moves into positive territory (+0.3%) in 2018.

Compared to the previous year, the 2015 Convergence Programme expects slightly lower real GDP growth. In 2015, the downward revision is explained by a negative contribution of net exports. In the outer years, the structure of real GDP growth has been reviewed: the 2015 Convergence Programme projects a faster recovery of net exports alongside lower domestic demand, in particular less dynamic private investment. Importantly, the 2015 Convergence Programme projects a significantly lower nominal GDP path in view of the substantial downward revision of the inflation outlook.

The macro economic scenario underpinning the 2015 Convergence Programme is very similar to the Commission 2015 spring forecast. The programme forecasts marginally higher real GDP growth (by 0.1 pp.) in 2015 and a more substantial difference of 0.4 pp. in 2016, mainly on account of more favourable assumptions for net exports. Moreover, in 2016, the Commission projects a non-negligible temporary drop in investment growth due to the transition to the EU's 2014-2020 Multi-annual Financial Framework, which will affect the absorption of EU structural funds. As far as the main tax bases are concerned, the programme's projection for private consumption is plausible, while it is favourable for compensation of the employees.

Overall, the macroeconomic outlook of the 2015 Convergence Programme is plausible in 2015 and favourable thereafter.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	3.4	3.4	3.3	3.4	3.4	3.8	3.9	4.0
Private consumption (% change)	3.0	3.0	3.4	3.4	3.6	3.7	3.8	3.8
Gross fixed capital formation (% change)	9.2	9.2	6.9	6.9	5.0	6.1	6.5	6.9
Exports of goods and services (% change)	5.7	5.7	6.3	5.7	6.7	5.9	5.6	5.5
Imports of goods and services (% change)	9.1	9.1	8.5	6.9	7.7	6.1	5.7	5.7
Contributions to real GDP growth:								
- Final domestic demand	4.4	4.4	4.1	3.9	3.7	3.7	3.9	4.0
- Change in inventories	0.4	0.4	0.0	0.0	0.0	0.1	0.0	0.0
- Net exports	-1.4	-1.4	-0.9	-0.6	-0.4	-0.1	-0.1	-0.1
Output gap[1]	-0.5	-0.6	-0.6	-0.9	-0.6	-0.7	-0.3	0.3
Employment (% change)	1.7	1.9	0.7	1.1	0.6	0.7	0.6	0.5
Unemployment rate (%)	9.0	9.0	8.4	8.2	7.9	7.6	7.0	6.5
Labour productivity (% change)	1.7	1.5	2.5	2.4	2.7	3.1	3.3	3.4
HICP inflation (%)	0.1	0.1	-0.4	-0.2	1.1	1.7	1.8	2.5
GDP deflator (% change)	0.5	0.6	0.4	0.5	1.0	1.3	1.7	2.5
Comp. of employees (per head, % change)	-0.3	-0.7	2.0	3.4	3.3	3.5	3.8	4.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.1	1.0	0.9	0.5	-0.1	0.5	0.5	0.3

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by the Commission on the basis of the programme scenario, using the commonly agreed methodology.

Source:

Commission 2015 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

The general government deficit amounted to 3.2% of GDP in 2014. Poland's 2014 Convergence Programme projected a surplus of 5.8% of GDP in 2014. However, the last year's projection included the transfer of assets from the second pillar pension system due to the reversal of the 1999 systemic pension reform. Under the statistical rules in force at the time (ESA-95), such transfers counted as general government revenue. Under the rules in force since autumn 2014 (ESA-2010), such asset transfers no longer count as revenue. Therefore, one should compare the 2014 deficit outturn with the general government deficit target from the 2014 Convergence Programme net of asset transfers. This gives a deficit target of 3.5% of GDP in the previous year’s programme, somewhat higher than the 2014 outturn of 3.2% of GDP. This difference is mostly due to other statistical changes linked to the switch to the new ESA-2010 system, in particular the inclusion in the general government sector of some entities (Bank Guarantee Fund, railway company PKP PLK S.A.) which were classified outside it under ESA-95.

3.2. Target for 2015 and medium-term strategy

The target for 2015

The programme targets a general government deficit of 2.7% of GDP in 2015, up from 2.5% of GDP in last year`s Convergence Programme. The difference is mostly due to the new European statistical rules. Without the estimated effect of the transfer of assets from the second pillar pension system to the government-run first pillar in the context of the 2013 amendment to the 1999 pension reform, the deficit target in the 2014 Convergence Programme would amount to 2.7% of GDP, i.e. it would be the same as in the current one. The programme's deficit target for 2015 is very close the one in the Commission 2015 spring forecast of 2.8% of GDP. The difference of 0.1 pp. is due to a slightly more cautious growth forecast by the Commission.

The programme targets a structural deficit (recalculated following the commonly agreed methodology) of 2.4% of GDP in 2015, which is similar to the projection in the Commission 2015 spring forecast of a structural deficit of 2.5% of GDP in that year. This implies an improvement in the structural balance by 0.3% of GDP in 2015 compared to 2014.

The medium-term strategy

The programme targets a gradual reduction of the headline deficit to 1.2% of GDP in 2018 and to achieve the medium-term budgetary objective (MTO) of a structural deficit of 1% of GDP in 2019, i.e. a year after the period covered by the programme.

While the MTO of -1% of GDP in structural terms is unchanged compared to the 2014 Convergence Programme, Poland plans to achieve it one year later than planned a year ago. The MTO is more stringent than what the Stability and Growth Pact requires; the minimum MTO for Poland is -2% of GDP.

The programme plans a gradual reduction of the deficit, both in nominal and structural terms. The programme targets are less stringent than those put forward by Poland in its 2014 programme. This is mostly due to more cautious projections of both real GDP growth and inflation. Moreover, as explained above, due to the introduction of new statistical rules, the transfer of assets from the second pillar pension system does no longer count as government revenue any longer. The planned fiscal adjustment is concentrated on the expenditure side, with public expenditure falling as a share of GDP over the programme horizon. The downward trend in the expenditure ratio reflects the expected effect of the national expenditure rule (introduced to the Polish fiscal framework in 2013).

In 2016, the deficit target reported in the programme is 2.3 % of GDP, which compares to a forecast of 2.6% of GDP in the Commission 2015 spring forecast. The difference is mostly due to two factors. First, following the usual no-policy-change assumption for the years without a budget, the Commission did not take into account the assumed effects of the domestic expenditure rule. Legislative or administrative measures need to be taken to make the expenditure rule work. Moreover, the Commission projectes lower tax revenues, due to the slightly more cautious macroeconomic forecast for 2016.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	Change: 2014-2018
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**38.6**	**38.9**	**38.8**	**38.7**	**38.5**	**37.9**	**37.8**	**-0.8**
of which:								
- Taxes on production and imports	12.7	12.8	12.8	12.7	12.9	12.4	12.3	-0.4
- Current taxes on income, wealth, etc.	7.0	7.0	7.0	7.0	7.1	7.1	7.1	0.1
- Social contributions	13.2	13.4	13.5	13.4	13.4	13.2	13.1	-0.1
- Other (residual)	5.8	5.7	5.5	5.5	5.1	5.2	5.3	-0.5
Expenditure	**41.8**	**41.7**	**41.5**	**41.3**	**40.8**	**39.8**	**39.0**	**-2.8**
of which:								
- Primary expenditure	39.9	39.9	39.7	39.6	39.3	38.3	37.5	-2.4
of which:								
Compensation of employees	10.2	10.1	10.0	10.1	9.7	9.4	9.0	-1.2
Intermediate consumption	6.0	6.1	6.0	6.1	5.9	5.8	5.7	-0.3
Social payments	16.3	16.2	16.2	16.1	16.1	15.8	15.4	-0.9
Subsidies	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.0
Gross fixed capital formation	4.4	4.6	4.5	4.5	4.5	4.3	4.2	-0.2
Other (residual)	2.4	2.3	2.4	2.3	2.5	2.5	2.5	0.1
- Interest expenditure	2.0	1.8	1.8	1.6	1.5	1.5	1.5	-0.5
General government balance (GGB)	**-3.2**	**-2.8**	**-2.7**	**-2.6**	**-2.3**	**-1.8**	**-1.2**	**2.0**
Primary balance	**-1.2**	**-1.0**	**-1.0**	**-1.0**	**-0.7**	**-0.3**	**0.3**	**1.5**
One-off and other temporary	-0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.2
GGB excl. one-offs	**-3.0**	**-2.8**	**-2.8**	**-2.6**	**-2.3**	**-1.8**	**-1.2**	**1.8**
Output gap[1]	-0.5	-0.6	-0.9	-0.6	-0.7	-0.3	0.3	0.8
Cyclically-adjusted balance[1]	-2.9	-2.4	-2.3	-2.3	-1.9	-1.6	-1.3	1.6
Structural balance (SB)[2]	**-2.7**	**-2.5**	**-2.4**	**-2.3**	**-1.9**	**-1.6**	**-1.3**	**1.4**
Structural primary balance[2]	-0.8	-0.7	-0.6	-0.7	-0.4	-0.1	0.2	0.9

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by the 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.

Source:

Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.

Measures underpinning the programme

The programme contains a list of measures taken or planned in 2014-2018, in most cases without providing estimates of their fiscal impact.

In 2014, the improvement in the general government balance of 0.8 pp. compared to 2013 was to a large extent driven by the partial reversal of the 1999 systemic pension reform enacted at the end of 2013. The reversal limited the role of the second pillar of the pension system formed by private pension funds, the participation in which was obligatory at the time. In particular, more than half of the assets accumulated in the private pension funds were

transferred to the first pillar of the pension system - public social security scheme. Moreover, the contributors had to declare until 31 July 2014 whether they wanted to continue to partially participate in the second pension pillar; by default, in case of no declaration, contributors were fully moved to the public social security scheme. Consequently, more than 80% of contributors were moved out of the second pension pillar. The partial reversal of the 1999 pension reform increased the proportion of social contributions retained by general government and lowered interest expenditure due to the transfer of assets which had been accumulated in the private pension funds. Since these changes entered into force in the course of 2014, they will have an additional impact on general government balance in 2015.

According to the programme, the main measure underpinning the targeted level of government expenditure over the programme period is the stabilising expenditure rule introduced in 2013. The expenditure rule was for the first time applied to the 2015 budget law and is, according to the programme, expected to significantly limit the growth of public expenditure also in the following years. The programme argues that as a result of this rule, changes in the associated expenditure items (i.e. increase or introduction of new categories of expenditure) are only possible if either other expenditure categories are adjusted or government revenues are increased. Consequently, any potential statutory change generating new expenditure within entities covered by the rule are, by design, assumed to be budget-neutral, thereby not to impacting on the aggregate level of expenditure. Moreover, discretionary measures affecting government revenues are also budget-neural, as the rule takes into account the estimated effect of discretionary revenue measures when setting the expenditure limit for a given year.

In its 2015 spring forecast, the Commission followed the usual no-policy-change assumption for the years without a budget. Therefore, the Commission did not take into account the assumed effects of the Polish expenditure rule in 2016 as the actual implementation of the rule requires legal and/or administrative acts that are not specified yet.

Main budgetary measures

Revenue	**Expenditure**
2014	
• A set of revenue measures, in particular the increase of social contributions accruing to the public pension pillar due to the reversal of the 1999 systemic pension reform (0.4% of GDP)	• Payments from the Bank Guarantee Fund (BFG) in connection with the restructuring of Credit Unions (+0.2%) – one-off
2015	
• A set of revenue measures, in particular (1) increase of social contributions accruing to the public pension pillar due to the reversal of the 1999 systemic pension reform and (2) personal income tax credit for families with children (0.3% of GDP)	• Expenditure rule (-1.2% of GDP) • Digital dividend (sale of rights to selected frequencies) (-0.1% of GDP) – one off

Revenue	Expenditure
2016	
• Introduction of tax debtors' register, a tax anti-avoidance clause and changes in rules on VAT deduction on cars (0.2% of GDP)	• Expenditure rule (-1% of GDP)
2017	
• Expiry of past temporary increase of VAT rates (-0.3% GDP)	• Expenditure rule (-1.1% of GDP)
2018	
	• Expenditire rule (-0.7% of GDP)

Notes:

The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.

The table lists only measures whose effect was quantified in the programme.

3.3. Debt developments

In the 2015 Convergence Programme, the government debt-to-GDP ratio is projected to peak at 51.7% in 2015 and to gradually decline to around 49.1% in 2018. This decline is set to be mostly driven by the impact of the projected real GDP growth.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**53.7**	**50.1**	**50.9**	**51.7**	**50.8**	**51.6**	**50.7**	**49.1**
Change in the ratio	1.8	-5.6	0.8	1.6	-0.1	-0.1	-0.9	-1.6
Contributions[2] :								
1. Primary balance	**3.0**	**1.2**	**1.0**	**1.0**	**1.0**	**0.7**	**0.3**	**-0.3**
2. "Snow-ball" effect	**-0.1**	**-0.2**	**0.0**	**-0.2**	**-0.5**	**-0.9**	**-1.2**	**-1.5**
Of which:								
Interest expenditure	2.5	2.0	1.8	1.7	1.6	1.6	1.5	1.5
Growth effect	-1.4	-1.8	-1.6	-1.6	-1.6	-1.9	-1.9	-1.9
Inflation effect	-1.2	-0.3	-0.2	-0.2	-0.5	-0.6	-0.8	-1.1
3. Stock-flow adjustment	**-1.1**	**-6.6**	**-0.2**	**0.8**	**-0.6**	**0.1**	**0.1**	**0.3**
Of which:								
Cash/accruals diff.				0.1		0.6	0.1	0.0
Acc. financial assets				1.0		0.0	0.3	0.7
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				-2.2		-3.1	-3.2	-3.6

Notes:

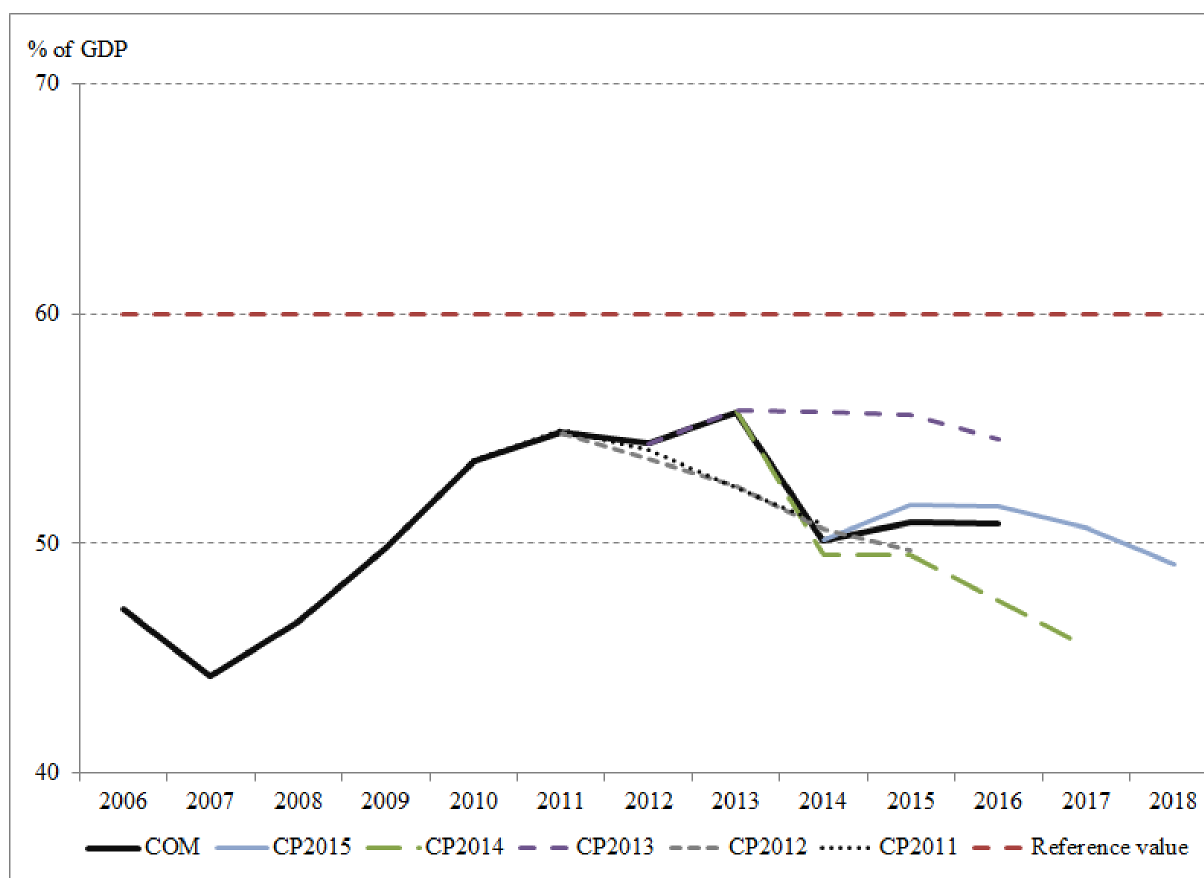
[1] End of period.

[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 2015 spring forecast (COM); Convergence Programme (CP), Comission calculations.

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



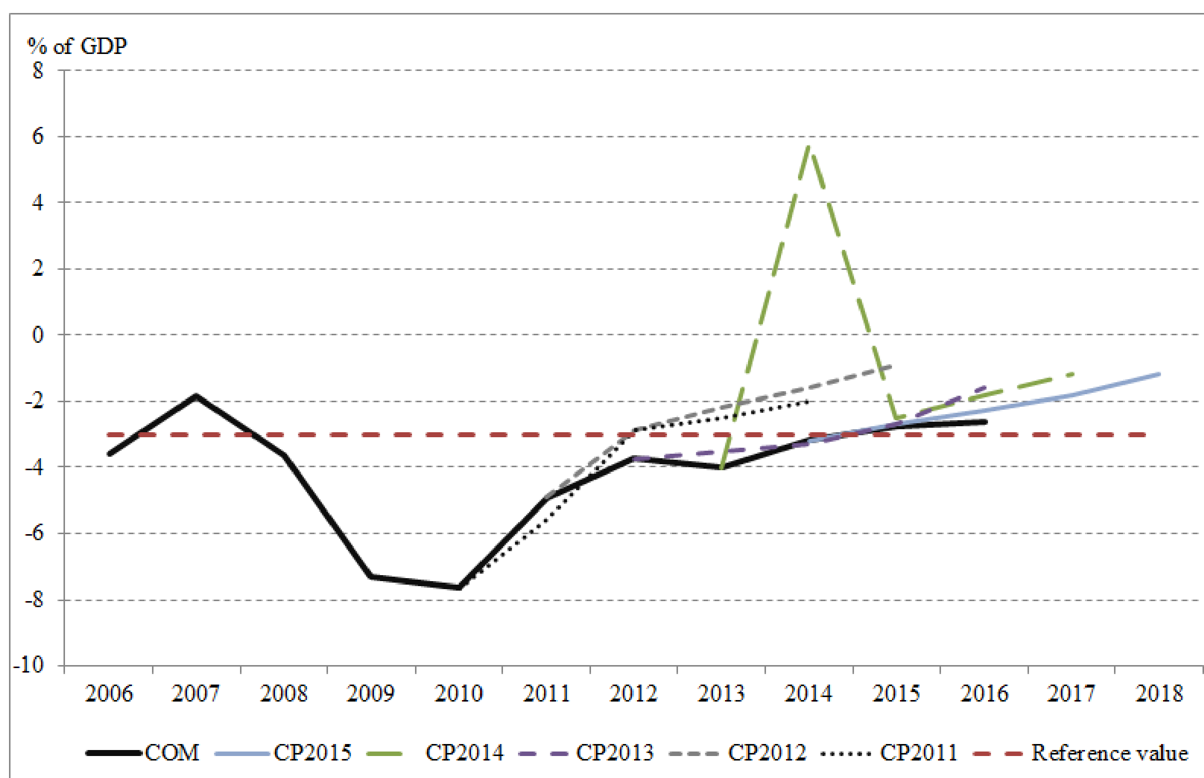
Sources: Commission 2015 Spring Forecast (COM) and Convergence Programmes (CP).

3.4. Risk assessment

As the macroeconomic projections are favourable in 2016 and beyond, the main downside risk to the general government deficit targets laid down in the programme is a lower economic growth. Moreover, the planned budgetary consolidation mainly relies on the hitherto untested effectiveness of the stabilising expenditure rule enacted in 2013. Lastly, the upcoming parliamentary elections entail some uncertainty in relation to the implementation of this year's budget and the budgetary targets for 2016.

The risks to the budgetary deficit targets previously mentioned would also have an impact on the public debt.

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



Sources: Commission 2015 Spring Forecast (COM) and Convergence Programmes (CP).

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

Box 1. Council recommendations addressed to Poland

– On 2 December 2013, the Council recommended Poland under Art. 126(7) of the Treaty to correct its excessive deficit by 2015. To this end, Poland shall reach a headline deficit of 4.8% of GDP in 2013, 3.9% of GDP in 2014 and of 2.8% of GDP in 2015. Based on the macroeconomic forecast underlying the Council recommendation, this was consistent with an improvement of the structural balance of 1% of GDP in 2014 and 1.2% of GDP for 2015. Poland was also recommended to implement rigorously the measures it had already announced and adopted, while complementing them with additional measures to achieve a sustainable correction of the excessive deficit by 2015. Poland was given a deadline of 15 April 2014 to report on the measures taken to comply with this recommendation.

– On 8 July 2014, the Council also addressed recommendations to Poland in the context of the European Semester. In particular, in the area of public finances the Council recommended Poland to reinforce the budgetary strategy to ensure the correction of the excessive deficit in a sustainable manner by 2015 through achieving the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. After the correction of the excessive deficit and until the medium-term objective is achieved, pursue an annual structural adjustment of 0.5% of GDP as a benchmark. A durable correction of the fiscal imbalances requires a credible implementation of ambitious structural reforms to increase the adjustment capacity and boost growth and employment. In that regard, minimise cuts in growth-enhancing investment, improve the targeting of social policies and the cost effectiveness of spending and the overall efficiency of the healthcare sector, broaden the

tax base by addressing the issue of an extensive system of reduced VAT rates, and improve tax compliance, in particular by increasing the efficiency of the tax administration. Establish an independent fiscal council.

4.1. Compliance with EDP recommendations

In 2014, the general government deficit amounted to 3.2% of GDP. Since this number can be considered to be close to the 3% of GDP reference value of the Treaty and Poland's debt-to-GDP ratio is below the 60% of GDP reference value in a sustained manner, Poland is eligible to benefit from the provisions regarding systemic pension reforms of Article 2(7) of Regulation (EC) 1467/97.

The Polish systemic pension reform from 1999 has been reversed by a law adopted in December 2013. Based on this reversal, part of the assets accumulated in the private, fully-funded pension funds (forming the second pillar of the Polish pension system) were transferred to the public social security scheme (first pillar of the Polish pension system). Moreover, the second pillar of the pension system lost its universal coverage, in the sense that participation stopped being compulsory. As a result, the 2013 reversal put to an end the systemic nature of the 1999 reform[1]. However, until end-July 2014 social contributions of all participants were still paid into the second pillar (as they had to declare until 31 July 2014 whether they wanted to continue to partially participate in the second pension pillar). These contributions are the net costs of the systemic pension reform of 1999 and are to be taken into account when assessing the correction of the excessive deficit. Total direct net costs for the period January-July 2014 amounted to 0.4% of GDP, as validated by Eurostat, and are thus sufficient to explain the excess of the general government deficit over the 3% of GDP Treaty reference value in 2014. Moreover, the estimated improvement of the structural balance by 0.9% of GDP is broadly in line with the Council recommendation of 1% of GDP.

Additionally, the headline deficit is set to remain below the Treaty reference value of 3% of GDP over the Commission forecast horizon and the general government gross debt has been and is projected to remain below the 60% of GDP reference value.

As a consequence, on 13 May the Commission recommended to the Council to abrogate the Council Decision of 7 July 2009 on the existence of an excessive deficit in Poland.

4.2. Compliance with the MTO or the required adjustment path towards the MTO

Poland aims to reach the MTO (of a structural deficit of 1% of GDP) in 2019, i.e. beyond the 2018 programme horizon.

In 2015, the estimated improvement of the structural balance recalculated following the commonly agreed methodology on the basis of the information provided in the programme deviates by 0.2% of GDP from the 0.5 % of GDP required. However, according to the information provided in the Convergence Programme, the growth rate of government expenditure, net of discretionary revenue measures, in 2015 is planned to be below the applicable expenditure benchmark rate. In 2016, there is also some deviation from the

[1] In December 2014 Eurostat confirmed in a letter to the Central Statistical Office of Poland that the 2013 amendment to the Polish pension reform of 1999 had put to an end the systemic nature of the reform. .

required improvement in the structural budget balance of 0.5% of GDP, while the growth rate of government expenditure, net of discretionary revenue measures, will equal the applicable expenditure benchmark rate. Over both years (2015-2016), there is some deviation (of 0.1% of GDP) between the change in the (recalculated) structural balance planned in the programme and the one required. At the same time, over the two years, the average growth rate of government expenditure, net of discretionary revenue measures, is planned to be below the applicable expenditure benchmark rate.

Based on the Commission 2015 spring forecast, there is some deviation in 2015 between the change in the structural balance and the improvement required by the SGP. At the same time, the projected growth rate of government expenditure, net of discretionary revenue measures, is below the applicable expenditure benchmark rate in 2015. Thus, the overall picture for 2015 is the same as in the programme. In 2016, and based on the usual no-policy-change assumption, the Commission 2015 spring forecast shows some deviation between the change in the structural balance planned in the programme and the improvement required by the SGP. Similarly (and contrary to the programme), the growth rate of government expenditure, net of discretionary revenue measures, in 2016 is expected to deviate somewhat from the applicable expenditure benchmark rate. Over both years (2015-2016), however, there is a significant deviation (of 0.3% of GDP) between the projected and the required change in the structural balance, while the expenditure benchmark is expected to be fulfilled.

Following an overall assessment, the adjustment path towards the MTO seems to be appropriate and compliant with the requirement of the preventive arm of the Pact in 2015. On the other hand, some deviation from the adjustment path towards the MTO is to be expected in 2016.

In 2017-2018, the (recalculated) annual structural adjustment planned in the programme (of 0.3% of GDP each year) is below 0.5% of GDP.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2015		2016	
Initial position[1]				
Medium-term objective (MTO)	-1.0		-1.0	
Structural balance[2] (COM)	-2.5		-2.3	
Structural balance based on freezing (COM)	-2.5		-	
Position vis-a -vis the MTO[3]	Not at MTO		Not at MTO	
(% of GDP)	**2015**		**2016**	
	CP	**COM**	**CP**	**COM**
Structural balance pillar				
Required adjustment[4]	0.5		0.5	
Required adjustment corrected[5]	0.5		0.5	
Change in structural balance[6]	0.3	0.2	0.4	0.2
One-year deviation from the required adjustment [7]	-0.2	-0.3	-0.1	-0.3
Two-year average deviation from the required adjustment [7]	In EDP	In EDP	-0.1	-0.3
Expenditure benchmark pillar				
Applicable reference rate[8]	2.5		2.5	
One-year deviation [9]	1.1	0.8	0.0	-0.1
Two-year average deviation [9]	In EDP	In EDP	0.6	0.4
Conclusion				
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	In EDP	In EDP	Overall assessment	Overall assessment

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 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 28.).

[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.

[7] The difference of the change in the structural balance and the required adjustment corrected.

[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 not at its MTO.

[9] 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.

Source :

Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report[2] published on 12 May. It therefore updates the assessment made in the Country Reports[3] published on 26 February.

Gross government debt stood at 50.1% of GDP in 2014. Under a no-policy-change assumption (based on the Commission Spring 2016 forecast), it is expected to rise slightly (to 51.4%) in 2025 remaining below the 60% of GDP Treaty threshold. The full implementation of the programme would put the general government debt on a slightly decreasing path, reaching 48.5% of GDP in 2025.

Overall, Poland appears to face medium fiscal sustainability risks. The medium-term sustainability gap, estimated at -0.3 % of GDP, indicates low medium-term fiscal sustainability risks. In the long-term, and in the no-policy-change scenario, Poland appears to face medium fiscal sustainability risks, primarily due to the initial budgetary position and the projected increase in ageing costs, driven by costs in healthcare and long-term care. The long-term sustainability gap shows that the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path is at 2.7 % of GDP. Risks would be lower in the event of the structural primary balance reverting to the higher values observed in the past, such as the average for the period 2004-2013. A focus on reducing government debt and containing age-related expenditure growth appears necessary to contribute to the sustainability of public finances in the long term.

The systemic pension reform of 1999 replaced a defined benefit public pension scheme with a three-pillar system based on defined contributions. The main objective of the 1999 reform was to improve the sustainability of the Polish pension system especially in light of the very challenging demographic outlook Poland is facing. The partial reversal of the 1999 systemic reform enacted at the end of 2013 (and implemented in the course of 2014) increased again the role of the first, public pillar, which, contrary to the second pillar, is not fully funded, but is a notional defined-contribution system. This reversal decreased the general government debt in 2014 due to a transfer of assets accumulated in fully funded private pension funds to the general government. While producing some budgetary relief in the short term, the reversal of the systemic reform of 1999 does not improve the long-term sustainability of public finances, as the short-term benefits from higher social contributions retained in the first, public pension pillar and from lower interest payments will be offset by higher future pension payments from the public pension pillar. Overall, the reversal of the systemic pension reform of 1999 carries some risks for Polish public finances in the long run and will have to be closely monitored going forward.

[2] See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

[3] See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

Table 4: Sustainability indicators

	Poland			European Union		
	2014 scenario	**No-policy-change scenario**	**Convergence Programme scenario**	**2014 scenario**	**No-policy-change scenario**	**Stability/ Convergence Programme scenario**
S2*	2.5	2.7	1.9	1.4	1.7	0.4
of which:						
Initial budgetary position (IBP)	1.7	1.7	0.8	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	0.7	1.0	1.2	1.0	1.1	1.1
of which:						
pensions	-0.6	-0.3	-0.2	0.0	0.1	0.1
healthcare	0.9	0.9	0.8	0.8	0.7	0.6
long-term care	0.6	0.6	0.6	0.7	0.7	0.6
others	-0.2	-0.1	0.0	-0.4	-0.3	-0.2
S1**	-0.4	-0.3	-0.8	1.4	1.8	0.5
of which:						
Initial budgetary position (IBP)	0.4	0.3	-0.2	-0.4	-0.3	-1.6
Debt requirement (DR)	-0.7	-0.7	-0.9	1.7	1.9	1.8
Long-term cost of ageing (CoA)	-0.2	0.1	0.2	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.20	:		:		
Fiscal subindex	0.10	:		:		
Financial-competitiveness subindex	0.25	:		:		
Debt as % of GDP (2014)	50.1			88.6		
Age-related expenditure as % of GDP (2014)	20.6			25.6		

Source: Commission, 2015 Convergence Programme

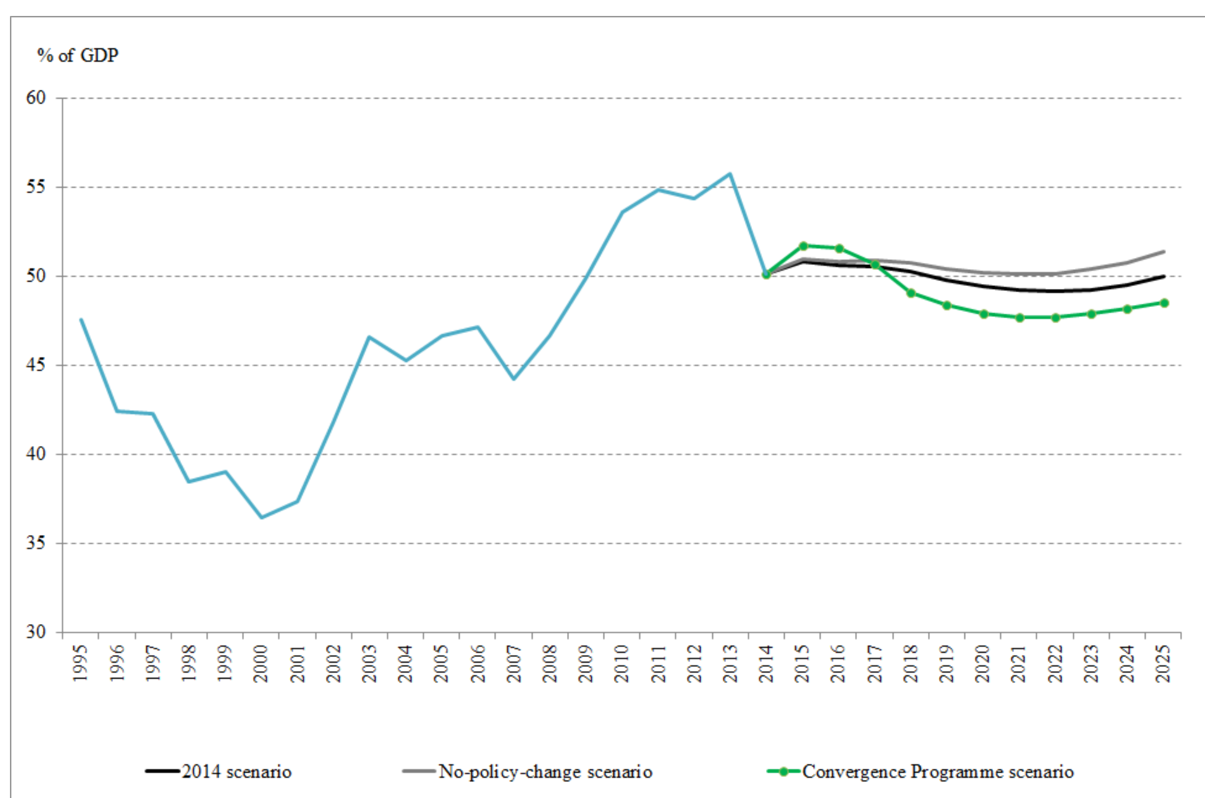
Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability 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 2015 Ageing Report.

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the foercast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

Figure 3: Gross debt projections (% of GDP)



Source: Commission calculations.

6. Fiscal framework and quality of public finances[4]

6.1. Fiscal framework

The Polish fiscal framework has been significantly strengthened by the recent introduction of the stabilising expenditure rule covering nearly the entire general government sector. However, Poland still lacks a fully-fledged independent fiscal council, with a remit combining (1) ex-ante checks of compliance with fiscal rules, an assessment of macroeconomic and budgetary forecasts and an analysis of the long-term sustainability of public finances; with (2) an ex-post assessment of compliance with fiscal rules. By issuing regular recommendations on fiscal policy to the government, such a body could contribute significantly to improving the quality of public debate on public finances. Independent fiscal councils are either already established or currently being introduced in all other EU Member States. Consequently, the Council recommended Poland to create an independent fiscal council within the European Semester 2014 and 2015 as well as in its EDP decision of December 2013. In spite of that, the Convergence Programme 2015 does not present any imminent plan to establish such an institution. It only points to the fact that the Court of Auditors is charged with presenting to the parliament an ex-post annual report on the execution of the state budget and that the

[4] This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence Programme.

regional accounting chambers control ex-ante and ex-post the financial situation of lower territorial units.

6.2. Quality of public finances

The programme describes the structure of government revenues in Poland. It concludes that the general government revenues as a share of GDP are below the EU average. This is driven by the fact that social contributions and taxes on income and wealth are lower than the EU average. The programme stresses the actions taken by Poland in order to improve tax compliance and the effectiveness of tax administration, contained in the action plan from spring 2014. On the expenditure side, the programme explains that the planned consolidation is concentrated on the costs of functioning of administration and on social expenditure, while public investments will be spared.

Indeed, Poland's tax burden as a share of GDP has been, and is set to remain significantly below the EU average. In particular, revenue from direct taxes is very low compared with the EU average. As a consequence, the overall Polish tax structure one of the growth-friendliest in the EU in terms of relative contribution from the different tax bases. However, improving tax compliance and tax governance has been an important challenge for Poland, whose tax system is characterised by both (1) high tax collection costs due to the inefficiencies in tax administration and (2) high tax compliance costs for taxpayers. In spring 2014 Poland published an action plan aimed at addressing this challenge and has been implementing the measures contained therein.

Poland applies reduced VAT rates to an extensive number of goods and services, which affects the efficiency of the VAT system and carries a large budgetary cost. A number of reduced VAT rates are presented as instruments for redistribution. However, reduced VAT rates are not an effective instrument for that purpose, as they are not specifically targeted to vulnerable households and thus translate into significant subsidies to rich taxpayers. Social benefits and income tax are instruments which are better targeted and thus more suitable to achieve redistributive goals. The tax free threshold in the personal income tax (PIT) is very low and has not been updated since 2007. This contributes to fact that according to some studies the tax-benefit system in Poland increases the incidence of in-work poverty[5].

Social security privileges for farmers and miners substantially hamper occupational mobility and pose costs to public finances. The agricultural sector in Poland employs 11.4% of the workforce, more than double the EU average, while producing only 3.3% of gross value added. The special social security scheme for farmers (KRUS), together with a preferential tax regime, disincentives people from leaving agriculture for more productive sectors. This results in hidden unemployment in rural areas and increased participation in the informal economy. KRUS is heavily subsidised, with social contributions from farmers covering only 9% of its costs and state subsidies amounting to almost 1% of GDP (i.e. higher than the fiscal cost of the second pillar pension system from before its 2013 reversal). Labour market mobility is similarly hampered by the special pension privileges for miners, who are exempt

[5] "In-Work Poverty in Poland: Diagnosis and Possible Remedies", Institute for Structural Research, http://ibs.org.pl/files/publikacje/In-Work%20Poverty%20in%20Poland_Diagnosis%20%20and%20Possible%20%20Remedies.pdf

from the defined contribution system. Miners' pensions cost around 0.5% of GDP to public finances.

7. CONCLUSIONS

In 2014, the general government deficit amounted to 3.2% of GDP. Since this number can be considered to be close to the reference value and Poland's debt-to-GDP ratio is below the 60% of GDP reference value in a sustained manner, Poland is eligible to benefit from the provisions regarding systemic pension reforms of Article 2(7) of Regulation (EC) 1467/97. As a consequence, on 13 May the Commission recommended to the Council to abrogate the Council Decision of 7 July 2009 on the existence of an excessive deficit in Poland.

According to the Commission 2015 spring forecast, the adjustment path towards the medium-term objective (MTO) seems to be appropriate and compliant with the requirement of the preventive arm of the Pact in 2015. On the other hand, some deviation from the adjustment path towards the MTO is to be expected in 2016. In 2017-2018, the (recalculated) structural adjustment planned in the programme is below the one required by the Stabilityand Growth Pact.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	4.3	4.1	4.4	1.8	1.7	3.4	3.3	3.4
Output gap [1]	0.7	-2.8	2.3	0.2	-0.7	-0.5	-0.6	-0.6
HICP (annual % change)	9.9	1.9	3.5	3.7	0.8	0.1	-0.4	1.1
Domestic demand (annual % change) [2]	4.4	4.0	4.4	-0.4	0.4	4.9	4.2	3.8
Unemployment rate (% of labour force) [3]	13.8	18.1	8.8	10.1	10.3	9.0	8.4	7.9
Gross fixed capital formation (% of GDP)	22.9	18.6	21.1	19.4	18.8	19.5	20.1	20.4
Gross national saving (% of GDP)	20.0	16.6	17.2	16.9	17.7	18.7	18.9	18.8
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.7**	**-4.7**	**-5.1**	**-3.7**	**-4.0**	**-3.2**	**-2.8**	**-2.6**
Gross debt	**38.7**	**45.5**	**49.8**	**54.4**	**55.7**	**50.1**	**50.9**	**50.8**
Net financial assets	**-10.8**	**-23.0**	**-22.9**	**-33.2**	**n.a**	**n.a**	**n.a**	**n.a**
Total revenue	40.7	40.0	39.4	39.2	38.2	38.6	38.9	38.7
Total expenditure	44.4	44.8	44.5	42.9	42.2	41.8	41.7	41.3
of which: Interest	3.5	2.7	2.4	2.7	2.5	2.0	1.8	1.6
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.5**	**0.3**	**2.5**	**4.3**	**5.5**	**7.2**	**6.7**	**6.2**
Net financial assets; non-financial corporations	**-70.6**	**-79.1**	**-83.1**	**-77.5**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**11.2**	**0.9**	**-4.1**	**-5.6**	**n.a**	**n.a**	**n.a**	**n.a**
Gross capital formation	15.7	11.0	12.1	10.6	10.3	11.1	11.5	11.8
Gross operating surplus	15.6	20.1	22.9	24.0	24.8	25.8	25.8	25.9
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**5.5**	**1.8**	**-0.9**	**-1.6**	**-1.9**	**-4.3**	**-4.5**	**-5.1**
Net financial assets	**40.6**	**56.2**	**49.2**	**49.9**	**n.a**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	35.2	32.8	32.2	31.1	31.1	30.6	30.4	30.3
Net property income	5.6	4.7	3.1	2.9	3.3	3.1	2.8	2.7
Current transfers received	20.2	20.3	19.0	18.4	18.7	18.6	18.5	18.3
Gross saving	9.9	6.5	3.8	3.0	2.3	0.0	-0.2	-0.7
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.0**	**-2.8**	**-3.4**	**-1.6**	**1.0**	**1.1**	**0.9**	**-0.1**
Net financial assets	**30.0**	**45.5**	**62.0**	**67.7**	**n.a**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-4.8	-2.3	-2.5	-0.2	1.9	1.5	1.4	0.9
Net primary income from the rest of the world	-0.5	-1.7	-3.4	-4.2	-4.1	-4.1	-4.2	-4.2
Net capital transactions	0.0	0.4	1.9	2.2	2.3	2.5	2.6	2.1
Tradable sector	51.1	51.3	50.7	52.1	51.9	52.4	n.a	n.a
Non tradable sector	36.9	36.7	37.2	36.5	36.9	36.4	n.a	n.a
of which: Building and construction sector	7.9	6.1	7.1	6.8	6.6	6.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	103.8	95.5	101.2	94.1	94.6	92.3	91.2	91.4
Terms of trade goods and services (index, 2000=100)	98.4	96.2	99.5	96.9	98.7	101.0	102.6	102.5
Market performance of exports (index, 2000=100)	70.0	80.5	96.0	106.4	109.1	110.8	112.5	113.5

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 2015 spring forecast.