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Assessment of the 2017 convergence programme for

Poland

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

On 28 April 2017, Poland submitted its 2017 convergence programme (hereafter called the programme), covering the period 2017-2020. The government approved the programme on 25 April 2017.

Poland is currently subject to the preventive arm of 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 22 February 2017 and updates it with the information included in the programme.

Section 2 presents the macroeconomic outlook underlying the programme and provides an assessment based on the Commission 2017 spring forecast (hereafter called Commission forecast). The following section presents the recent and planned budgetary developments, according to the programme. In particular, it includes an overview on the medium-term budgetary plans, an assessment of the measures underpinning the programme and a risk analysis of the budgetary plans based on the 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 and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

In 2016, real GDP growth reached 2.7%. The scenario presented in the programme assumes a gradual increase in the real GDP growth rate over the programme horizon, from 3.6% in 2017 to 3.9% in 2020. Private consumption and investment are projected to be the main growth drivers. Having increased by 3.8% in 2016, private consumption is expected to increase by 4.0% in 2017 and then to continue rising by 3.5% per year until 2020 (Table 1). Its expansion is set to be supported by growing compensation of employees (between 2.3% and 2.8% in real terms over the programme horizon), increasing employment (0.5% in 2017 and 0.3% in 2020) and social transfers. Simultaneously, the unemployment rate is set to decrease from 6.2% in 2016 to 4.0% in 2020. After a significant drop (-7.9%) in 2016, primarily due to a lower absorption of EU funds, investment is expected to increase steadily over the programme horizon by between 7.0% and 7.6% per year. According to the programme, private investment will be driven by the current high capacity utilisation, low cost of capital, as well as government policy supporting innovation and productivity. Net exports' contribution to real GDP growth is expected to be marginally negative in 2017, neutral in 2018 and marginally positive in the following years. Export growth, after having reached 9.0% in real terms in 2016, is set to progressively slow down from 7.1% in 2017 to 6.0% in 2020. Import growth – although also gradually decreasing from 8.9% in 2016 to 6.1% in 2020 – is expected to remain slightly stronger than export dynamics over the programme horizon.

The macroeconomic scenario underpinning the programme is slightly more pessimistic than in the previous programme. Overall, real GDP is set to grow at a slower pace, down by 0.3 pp in 2017 and by 0.2 pp in 2018-2019. The difference concerning 2017 stems mainly from the expected negative growth contribution of the change in inventories (in the 2016 programme, they were set to remain neutral for GDP growth). For 2018-2019, the current programme

foresees a lower contribution of private consumption to growth than in the previous programme.

The real GDP growth rate for 2017 is slightly (0.1 pp) more optimistic than the Commission forecast. In 2018, it is significantly more optimistic than the Commission forecast (0.6 pp). The difference mostly concerns more positive projected developments of investment, private consumption and imports in the programme.

The output gap as recalculated by the Commission based on the information in the programme, following the commonly agreed methodology, is slightly negative in 2017. It increases steadily over the programme horizon to reach a positive level of 0.9% of GDP in 2020.

The macroeconomic scenario of the programme is plausible in 2017 and favourable thereafter.

Table 1: Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019	2020
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.7	2.7	3.5	3.6	3.2	3.8	3.9	3.9
Private consumption (% change)	3.8	3.8	3.9	4.0	3.1	3.5	3.5	3.5
Gross fixed capital formation (% change)	-7.9	-7.9	4.9	7.2	6.1	7.6	7.3	7.0
Exports of goods and services (% change)	9.0	9.0	7.7	7.1	6.6	6.4	6.0	6.0
Imports of goods and services (% change)	8.9	8.9	8.5	7.7	7.4	6.9	6.1	6.1
Contributions to real GDP growth:								
- Final domestic demand	1.1	1.1	3.6	4.3	3.4	3.7	3.8	3.7
- Change in inventories	1.2	1.2	0.0	-0.5	0.0	0.0	0.0	0.0
- Net exports	0.3	0.3	-0.1	-0.1	-0.2	0.0	0.1	0.1
Output gap[1]	-0.3	-0.6	0.4	-0.1	0.5	0.2	0.5	0.9
Employment (% change)	0.6	0.7	0.4	0.5	0.0	0.4	0.4	0.3
Unemployment rate (%)	6.2	6.2	5.2	5.7	4.4	5.0	4.4	4.0
Labour productivity (% change)	2.1	2.1	3.1	3.1	3.2	3.4	3.5	3.6
HICP inflation (%)	-0.2	-0.2	1.8	1.8	2.1	2.3	2.3	2.5
GDP deflator (% change)	0.2	0.3	1.4	1.0	2.0	2.3	2.3	2.5
Comp. of employees (per head, % change)	3.6	1.4	4.3	3.9	5.1	4.3	4.8	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.0	0.8	1.0	0.3	0.6	1.8	1.7	1.3

Note:

[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.

Source:

Commission 2017 spring forecast (COM); convergence programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2016 AND IN 2017

The headline general government deficit reached -2.4% of GDP in 2016, its lowest level since 2007. This was a slightly better outcome than envisaged in the 2016 programme (-2.6% of GDP). As a share of GDP, both revenue and expenditure turned out marginally lower than projected in the 2016 programme. On the revenue side, taxes on production and imports and taxes on income and wealth turned out to be higher, driven by the introduction of a new tax and, to some extent, increased tax compliance. In turn, social contribution revenue was lower in proportion to nominal GDP than estimated in the 2016 programme. On the expenditure side, compensation of employees and social transfers both exceeded the levels planned in the 2016 programme, while public investment was significantly lower than projected earlier. In 2016, Poland did not implement any significant temporary or one-off measures to meet the fiscal targets.

In 2017, the programme envisages the headline general government deficit to widen to 2.9% of GDP. The 2016 programme forecast the headline general government deficit at 3.1% of GDP. As a share of GDP, both revenue and expenditure are currently expected to be higher than projected in the 2016 programme. On the revenue side, taxes on production and imports and taxes on income and wealth are forecast to be 1.3% of GDP higher than in the 2016 programme, driven by higher expected tax compliance. On the expenditure side, mainly the compensation of employees, social payments and interest expenditure are envisaged to be higher than in the 2016 programme[1].

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The programme targets a gradual reduction of the headline general government deficit from 2.9% of GDP in 2017 to 1.2% of GDP in 2020. Simultaneously, the general government structural balance recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology (hereafter called recalculated structural balance) is set to improve from -2.9% of GDP in 2017 to -1.6% of GDP in 2020 (Table 2). The achievement of the budgetary targets in the programme requires the implementation of measures specified therein, such as freezing of the wage bill for the central government institutions in 2018 or measures to further increase tax compliance.

According to the programme, the MTO of a structural balance of -1% of GDP will not be reached within the programme horizon. Instead, the MTO is expected to be achieved in 2021, one year beyond the programme horizon. Postponing the achievement of the MTO to one year beyond the programme horizon is a practice also stated in previous programmes. The MTO reflects the requirements of the SGP.

The programme envisages the headline deficit reduction to be slower than previous programmes, with a projected headline general government deficit path that is 0.5%-0.7% of

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[1] Note that the programme includes in 2017 a transaction of some 2% of GDP related to the cancellation of debt granted to the Social Security Fund between 2009 and 2014. This transaction is neutral for the government balance as the debtor and the creditor are parts of the general government. Thus, it should be cancelled out in the data. However, it was included in the Programme on both, revenue and expenditure, sides. In the current analysis, this transaction is excluded for the sake of clarity.

GDP higher than expected last year. This reflects, as stated in the programme, the "*implementation of priority reforms of the new government, supporting inclusive growth in the context of one of the highest tax gaps in the EU*". In practical terms, compared to the 2016 programme, social transfers relative to GDP are currently expected to be higher by 0.4 pp in 2017 and by 0.8 pp in 2018. This change in expenditure envisaged in the programme reflects, amongst other factors, the costs of the lowering of the statutory retirement age from October 2017. Simultaneously, the programme assumes an extension of the temporary application of higher VAT rates until 2020 and an increase in tax compliance. As a consequence, the programme forecasts higher tax revenue relative to GDP by 1.1 pp – 1.5 pp than in the previous programme.

The planned fiscal adjustment is projected to mainly occur on the revenue side. Revenue as a share of GDP is set to grow substantially until 2018, and then to decrease slightly, so that by 2020 total revenue as a share of GDP is broadly at the same level as in 2017[2]. A number of measures were implemented in the course of 2016 – 2017 to improve tax collection, in particular as regards indirect taxes. Further measures are set to enter into force within a year. They include the new sectoral tax on the retail sector (currently suspended) and additional measures to increase tax compliance. Simultaneously, Poland extended the temporary application of higher VAT rates until the end of 2018, while the programme assumes a further extension until 2020. As a result, tax revenue as a share of GDP is expected to increase by 0.8 pp between 2017 and 2020. In contrast, social security contributions are set to decrease as a share of GDP over that period (Table 2).

Expenditure as a share of GDP is set to increase strongly until 2018 driven by rising public investment and social transfers. Over the period 2019-2020, total expenditure and expenditure in the latter two categories are expected to fall, so that by 2020, total expenditure as a share of GDP is projected to be at the level of 2016.

Both the programme and the Commission forecast expect the headline general government deficit to reach 2.9% of GDP in 2017. In 2018, the headline deficit envisaged in the programme falls to 2.5% of GDP, while according to the Commission forecast it is set to remain at 2.9% of GDP (Figure 1). The difference stems primarily from a slower increase in revenues projected by the Commission.

The structural balance is set to widen in 2017, both in terms of the programme's recalculated structural balance and the Commission forecast. Afterwards, it is set to decline, with the programme envisaging a faster decline than in the Commission forecast. This is due to a higher headline general government deficit and the output gap closing faster in the Commission forecast.

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[2] See footnote above.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018		2019	2020	Change: 2016-2020
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**38.8**	**39.1**	**42.4**	**39.3**	**40.8**	**40.7**	**40.1**	**1.3**
of which:								
- Taxes on production and imports	13.4	13.7	13.9	13.7	14.4	14.4	14.4	1.0
- Current taxes on income, wealth, etc.	7.2	7.1	7.3	7.2	7.3	7.5	7.6	0.4
- Social contributions	14.0	14.0	14.1	13.9	13.8	13.7	13.6	-0.4
- Other (residual)	4.3	4.3	7.1	4.4	5.3	5.1	4.5	0.2
Expenditure	**41.3**	**42.0**	**45.3**	**42.1**	**43.4**	**42.7**	**41.3**	**0.0**
of which:								
- Primary expenditure	39.6	40.4	43.6	40.5	41.6	40.9	39.5	-0.1
of which:								
Compensation of employees	10.3	10.1	10.1	10.1	9.7	9.4	9.1	-1.2
Intermediate consumption	5.8	5.8	6.0	5.7	6.0	5.9	5.9	0.1
Social payments	17.2	17.4	17.6	17.7	17.6	17.4	17.2	0.0
Subsidies	0.5	0.5	0.6	0.5	0.6	0.6	0.6	0.1
Gross fixed capital formation	3.3	4.0	4.5	4.0	5.0	4.9	4.2	0.9
Other (residual)	2.4	2.5	4.8	2.4	2.7	2.6	2.5	0.1
- Interest expenditure	1.7	1.7	1.7	1.6	1.8	1.8	1.8	0.1
General government balance (GGB)	**-2.4**	**-2.9**	**-2.9**	**-2.9**	**-2.5**	**-2.0**	**-1.2**	**1.2**
Primary balance	**-0.7**	**-1.3**	**-1.2**	**-1.2**	**-0.7**	**-0.2**	**0.6**	**1.3**
One-off and other temporary	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.4**	**-3.0**	**-2.9**	**-2.9**	**-2.5**	**-2.0**	**-1.2**	**1.2**
Output gap[1]	-0.3	0.4	-0.1	0.5	0.2	0.5	0.9	1.2
Cyclically-adjusted balance[1]	-2.3	-3.1	-2.9	-3.1	-2.6	-2.3	-1.6	0.6
Structural balance[2]	**-2.2**	**-3.2**	**-2.9**	**-3.1**	**-2.6**	**-2.3**	**-1.6**	**0.6**
Structural primary balance[2]	-0.5	-1.5	-1.2	-1.5	-0.8	-0.5	0.2	0.7

Notes:

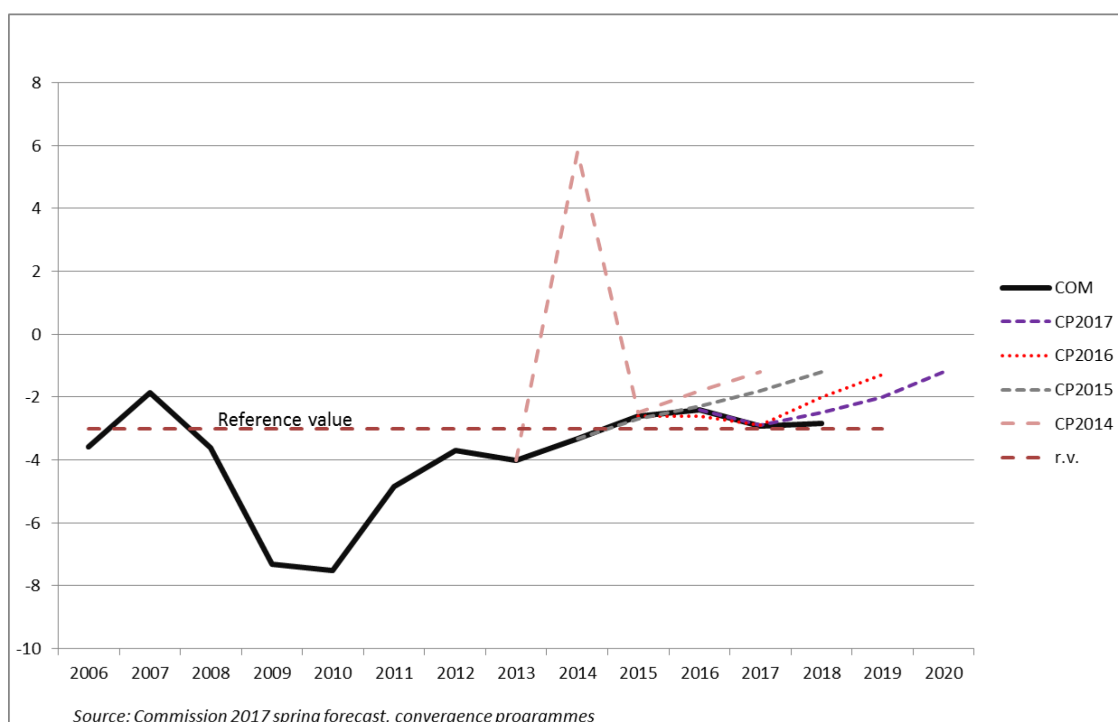
[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence programme (CP); Commission 2017 spring forecasts (COM); Commission calculations.

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



3.3. MEASURES UNDERPINNING THE PROGRAMME

The main objective of the programme is to reduce the structural deficit, ensure inclusive growth and limit the tax gap. With that aim, the programme lists several measures to be implemented mainly in 2017-2018, complementing those implemented in 2016 and having a fiscal impact in the following years. Achieving the agenda presented in the programme requires the effective implementation of these measures.

The programme focuses on increasing tax revenue through better tax compliance. Several measures are planned for implementation in the area of VAT in 2017. A detailed automated analysis of the standard audit files, an analysis of banking information and the implementation of the split payment scheme (VAT and net price from an invoice to be paid to separate accounts) are expected to limit VAT fraud. A similar effect is expected from the tracking of particular categories of goods transported in Poland and from several measures implemented by an amendment to the VAT law. Finally, a positive impact of changes implemented in the course of 2016 is expected in 2017. In particular, this concerns the general tax anti-avoidance rule or the so-called "*fuel package*" aiming to curb tax fraud in the fuel sector. The above measures are expected to generate additional revenue to an amount of 0.6%-0.7% of GDP in 2017 and an additional 0.2%-0.4% of GDP in 2018. The temporary application of higher VAT rates is extended by two years, until the end of 2018. Further extension of application of higher VAT rates to 2020, as assumed in the programme scenario, requires amending the relevant legislation. In 2017, excise duty rates remain broadly unchanged, while Corporate Income Tax rates for small taxpayers are lowered without a significant impact on the fiscal outcome. The programme also lists a number of other measures, for instance a better tax collection resulting from tax authority efficiency measures or the application of new taxes in 2018 and 2020, but without a precise estimation of their impact.

Important measures are also taken on the expenditure side. They concern mainly the lowering of the statutory retirement age from October 2017. Additionally, in 2017, the full yearly cost of the child benefit introduced in 2016 will be felt, as well as the impact of several other smaller measures implemented in 2017. As a consequence, social transfers are projected to rise from 17.2% of GDP in 2016 to 17.6% of GDP in 2018 (17.7% of GDP in the Commission forecast). The programme also envisages the freezing of the wage bill of the central government institutions in 2018.

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 2018 – 2020 amounts to the maximum expenditure allowed by the rule.

The Commission forecast for 2018 was prepared under the customary no-policy-change assumption. As a result, it does not include the expected effects of not yet legislated fiscal measures that have not been specified in sufficient detail.

3.4. DEBT DEVELOPMENTS

General government debt, having dropped significantly in 2014 – due to the transfer of assets from the private to the public pension fund and the redemption of the underlying debt, continued to increase thereafter. In 2016, it rose to 54.4% of GDP from 51.1% of GDP in 2015. According to the programme, general government debt is set to further increase in 2017 to 55.3% of GDP and afterwards to gradually slide down to 52.1% of GDP, i.e. below the 2016 level, at the end of 2020 (Figure 2). The main driving forces of the debt dynamics are the headline deficit improvement and nominal GDP growth.

Previous editions of the programme had a tendency to underestimate the general government debt developments, in particular in timeframes longer than one year. This partly reflected lower projected fiscal deficits.

Table 3: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**53.0**	**54.4**	**54.6**	**55.3**	**55.4**	**54.8**	**54.0**	**52.1**
Change in the ratio	-0.4	3.3	0.3	0.9	0.8	-0.5	-0.8	-1.9
Contributions[2] *:*								
1. Primary balance	**1.5**	**0.7**	**1.3**	**1.2**	**1.2**	**0.7**	**0.2**	**-0.6**
2. "Snow-ball" effect	**0.0**	**0.3**	**-0.9**	**-0.7**	**-1.1**	**-1.3**	**-1.4**	**-1.4**
Of which:								
Interest expenditure	2.3	1.7	1.7	1.7	1.6	1.8	1.8	1.8
Growth effect	-1.5	-1.3	-1.8	-1.9	-1.7	-2.0	-2.0	-2.0
Inflation effect	-0.7	-0.1	-0.7	-0.6	-1.0	-1.2	-1.1	-1.2
3. Stock-flow adjustment	**-1.9**	**2.3**	**-0.1**	**0.5**	**0.7**	**0.2**	**0.4**	**0.1**
Of which:								
Cash/accruals diff.				0.1		-0.2	-0.1	-0.2
Acc. financial assets				0.7		0.2	0.5	0.3
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				-2.8		-3.1	-3.1	-3.2

Notes:

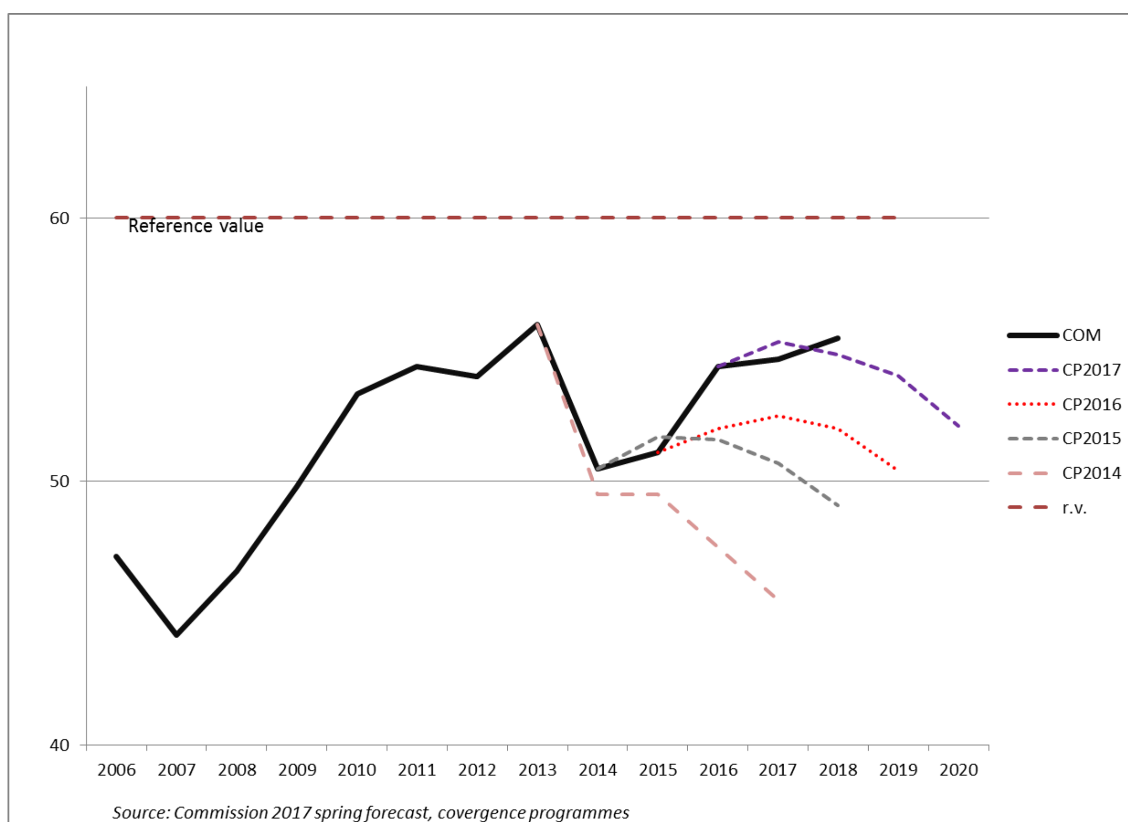
[1] End of period.

[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 2017 spring forecast (COM); convergence programme (CP), Comission calculations.

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



3.5. RISK ASSESSMENT

With favourable macroeconomic projections in the programme for 2018 and beyond, lower economic growth constitutes a key downside risk to the headline general government deficit targets as laid down in the programme. On the revenue side, the higher tax collection projected in the 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 programme envisages higher public investment in 2018 than projected in the Commission forecast. At the same time, the programme assumes lower spending on compensation of employees than the no-policy-change Commission forecast. Overall, fiscal risks appear limited up to 2018, but gradually increase thereafter.

The risks to the debt scenario presented in the programme are mainly related to the significant share of debt denominated in foreign currencies. In addition, the risks to the headline deficit targets mentioned above would also have an impact on public debt, should they materialise.

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

Box 1. Council recommendations addressed to Poland

On 12 July 2016, 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 achieve a fiscal adjustment of 0.5% of GDP towards the MTO in both 2016 and 2017, to strengthen the fiscal framework, including by establishing an independent fiscal council, to improve tax collection by ensuring better VAT compliance, and to limit the extensive use of reduced VAT rates.

Poland is subject to the preventive arm of the Stability and Growth Pact.

In 2016, the structural balance improved by 0.1% of GDP, resulting in a deviation of -0.4% of GDP from the recommended structural adjustment of 0.5% of GDP (Table 4). This points to some deviation in 2016. The growth of government expenditure, net of discretionary revenue measures and one-offs, was just in line with the applicable expenditure benchmark, pointing to compliance with the recommended adjustment path towards the MTO. This calls for an overall assessment. Among other factors, the difference between the indicators stems from the effect of lower-than expected inflation. The expenditure benchmark pillar uses the GDP deflator from earlier vintages of the forecast, while the structural balance reflects actual inflation which turned out to be lower than previously forecast. At the same time, the structural balance reflects the full impact of the sharp decline in investment expenditure, while in the expenditure benchmark pillar, investment expenditure is smoothened over a four-year period. The above effects broadly cancel each other out. Additionally, the estimate of potential growth underlying the improvement of the structural balance is lower than the medium-term average used in the expenditure benchmark. The former seems to provide a more plausible estimate of Poland's medium-term potential growth at the current juncture. Over 2015 and 2016 taken together, the average deviation based on the structural balance pillar amounts to -0.3% of GDP according to the Commission forecast, indicating a significant deviation. Simultaneously, the expenditure benchmark pillar points to compliance. The difference between the indicators results, amongst other factors such as a slight revenue shortfall, from the above-mentioned evolution of the GDP deflator and investment dynamics. Hence, the overall assessment points to some deviation from the requirements of the preventive arm in 2016.

For 2017, the programme envisages a worsening of the recalculated structural balance by 0.8% of GDP. This leads to a deviation of -1.3% of GDP from the recommended adjustment path towards the MTO in 2017. According to the information provided in the programme, the growth of government expenditure, net of discretionary revenue measures and one-offs, in 2017 will exceed the applicable expenditure benchmark leading to a negative impact of 2.4% of GDP on the underlying fiscal position. The difference between the indicators results to a significant extent from the way the programme takes into account one particular one-off transaction related to the cancellation of loans granted by the central government to the social security fund between 2009 and 2014. The value of the debt cancellation transaction amounts to 2.0% of GDP and it is presented on both revenue and expenditure sides. However, as a transaction within the general government sector, it should be offset and not appear in general government revenue and expenditure data.

While the transaction does not impact the recalculated structural balance, it appears as additional expenditure which is not offset by a discretionary revenue measure in the

calculations underpinning the assessment of compliance with the expenditure benchmark pillar. After taking this factor into consideration, the growth of government expenditure, net of discretionary revenue measures and one-offs, still exceeds the applicable expenditure benchmark in 2017, leading to a negative impact of -0.4% of GDP on the underlying fiscal position. In turn, the recalculated structural balance remains unchanged and continues to point to a deviation of -1.3% from the recommended adjustment path towards the MTO in 2017. The assessment based on the programme for 2017 is broadly confirmed by the Commission forecast. According to the Commission forecast, the structural balance is expected to widen by 1.0% of GDP, pointing to a deviation of -1.5% of GDP from the recommended adjustment path towards the MTO in 2017. Simultaneously, the growth of government expenditure, net of discretionary revenue measures and one-offs, in 2017 is forecast to exceed the applicable expenditure benchmark, leading to a negative impact of 0.4% of GDP on the underlying fiscal position. This calls for an overall assessment. The reading of the fiscal effort based on the structural balance pillar is negatively impacted by an estimated revenue shortfall, as revenue developments are estimated to fall short of what could be expected based on standard elasticities with strong nominal GDP growth. Taking this into consideration, following an overall assessment and based on the Commission forecast, there is a risk of some deviation from the requirements of the preventive arm in 2017.

For 2018, the programme assumes an improvement of the structural balance by 0.3% of GDP, resulting in a deviation of -0.2% of GDP from the recommended structural adjustment of 0.5% of GDP. According to the information provided in the programme, the growth of government expenditure, net of discretionary revenue measures and one-offs, in 2018 will be lower than the applicable expenditure benchmark, leading to a positive impact of 1.9% of GDP on the underlying fiscal position. This calls for an overall assessment. The difference between the indicators results mainly from the statistical treatment of the above-mentioned extraordinary transaction (as the expenditure benchmark mechanically benefits from the planned sizeable decrease of government expenditure in 2018, compared to 2017). After taking this factor into consideration, the growth of government expenditure, net of discretionary revenue measures and one-offs, would be just in line with the applicable expenditure benchmark in 2018.

The recalculated structural balance would remain unchanged and continue to point to a deviation of -0.2% of the recommended adjustment path towards the MTO in 2018. Based on the no-policy-change assumption, according to the Commission forecast, the structural balance is expected to improve in 2018 by 0.1% of GDP, resulting in a deviation of -0.4% of GDP from the recommended structural adjustment of 0.5% of GDP and thus pointing to a risk of some deviation. The growth of government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark, leading to a negative impact of 0.5% of GDP on the underlying fiscal position and thereby pointing to a risk of a significant deviation from this requirement. This calls for an overall assessment. The marginal difference between the two indicators stems from a limited revenue windfall positively impacting the reading of the fiscal effort based on the structural balance pillar. The difference between the Commission and the programme estimates results mainly from less optimistic assumptions on GDP growth and the evolution of the general government balance included in the Commission forecast. Over 2017 and 2018 taken together, both indicators point to a risk of a significant deviation from the adjustment path towards the MTO as the deviations from 2017 are not expected to be compensated for in 2018. Therefore, the overall assessment based on the Commission forecast points to a risk of a significant deviation from the requirements of the preventive arm in 2018.

These assessments are based on the matrix of preventive arm requirements agreed with the Council, which takes into account (i) the cyclical position of the economy, as assessed on the basis of output gap estimates using the commonly agreed methodology as well as the projected real GDP growth rate, and (ii) debt sustainability considerations. Given the current cyclical conditions and the uncertainty surrounding them, it is important that the fiscal stance strikes the right balance between both safeguarding the ongoing recovery and ensuring the sustainability of Poland's public finances. The Commission noted that, in carrying out its future assessments, it stands ready to use its margin of appreciation in cases where the impact of large fiscal adjustment on growth and employment is particularly significant. In that context, it will make use of any updated information regarding the projected position in the economic cycle of each Member State and work closely with the Council to that effect.

Table 4: Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-2.2	-3.2		-3.1	
Structural balance based on freezing (COM)	-2.2	-3.2		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.5	0.5		0.5	
Required adjustment corrected[5]	0.5	0.5		0.5	
Change in structural balance[6]	0.1	-0.8	-1.0	0.3	0.1
One-year deviation from the required adjustment [7]	-0.4	-1.3	-1.5	-0.2	-0.4
Two-year average deviation from the required adjustment [7]	-0.3	-0.8	-0.9	-0.8	-1.0
Expenditure benchmark pillar					
Applicable reference rate[8]	2.5	1.8		3.7	
One-year deviation adjusted for one-offs[9]	0.0	-2.4	-0.4	1.9	-0.5
Two-year deviation adjusted for one-offs[9]	0.1	-1.2	-0.2	-0.2	-0.5
PER MEMORIAM: One-year deviation [10]	0.0	-2.4	-0.3	1.9	-0.6
PER MEMORIAM: Two-year average deviation [10]	0.2	-1.2	-0.1	-0.2	-0.4
Conclusion					
Conclusion over one year	Overall assessment	Significant deviation	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Significant deviation	Overall assessment	Overall assessment	Significant deviation

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 2014) is carried out on the basis of Commission 2015 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.

Source :

Convergence programme (CP); Commission 2017 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

General government gross debt stood at 54.4% of GDP in 2016. The programme scenario would imply general government debt to decline to 51.3% of GDP in 2027. In contrast, under a no-policy-change assumption (based on the Commission forecast), general government debt is expected to rise to 67.6% of GDP in 2027, above the 60%-of-GDP Treaty reference value.

Overall, Poland does not appear to face fiscal sustainability risks in the short run according to the S0 indicator, which captures the short-term risks of fiscal stress stemming from the fiscal, as well as the macro-financial and competitiveness sides of the economy. In the medium term, however, fiscal risks appear to be high from a debt sustainability analysis perspective due to the increasing and relatively high stock of debt at the end of the projection period (2027). The fiscal sustainability risk indicator S1 is at 1.5 pps of GDP, mainly related to the unfavourable initial budgetary position (contribution of 1.6 pps of GDP) mitigated to some extent by the debt requirement (-0.3 pp of GDP), thus indicating medium risks in the medium term (Table 5). The full implementation of the programme would put debt on a slightly increasing path by 2027, although remaining below 60%-of-GDP Treaty reference value in 2027. The implementation of the programme would reduce the sustainability risk indicator S1 to -0.8 pp of GDP, indicating low medium-term risk.

The value of the long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is 3.6 % of GDP. In the long term, Poland therefore appears to face medium risks to fiscal sustainability. These risks are also largely connected to the unfavourable initial budgetary position (contribution of 2.4 pps of GDP to the required fiscal adjustment) and to increases in the projected costs of ageing (1.2 pps of GDP, corresponding in particular to the healthcare and long-term care costs). Full implementation of the programme would put the S2 indicator at 2.0 pps of GDP, leading to a similar long-term risk.

It needs to be noted that the above conclusions are based on the projections of the age-related expenditure path from the 2015 Ageing Report which assumed a gradual increase of the effective retirement age in Poland. This was to a significant extent a result of a mandated gradual increase of the statutory retirement age to 67 for both men and women. However, this may no longer be a realistic assumption following a recent decision to lower the statutory retirement age to 60 for women and 65 for men, which is to enter into force in October 2017. This recent development thus poses a risk to the above scenario.

Table 5. Sustainability indicators
Poland

Time horizon	No-policy Change Scenario		Convergence Programme Scenario	
Short Term	**LOW risk**			
S0 indicator [1]	0.3			
Fiscal subindex	0.1	LOW risk		
Financial & competitiveness subindex	0.4	LOW risk		
Medium Term	**HIGH risk**			
DSA [2]	HIGH risk			
S1 indicator [3]	1.5	MEDIUM risk	-0.8	LOW risk
of which				
Initial Budgetary Position	1.6		-0.3	
Debt Requirement	-0.3		-0.7	
Cost of Ageing	0.3		0.3	
of which				
Pensions	-0.2		-0.1	
Health-care	0.3		0.2	
Long-term care	0.1		0.1	
Other	0.0		0.0	
Long Term	**MEDIUM risk**		**MEDIUM risk**	
S2 indicator [4]	3.6		2.0	
of which				
Initial Budgetary Position	2.4		0.7	
Cost of Ageing	1.2		1.3	
of which				
Pensions	-0.2		-0.1	
Health-care	0.8		0.8	
Long-term care	0.6		0.6	
Other	0.0		0.0	

Source: Commission services; 2017 convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2017 forecast covering until 2018 included. The '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 2015 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 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change 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 2016.

6. FISCAL FRAMEWORK

The 2017 budget was the third consecutive budget to which Poland applied an expenditure rule covering nearly the entire general government sector[3]. The Public Finance Act requires an ex-post assessment of compliance 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 May 31st. This assessment will in turn 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 programme. Given that its coverage is close but not identical to the general government, it is not possible to provide an assessment for 2016 without the information to be published by end-May.

The applicable debt ceilings defined in the Constitution and in the Public Finance Act have not been breached in 2016. In addition, the 2016 central government deficit was lower than the limit defined in the 2016 budget law. Both the 2016 headline and the structural general government deficits (2.4% of GDP and 2.2% of GDP respectively) were also lower than projected in the previous year's programme.

According to the programme, the 2017 fiscal plans and the targets for the outer years are consistent with the limits defined by the expenditure rule. For 2017, the expenditure rule was also respected in the 2017 budget law. The evolution of the debt-to-GDP ratio in the programme also respects the debt ceilings defined in the Constitution and in the Public Finance Act.

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

The macroeconomic forecasts underpinning the 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. Poland has not established and does not have plans to establish an independent fiscal council that could fulfil such a role. 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 2016, the general government deficit was 2.4% of GDP, while the structural deficit reached 2.2% of GDP. The structural balance improved by 0.1% of GDP, which is 0.4% of GDP below the recommended adjustment towards the MTO. The growth rate of government expenditure, net of discretionary revenue measures, met the applicable expenditure benchmark rate. Following an overall assessment, this points to some deviation from the recommended adjustment path towards the MTO.

At the end of 2016, the general government debt amounted to 54.4% of GDP. It is expected to remain below the Treaty reference value of 60% of GDP over the programme horizon.

[3] Note that the rule was amended in late 2015 by adjusting the expenditure ceiling to the medium-term inflation target of the central bank and allowing for increased expenditure in the event of one-off and temporary revenue measures. In the current circumstances with low inflation rates this allowed for a higher expenditure level than under the initially enacted rule.

Poland plans to achieve compliance with its MTO, set at a structural balance of -1% of GDP, after 2020, i.e. beyond the programme period.

The recalculated structural balance is expected to worsen by 0.8% of GDP in 2017 and to improve by 0.3% of GDP in 2018. This would lead to a deviation from the recommended adjustment path towards the MTO of -1.3% of GDP in 2017 and -0.2% of GDP in 2018. At the same time, the growth rate of government expenditure, net of discretionary revenue measures after correcting for the impact of an exceptional transaction within the general government sector in 2017, is planned to exceed the applicable expenditure benchmark rate in 2017 (leading to a negative impact of 0.4% of GDP on the underlying fiscal position) and to be in line with it in 2018. For 2017, the assessment based on the programme is broadly confirmed by the Commission forecast pointing to a risk of some deviation from the recommended adjustment path towards the MTO. In 2018, the Commission projects a deviation from the recommended adjustment path towards the MTO of -0.4% of GDP and predicts the growth rate of government expenditure, net of discretionary revenue measures to exceed the expenditure benchmark (leading to a negative impact of 0.5% of GDP on the underlying fiscal position). Over 2017 and 2018 taken together, both indicators point to a risk of a significant deviation from the adjustment path towards the MTO as the deviations from 2017 are not expected to be compensated for in 2018. This would point to a risk of significant deviation from the recommended adjustment path towards the MTO in 2018.

8. ANNEXES

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	3.2	5.2	2.9	3.3	3.8	2.7	3.5	3.2
Output gap [1]	-1.8	0.1	0.7	-1.1	-0.3	-0.3	0.4	0.5
HICP (annual % change)	5.0	2.8	3.0	0.1	-0.7	-0.2	1.8	2.1
Domestic demand (annual % change) [2]	2.3	6.1	1.4	4.7	3.3	2.4	3.7	3.5
Unemployment rate (% of labour force) [3]	17.5	13.5	9.6	9.0	7.5	6.2	5.2	4.4
Gross fixed capital formation (% of GDP)	21.0	20.6	20.2	19.7	20.1	18.1	18.4	19.0
Gross national saving (% of GDP)	18.3	17.0	17.5	19.0	20.6	20.0	19.4	19.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.2**	**-3.6**	**-5.4**	**-3.5**	**-2.6**	**-2.4**	**-2.9**	**-2.9**
Gross debt	**40.2**	**45.8**	**53.2**	**50.2**	**51.1**	**54.4**	**54.6**	**55.4**
Net financial assets	**-25.5**	**-19.3**	**-30.1**	**-42.0**	**-42.0**	**-43.1**	**n.a**	**n.a**
Total revenue	40.1	40.3	38.6	38.8	39.0	38.8	39.1	39.3
Total expenditure	44.2	43.9	44.0	42.3	41.6	41.3	42.0	42.1
of which: Interest	3.0	2.4	2.5	1.9	1.8	1.7	1.7	1.6
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.8**	**1.1**	**6.4**	**6.7**	**8.3**	**6.4**	**6.9**	**6.7**
Net financial assets; non-financial corporations	**-79.9**	**-83.8**	**-80.0**	**-82.3**	**-81.5**	**-84.8**	**n.a**	**n.a**
Net financial assets; financial corporations	**4.5**	**-7.2**	**-3.8**	**-3.7**	**1.0**	**0.7**	**n.a**	**n.a**
Gross capital formation	14.1	12.7	10.8	11.3	11.3	11.7	11.2	11.7
Gross operating surplus	16.9	22.3	24.4	25.3	26.0	24.5	24.4	24.7
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**4.7**	**-2.2**	**-2.6**	**-3.0**	**-3.3**	**-1.9**	**-2.5**	**-2.7**
Net financial assets	**57.1**	**57.6**	**49.7**	**59.0**	**59.8**	**64.1**	**n.a**	**n.a**
Gross wages and salaries	34.6	32.5	32.0	31.7	31.0	31.6	31.8	31.8
Net property income	5.5	3.9	3.2	3.1	2.4	2.5	2.4	2.2
Current transfers received	20.3	17.1	16.7	16.5	16.4	17.4	17.6	17.9
Gross saving	9.3	3.3	2.0	1.3	1.1	2.3	1.7	1.5
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.3**	**-4.7**	**-1.6**	**0.3**	**2.4**	**2.0**	**1.0**	**0.6**
Net financial assets	**44.4**	**53.3**	**65.2**	**69.8**	**63.4**	**63.9**	**n.a**	**n.a**
Net exports of goods and services	-4.4	-2.9	-0.7	1.4	3.1	3.9	3.0	2.7
Net primary income from the rest of the world	-0.5	-2.4	-3.5	-3.7	-3.7	-3.8	-3.9	-4.0
Net capital transactions	0.0	0.6	1.8	1.6	2.3	1.6	1.7	1.8
Tradable sector	50.6	51.0	51.1	51.0	51.4	52.6	n.a	n.a
Non tradable sector	37.6	36.7	37.3	37.7	37.2	36.3	n.a	n.a
of which: Building and construction sector	7.0	6.8	7.3	7.0	6.9	6.0	n.a	n.a
Real effective exchange rate (index, 2000=100)	102.1	99.5	95.4	94.5	90.9	87.8	89.6	90.0
Terms of trade goods and services (index, 2000=100)	96.1	98.3	99.1	100.1	102.5	103.7	102.8	102.7
Market performance of exports (index, 2000=100)	73.3	84.5	103.4	112.4	114.6	120.7	124.7	127.2

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 2017 spring forecast