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Budget System in Poland: Challenges & Ongoing Reforms

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Budget System in Poland

Challenges and Ongoing Reforms

By Bartłomiej Wiczewski

Abstract

In recent years, amid solid economic growth and measures to increase tax collection, Poland significantly reduced its fiscal deficit and public debt. Simultaneously, the country implemented several policies that are likely to weigh on public finances in the future. In the medium and long term, Poland will face challenges resulting from the Covid-19 pandemic and high expenditure related to population ageing, switching its growth engine to more knowledge-based activities and tackling climate challenges. Given recent increases in tax collection, procyclicality of tax revenue and the recession caused by the pandemic, achieving further collection gains does not appear plausible. Thus, an efficient management of public expenditure is expected to be crucial for fiscal policy. The budget system plays a major role in this.

The current budget system in Poland has not undergone a major reform for years. Its current setup may not always be conducive to an effective management and control of funds. Longer-term planning is not sufficient and value-adding tools, like spending reviews, are not an inherent part of the process. Also, external, independent oversight is not optimal. The authorities, recognising the scale of these issues, are reforming the budget system. They benefit from a technical support financed by the EU under the Structural Reform Support Programme. As the reform will involve nearly all general government units and entail a significant change of working methods, it needs to be spread over several years.

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Introduction

In recent years, before the Covid-19 pandemic outbreak, Poland's strong economic growth allowed for a significant reduction of the fiscal deficit and public debt. In particular, revenues from taxes and social contributions increased strongly. At the same time, Poland introduced a number of new expenditure measures. These weigh on public finances now and create long-term liabilities.

Recent improvements in tax compliance resulting from a favourable cyclical position and a number of reforms mitigate short-term risks. As tax revenue tends to be driven by the economic cycle and as spending needs will remain strong, in the long run an efficient management of public spending will be key for keeping public finances in check. The budget system plays a major role in this. Recognising the importance of this issue, in 2018 and 2019 the Council of the European Union recommended Poland to increase the efficiency of public spending, including by improving the budgetary system.

This economic brief analyses key features and challenges of the budget system in Poland. It starts by giving a brief overview of recent fiscal developments and analysing likely sources of future expenditure increases, before reviewing the current budget system and the authorities' actions to improve it. It also includes considerations for tools and solutions to ensure a more efficient management of public expenditure.

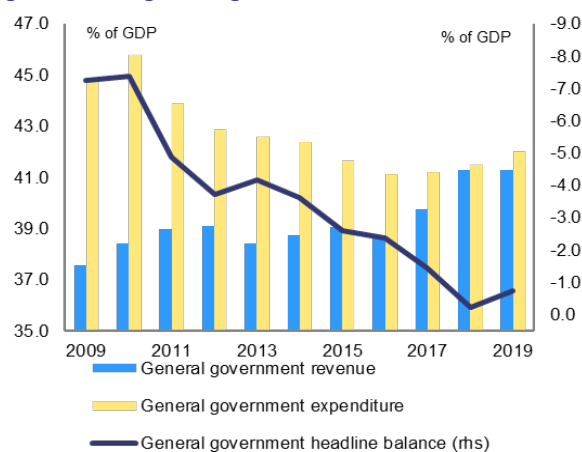
Public finances under rising pressure

Good economic times not used for a stronger fiscal consolidation

The headline deficit had been improving until 2018. Between 2008 and 2010, Poland was the only EU member state that did not experience a recession, while its general government deficit increased to 7.3% of GDP in 2009. In reaction, in 2009 the Council of the European Union launched the Excessive Deficit Procedure and recommended Poland to bring its general government deficit below 3% of GDP ⁽¹⁾. Thereafter, Poland undertook an ambitious fiscal consolidation. The headline deficit-to-GDP ratio fell to close to zero in 2018, thanks to higher revenue driven by strong economic growth, an excellent situation on the labour market and a

number of reforms to increase tax compliance (for more details, see European Commission, 2019). These factors offset a substantial rise in social spending and contributed to the observed deficit reduction (Graph 1). A prominent role in this was also played by the stabilising expenditure rule. The rule, implemented the first time for the 2015 budget, sets a limit of expenditure for every year and obliges policymakers to match any expenditure increases going beyond the ceiling with new revenue measures. The deficit increased in 2019 to 0.7% of GDP, driven mainly by new tax and social policies against the backdrop of limited further compliance gains.

Graph 1: Revenue and expenditures of the general government, general government headline balance



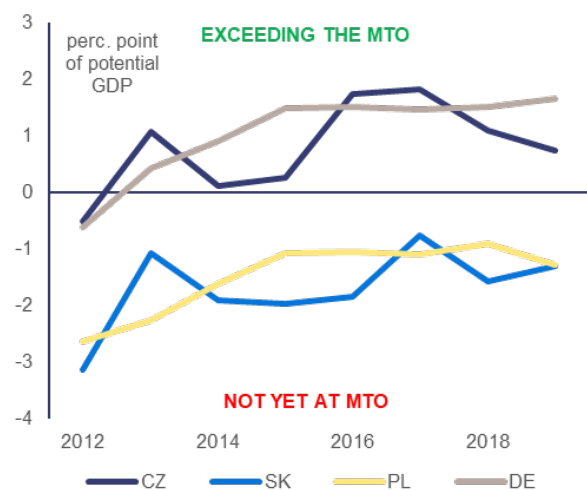
Note: Right axis values in reversed order.

Source: European Commission.

Poland has not used strong growth to continue the structural fiscal consolidation. Until 2020, the country has been experiencing solid economic growth for several years and unemployment fell to record lows. Several EU Member States used good economic times for a growth-friendly structural fiscal tightening to safeguard solid public finances and prepare for worse economic times. Instead, Poland's structural fiscal balance did not follow the same steep curve of improvement as the headline balance between 2015 and 2017. It improved in 2018, while it worsened again in 2019, due to the implementation of new social and tax policies. The structural balance has strongly deviated in 2019 from the medium-term objective (MTO) of a deficit of 1% of potential GDP ⁽²⁾. Meanwhile, a number of Poland's peer countries have reached their MTO and

their public finances were better prepared for the economic crisis (Graph 2).

Graph 2: Distance to the medium term objective



Note: Positive values indicate by how much a country exceeded the MTO, while negative values show deviation from the MTO.

Source: European Commission.

Future challenges for public finances

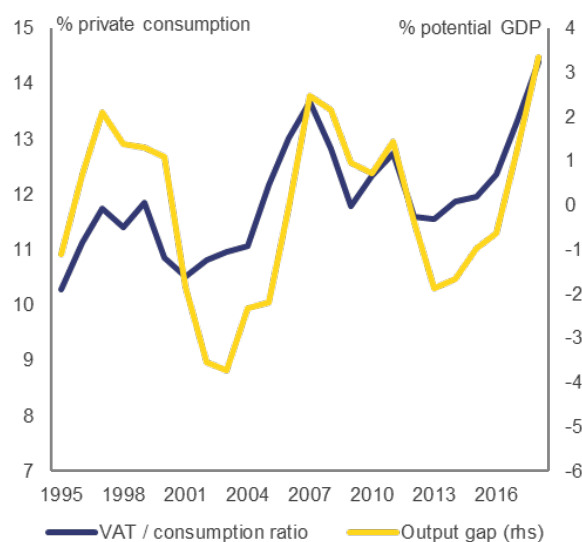
The Covid-19 pandemic will have a highly negative impact on the economy in the short and medium term. The outbreak of the pandemic in early 2020 was followed by unprecedented lockdown measures imposed worldwide. It put some parts of the global economy on hold for several weeks and disrupted global supply chains. The state of epidemic emergency was imposed in Poland mid-March 2020 and lasted for several weeks. The Polish economy is expected to fall into recession in 2020, for the first time in nearly 30 years.

The authorities implemented a series of measures to cushion the impact of the crisis that come at a high cost. In the EU and worldwide, governments decided to support economies with unprecedented measures. Also in Poland, several measures were implemented with a view to safeguarding jobs and limiting the negative economic impact of the crisis. They cover direct spending and liquidity support to companies. Combined, they could exceed 10% of GDP. While they were needed and targeted, together with the increased expenditure on healthcare, they will strongly lift the fiscal deficit. In the light of the

absence of ample fiscal buffers (see above), the government debt is expected to rise from below 50% of GDP in 2019 to nearly 60% of GDP in 2020.

The crisis will negatively affect public revenue. While various tax compliance measures were successfully implemented in the past years, the recent particularly favourable economic conditions were the primary reason for the improved situation of public finances. This cyclical effect is expected to reverse during the recession. The pro-cyclicality is visible not only in nominal levels of tax revenue but also in ratios of tax revenue to relevant tax bases (Graph 3; see also Sancak et al., 2010; European Commission, 2019).

Graph 3: Pro-cyclicality of VAT revenue to private consumption ratio, 1995–2018



Source: European Commission.

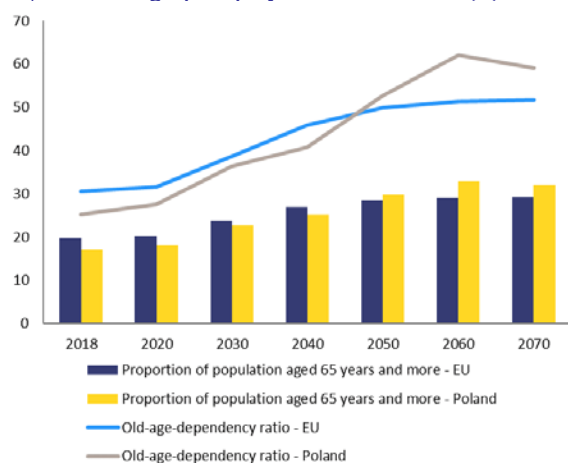
A part of the recently introduced expenditure will weigh on budgets in the medium term. In recent years, Poland has adopted a number of policies that structurally increase spending, for instance lowering the statutory retirement age. These policies are difficult to reverse, create long-term liabilities (see below) and – also via its impact on the labour force participation – may be a drag on public finances in case of an economic slowdown.

Public investment may require a higher share of domestic financing in the medium and long term. Currently, Poland benefits substantially from EU funds that support a large part of public and private investment and contribute to economic growth. In the current EU financing perspective covering the years 2014–2020, Poland, in absolute terms, is the biggest beneficiary of European

Structural and Cohesion funds among all EU Member States. As Poland's income per capita level converges towards the EU average, the allocation of EU cohesion funds can be expected to decline (while Poland is expected to be a beneficiary of the Just Transition Fund and the Recovery and Resilience Facility). To change its current growth model relying on workforce with relatively low wages towards a model more strongly based on knowledge and innovation and to tackle environmental challenges, a continuous and sizeable investment effort will be needed (European Commission, 2019). This implies the need for securing higher domestic resources for funding public investment in the future.

In the long term, Poland will face increasing fiscal pressures due to population ageing. In the next years, Poland plans to increase spending on healthcare from below 5 % of GDP in 2018 to 6 % of GDP in 2024. According to recent projections, between 2018 and 2070, the share of Poland's population aged 65 years and above will almost double (Graph 4). That will trigger substantial age-related expenditure, in particular for health, long-term care and pensions, aggravated also by the recent decision to lower the statutory retirement age ⁽³⁾.

Graph 4: Demographic projections 2018-2070 (%)



Note: Old-age-dependency ratio is the ratio of population aged 65 years and over to population aged 15 to 64 years. The value is expressed per 100 persons of working age (15-64).

2018 Eurostat baseline demographic balances and indicators projection, last update 03.07.2019.

Source: European Commission.

Efficient management of public spending can contribute to ensuring the stability of public finances. A substantial part of the expected rise of future expenditure will be of a structural nature. For the stability of public finances, it is thus important to ensure an efficient management of expenditure. Addressing the existing weaknesses of the budget system is therefore one of the most pressing challenges. Consequently, in 2018 and 2019, the Council of the European Union recommended that Poland take steps to increase the efficiency of spending, including by improving the budgetary system ⁽⁴⁾.

Budget system: challenges and first steps taken

A complex and inefficient setup

Poland's budget classification has been in place for a long time and has not undergone any deep revision recently. A traditional, complex budget classification continues to be used as a basis for budget preparation, approval, execution and control. The budget structure has a compound multi-layer structure assigning funds to relevant entities and areas. It encompasses 80 budgetary parts. The traditional budget classification covers a significant number of sections, chapters and paragraphs. Parts are intended to correspond to an administrative classification. In practice, they cover a mix of organisational units (e.g. President's cabinet), functions (e.g. education or defence) and transfers received and paid (e.g. revenue from European funds). Sections represent primarily a functional classification, while chapters correspond to an organisation or a programme. Finally, paragraphs are the basic item of the budget structure providing detailed information on revenue and expenditure.

The current budget classification and the way of recording information on spending have scope for improvements. To allow for a proper analysis and management of funds, spending should be recorded in a way that allows for their systematic aggregation along certain dimensions for which budget decisions can be made. This would require a relevant structure of granular budget items (paragraphs, but also sections and chapters) and provide a number of information for spending items recorded. While the current budget setup has several layers and is complex, it still does not allow for a

thorough and systematic analysis of expenditure (MF, 2016; IMF, 2017). Hence, reallocating funds between and within expenditure areas to ensure more efficient spending is a complex undertaking that hardly takes place in Poland.

The current setup may not always be conducive to an effective management and control of funds.

A well-constructed budget clearly indicates responsibilities and makes relevant actors and institutions (e.g. ministers) accountable for funds assigned to them. This eases the operational administration of the budget. Moreover, of crucial importance, it allows for performance analyses, identification of inefficient spending and reallocation of funds to areas where they would add most value (see for instance OECD, 2015). The current setup in Poland makes it difficult to deliver on this. This is primarily because ministries in charge of policy areas often have limited influence and control of spending on tasks within their policy areas (European Commission, 2019; IMF, 2017). In fact, spending on particular programmes or tasks is in many cases split between several institutions, which diminishes chances for an effective spending control and may dilute responsibilities. As it stands, the regional dimension of the budget, e.g. spending on central programmes by regional governments, adds an additional layer potentially hampering a genuine control of spending efficiency. As a result, accountability for policies and programmes (government, ministries) is often not coupled with accountability for spending.

A programme-based budget classification could increase spending efficiency. The main feature of a programme-based classification of public spending is classifying expenditure by the objectives it serves. Public funds are therefore assigned to programmes that have clearly assigned and accountable owners. Often it is possible to put in place a set of related indicators. They can support monitoring performance and decisions to reroute funds to where they are spent in the most efficient way⁽⁵⁾. Such budget structure and resulting process have several advantages. They help identifying the government objectives, monitoring performance of spending and thus prioritising it. They also make the programme owners more accountable and therefore can increase their efficiency (Robinson, 2013; Jacobs et al., 2009). Note, however, that an actual setting up of such a system is a compound and difficult process.

Poland hardly uses performance-based budgeting as an effective tool in the budget process. In

parallel to the mainly used functional budgeting, in 2008, Poland implemented a performance-based (programme) budgeting. Although it was modified in the following years, the performance-based budget still only has a minimal role in the management of public funds. A number of reasons explain this. The performance-based budget only complements the traditional one; it is presented in a document accompanying the draft budget law. Currently, the Ministry of Finance or line ministries have limited possibilities to translate the outcome of performance analysis into the shape of the budgets for the next year. Furthermore, the accountability for policies is not always directly linked to the accountability for spending (see above). Finally, the way the performance indicators are defined is often not conducive to a meaningful and relevant performance assessment. This is due to the use of indicators that do not reflect the objective or that depend on factors outside the full control of the corresponding authorities. For instance, for the 2020 budget, the performance relative to the objective 'support of the economy's competitiveness and innovation' is measured by labour force productivity and GDP per capita.

Setting up meaningful indicators for annual budget decisions is a difficult task. The Ministry of Finance attempted to rationalise the system of indicators in 2015, allowing for the absence of performance indicators in cases where it is operationally impossible or inefficient to set them (MF, 2015a). Consequently, the number of indicators decreased and for several activities or programmes the indicators are not set. This reform brought the system of indicators used in Poland closer to what is recommended internationally (see OECD, 2015). However, there remain a number of indicators that are hard to operationalise and make the budgetary system complex, without adding value.

The authorities plan reforms towards a programme-based budget, but the timeline is not yet set. In 2016, Poland announced plans to reform its budget system. An overarching objective of the reform is to implement tools and a process allowing responsible and coherent budgeting that would go beyond one-year planning. The reform has the potential to address major shortcomings in the current budget system and process as described above. One of the main elements of the reform is to make ministers more accountable for policy implementation, while giving them more flexibility

in terms of spending (MF, 2016). The authorities also intend to simplify the budget structure and classifications. A new, programme-based budget is planned to replace the current dual setup. However, the calendar for reform implementation is not yet known.

Setting up a new standard chart of accounts is a first step of the reform. The objective is to set up one standardised chart of accounts for all government units that would replace a number of those currently used. This would increase consistency and make data consolidation easier. Since the start of the reform, the authorities have made progress, in particular as regards designing the structure of the standard chart of accounts, however there are several challenges for which an answer still needs to be worked out. This concerns amongst others a need to rethink the budget classifications or a necessity to fully identify IT gaps to be addressed to successfully implement the reform. Overall, the implementation of the standard chart of accounts will depend on a number of other necessary changes in the areas of accounting systems, organisational processes, and accounting and financial reporting standards and policies (IMF, 2020). Since 2017, the authorities have benefited from financial and technical support by the European Commission to carry out this task (6).

Long-term budgetary planning to be developed further

Every year, the government adopts a medium-term budgetary framework. Each April, the government approves its Multiannual State Financial Plan. Since 2014, it has been composed of a convergence programme and a list of major functions of the state accompanied by relevant performance indicators. The convergence programme is sent to the European Commission for an assessment in line with the EU rules. The programme covers the general government planned revenue, expenditure and debt for the current and three subsequent years. The programme also specifies measures to achieve these budgetary targets and assumptions on the underpinning macroeconomic parameters.

The convergence programme projections do not translate into targets for subsequent budget laws. According to the act on public finances, the

convergence programme for the current year t is the basis for the draft budget law for the next year $t+1$. Even if the programme is the main medium-term planning tool for public finances officially adopted by the authorities (7), the link between the financial plans presented there and the subsequent budget laws is not always straightforward.

Poland plans to strengthen the medium-term planning. The authorities believe that the management of public expenditure should be based on a medium-term planning that forms a starting point for budget laws (MF, 2016). Therefore, they plan to link both processes more closely. The medium-term planning would define the expenditure priorities as well as their preliminary ceilings. It would also encompass new political initiatives and corresponding new expenditure categories. The differentiation of continued (based on a no-policy-change principle) and new expenditure would allow for a better monitoring of developments in the expenditure base and hence enable an early reaction to ensure that expenditure ceilings are respected in subsequent budget laws. The authorities made some progress in implementing this reform, for instance by introducing changes to allow the council of ministers to make decisions earlier in the budget process (IMF, 2020). However, the full implementation of the reform relies upon several other reforms that have not yet been initiated. Currently, there is no binding date for fully implementing these plans.

Not adequate follow-up on spending reviews

Poland performs spending reviews, but their effective follow-up is weak. Spending reviews are a tool to give the government better control over the level of aggregate expenditure and to improve expenditure prioritisation. Their objectives are manifold: to identify efficiency savings and opportunities for cutting ineffective expenditures as well as to assess and compare the effectiveness of various spending programmes (Vandierendonck, 2014; Robinson, 2014). Spending reviews are time and labour consuming, and need preparation. They are, however, a tool to assess effectiveness and efficiency of spending used in many countries. In 2015, Poland officially defined the legal framework for spending reviews (MF, 2015b). Since then, several reviews have been carried out, covering for

instance housing policy or indexation of social expenditure ⁽⁸⁾. They concluded with publicly available reports summarising main findings and recommendations. There is no indication that these reports have been presented and discussed in the parliament.

Spending reviews do not directly underpin the budget process. Currently, in Poland the outcome of spending reviews does not need to be implemented or at least formally followed up by an empowered body, for instance a parliamentary committee. Spending reviews are not part of the budget process. As a result, the chances that measures to increase the effectiveness of public spending are implemented may be somewhat diminished.

The government intends to incorporate spending reviews into the budget process. One of the objectives of the announced reform is to ‘institutionalise’ reviews and incorporate them formally into the budget preparation process (MF, 2016). This would allow reviews to fully play their intended role. Such approach would be in line with good international practice (see for instance OECD, 2015 and Robinson, 2014). The implementation date of this plan is not yet known.

Incomplete independent checks

Poland does not have an independent fiscal council. A fiscal council, as an independent fiscal institution, is a publicly funded, independent body providing on a regular basis independent analysis and/or recommendations in the area of fiscal policy (European Commission, 2006). In practice, fiscal councils usually assess macroeconomic and budget forecasts, assess compliance with fiscal rules, perform costing of government policy proposals, analyse long-term sustainability of public finances and promote fiscal transparency. While Poland, in contrast to euro area countries, is not formally obliged to set up a fiscal council, in 2020 it is the only EU member state without such an independent body and without any official plans to establish it.

Fiscal councils can strengthen fiscal frameworks and the reliability of the budget system. Although the empirical assessment of the effectiveness of fiscal councils is challenging (see Jankovics and Sherwood, 2017), several analyses show that fiscal councils may improve fiscal governance, in particular when combined with fiscal rules. When

properly designed, staffed and empowered, fiscal councils seem to limit the deficit bias inherent to policymaking and to improve the budget process ⁽⁹⁾.

Several institutions fulfil some tasks typically assigned to fiscal councils, but a scattered approach weakens their impact. The National Bank of Poland and the Social Dialogue Council, a body bringing together representatives of employers, employees and the government, independently assess draft annual budgets, including their underpinning parameters. The opinion of the National Bank of Poland also includes an assessment of compliance of planned fiscal policy with fiscal rules. At the same time, the parliamentary Public Finance Committee regularly commissions analyses of draft annual budgets by independent experts. The ex-post assessment of compliance with fiscal rules is performed by the Supreme Audit Office, at the level of state budget, and by its regional analogues, at the level of regional and local governments. At the same time, no public institution monitors long-term fiscal sustainability or independently costs major policy initiatives. What is, however, crucially important is that the tasks that could be done by a standalone fiscal council are scattered between various institutions that differ significantly in terms of their analytical capacity and weight in the public debate. This significantly weakens the impact they potentially could have, in particular in terms of public debate on fiscal policy issues (European Commission, 2018).

Conclusions

The recession triggered by the Covid-19 pandemic will impact the Polish economy in the short term. In the medium to long term, Poland will face increasing expenditure pressures in a number of areas. To anticipate these developments, a robust framework for managing expenditure needs to be put in place. Addressing several weaknesses in the budget system is an important step towards this objective. As an indication of the importance of the issue, in 2018 and then again in 2019, the Council of the European Union recommended Poland to improve the efficiency of public spending, including by reforming the budgetary system. Recognising this challenge, the Polish authorities proposed a reform of the budget system to tackle the challenges described above. First steps have already been undertaken and some progress was made.

As the implementation of such a reform is bound to be resource-consuming, it will need to be spread over several years. The reform will involve nearly all general government units and require a significant change of working methods of involved institutions and individuals. Considering the extent of the reforms, these resource requirements are non-negligible. Nevertheless, overall the reform has the potential to address the existing challenges. Public finances could also benefit, if in parallel Poland establishes a fiscal council – a stand-alone independent, competent body that would scrutinise fiscal policy and become a strong voice in the public debate.

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¹ The procedure was abrogated in 2015 after the deficit came into line with the Treaty reference value of 3% of GDP.

² The structural balance is the general government balance adjusted by the impact of the economic cycle and temporary measures. The MTO is set at a level that ensures sound fiscal stance. It takes into account the countries' economic situation and the need to achieve sustainable debt levels. At the same time, it guarantees that countries have a sufficient fiscal buffer protecting them from breaching the EU's fiscal rules in the case of worsening economic conditions.

³ As explained in the Country Report for Poland (European Commission, 2019), the pension-related expenditure can play a negative role for the long-term fiscal sustainability. While the design of the defined-contribution pension system scheme prima facie makes the system neutral for public finances in the long run, the expected ratio of average pension benefits to wages is to fall sharply in the next decades. Considering the expected increase of number of pensioners that would not accumulate sufficient capital for the guaranteed minimum pension benefit or who would receive pensions close to that minimum, it is not to be excluded that such situation could trigger pressure to increase (minimum) pensions. This would have a direct negative impact on public finances.

⁴ Council Recommendation of 9 July 2019 on the 2019 National Reform Programme of Poland and delivering a Council opinion on the 2019 Convergence Programme of Poland, OJ C 301, 05.09.2019, p. 123.

⁵ 'Spent in the most efficient way' means here that they generate the same value / output with fewer resources or better address the needs of the recipients with the same resources.

⁶ Under the Structural Reform Support Programme.

⁷ The budget law adopted every year by the parliament contains in one of its attachments a list of multiannual programs and their costs in subsequent years. This has, however, limited value from the budget planning perspective. Similarly, long-term development strategies adopted by the government have limited value for the budget planning purposes.

⁸ A list of and reports concluding on spending reviews performed up to date is available at: <https://www.gov.pl/web/finanse/przeglady-wydatkow-publicznych>

⁹ See for example Jankovics and Sherwood (2017), Nerlich and Reuter (2013), Debrun et al. (2009), Debrun and Kinda (2014), Coletta et al. (2015), Beetsma and Debrun (2016).

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