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Analysis of the budgetary situation in Poland
following the adoption of the COUNCIL RECOMMENDATION to POLAND
of 21 June 2013
with a view to bringing an end to the situation of an excessive government deficit

Accompanying the document

Recommendation for a
COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Poland

and the

Recommendation for a
COUNCIL DECISION

establishing that no effective action has been taken by Poland
in response to the Council Recommendation of 21 June 2013

{COM(2013) 906 final}
{COM(2013) 907 final}

1. INTRODUCTION

Poland is currently subject to the corrective arm of the Pact. The Council opened the Excessive Deficit Procedure for Poland on 7 July 2009 and recommended to correct the excessive deficit by 2012. On 21 June 2013, the Council concluded that Poland had taken effective action but adverse economic events with major implications on public finances had occurred, and issued revised recommendations. Poland was given a deadline of 1 October 2013 to take effective action to ensure a sustainable correction of the excessive deficit by 2014. Poland has submitted a report on effective action ("REA") on 2 October 2013.

Section 2 of this document presents the macroeconomic outlook underlying the report on effective action and provides an assessment based on the Commission Forecast. The following section presents the recent and planned fiscal developments, according to the report on effective action, including an analysis of risks to their achievement based on the Commission Forecast. In particular, it also includes an assessment of the measures underpinning the report. Section 4 assesses the recent and planned fiscal developments in 2013-2014 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 presents the proposed new adjustment path and section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario underpinning the report on effective action and the draft 2014 budget is almost unchanged compared to the one used for the Convergence Programme 2013. After a sharp slowdown from an average real GDP growth of 4% over 2001-2011 to 1.9% in 2012 (Table 1) and an opening of a negative output gap (-0.7% in 2012), the government projects for 2013 another year of weak economic activity. Real GDP growth is forecast to reach 1.5%. Private consumption is set to remain subdued (+1.1%) as households are expected to rebuild savings, while investments are forecast to drop by 0.7% on account of cuts in public spending. The positive contribution to growth from net external demand is expected to shrink to 0.8 pp. of GDP.

The government projects some rebound in economic activity in 2014 with real GDP expanding by 2.5%. On the back of better economic prospects, an improving labour market and consumer sentiment, private consumption is expected to pick up by 2.1%. Investment is set to increase by 4.4% driven by strong growth in private outlays. The contribution of external trade is expected to be broadly neutral as import accelerates in line with increasing domestic demand.

For 2015, the government expects that real GDP will grow at a robust rate of 3.8%. Private consumption (+3.2%) and investments (+7.8%) are the main contributors, while external trade is forecast to remain broadly neutral.

According to the Commission 2013 autumn forecast, which takes into account the outturn in the first half of 2013, the macroeconomic situation in 2013 and the outlook for 2014 are somewhat better than the one underlying the latest Council recommendation under Article 126(7) of the Treaty ("EDP baseline"). For 2013 real GDP is set to grow at 1.3% (compared to 1.1% in the EDP baseline) on the back of a much better-than-expected contribution of net exports, which more than compensate for a more negative contribution of inventories. Similar to the Polish authorities, the Commission expects private consumption as well as investment to become the main driver of economic growth in 2014 and 2015. Real GDP is set to grow by 2.5% in 2014 (2.2% in EDP baseline) and 2.9% in 2015.

Table 1: Comparison of macroeconomic developments and forecasts

	2012	2013			2014			2015		
	COM	CP	REA	COM	CP	REA	COM	CP	REA	COM
Real GDP (% change)	1.9	1.5	1.5	1.3	2.5	2.5	2.5	3.8	3.8	2.9
Private consumption (% change)	1.2	1.1	1.1	0.6	2.1	2.1	1.6	3.2	3.2	2.0
Gross fixed capital formation (% change)	-1.7	-0.7	-0.7	-3.8	4.4	4.4	2.9	7.8	7.8	5.9
Exports of goods and services (% change)	3.9	2.8	2.8	5.4	4.3	4.3	5.1	5.0	5.0	5.9
Imports of goods and services (% change)	-0.7	0.9	0.9	1.1	4.9	4.9	3.8	5.5	5.5	5.8
Contributions to real GDP growth:										
- Final domestic demand	0.4	0.8	0.8	-0.1	2.7	2.2	1.8	4.0	3.6	2.7
- Change in inventories	-0.6	0.0	0.0	-0.7	0.5	0.5	0.0	0.4	0.4	0.0
- Net exports	2.1	0.8	0.8	2.0	-0.1	-0.1	0.7	-0.2	-0.2	0.2
Output gap[1]	-0.7	-2.2		-2.1	-2.7		-2.0	-2.0		-1.6
Employment (% change)	0.2	-0.3	-0.4	-0.4	0.0	-0.1	0.1	0.6	0.6	0.4
Unemployment rate (%)	10.1	10.8	10.7	10.7	11.0	11.0	10.8	10.6	10.6	10.5
Labour productivity (% change)	1.7	1.7	1.9	2.5	2.5	2.6	2.6	3.1	3.2	2.6
HICP inflation (%)	3.7	1.6	1.6	1.0	2.4	2.4	2.0	2.5	2.5	2.2
GDP deflator (% change)	2.4	1.5	1.5	1.0	2.2	2.2	1.8	2.5	2.5	1.9
Comp. of employees (per head, % change)	4.1	2.4	2.4	2.5	3.4	3.4	3.1	5.3	5.3	3.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1.6	0.2	0.2	0.0	1.1	1.1	0.6	2.4	2.4	0.3

Note:

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

Source:

Converence Programme update 2013 (CP); Report on Effective Action 2013 (REA); Commission 2013 Autumn Forecast (COM).

However, compared to the Polish authorities, the Commission has a less optimistic view on domestic demand growth over the forecast horizon and still expect a positive albeit declining contribution to growth from net exports. In particular, the projection of private consumption growth is much more conservative because the Commission projects that households will continue to increase their saving rate more than assumed in the government forecast.

The development of the saving rate is also a significant risk for the government's macroeconomic scenario. Because the saving rate reached its lowest level ever in 2012, the assumption of a relatively limited increase over the forecast horizon significantly below the long term average seems to be too optimistic. Additionally, the government expects significant positive effects of rebounding external demand and recent changes in the Polish investment support framework on private investment growth, which might turn out too optimistic.

3. FISCAL DEVELOPMENTS

3.1. Fiscal forecasts

In its update of the Convergence Programme of April 2013 ("CP2013"), the Polish government expected a general government deficit of 3.5% for 2013. In their assessment the Commission considered this forecast as too optimistic and projected a general government deficit of 3.9% with a downside risk because of strong procyclicality of indirect and direct tax revenues, below standard revenue elasticities.

Indeed, a significant downward revision of expected tax revenues of the central government for 2013 by PLN 23.7 bn (1.5% of GDP) forced the Polish government to amend its 2013 budget in September. The amendment introduced expenditure cuts of 0.5% of GDP, the rest of the revenue shortfall is reflected in an increase of the deficit by 1% of GDP[1].

1 For more details, please see the following section on measures underpinning the report.

The government's fiscal forecast underpinning the REA, is profundly changed compared to the fiscal forecast underpinning the CP2013. The government foresees a general government deficit of 4.8% in 2013. It estimates the shortfall in general government revenues at 1.2% of GDP (from 37.8% in the CP2013 to 36.6% in the REA) and considers the significant reduction in particular in VAT, excise duties and corporate income tax as cyclical. However, since the sizeable shortage in revenues cannot be solely accounted for by a change in the composition of growth and therefore in the underlying tax base[2], it seems that not only cyclical aspects but also tax compliance/tax evasion has contributed to lower revenues.

The government projects total expenditures of 41.5% of GDP, i.e. 0.1 pp. higher than in the 2013 Convergence Programme. Since the 2013 budget amendment reduced expenditure projections by 0.5% of GDP, the numbers contained in the report on effective action indicate that in addition to the revenue shortfall that the budget amendment tried to compensate, an expenditure slippage of 0.6% of GDP (compared to the Convergence Programme) occurred as well. While the government argues that this expenditure slippage is cyclical and due to an increase in social expenditures (they increased by +0.3% of GDP compared to CP2013), this cyclical effect is not reflected in a change in the underlying macroeconomic forecast, which has remained unchanged since the CP2013. Moreveover, the cyclical part of social expenditures, i.e. unemployment benefits, increased by less than 0.1% of GDP.

For 2014, the Polish Ministry of Finance projects a general government surplus of 4.5% of GDP on the back of the intended pension reform (see Box 1 for details). The reform foresees a shift of a sizeable amount of assets (8.5% of GDP) from the second pillar to the first pillar of the pension system, which under ESA-95 is treated as a revenue. Since the asset transfer is a one-off transfer, in 2015 the Polish authorities forecast a deficit of 3% of GDP. The improvement compared to 2013 is due to the permanent impact of other aspects of the planned pension reform, in particular the higher number of contributors in the first pillar.

In 2013 and 2014, the Commission 2013 autumn forecast is similar to the Polish authorities'. It projects a deficit of 4.8% of GDP in 2013, the deterioration compared to the EDP baseline being due to significant lower tax revenues. In 2014, the general government balance is projected to be in surplus (+4.6% of GDP) as a consequence of the one-off asset transfer from the second pillar of the pension system (8.5% GDP).

For 2015 the Commission is less optimistic compared to the Polish authorities and expect a general government deficit of 3.3% of GDP. The difference of 0.3 pp is mainly due to lower current revenues based on a more conservative nominal GDP growth projection (see Section 2). Moreover, the Commission forecasts higher government expenditure on intermediate consumption (by 0.3 pp of GDP) using as a proxy growth rate nominal GDP (+4.7%), while Poland assumes an increase by 0.8% without a sufficient back up by enacted or publicly announced measures. At the same time, Commission projects higher capital transfers from OFE to public pension pillar, related to the changes in the pension system (gradual transfer of assets to ZUS of those employees retiring within 10 years ("suwak")), which has not been included in the Polish projection (yielding 0.36% of GDP in additional revenues in COM forecasts).

[2] The change in the contribution of domestic demand to real GDP growth (deterioration by 0.3 pp.) in the Commission macroeconomic forecast between the spring 2013 vintage and the autumn 2013 vintage cannot explain the full shortfall in current revenues of 0.6% of GDP.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2012	2013			2014			2015		
	COM	**CP**	**REA**	**COM**	**CP**	**REA**	**COM**	**CP**	**REA**	**COM**
Revenue	**38.3**	**37.8**	**36.6**	**36.7**	**37.2**	**44.9**	**45.2**	**36.2**	**36.1**	**36.9**
of which:										
- Taxes on production and imports	12.9	12.8	12.5	12.2	12.8	12.3	12.1	12.6	12.1	12
- Current taxes on income, wealth, etc.	7.2	6.9	6.6	6.9	6.9	6.8	7	6.9	7	7.1
- Social contributions	12.3	12.2	12.1	12.2	12	12.1	12.3	11.8	12.2	12.4
- Other (residual)	6	5.9	5.4	5.4	5.5	13.7	13.8	4.9	4.8	5.3
Expenditure	**42.2**	**41.3**	**41.4**	**41.5**	**40.5**	**40.4**	**40.6**	**38.9**	**39.2**	**40.2**
of which:										
- Primary expenditure	39.4	38.6	38.7	38.8	38.1	38.2	38.5	36.7	37	38
of which:										
Compensation of employees	9.4	9.7	9.6	9.4	9.5	9.4	9.3	9.1	9.1	9.1
Intermediate consumption	5.7	5.5	5.5	5.7	5.3	5.5	5.6	5	5.2	5.6
Social payments	16.4	16.4	16.7	16.9	16.2	16.6	16.9	15.9	16.4	16.8
Subsidies	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Gross fixed capital formation	4.6	3.8	3.6	3.6	3.5	3.5	3.5	3.3	3.3	3.3
Capital transfers	0.4	0.6	0.4	0.4	0.6	0.3	0.3	0.6	0.4	0.3
Other (residual)	2.5	2.3	2.5	2.5	2.6	2.5	2.5	2.4	2.2	2.5
- Interest expenditure	2.8	2.7	2.7	2.7	2.4	2.2	2.2	2.2	2.2	2.2
General government balance (GGB)	**-3.9**	**-3.5**	**-4.8**	**-4.8**	**-3.3**	**4.5**	**4.6**	**-2.7**	**-3**	**-3.3**
Primary balance	**-1.1**	**-0.8**	**-2.2**	**-2.2**	**-0.9**	**6.7**	**6.7**	**-0.5**	**-0.9**	**-1.2**
One-off and other temporary measures	0.1	0.1		0	0		8.4	0		0
GGB excl. one-offs	**-4**	**-3.6**		**-4.8**	**-3.3**		**-3.9**	**-2.7**		**-3.3**
Output gap[1]	-0.7	-2.2		-2.1	-2.7		-2.1	-2		-1.8
Cyclically-adjusted balance[1]	-0.8	-2.6		-1.2	-2.2		7.7	-1.9		-1.6
Structural balance (SB)[2]	**-3.7**	**-2.7**		**-4**	**-2.2**		**-3.2**	**-1.9**		**-2.7**
Change in SB	1.6	1		-0.3	0.5		0.8	0.3		0.5
Two year average change in SB	2.3	1.4		0.7	0.8		0.3	0.4		0.7
Structural primary balance[2]	-0.9	0		-1.3	0.2		-0.8	0.3		-0.5
Change in structural primary balance		0.9		-0.4	0.2		0.5	0.1		0.3

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance recalculated by Commission services on the basis of the macroeconomic scenario provided in the 2013 Convergence Programme, using the commonly agreed methodology.

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

Source:

2013 Convergence Programme (CP); Report on Effective Action (REA); Commission 2013 Autumn Forecast (COM); Commission services' calculations.

The general government gross debt in Poland is projected to remain below the 60% threshold over the entire period under consideration. The intended pension reform is the main driver behind this projection. Similar to the Polish authorities, the Commission forecasts the general government gross debt to remain below the 60% threshold over the entire period under consideration. General government debt-to-GDP ratio is forecast to fall from 55.6% in 2012 to 51% in 2014, mainly as an effect of the announced transfer of pension funds' assets of 8.5% of GDP, before edging up to 52.5% in 2015. It has to be noted that the budgetary forecasts are subject to implementation risks.

Table 3: Debt developments

(% of GDP)	Average 2007-2011	2012	2013			2014			2015		
			CP	REA	COM	CP	REA	COM	CP	REA	COM
Gross debt ratio[1]	**50.8**	**55.6**	**55.8**	**58.0**	**58.2**	**55.7**	**49.9**	**51.0**	**55.6**	**51.1**	**52.5**
Change in the ratio	1.7	-0.6	0.2	2.4	2.6	-0.1	-8.1	-7.2	-0.1	1.2	1.5
Contributions [2] *:*											
1. Primary balance	**2.7**	**1.1**	**0.8**	**2.2**	**2.2**	**0.9**	**-6.7**	**-6.7**	**0.5**	**0.9**	**1.2**
2. "Snow-ball" effect	**-0.9**	**0.5**	**1.1**	**1.2**	**1.4**	**-0.1**	**-1.2**	**-0.3**	**-1.1**	**-0.2**	**-0.2**
3. Stock-flow adjustment	**0.0**	**-2.2**	**-1.7**	**-1.0**	**-1.0**	**-0.8**	**-0.2**	**-0.2**	**0.5**	**0.5**	**0.5**

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 :

2013 Convergence Programme (CP), Report on Effective Action (REA); Commission 2013 Autumn Forecasts (COM); Commission staff

3.2. Measures underpinning the report

For 2013, the Polish authorities claim to have introduced measures of an overall deficit-reducing effect of 1.1% of GDP. Out of these, the only new, significant measures introduced since the Council recommendation of June 2013 are the expenditure cuts provided in the 2013 budget amendment. Excluding the lower costs of servicing of public debt in 2013 (which are out of direct control by the authorities and thus do not qualify as a measure) they amount to 0.4% of GDP. The largest cut contained in the 2013 budget amendment concerns planned defence spending (0.2% of GDP). The other main reductions concern transport infrastructure and special purpose reserves ("rezerwy celowe"), and other smaller items to an overall effect of 0.2%.

In 2014-2015, the main new measure is the planned change to the second pillar of the penion system, described in detail in the box below.

Box 1: Planned second pillar pension reform

On 2 July the Polish government adopted a report on the pension system prepared by the Ministers of Labour and Finance, with a focus on the second pillar (OFEs). On 10 October, the government published draft law on a reform to the second pillar of the pension system (OFEs), based largely on the report. It is currently discussed in parliament and expected to come into force on 1 April 2014. The reform includes the following provisions:

- All non-equity portfolios (mostly government bonds) held in the second pillar by OFEs would be transferred to the public social security scheme (ZUS). Roughly 51.5% of OFEs assets (equivalent to 8.5% of GDP) would be affected by this transfer.
- The existing (and future) contributors would have to declare if they want to continue (enter) the current mixed system (ZUS + OFEs) or to move fully into PAYG ZUS. In case of no declaration within three months, they will be by default moved to ZUS.
- For persons participating in the second pillar, the contribution to OFE would be permanently lowered to 2.92% of salary.
- Starting 10 years before the retirement age, pension capital accumulated in OFE would be gradually transferred to ZUS. Payments of pensions will be executed by ZUS only.
- Investment by OFEs in treasury bonds will be banned. Pension funds' benchmarks are to be changed to reflect their new investment mandate. Also, in line with an EU requirement, pension funds would be permitted to invest a higher share of their funds abroad. Pension funds' fees would be cut by half. OFEs would be banned from adversting (subject to prison

terms of up to 2 years or PLN 1 million fine).

Given the change in the Polish pension system it needs to be assessed (by Eurostat) if Poland can benefit any longer from the pension clause in the Stability and Growth Pact..

The effects of the planned pension reform are as follows:

(i) One-off asset transfer

Under ESA-95, the general government balance would improve by the value of the assets transferred to ZUS from OFEs. This transfer would constitute one-off revenue and amounts to 8.5% of GDP[3]. Additionally, the lower general government debt would result in lower annual interest payments (yielding 0.28% of GDP in 2014 and an additional 0.05% of GDP in 2015[4]).

(ii) Contributions

The general government balance would improve by the value of the those contributions no longer transferred to the second pillar in the future, but would worsen by the respective pension liabilities taken over by ZUS from OFEs. Since the contributions to OFEs are currently much higher than the pensions paid by OFEs, the overall impact on the government balance is expected to be positive in the near future. The precise number depends on how many people decide to remain in the second pillar. The Polish Ministry of Finance assumes that half of the current members would remain in the second pillar. Based on this conservative assumption, the estimated annual effect of the lower contributions to OFE amounts to 0.2% of GDP in 2014 and an additional 0.22% of GDP in 2015.

(iii) Gradual transfer of assets to ZUS of those employees retiring within 10 years ("suwak")

The general government balance would improve by the value of the pension capital which would be gradually transferred starting 10 years before retirement (10% annually). Again, the precise number depends on how many people decide to remain in the second pillar. Under the baseline assumption that half of the current members would remain in the second pillar, the estimated annual effect in 2014 amounts to 0.26% of GDP and an additional 0.36% of GDP in 2015[5].

To sum up, a permanent and decreasing impact of changes in the pension system on general government deficit (excluding the one-off asset transfer of 8.5% of GDP in 2014) is likely to amount to 0.74% of GDP in 2014 and an additional 0.63% of GDP in 2015[6].

After the EDP recommendation in June 2013, apart from the pension reform, the Polish government has introduced some changes to indirect taxes (increase in excise duty on alcohol and a change to Value Added Tax (VAT) removing the possibility to recover some of the expenses for housing purposes) with a deficit-decreasing effect of 0.1% of GDP in 2014. For 2015, apart from the full-year effects of the planned pension reform, there are no new

3 Under ESA-2010, which comes into force in September 2014, this one-off transfer would not count as revenue anymore.

4 I.e., unlike the lower debt servicing costs in 2013 contained in the 2013 budget amendment, they are treated as a discretionary measure. This is due to the fact that the lower debt servicing costs in 2014 are a direct result of the planned pension reform, i.e. of factors controlled by the government.

5 Under ESA-2010, which comes into force in September 2014, this transfer would no longer count as revenue.

6 Under ESA-2010 this impact would no longer include "suwak", and amount to 0.48% in 2014 and 0.27% in 2015.

measures which have been enacted or publicly annnounced since the time of the EDP recommendation.

Box 2. New fiscal measures since the Council EDP recommendation of 21 June 2013	
Revenue	**Expenditure**
2013	
	Amendment 2013 budget (net of lower debt financing costs) (-0.4%)
2014	
*Pension reform: transfer of non-equity assets to the first pillar (+8.5%) (one-off)** *Pension reform: "suwak" (+0.3%)** Pension reform: opt-out (+0.2%) Changes to indirect taxes: excise on alcohol and VAT on housing expenditures (+0.1%)	Pension reform: Savings on debt-financing costs due to the assets transfer (-0.3%)
2015	
*Pension reform: "suwak" (+0.4%)** Pension reform: opt-out (+0.2%)	
Note: A positive sign implies that revenue / expenditure increases as a consequence of this measure. Annual budgetary impacts are estimated by the Commission services and expressed as a % of GDP. Measures with a budget impact of at least 0.1% of GDP are listed. * These measures have an impact on revenues under ESA-95 but will not be treated as such under ESA-2010.	

4. Compliance with Council recommendations

Box 3. Council recommendations addressed to Poland

On 21 June 2013, the Council recommended Poland under Art. 126(7) of the Treaty to correct its excessive deficit by 2014. To this end, Poland *should reach a headline deficit target of 3.6% of GDP in 2013 and 3.0% of GDP in 2014, which is consistent with an annual improvement of the structural balance of at least 0.8% and 1.3% of GDP respectively, based on the updated Commission 2013 spring forecast*.

On 9 July, the Council addressed recommendations to Poland in the context of the European Semester. In particular, in the area of public finances the Council recommended to Poland *to reinforce and implement the budgetary strategy for the year 2013 and beyond, supported by sufficiently specified measures for both 2013 and 2014, to ensure a timely correction of the excessive deficit by 2014 in a sustainable manner and the achievement of the fiscal effort specified in the Council recommendations under the EDP. A durable correction of the fiscal imbalances requires credible implementation of ambitious structural reforms, which would increase the adjustment capacity and boost potential growth and employment. After the correction of the excessive deficit, pursue the structural adjustment effort that will enable Poland reaching the medium-term objective by 2016. With a view to improving the quality of public finances minimise cuts in growth-enhancing investment, reassess expenditure policies improving the targeting of social policies and increasing the cost effectiveness and efficiency of spending in the healthcare sector. Improve tax compliance, in particular by increasing the efficiency of the tax administration. Ensure the enactment of a permanent expenditure rule in 2013* *consistent with the rules of the European System of Accounts. Take measures to strengthen annual and medium-term budgetary coordination mechanisms among different levels of government.*

4.1. Compliance with EDP recommendations (assessment of effective action)

The current assessment of the effective action is based on the Commission 2013 autumn forecast. It takes into account the economic and budgetary developments since the June Council revised recommendations under Article 126(7), including the measures taken to deliver effective action included in the REA. It assesses in parallel if the nominal target is met and if the recommended change in structural budget balance is ensured after correction for revisions to the estimates of (i) potential output growth compared to that underlying the growth scenario in the Council recommendation, and (ii) the impact on revenue of revisions of the tax content of economic activity relative to what is implied by long-term standard elasticities. This top-down approach in the assessment is complemented by a careful analysis, including a bottom-up assessment of consolidation measures undertaken by the Polish government. All these elements are taken into account in the final conclusion.

The general government deficit in 2013 is projected to reach 4.8% of GDP. Consequently, Poland will miss the headline deficit target of 3.6% of GDP recommended by the Council for 2013. In 2014, a general government surplus of 4.6% of GDP is expected and the headline deficit target is set to be fulfilled although it is due to the one-off transfer of pension funds' assets (8.5% of GDP)[7].

Thus, a detailed assessment of the structural effort is required to see whether Poland has made sufficient progress towards a timely and sustainable correction of its excessive deficit. The structural deficit is estimated to reach 4.0% of GDP in 2013 compared to 3.3% at the time of the EDP recommendation. The change in the structural balance for this year is estimated at -0.3% of GDP. After adjusting for the revision in potential output growth since the time when the recommendation was issued (+0.1 pp.) and for revenue shortfalls (compared to that implied by the standard elasticities) (+0.5 pp.), the corrected change in the structural balance (0.3% of GDP) is still below the recommended annual fiscal effort (0.8% of GDP) for 2013.

This creates a strong presumption of lack of effective action, which has to be confirmed by a careful analysis of measures taken. On the revenue side, there have been no significant new measures since the EDP recommendations, while on the expenditure side, the government in the 2013 budget amendment cut expenditure by 0.4% of GDP (this number excludes the lower costs of servicing of public debt, which are out of direct control by the authorities and thus do not qualify as a measure).

These budget cuts have been partially offset by an overall non-cyclical expenditure slippage of 0.2% of GDP[8]. To estimate the non-cyclical expenditure overrun, the Commission compared the adjusted EDP baseline scenario to the adjusted Commission 2013 autumn forecast, taking into account the impact of the economic cycle on government expenditure:

[7] Excluding this one-off asset transfer, the general government balance is set to reach a deficit of 3.9% of GDP, including the effects of "suwak".

[8] On the expenditure side, except for a limited number of exogenously driven expenditure changes (notably changes in unemployment benefits due to a change in the number of unemployed and changes in interest expenditure related to fluctuations in interest and exchange rates), and to the extent that expenditures are not driven by inflation surprises, most items of public expenditure can be considered as being largely under the control of the government.

- The EDP baseline scenario was corrected for the 2012 expenditure execution using the Eurostat October 2013 notification. This avoids mistaking base-year effects (i.e. change in the result for 2012) for expenditure under- and over-execution in 2013.
- In a second step, the Commission adjusted the 2013 autumn forecast and excluded the effect of the 2013 budget amendment cuts in order to derive pre-2013 budget amendment expenditure forecast.

A comparison of the two adjusted forecasts shows that the total expenditure (before the 2013 budget amendment) is 0.3% of GDP higher than in the corrected EDP baseline scenario. This difference is driven by an increase in intermediate consumption (0.2% of GDP), social transfers (0.1% of GDP) and other current expenditure (0.1% of GDP), and is moderated by a fall in capital expenditure (0.1% of GDP).

Even assuming that the entire increase in social expenditures is cyclical and therefore outside the control of the government (as is the slight decrease in debt servicing costs), would result in a non-cyclical expenditure overrun of 0.2% of GDP.

Therefore, the bottom-up analysis of new discretionary measures complemented by an assessment of expenditure developments which are not outside the control of the government shows an overall fiscal effort of 0.2% of GDP. This falls short of the additional measures referred to in recital (19) of the Council Recommendation of 0.4% of GDP and confirms that Poland has not implemented structural effort as recommended by the Council.

For 2014 the Commission 2013 autumn forecast projects a structural balance of -3.2% of GDP. The change in the structural balance in 2014 is estimated at +0.8% of GDP. After adjusting for the revision in potential output growth since the time when the recommendation was issued (+0.1 pp.) and for revenue shortfalls (compared to that implied by the standard elasticities) (+0.5 pp.), the corrected change in the structural balance (1.4% of GDP) is above the recommended annual fiscal effort (1.3% of GDP) for 2014.

Overall, based on Commission 2013 autumn forecast Poland is forecast to miss the nominal deficit target for 2013 and the recommended structural effort for this year. For 2014, the targets – in terms of both nominal deficit and structural effort - specified in the Council recommendation of June 2013 are forecast to be reached[9]. However, under a no-policy-change assumption, the correction of the excessive deficit forecast for 2014 seems not sustainable on the basis of the Commission projection for 2015 as the deficit is set to reach 3.3% of GDP.

9 Under the statistical regime currently in force, i.e. ESA-95.

Table 4: Change in structural balance

Uncorrected change in structural balance		Correction coefficient α		Correction coefficient β		Change in structural balance corrected for **α** and **β**		Change in structural balance required in the latest Council recommendation	
2013	2014	2013	2014	2013	2014	2013	2014	2013	2014
-0.3	0.8	0.1	0.1	0.5	0.5	0.3	1.4	0.8	1.3

Notes:
α - the impact of revisions in potential output growth compared to that underlying the growth scenario in the recommendation
β - the impact of revisions on the composition of economic growth or of other windfalls/shortfalls on revenue
Source: Commission services' 2013 Autumn Forecast

4.2. Compliance with fiscal European Semester recommendations

The structure of the additional cuts in 2013 and 2014 broadly follows the Council recommendation, though part of it (e.g. railways, defence spending) is to be attributed to investment spending. However, the government has not presented any plans to reassess expenditure polices improving the targeting of social policies or increasing the cost effectiveness and efficiency of spending in the healthcare sector, as recommended by the Council. Furthermore, the government has not yet addressed the need to improve tax compliance, in particular by increasing the efficiency of the tax administration, which becomes urgent in view of recurrent slippages on the revenue side.

The Polish authorities have been working on the permanent expenditure rule, which seems to be fulfilling most of the conditions set by the Directive 2011/85/EU. However, a mechanism ensuring an effective and timely monitoring of compliance with the rule, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities seems to be missing. Moreover, the consequences in the event of non-compliance with the rule (and ideally, correction mechanisms) are not spelled out in the draft law. In general, many weaknesses of the fiscal framework remain, in particular discrepancy between the national standards and ESA as well as the vulnerability of fiscal rules to frequent changes which risks undermining their credibility and effectiveness.

5. PROPOSED NEW ADJUSTMENT PATH

Overall, based on Commission 2013 autumn Forecast Poland is forecast to miss the nominal deficit target as well as the recommended structural effort for 2013.

Under ESA95, the excessive deficit it corrected in 2014, although not in a sustainable manner. According to the Commission 2013 autumn forecast, the deficit is well below 3% of GDP in the current forecast (as a result of a sizeable one off (+8.5% of GDP) from the pension reform). On a no-policy change basis the deficit is forecast at 3.3% of GDP in 2015 and the correction of the excessive deficit is not sustained. Based on the current forecast and ESA95 additional measures of at least 0.5% of GDP would be needed to bring the deficit below the 3% of GDP Treaty reference value to ensure a sustainable correction of the deficit beyond the 2014 deadline.

However, under ESA2010 which will be introduced in autumn 2014 not all elements contained in the pension reform will be counted as deficit reducing, in particular the one-off asset transfer (8.5% of GDP in 2014) as well as the gradual asset transfer ("suwak", 0.3% of GDP in 2014 and 0.4% in 2015) will no longer count. Therefore in autumn 2014 the deficit under ESA2010 will no longer be below 3% of GDP, but is expected to stand at 4.2% of GDP for 2014 and 3.9% of GDP in 2015.

Since the Council will decide on an abrogation based on the EDP figures assessed by EUROSTAT in spring 2015 under ESA2010, additional measures are to be required to compensate for those elements of the pension reform, which will not reduce the deficit any longer under ESA2010.

As the assessment of the correction of the excessive deficit will be taken under ESA2010 regime, it is necessary to anticipate its entry into force and consider the level of the deficit net of asset transfers related to the pension reform. However, in order to reduce the deficit below the 3% of GDP threshold by 2014 i.e. in line with the current deadline, and consistent with ESA-2010 rules, the required additional structural effort, on top of the measures already included in the Commission 2013 autumn forecast (which under ESA2010 would yield an improvement in structural deficit of 0.6% of GDP in 2014), would amount to at least 1.6% of GDP[10]. Such a yearly effort would be much higher than requested in the Council Recommendation of 7 July 2009 (1¼ % of GDP) and in the one of 21 June 2013 (1.3% of GDP), despite the fact that fiscal risk has fallen since 2009 as the headline deficit is at a much lower level and debt remains below the 60% threshold. If a correction had to be done in 2014, it would also result in sizeable output costs. In view of the above and in line with the flexibility foreseen in the Stability and Growth Pact, setting a deadline of 2015 to correct the excessive deficit is warranted.

Correcting the excessive deficit by 2015 would be commensurate with intermediate headline deficit targets of 3.9% of GDP for 2014 (excluding the effect of the pension reform not valid under ESA 2010) and 2.8% of GDP for 2015 (see Table 5 and Table 6). Improvements in the structural budget balance implied by these targets are at 1% of GDP in 2014 and 1.2% of GDP in 2015, taking into account the measures included in the Commission 2013 autumn forecast yielding an improvement in structural balance under ESA2010 of 0.6% of GDP in 2014 and 0.2% of GDP in 2015.

The baseline scenario (see Table 5) is an updated version of the Commission 2013 autumn forecast taking into account the change in the statistical classification of pension funds' asset transfer due to introduction of ESA-2010 statistical system. A strict implementation of adopted savings, adoption and implementation of announced and budgeted savings measures, as well as additional measures of about 0.4% of GDP in 2014 and 1% of GDP in 2015 are needed to correct the excessive deficit by 2015.

[10] Assuming no additional fiscal effort in 2013.

Table 5: Forecast of key macroeconomic and budgetary variables under the baseline scenario

% of GDP	2013	2014	2015
Revenues	36.7	36.5	36.3
Current revenues	35.7	35.6	35.7
Discretionary measures with impact on current revenue	0.1	0.3	0.3
Expenditure	41.5	40.7	40.3
Real GDP growth (%)	1.3	2.5	2.9
Nominal GDP growth (%)	2.3	4.4	4.8
Potential GDP growth (%)	2.7	2.5	2.5
Structural balance	-4	-3.4	-3.2
General government balance	-4.8	-4.2	-3.9
p.m Output gap (% of pot. Output)	*-2.1*	*-2*	*-1.6*

Source: Commission calculations based on Autumn 2013 forecast, incorporating ESA-2010

Table 6: Forecast of key macroeconomic and budgetary variables under the EDP scenario

% of GDP	2013	2014	2015
Real GDP growth (%)	1.3	2.2	2.4
Potential GDP growth (%)	2.7	2.5	2.5
Structural balance	-4.0	-3.0	-1.8
General government balance	-4.8	-3.9	-2.8
p.m Output gap (% of pot. output)	-2.1	-2.3	-2.4

Source: Commission calculations based on Autumn 2013 forecast, incorporaitng ESA-2010

At the current juncture of the economic cycle with growth significantly below potential, it is important to reduce negative impact of consolidation measures on growth. Moreover, uncertainty surrounding the impact of the measures taken requires close monitoring and further corrective action. Furthermore, and in line with the June 2013 Council recommendation (i) improving the quality of public finances, in particular through minimising cuts in growth-enhancing investments, a careful review of expenditures and their efficiency; (ii) better tax compliance and an increase in the efficiency of tax administration and (iii) making the framework of public finances more binding and transparent, including through adjusting the definitions used in national accounting to ESA [95] standards and ensuring sufficiently broad coverage, improving intra-annual monitoring of budget execution and ensuring an effective and timely monitoring of compliance with the permanent expenditure rule, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities could underpin the consolidation efforts further.

6. SUMMARY

In 2013, Poland will miss the nominal target and the structural effort, whereas for 2014 the targets specified in the Council recommendation of June 2013 are forecast to be met[11], although the nominal deficit only as a result of a one-off measure. Also, under a no-policy-change assumption, the correction of the excessive deficit forecast for 2014 seems not sustainable on the basis of the Commission projection for 2015 as the deficit is set to reach 3.3% of GDP.

Since the Council will decide on an abrogation based on the EDP figures assessed by EUROSTAT in spring 2015 under ESA2010, additional measures are required to compensate for those elements of the pension reform, which will not reduce the deficit any longer under ESA2010.

Under ESA 2010 the headline deficit is forecast to reach 4.2% of GDP in 2014 and 3.9% of GDP in 2015.Correcting the excessive deficit under the new rules would require a fiscal effort well beyond what has been recommended for by Poland in previous recommendations and would have negative effects on output, while at the same time the fiscal risk is lower compared to the time when Poland entered EDP in 2009. Overall, setting up a deadline of 2015 seems to be appropriate.

Granting one more year for the correction of excessive deficit implies the headline deficit targets of 3.9% of GDP in 2014 (net of pension asset transfer) and 2.8% of GDP in 2015. The underlying improvements in the structural budget balance implied by these targets are 1% of GDP in 2014 and 1.2% of GDP in 2015. This implies a need of additional measures of 0.4% of GDP in 2014 and 1% of GDP in 2015, on top of those already included in the autumn forecast and the report on the effective action.

11 Under rules currently in force, i.e. ESA-95.

ANNEX. EDP RELATED TABLES

Table A1. Baseline scenario underlying the June 2013 EDP recommendation

% of GDP	2012	2013	2014
Revenues	38.4	37.6	37.3
Current revenues	37	36.3	36.2
Discretionary measures with impact on current revenue	1.4	0.2	-0.2
Expenditure	42.3	41.6	41
Real GDP growth (%)	1.9	1.1	1.8
Nominal GDP growth (%)	4.4	2.5	3.8
Potential GDP growth (%)	3.6	2.8	2.8
Structural balance	-3.8	-3.3	-2.4
General government balance	-3.9	-3.9	-3.7
p.m CAB methodology revenue elasticity	0.8	0.8	0.8
p.m Apparent revenue elasticity	1.2	0.3	0.5
p.m Output gap (% of pot. Output)	-0.7	-2.3	-3.2
Source: Commission Staff Working Document accompanying Council Recommendation of 21 June 2013			

Table A2. EDP scenario underlying the June 2013 EDP recommendation

% of GDP	2012	2013	2014
Real GDP growth (%)	1.9	0.8	1.6
Potential GDP growth (%)	3.6	2.7	2.6
Structural balance	-3.8	-3.0	-1.7
General government balance	-3.9	-3.6	-3.0
p.m Output gap (% of pot. output)	-0.7	-2.7	-3.3
Source: Commission Staff Working Document accompanying Council Recommendation of 21 June 2013			

Table A3. Current estimates of the macroeconomic and fiscal developments

% of GDP	2012	2013	2014	2015
Revenues	38.3	36.7	45.3	36.9
Current revenues	37.0	35.7	35.6	35.7
Discretionary measures with impact on current revenue	1.5	0.1	0.4	0.3
Expenditure	39.4	38.9	40.7	40.3
Real GDP growth (%)	1.9	1.3	2.5	2.9
Nominal GDP growth (%)	4.4	2.3	4.4	4.8
Potential GDP growth (%)	3.5	2.7	2.5	2.5
Structural balance	-3.7	-4.0	-3.2	-2.7
General government balance	-3.9	-4.8	4.6	-3.3
p.m CAB methodology revenue elasticity	*0.8*	*0.8*	*0.8*	*0.8*
p.m Apparent revenue elasticity	*0.3*	*-0.7*	*0.7*	
p.m Output gap (% of pot. Output)	*-0.7*	*-2.1*	*-2.0*	*-1.6*
Source: Commission 2013 Autumn Forecast				

Table A4: Adjustment of apparent structural effort for the revision in potential growth – details of calculation

	Potential GDP growth underlying the Council Recommendation (%)	Potential GDP growth at the time of assessment (%)	Forecast error (%)	Structural expenditure (% of potential GDP)	Correction coefficient α (% of nominal potential GDP)
	(1)	(2)	(3)=(1)-(2)	(4)	(5)=(3)*(4)/100
2013	2.9	2.7	0.2	41.6	0.1
2014	2.8	2.5	0.3	39.7	0.1

Table A5: Adjustment of apparent structural effort for the unexpected revenue windfalls/ shortfalls – details of calculation

	Change in current revenues (yoy) (billions of national currency)		Discretionary current revenue measures (billions of national currency)		Nominal GDP growth assumptions (%)		Current revenues in year t-1 (billions of national currency)		Revenue gap (billion of national currency)*	Correction coefficient β (% of nominal potential GDP)
	2013E	2013AF	2013E	2013AF	2013E	2013AF	2013E	2013AF	0	0
	(1)	(1')	(2)	(2')	(3)	(3')	(4)	(4')	(5)=[(1')-(2')-ε*(3')*(4')]-[(1)-(2)-ε*(3)*(4)]	0
2013	4.1	-7.7	3.1	1.3	2.5	2.3	590.5	590.5	-8.9	-0.5
2014	19.4	22.7	-2.7	6.8	3.8	4.4	594.6	582.7	-8.3	-0.5