COUNCIL OF THE EUROPEAN UNION

Brussels, 14 March 2006

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NOTE

from :	General Secretariat of the Council
to :	Delegations
Subject:	Council Opinion on the updated Convergence Programme of Poland

Delegations will find attached the Council's opinion on the updated Convergence Programme presented by Poland, as adopted by the ECOFIN Council on 14 March 2006.

Attachment

COUNCIL OPINION

of 14 March 2006

on the updated convergence programme of Poland, 2005-2008

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 14 March 2006 the Council examined the updated convergence programme of Poland, which covers the period 2005 to 2008.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

(2) Polish real GDP growth averaged 4.5% per year between 1994 and 2004 more than two percentage points above the EU25 average of 2.4%. After a period of strong economic expansion, real GDP growth slowed to 1.0% in 2001, reflecting both domestic and external cyclical factors. It has since rebounded reaching 5.3% in 2004. Per capita income in purchasing power standards reached 46.5% of the EU25 average in 2004. HICP inflation has remained high, at 7.0% on average, over the last ten years, but dropped significantly in 2005, to around 2%. The labour market situation remains Poland's major problem, with unemployment rate of 18.8% in 2004 and the lowest rate of employment in the EU (51.7% in 2004). For the last ten years, the general government balance has always been negative in Poland. It fluctuated between -1.4% and -4.8%[1] of GDP until 2003, since when it started to improve, reaching -3.8% of GDP in 2004 and –2.9% of GDP in 2005.

(3) On 5 July 2004 the Council decided that Poland was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit has to be corrected by 2007. In its opinion of 17 February 2005 on the previous update of the convergence programme, covering the period 2004-2007, which has been taken before modification of Stability and Growth Pact the Council invited Poland to "(i) strengthen the fiscal adjustment beyond 2005 and lower the deficit target for 2007; (ii) to ensure a full implementation of the structural measures contained in the *Hausner plan* and make further efforts to introduce alternative measures if implementation risks were to materialize".

(4) As regards budgetary implementation in 2005, the general government deficit for 2005 is estimated at 3.6% of GDP in the Commission services' autumn 2005 forecast, against a deficit target of 3.9% of GDP set in the previous update of the convergence programme and in comparison with the deficit of 2.9% of GDP projected in the current programme. The comparison with previous convergence programmes is complicated by significant data revisions linked to methodological changes. The better-than-expected outcome was mainly determined by the budgetary performance of the central government, in particular the state budget, which recorded (on a cash basis) higher-than-planned direct tax revenues and an under-execution of expenditures, reducing the deficit by about 0.7 percentage points compared to the budget plan for 2005.

[1] EDP definition, all pension funds classified within the general government sector, revised data.

(5) The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.[1] Poland submitted its convergence programme update on 19 January, 7 weeks beyond the 1 December deadline set in the code of conduct. The delay was caused by the formation of a new government in November 2005 following parliamentary elections and the replacement of the minister of finance in early January 2006.

(6) The programme's macroeconomic scenario expects annual real GDP growth to increase from 3.3% in 2005 to 4.3% in 2006 and to reach 5.0% in 2008. The growth assumptions underlying the programme can be considered as plausible, tilted to favourable in the outer year. The programme's projections for inflation also appear realistic, except for 2006 when they seem to be on the upper side taking into account the latest CPI developments.

(7) The current update of the convergence programme aims at a gradual reduction of the general government deficit (calculated taking into account the Eurostat decision of 2 March 2004) to meet the convergence criteria by the end of the legislature, hence implicitly by the end of 2009. The deficit target for 2007 is unchanged at 2.2% of GDP, with the second-pillar funded pension schemes included in the general government sector. If the pension schemes are excluded from the government sector, the deficit target increases compared to the previous update, from 3.9% of GDP to 4.1% of GDP because the estimated balance of the pension scheme now reaches 1.9% of GDP. If the regressive reduction of net cost of pension reforms were allowed to be taken into account, Poland's general government deficit would be below 3% of GDP throughout the period. The primary balance (second-pillar funded pension schemes in the general government sector) is expected to improve from –0.3% of GDP in 2005 to 0.6% in 2008. This slow adjustment is driven primarily by favourable revenue developments in 2006 and some expenditure cuts in 2007 and 2008. Compared with the previous update, the current update sets more ambitious deficit targets in 2006, thanks to carry-over effect from favourable revenue developments in 2005, but afterwards the adjustment effort is lower and expenditure reforms are postponed until 2007 and 2008.

[1] The programme provides all compulsory and most optional data prescribed by the new code of conduct. The data on employment in hours worked and labour productivity measured as GDP per hours worked have not been provided. There are no data for general government expenditure by function for 2008. Differences between cash and accruals, net accumulation of financial assets are also missing. Total revenues and expenditures in Table 7 (long-term sustainability) are missing

(8) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated by the Commission services on the basis of the information provided in the programme according to the commonly agreed methodology is planned to improve on average by ¼% of GDP per year. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit of -1.0% of GDP, which it does not aim to achieve within the programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around -1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO reflects the debt ratio and average potential output growth in the long term.

(9) The budgetary outcome could be worse than projected in the programme. Although the record of overachievement of the budgetary targets set in the previous programmes make the budgetary projections look cautious, several factors may weigh on the planned adjustment. Following the good tax revenue developments in 2004 and 2005, assumptions about the tax elasticity are rather optimistic, in particular in 2006Furthermore, the growth assumptions in the outer year of the programme period (2008) seem favourable. In the current political climate, miners have been granted special pension rights, inducing other social groups to also make demands for special schemes, undermining the pension reform implemented in 1999. The four-year nominal anchor of PLN 30bn for the state budget, introduced in the convergence programme, is aimed at tackling the problem of the excessive deficit. Nevertheless, some alternative or additional fiscal rule aiming at controlling increase in government expenditure would be beneficial.

(10) The programme does not follow the deficit reduction path for 2007 specified by the Council in its recommendation under Article 104(7) and the fiscal stance in the update seems inconsistent with a correction of the excessive deficit by the deadline set by the Council. The conclusion is reinforced taking into account the balance of risks. The deficit targets for 2005 and 2006 are lower than in the previous update and meet the nominal targets set in the Council recommendation of 5 July 2004, thanks to better than planned execution of the 2005 budget with carry-over effects to 2006. A comparison of targets should take into account the changes in national accounts methodology required by Eurostat. For the critical year 2007, the programme foresees a deficit reduction to 2.2% of GDP. However, when excluding the second-pillar funded pension schemes from the general government sector in line with Eurostat decision of 2 March 2004, the planned deficit in 2007 is at 4.1% of GDP If the regressive reduction of net cost of pension reforms were allowed to be taken into account, Poland's general government deficit would be below 3% of GDP. Substantial additional adjustment effort would be needed to correct the excessive deficit by the set deadline.

(11) Between 2005 and 2008, government debt is expected to increase by 3¼ percentage point of GDP and reach 45½% of GDP in 2008, well below the 60% of GDP reference value. It is also about 2 percentage points lower than in the previous Convergence programme update. Significant debt-increasing stock-flow adjustments are expected to offset the effect of primary surpluses and a favourable snowball effect (i.e. the negative contribution of the implicit interest is outweighed by sustained high nominal GDP growth).

(12) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. However, the measures proposed are not sufficient to correct promptly the excessive deficit.

(13) The National Reform Programme of Poland, submitted on 5 January 2006 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: budgetary consolidation in view of high deficits, upgrading the underdeveloped infrastructure and reducing charges imposed on labour to decrease the high unemployment in Poland. However, the budgetary implications of the actions outlined in the National Reform Programme are not presented in the budgetary projections of the convergence programme. Among the public finance measures introduced in the National Reform Programme, convergence programme mentions the deficit anchor and the multi-annual budgetary planning.

(14) With regard to the sustainability of public finances, Poland appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The level of debt is currently under the 60% reference value and should remain so under the assumption that savings related to the implementation of the 1999 pension reform will materialise. The reform is ambitious and contributes to the solving of the ageing problem, but measures recently adopted by the government to exclude particular employment groups from the reformed pension scheme could weaken the reform's long-term outcome, particularly if further exemptions from the pension schemes were granted. The realization of contingent liabilities as well as the currently high structural deficit may increase the debt/GDP ratio faster than planned over the medium term. Implementing rigorously the planned consolidation of public finances over the medium-term would reduce risks to long-term sustainability[1].

In view of the above assessment, the Council notes that the convergence programme envisages some progress, but not the effective correction of the excessive deficit in 2007, as required by the Council recommendation of 5 July 2004, and that the Commission intends to recommend further steps under the excessive deficit procedure as required by the Stability and Growth Pact. In the meantime, Poland should:

(i) strengthen the adjustment in 2006 in particular, by allocating any higher-than-budgeted revenues or lower-than-budgeted expenditure to deficit reduction;

[1] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

(ii) safeguard the results of the pension reform;

(iii) enhance the institutional framework of public finances by complementing the nominal anchor with other measures, for example a medium-term expenditure rule.

Comparison of key macroeconomic and budgetary projections[1]

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Jan 2006**	**5.3**	**3.3**	**4.3**	**4.6**	**5.0**
	COM Nov 2005	5.3	3.4	4.3	4.5	n.a.
	CP Dec 2004	*5.7*	*5.0*	*4.8*	*5.6*	*n.a.*
HICP inflation (%)	**CP Jan 2006**	**3.6**	**2.2**	**1.5**	**2.2**	**2.5**
	COM Nov 2005	3.6	2.2	2.3	2.5	n.a.
	CP Dec 2004	*3.5*	*3*	*2.7*	*2.5*	*n.a.*
Output gap (% of potential GDP)	**CP Jan 2006[2]**	**0.4**	**0.1**	**0.3**	**0.3**	**0.6**
	COM Nov 2005[5]	0.4	0.2	0.4	0.6	n.a.
	CP Dec 2004[2]	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Jan 2006**	**-3.8**	**-2.9**	**-2.6**	**-2.2**	**-1.9**
	COM Nov 2005	-3.9	-3.6	-3.6	-3.4	n.a.
	CP Dec 2004	*-5.4*	*-3.9*	*-3.2*	*-2.2*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2006**	**-1.2**	**-0.3**	**-0.2**	**0.3**	**0.6**
	COM Nov 2005	-1.2	-1.0	-1.1	-1.0	n.a.
	CP Dec 2004	*-2.6*	*-1.3*	*-0.5*	*0.4*	*n.a.*
Cyclically-adjusted and Structural balance[3] (% of GDP)	**CP Jan 2006**	**-4.1**	**-2.9**	**-2.7**	**-2.3**	**-2.1**
	COM Nov 2005[4]	-4.1	-3.7	-3.7	-3.6	n.a.
	CP Dec 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2006**	**41.9**	**42.5**	**45.0**	**45.3**	**45.4**
	COM Nov 2005	43.6	46.3	47.0	47.3	n.a.
	CP Dec 2004	*45.9*	*47.6*	*48.0*	*47.3*	*n.a.*

Notes:
[1]The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated programme would be -5.6% of GDP in 2004, -4.7% in 2005, -4.6% in 2006, -4.1% in 2007 and -3.7% in 2008, while government gross debt would be 45.9% of GDP in 2004, 47.9% in 2005, 51.2% in 2006, 52.1% in 2007 and 52.6% in 2008.
[2]Commission services calculations on the basis of the information in the programme
[3]Cyclically-adjusted balance and structural balance are the same since one-off and other temporary measures taken from the programme are insignificant (0.04% of GDP in 2005, deficit-reducing)
[4]There are no one-off and other temporary measures in the Commission services' forecast
[5]Based on estimated potential growth of 3.3%, 3.6%, 4.2% and 4.5% respectively in the period 2004-2007.
Source:
Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations