POLAND'S PUBLIC FINANCE CONVERGENCE WITH THE EURO AREA

Kawecka-Wyrzykowska, E.

The situation of Poland's public finances has been improving. Helped by solid economic growth in 2011, Poland has reduced its budget deficit in line with the Commission's recommendations. However, contrary to earlier forecasts, in 2012 it was still well above the ceiling of 3% of GDP. As a result, the excessive deficit procedure was extended by two years, by 2014. The deficit should be further reduced to reach, in 2015, the level of 1% of GDP in terms of structural deficit. The slowdown of the economy in 2012 and probably in 2013 will not make this task easy. Public debt has risen steadily over the past few years but in recent times, the level has still been well below the 60% of GDP ceiling. The national reform program and the convergence program were adopted by Poland's Council of Ministers on 25 April 2012. The convergence program outlined in an integrated manner the fiscal consolidation efforts, the key structural reforms and the reforms that underpin macroeconomic stabilization. In the medium- to long-term, Poland is faced with a number of challenges. A very low labor force participation rate, in particular of women, and the poor quality of vocational training and education are major concerns given an ageing population. The low level of public and private R&D spending, weak links between science and industry and poor innovation performance call for improvements. Apart from the program of national reforms, crucial for future sustained economic growth and good performance of public finances, an additional factor stimulating activities towards fiscal improvement should be Poland's participation in strengthened economic governance architecture recently introduced in the EU. Euro adoption remains an important goal of the Polish government. The uncertain situation in the euro zone has, however, postponed adoption of a clear timetable of joining the euro zone. The government decided that an additional condition to join the euro zone, apart from meeting the nominal convergence criteria (and legal conditions not discussed here), is stabilization of the euro area situation.

JEL Classification: E61, F32, F33

Keywords: convergence fiscal criteria; public finances stabilization; Poland's budgetary situation; EU economic governance; Economic and Monetary Union (EMU)

1. Introductory Remarks

Nine years have elapsed since Poland's accession to the EU and its commitment to join the euro zone as stated in the Accession Treaty. The difficult situation in the euro zone itself doesn't make the decision easy for any applicant country, even if all entrance criteria are met. Adoption of the euro is, however, still an important objective declared by the Polish government.

The objective of this paper is to analyze Poland's recent public finances situation from the point of view of meeting the Maastricht fiscal criteria, i.e. to see whether progress (in terms of meeting fiscal criteria) has been achieved and if so, how solid it is. The answer is relevant not only from the point of view of Poland's ability to join the euro zone but also from the point of view of the stability of the country's economic foundations and prospects for further economic growth. The analysis covers the 2008-2012 period, it is the year before the economic slowdown in Poland (2009) and the next years for which full-year statistics exist.

The paper starts with a short overview about the nominal criteria of convergence with the euro area. Next, economic growth changes and their driving factors are presented as a confirmation of close synergies between the economic growth and public finances situation. Next, the evolution of budgetary position of Poland and main elements of policy reforms to address the fiscal imbalances are discussed. Also, Council recommendations addressed to Poland under the EDP and challenges that may hinder improvement of the fiscal and macroeconomic situation are presented. Finally, the prospects of exiting excessive deficit and meeting fiscal convergence criteria are elaborated on.

2. The Legal Status of Poland with Regard to the EMU and Nominal Convergence Criteria[1]

Under the Accession Treaty, Poland – like all other Member States which acceded to the EU in 2004 and 2007 (we will use the abbreviation NMS – New Member States – despite the fact that they are not "new Members" any more)[2] – became a member of the Economic and Monetary Union (EMU). None of the NMS entered the euro zone on the day of EU accession. All of them committed themselves in their Accession Treaties to adopt the euro in the future, after having fulfilled the required criteria and obligations, including the so-called Maastricht criteria (nominal convergence criteria). Apart from these criteria, candidate countries have to ensure full independence of the national central banks and to adjust respective domestic laws.[3]

There is no deadline for euro adoption. In early September 2008, Poland's Prime Minister Mr. D. Tusk, announced that the country would be ready to join the euro zone in 2011. It was bad timing to announce such a date, as just a few days later Lehman Brothers collapsed and the government had to drop its previous timing target. Since this announcement, no new date has been set. The government has not, however, dropped the preparations for euro zone accession. Respective actions have been taken to speed up the country's fulfillment of the Maastricht criteria. At the same, Poland says that the euro zone has to be prepared for enlargement. It means also that euro adoption in Poland has become highly conditional on the enforcement of the economic governance enhancements in the EU, which are of utmost importance for boosting the stability of the euro area as a whole (Ministry of Finance, Poland, 2012c).

Given that at the time of the EU accession, the NMS did not fulfill these criteria, they obtained the so-called status of EMU "Member States with a derogation".[4] The condition for lifting the derogation was the fulfillment of the above mentioned nominal convergence (Maastricht) criteria. The adoption of the common currency implies, above all, that applicant countries should apply disciplined macroeconomic policy which enables both their sustainable development and brings them forward towards meeting the convergence criteria. Nominal economic convergence criteria involve two types of requirements to be met by countries aspiring to the euro zone:

a) two fiscal criteria (low budget deficit and gross government (public) debt),
b) three monetary criteria (low inflation and interest rate, stable exchange rate of domestic currency).

The degree of fulfillment of convergence criteria is subject to ECB and European Commission (EC) periodic evaluation. Also, the final assessment of a country's readiness for membership in the euro area is based on Commission and EBC reports. The fulfillment of these criteria allows recognizing the economy of a given EU country as sound and competitive, which, in the future, will not constitute a burden for the remaining euro area members.

Table 1: Real GDP growth rates of the EU Member States in 2008-2013 (%)

Country	2008	2009	2010	2011	2012	2013F
EU 27	0.3	-4.3	2.1	1.6	-0.3	-0.1
Belgium	1.0	-2.8	2.4	1.8	-0.3	0.0
Bulgaria	6.2	-5.5	0.4	1.7	0.8	0.9
Czech Rep.	3.1	-4.5	2.5	1.8	-1.3	-0.4
Denmark	-0.8	-5.7	1.6	1.1	-0.5	0.7
Germany	1.1	-5.1	4.2	3.0	0.7	0.4
Estonia	-4.2	-14.1	3.3	8.3	3.2	3.0
Ireland	-2.1	-5.5	-0.8	1.4	0.9	1.1
Greece	-0.2	-3.1	-4.9	-7.1	-6.4	-4.2
Spain	0.9	-3.7	-0.3	0.4	-1.4	-1.5
France	-0.1	-3.1	1.7	2.0	0.0	-0.1
Italy	-1.2	-5.5	1.7	0.4	-2.4	-.1.3
Cyprus	3,6	-1.9	1.3	0.5	-2.4	-8.7
Latvia	-3.3	-17.7	-0.9	5.5	5.6	3.8
Lithuania	2.9	-14.8	1.5	5.9	3.7	3.1
Luxembourg	-0.7	-4.1	2.9	1.7	0.3	0.8
Hungary	0.9	-6.8	1.3	1.6	-1.7	0.2
Malta	3.9	-2.6	2.9	1.7	-0.8	-1.4
Netherlands	1.8	-3.7	1.6	1.0	-1.0	-0.8
Austria	1.4	-3.8	2.1	2.7	0.8	0.6
Poland	5.1	1.6	3.9	4.5	1.9	1.1
Portugal	0.0	-2.9	1.9	-1.6	-3.2	-2.3
Romania	7.3	-6.6	-1.1	2.2	0.7	1.6
Slovenia	3.4	-7.8	1.2	0.6	-2.3	-2.0
Slovakia	5.8	-4.9	4.4	3.2	2.0	1.0
Finland	0.3	-.8.5	3.3	2.7	-0.2	0.3
Sweden	-0.6	-5.0	6.6	3.7	0.7	1.5
United Kingdom	-1.0	-4.0	1.8	1.0	0.3	0.6

Note: F - forecast
Source: Eurostat (2013)

1 This chapter draws on Kawecka-Wyrzykowska (2009).

2 The group includes: Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia.

3 We skip here the process of real convergence of applicant countries.

4 In conformity with art. 140 of TFEU (former art.121 and 122 of the TEC).

3. Economic Growth and its Driving Factors

In recent years, Poland was the only country without recession in 2009: GDP growth was at 1.6% (see Table 1).According to the Ministry of Finance, Poland's cumulated economic growth in 2008-2011 was the highest in the European Union and amounted to 15.8% (Ministry of Finance, Poland, 2012). Slovakia, ranked second, achieved over the past four years, a growth rate of "only" 8 percent, states the report. The GDP of the entire European Union fell, during the same period, by 0.5 percent.

A number of factors can explain the relatively good macroeconomic situation in Poland in recent years, including things related to the public finance situation. First, the Polish economy is less dependent on exports than many other countries, including its smaller neighboring countries (such as the Czech Republic and Slovakia, which are heavily dependent upon auto exports). Lower export dependence meant that the Polish economy suffered less from declining foreign demand for Polish products than many other countries (Rae, 2012).

Next, the floating exchange rate of Poland's national currency (Polish Zloty – PLN) allowed for a real depreciation in the value of the Złoty, which helped to boost exports.[5] In this period, staying outside the euro zone proved to be advantageous for the economy.

Also, Poland has a relatively sound banking system (due to its tight lending standards and relatively low level of private debt), which has not negatively affected the credit ability of banks. Also, due to this situation, the government was not required to divert large sums of public money to bail out its banking and financial sectors and more money could be spent in other sectors of the economy.

A positive role was also played by the reduction of taxes in Poland which was decided upon in the period before the crisis. Both, personal income tax rates and corporate income tax rates were reduced substantially.[6]

The government has significantly increased public investment throughout the crisis, which has helped to stave off a recession. Public investment increased from 35% to 43% of overall investment between 2005 and 2010. This ensured that although private investment fell sharply throughout the crisis, Poland's overall investment rate only declined slightly (by 0.08 percent) in 2009, while in other years it has continued to rise. The biggest increase in investment has been in the area of buildings and infrastructure. Massive public investment was to a great degree related to the European football championship that Poland was co-hosting in 2012 (Ministry of Finance, Poland, 2012).

Investments' role has been intensified by the utilization of available EU funds. Poland has been the single largest recipient of EU funds from the 2007–2013 budget, as it is to receive up to 67 billion euros in structural funds and Cohesion Fund. This sum increases to 82 billion euros (2,500 euros per capita) once the designated national public funds have been added. These funds have helped the government start large investments in the country's infrastructure (partly related to the preparation of the Euro 2012 football championship) and have contributed much to the increase of demand in the economy, thus mitigating the reduction of external demand in the period of world recession (Rae, 2012).

Another source of growth for the Polish economy has come through an increase in consumer demand. This has been helped by the relatively small rise in unemployment, which has partly been made possible by the low reduction in public sector employment (this sector makes up over a quarter of all jobs in Poland). Moreover, wages and salaries have continued to rise throughout the crisis (and in the following years).

A very important factor has been the already mentioned constitutional ceiling concerning public debt. The Polish Constitution (adopted in 1997) limits public debt to 60% of GDP. The executive acts provide for ensuring that this ceiling is not breached. If the threshold of 55% of GDP is crossed, the government has to take actions to balance the budget.

The relatively good macroeconomic situation of Poland was rewarded. The positive (albeit relatively low) economic growth in 2009, avoiding a crisis in the financial sector, and a low – compared to other European countries – increase of public debt (in relation to GDP) positively impacted the assessment of the country's credibility in the financial markets and resulted in the IMF granting Poland a so-called flexible credit line. The country has also managed to maintain its good rating (A+), which was reduced in the case of the majority of other EU Member States.

4. Changes of the Public Finance Sector – Poland's Situation Against the Situation of Other EU Member States

Budget deficit

Similar to the majority of EU Member States, in years 2009-2010, a sharp increase of the budget deficit was recorded in Poland (from -3.7% of GDP in 2008 to -7.4%

5 In the first half of 2009, the Polish Zloty depreciated vis-à-vis Euro by 27.9% (calculated on yearly basis), see Ministry of Economy, Poland (2009), p. 16.

6 The corporate income tax rate was cut from 27% to 19% in 2004. Personal income tax rates were changed from three bands (19%, 30% and 40%) to two (18% and 32%), effective since 2008.

Table 2: Changes in government deficit and government debt situation of the EU Member States in 2008-2012 (% of GDP)

Country	Government deficit/surplus					General government gross debt				
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
EU 27	-2.4	-6.9	-6.5	-4.4	-4.0	62.2	74.6	80.0	82.5	85.3
Belgium	-1.0	-5.5	-3.8	-3.7	-3.9	89.2	95.7	95.5	97.8	99.6
Bulgaria	1.7	-4.3	-3.1	-2.0	-0.8	13.7	14.6	16.2	16.3	18.5
Czech Rep.	-2.2	-5.8	-4.8	-3.3	-4.4	28.7	34.2	37.8	40.8	45.8
Denmark	3.2	-2.7	-2.5	-1.8	-4.0	33.4	40.6	42.9	46.6	45.8
Germany	-0.1	-3.1	-4.1	-0.8	0.2	66.8	74.5	82.5	80.4	81.9
Estonia	-2.9	-2.0	0.2	1.2	-0.3	4.5	7.2	6.7	6.2	10.1
Ireland	-7.4	-13.9	-30.9	-13.4	-7.6	44.5	64.9	92.2	106.4	117.6
Greece	-9.8	-15.6	-10.7	-9.5	-10.0	112.9	129.7	148.3	170.3	156.9
Spain	-4.5	-11.2	-9.7	-9.4	-10.6	40.2	53.9	61.5	69.3	84.2
France	-3.3	-7.5	-7.1	-5.3	-4.8	68.2	79.2	82.3	85.8	90.2
Italy	-2.7	-5.4	-4.5	-3.8	-3.0	106.1	116.4	119.2	120.8	127.0
Cyprus	0.9	-6.1	-5.3	-6.3	-6.3	48.9	58.5	61.3	71.1	85.8
Latvia	-4.2	-9.8	-8.1	-3.6	-1.2	19.8	36.7	44.5	41.9	40.7
Lithuania	-3.3	-9.4	-7.2	-5.5	-3.2	15.5	29.3	37.9	38.5	40.7
Luxembourg	3.2	-0.8	-0.8	-0.2	-0.8	14.4	15.3	19.2	18.3	20.8
Hungary	-3.7	-4.6	-4.4	4.3	-1.9	73.0	79.8	81.8	81.4	79.2
Malta	-4.6	-3.9	-3.6	-2.8	-3.3	62.0	67.6	68.3	70.3	72.1
Netherlands	0.5	-5.6	-5.1	-4.5	-4.1	58.5	60.8	63.1	65.5	71.2
Austria	-0.9	-4.1	-4.5	-2.5	-2.5	63.8	69.2	72.0	72.5	73.4
Poland	-3.7	-7.4	-7.9	-5.0	-3.9	47.1	50.9	54.8	56.2	55.6
Portugal	-3.6	-10.2	-9.8	-4.4	-6.4	71.7	83.2	93.5	108.3	123.6
Romania	-5.7	-9.0	-6.8	-5.6	-2.9	13.4	23.6	30.5	34.7	37.8
Slovenia	-1.9	-6.0	-5.7	-6.4	-4.0	22.0	35.0	38.6	46.9	54.1
Slovakia	-2.1	-8.0	-7.7	-5.1	-4.3	27.9	35.6	41.0	43.3	52.1
Finland	4.4	-2.5	-2.5	-0.8	-1.9	33.9	43.5	48.6	49.0	53.0
Sweden	2.2	-0.7	0.3	0.2	-0.5	38.8	42.6	39.5	38.4	38.2
United Kingdom	-5.1	-11.5	-10.2	-7.8	-6.3	62.3	67.8	79.4	85.5	90.0

Source: Eurostat (2013)

in 2009 and -7.9% in 2010) – table 1. The increase of imbalance of the Polish public finance sector (of the budget deficit and also of the debt) resulted mostly from an exceedingly expansive fiscal policy. Public expenditures have continued to increase with the government's policy aimed at supporting a low rate of economic growth through increased expenditure (see also the next chapter).[7] An important part of public investments in 2008-2011 was related to infrastructural projects (mostly roads of nationwide and local character) implemented to speed up Poland's convergence with other EU countries. A big part of the projects was directly linked to the football championships to be organized in Poland in 2012. Such a big investment wouldn't be possible without substantial financial support from the EU budget in the form of structural funds and the Cohesion Fund.[8] Let's make it clear, however, that EU funds are not included into the assessment of the budget situation. Only national co-financing created a part of the

7 Unfortunately, the accelerated economic growth in 2008 was not used to improve the public finance sector situation and reduce the deficit. The budget adopted for 2008 did not provide for adjustments, on the contrary – it was characterized by expansionary fiscal policy.

8 As a result, the share of public investments in total investments increased substantially: the increase in investment compared to GDP was at the highest level in the EU amounting to 6.4 percentage points in 2008-2011 while the average for EU-27 amounted to minus 0.1 p.p. and the second highest share was recorded in Luxembourg where it stood at 1 p.p., see Ministry of Finance, Poland (2012).

Box no. 1. Constitutional ceiling for public debt in the EU Member States

As already mentioned, the 60% debt-to-GDP ceiling is written into the Polish constitution which entered into force in 2007. The main reason for this decision at that time was to faster prepare Poland for joining the EU (accession negotiations started only at the beginning of 2008) and in particular to show the EU-15 how much Poland was committed to adjust domestic laws to EU membership requirements.

In 2009 the German Constitution was amended to introduce a balanced budget provision, or *Schuldenbremse* [debt brake]. Starting in 2016 the German federal government will be constrained to a deficit ceiling of 0.35% of GDP; from 2020, the Länder will not be permitted to run any deficit at all. An exception can be made for emergencies such as a natural disaster or economic crisis.

Let's add that strengthened financial requirements were introduced under the Six Pack which entered into force in December 2011. They provide not only for easier and earlier possibility of financial sanctions (or suspension of the Cohesion Fund in the case of non-euro-zone members) but also for stricter application of national fiscal rules. The Six Pack ensures stricter application of the fiscal rules by defining quantitatively what constitutes a "significant deviation" from the *Medium Term Objective* (MTO). The MTO is the required structural balance which will ensure sustainability of the public finances, set out in the SGP.[11]

The most recent articulation of EU fiscal rules is the Fiscal Compact (the main part of the Treaty on Stability, Coordination and Governance, TSGC), which requires countries to ensure convergence with their respective MTOs. It introduces a more explicit budget rule, whereby all States must strive for budgetary balance and achieve a structural deficit of no more than -0.5% of GDP. Importantly, the Fiscal Compact requires that both budget rules must be implemented in the national law, preferably in the constitution, that compliance is monitored by independent institutions and that an automatic correction mechanism is put in place to correct divergences from these rules.

Let's notice, that a debt ceiling which is written into the constitution cannot guarantee fiscal discipline. In fact, achieving this goal will depend much on the political culture of EU Member States.

Some other EU Members besides Poland and Germany decided to work on including the debt ceiling into their national constitutions. In autumn 2011, Slovakia passed a respective law which includes automatic sanctions that are triggered when the debt level passes the 50% threshold. Also Spain decided to enact a respective law in 2012, but it will not come into force until 2020.

Source: http://dmarionuti.blogspot.com/2011/02/schuldenbremse-debt-brake-by.html

increased deficit.[9] Increased expenditures (including direct and indirect effects of EU funds) helped reduce negative implications of the fall of demand on export markets for Polish goods and services.

Of course, Poland's worsening of the public finance situation was not exceptional among EU countries. The deficit in turbulent 2009 and during the low recovery in 2010 increased also in a number of other EU countries (table 2).

Public debt

In recent years the gross government (public) debt has been under control in Poland – well below the Maastricht-prescribed 60% of GDP threshold and that of the euro zone (some 62-83% in EU 27 in recent years)[10] – see table 2. Public debt has been increasing year by year since the level of 45% of GDP in 2007 – to slightly more than 56% of GDP in 2011 but was still lower than the 60% Maastricht criterion. The main factor triggering its increase seems to be the constitutional ceiling at 60% of the debt-to-GDP ratio and related executive acts which encourage the government to control effectively the public finances situation (box 1) as well as EDP in the years 12.05.2004 – 08.07.2008 (European Commission, 2012b) when Polish authorities had to follow the Council's recommendations to exit this procedure (see subchapter below).

9 They are registered in a separate sub-budget of EU funds into the expenditures of the general budget of Polish central government. However, Polish contributions to the EU budget are included (like co-financing of EU funds); see: Ustawa z dnia 27 sierpnia 2009 r. o finansach publicznych. Dz. U. z 2009 r. Nr 157, poz. 1240 1241 as amended later.

10 Let's notice that although following Eurostat's calculations (so-called Maastricht definition) public debt already exceeds 55% of GDP, but according to the national definition (Polish government's methodology), it has remained recently below 55%. This is because the government shifted public infrastructure spending to the National Road Fund and more recently the BGK (bank dependant on Polish decisions), both of which are excluded from the domestic definition. Harmonizing the domestic definition of debt with its Maastricht counterpart would clarify the debt ceiling and make it a harder constraint on fiscal policy, less open to manipulation.

11 Throughout 1999-2004 the Stability and Growth Pact (SGP) had outlined a common mid-term objective (hereinafter – MTO) for all Member States, which was „to achieve a budgetary position of close to balance or in surplus over a complete business cycle". After the reform in 2005, MTOs were calculated to reflect country-specific values according to „the economic and budgetary position and sustainability risks of the Member State", based upon the state's current debt-to-GDP ratio and long-term potential

Box no 2. Excessive Deficit Procedure (EDP)

At the time when the Excessive Deficit Procedure (EDP) was adopted, the assumption was that this procedure should be an essential element preventing "excessive" deficits and public debts and ensuring sound EU fiscal framework. Practice showed that this was not the case. The enforcement appeared to be extremely weak. The budget deficit ceiling was exceeded many times by Member States but no single fine was introduced. Public debt was never examined under SGP as a serious criterion. Deficits and debts increased not decreased, in the majority of EU Members and in some of them, it became a reason for serious economic troubles.
On 13 December 2011, a new set of rules entered into force under the so-called „Six-Pack". Their main purpose is to enforce the SGP mechanism. The new rules affect both arms of the SGP, it is the preventive arm and the corrective arm of the pact, the EDP.
New enforcement mechanisms, including fines, were drawn up for non-compliant euro-area Member States in order to make the SGP more effective. Also, it is now possible to open an EDP on the basis of the debt criterion.

Source: Kawecka-Wyrzykowska (2013).

Poland under excessive deficit procedure

As already mentioned, for many years public finances in Poland have suffered from deficits which exceeded the Maastricht criterion ceiling. The high deficit in excess of the prescribed reference value of 3% of GDP made it such that the European Commission recommended Council to start the excessive deficit procedure upon Poland's accession in May 2004. The deficit reduction efforts on the part of the Government aided by high economic growth proved successful: the deficit gradually decreased from 6.3% in 2003 down to 2% in 2007 when the original deadline to eliminate excessive deficit was established by the Council. It allowed the EU to drop the procedure in July 2008 (European Commission, 2012b). The excessive deficit procedure (box 2) was started by the European Commission against Poland once again in May 2009. The argument was the 3.7% deficit in 2008, exceeding the Maastricht ceiling at 3.0% of the GDP.

5. Reform Policies to Reduce Fiscal Imbalances

Despite avoiding a program of austerity during the economic slowdown (the first term of office of the present Prime Minister D. Tusk), the government did implement a number of spending cuts. Among the most important cuts were the following: reduction of subsidies for funerals, cutting money that goes to the labor fund (which helps people find employment) and freezing the income level at which families are entitled to receive social benefits (which had been set in 2004). Also, some measures on the revenue side were introduced, the most important being a VAT increase by 1 percentage point – from 22% to 23% (the reduced rates were also increased in line), and increases in excise taxes. In addition, some pension contributions were shifted from the private to the public system.

In 2011, after the re-election, the government declared that it was seeking to reduce its public debt to 42 percent of GDP by the end of 2015 and its budget deficit to just 1% by the end of its term of office (PMR, 2011). To achieve this goal, the government started a serious consolidation of public finances in Poland which aimed at eliminating the excessive deficit in 2012 (to reduce it to 2.9% of the GDP in 2012), i.e. in line with the recommendations of the Council of the European Union. The program of major fiscal and other measures was presented in the first address of Mr. D. Tusk to the new parliament on 18 November 2011. Some of these measures were to make an impact already next year, most from 2013, while others, notably the proposed reform of the pension system, will bring benefits in the long-term. Out of these proposals, the following were implemented by the end of 2012: changes of the incapacity benefit contributions paid by employers (in February 2012); a new tax on copper and silver (in March 2012); modified health insurance contributions by farmers (in February 2012); new pension rules for the uniformed workers (i.e. the reduction of early retirement privileges for certain labor

Box no. 3. Government's proposals of 2012:

– reduced eligibility for pro-family personal tax relief (relief for a family with at least two children and an annual income of less than 20,000 euros;
– elimination of subsidies for connecting to the Internet;
– reduction of tax reliefs for those earning through their own creative work (scientists, artists and journalists) – they will no longer be able to claim back costs after earning over 10,000 euros a year;
– abolition of the special social insurance fund for farmers (KRUS), which allows them to pay lower rates of social and health insurance.

Source: http://www.premier.gov.pl/en/government activities/public_finance/

GDP growth, while the overall objective over the medium term was still the same." Later on, Member States and the European Commission completed a joint work elaborating a methodology for computing MTOs that renders operational the MTO determination criteria.

groups, such as uniformed workers - in May 2012); and gradual increase of the retirement age for men and women to a uniform level of 67 years, up from 65 and 60, respectively, starting from 2012 and to be completed until 2020 (men) and 2040 (women), involving probably the most long-lasting effects. Other proposals entered into force on 1 January 2013.

On 25 April 2012, the national reform program and the convergence program were adopted by Poland's Council of Ministers. The convergence program outlined, in an integrated manner, the fiscal consolidation efforts, the key structural reforms and the reforms that underpin macroeconomic stabilization. Undoubtedly, the government's program to speed up of fiscal reforms was stimulated much by EU pressure to exit the excessive deficit procedure. Another major reason for the government's reform program was the awareness of an oncoming demographic crisis. This is primarily caused by the extremely low fertility rate in Poland (1.38) that has fallen sharply since the beginning of transformation.

In October 2012, in the so-called second expose, the Prime Minister Donald Tusk, presented the proposal of the next package of reforms, among them those aimed at a faster balancing the budget. The most important proposals included reduction or complete elimination of a number of tax privileges for citizens and elimination the special social insurance fund for farmers (KRUS) – see more in box 3. The new proposals – all of them entered into force in 2013 except for smaller than announced KRUS changes – have been adding to reduction of budgetary expenditures or increasing revenue.[12]

6. Prospects of Existing Excessive Deficit and Meeting Fiscal Criteria

In its 2012 convergence program, the Polish government confirmed its objective to correct the excessive general government deficit in 2012 and to continue fiscal consolidation thereafter in order to reach the medium-term objective, i.e. a structural deficit of 1% of GDP, in 2015. Poland's convergence 2012 program assumed deficit of 2.9% of GDP in 2012 and 2.2% next year but Finance Ministry officials have later pointed to figures around 3.4% and around 3.0% in 2012 and 2013 respectively.

In 2012, the adjustment efforts regarding public finances were concentrated on the revenue side. However, total expenditures were also expected to decline as a result of measures introduced in previous years (see table 3 for main measures in 2011 and 2012). The 2012 budget also provided for revenues from dividends of state-owned enterprises, which were classified as a one-off measure.

Over the period 2013-2015, both the expenditure-to-GDP ratio and revenue-to-GDP ratio are planned to fall gradually every year. In the case of revenues, the government plans a sharp decline from 42.6% in 2012 to 38.6% in 2015. In the absence of significant new measures,[13] the fall in revenues will result from the expiry or gradual reversal of some consolidation measures implemented in 2011 (see table 3 for details).

A decrease in expenditure in proportion to the GDP (from 39.6% in 2012 to 37.6% in 2015) will more than offset the fall in the revenues. The expected consolidation will be driven by a sharp decline in public gross fixed capital formation and a further decline in the pension expenditure as a result of the abolishment of the early pension system in 2009. Moreover, increase of new expenditures will be controlled by the expenditure rule which was introduced by Polish government in 2011. Under this rule, all state budget "flexible" (nominal) spendings[14] can increase annually by one percentage point maximum over the inflation rate (CPI). The existing debt rule is fully operational and enforceable, although based on national classification of national accounts, different from internationally comparable ESA95. Also, it has a temporary character. The Polish government has promised to implement a permanent expenditure rule by 2013 but such a decision has not been taken yet. At the local level, a complex set of deficit, expenditure and debt rules is not compatible with the rules applying to central government, in the Commission's opinion (European Commission, 2012a, p. 12).

Overall, according to the Council's assessment, the steps presented above have put Poland on right track to fulfill the Council recommendations on fiscal consolidation (European Commission, 2012a, p. 9).

The Council also recommended that Poland should make adequate progress towards the MTO, i.e. a structural general government deficit of 1% of GDP. The Polish government is committed to reach the MTO in 2015, targeting a (recalculated) structural deficit of 0.7%

12 As these initiatives were made public only in autumn 2012, they were not included in the timetable of government deficit reduction presented in table 3.

13 Some reforms with a positive, though minor, budgetary effect were enacted, however. They include an increase in personal income tax revenues on the author's rights revenues, abolishment of PIT exemptions on internet use and multiple children upbringing.

14 This rule relates to so-called flexible expenditures which account for about 25% of all expenditures of the budget and does not apply to statutory expenditures, e.g. those related to servicing of the public debt or provided for the national defense.

Table 3: Government measures reducing the general government deficit (in % of GDP)

Revenue	Expenditure
2012	
Amendment of the pension reform (0.5% of GDP) Changes in excise duty regulations (0.2% of GDP) Increase in disability contribution (0.4% of GDP) Tax on copper and silver extraction (0.1% of GDP) Increase in dividends from state-owned companies due to exceptionally high profits (0.1% of GDP)	Expenditure rule (including nominal freeze in wage fund) (0.1% of GDP) Replacement of early retirement by 'bridge' pensions (0.3% of GDP) Decrease in complementary payments to farmers (0.1% of GDP)
2013	
Amendment of the pension reform (-0.1% of GDP) Abolition of specific VAT exemptions (-0.1% of GDP) Reversal of revenues from dividends to the long-term trend (-0.1% of GDP)	Reversal of the freeze in the wage fund (-0.1%)
2014	
Amendment of the pension reform (-0.1% of GDP) End of temporary increase VAT rates by 1 pp. (-0.4% of GDP)	

Note: The budgetary impact in the table is the impact reported in the program, i.e. by the national authorities. A positive sign means that revenue/expenditure increases/decreases as a consequence of the measure.

Source: European Commission (2012a), p. 10.

of GDP for that year. Thus, a further annual structural improvement of 0.6% of GDP was planned after the expected correction of the excessive deficit in 2012. As we know, these targets had not been reached by the end of 2012, which means that more ambitious program has to be implemented in the next few years.[15]

7. Challenges Threatening Improvement of Fiscal and Macroeconomic Situation

Despite relatively good economic performance in the worst period of 2009's recession Poland faces, like other countries, significant challenges. According to the Commission's opinion of 2012, Poland's most pressing challenges are in public finances, the labor market, infrastructure development, and the business and innovation environment (European Commission, 2012a, p. 6). The budget deficit has to be further reduced to reach the medium-term objective and maintain the confidence of financial markets. The Commission stressed also the structural weaknesses of the fiscal framework which include: poor monitoring of budget implementation, discrepancies between the public accounting and reporting system and the European System of National and Regional Accounts (ESA95), and problems with coordination between various tiers of the general government in the annual and multi-annual budgetary planning. Since 2011, new challenges have appeared in the financial sector. In general, the Polish financial system functions well, partly due to the implementation of a prudent and pre-emptive regulatory policy. This has helped the country withstand the financial crisis and attract foreign investments. The Commission stressed, however, that this success has also created a new risk. An important risk for Poland comes from a possible withdrawal of foreign capital or liquidity from the financial sector. In December 2012 there were the initial signs of a new "credit crunch" within the euro zone, with growth in credit falling to new lows and bank funding being withdrawn from the Central European region. The European Central Bank reacted quickly through its two refinancing operations which totaled more than EUR 1,000 billion and this has helped to avert a liquidity crisis. The risks are not, however, over. On the other hand, one should add that external financial risks are mitigated by the relatively high financial credibility, sufficient foreign exchange reserves (increased by a special flexible credit line secured by the IMF) and relatively high attractiveness for FDI. Polish banks remain resilient, having proven their relative immunity to exchange rate fluctuations and global financial markets turbulence.

A very low labor force participation rate is, according to the Commission, another major concern in the

15 Given this situation, the Commission recommended to the Council on 29 May 2013 an extension of excessive deficit situation by 2014 at the latest, see European Commission (2013a).

medium- to long-term, given an ageing population. The labor participation rate for female (% of female population ages 15+) in Poland was 48.20 as of 2010 and for men (% of male population ages 15+) was reported at 64.30 in 2010, according to a World Bank report published in 2010 (Index Mundi, 2011, and Trading Economics, 2013). These rates were among the lowest rates in EU Member States. This is of particular concern in the medium- to long-term, given an ageing population and growing life expectancy. The old age dependency ratio (population aged 65 and over as a percentage of the population aged 15-64) in Poland will double in the next 30 years, from about 20% to 40%. Women's participation in the labor market is very low, owing partly to the lack of affordable childcare. Thus, the main challenge is to prolong the working life by raising the statutory and effective retirement age in line with longer life expectancy and to improve availability of childcare for infants and young children.

Moreover, the efficiency of public administration needs to be significantly improved. Notwithstanding sizeable investments in the road network, the country's transport infrastructure, particularly the railway system, remains underdeveloped and is thus a factor that severely hinders growth. In the Commission's opinion, the recent growth in Poland has been to some extent based on the inflow of structural funds, a price competitive labor force and growing integration of Polish subcontractors and manufacturing centers into the global value chain. In a medium- and long -term perspective, however, a shift toward an innovations-driven economy is necessary. Measures adopted so far have not led to visible improvement in the innovativeness of Polish companies. Low public R&D spending, weak linkages between science and industry, and severe underinvestment in research and innovation in the private sector are the main factors responsible for such situation. Thus, a key challenge for Poland to stay competitive in the next years is to base the economic growth more on R+D investment, including education, and innovations. Also, without any improvement, the business environment may hold back growth as Poland's rankings in internationally comparable 'business environment' indicators remain relatively low.

In the Convergence Report Update 2012, an additional risk was stressed related to not full absorption of EU money in the end of the present financial perspective for 2007-2013. This risk results mainly from the possibility of cumulated inflow of structural funds in the end of the programming period and related increased demand for pre-financing and co-financing from public money (Ministry of Finance, Poland, 2012a, p. 28)

Moreover, it's important to notice that many of the strengths that helped Poland's economy in the 2009-2010 period are no longer at hand. First of all, infrastructure investments have slowed as the EU's 2007-2013 budgeting period comes to the end and investments tied to the UEFA Euro 2012 championships have ended. Also, Polish exports lost steam on account of the weakness for Poland's main trading partner, Germany.

8. Conclusions

Albeit Poland's public finance situation is much better than in many other EU Members and much has been done to allow Poland soon exit from the excessive deficit procedure, still much has to be done in the immediate future.

Achieving sound a fiscal policy is a major pre-requisite for respecting the Maastricht criteria. The consolidation of public finances would lower inflation pressure, contribute to reducing the volatility of the currency and favor the convergence of interest rates, while offsetting their expansionary impact on activity at the same time. Let's add that these reforms are desirable independent on the effective date of the euro adoption, given the necessity to restore fiscal discipline, maintain price stability and ensure a balanced growth going forward. Plans for euro adoption should serve as a policy anchor.

In the medium- and long-term, the key role will be played by structural reforms, going much beyond the public finance sector. They include first of all increased flexibility of labor market, improved business environment, improvement of transport infrastructure, increased role of innovations in economic growth etc. Such reforms are necessary to ensure sustainable growth and the longer term competitiveness of the economy. Structural reforms are even more essential in the run up to euro adoption as the process of real and nominal convergence remains largely incomplete and requires a substantial strengthening of alternative adjustment mechanisms in the area of labor market and its flexibility as well as of fiscal system. Poland's Convergence Report Update 2012 offers the timetable of changes to improve substantially public finances. An important additional factor inducing Poland's fiscal reforms is the new elements of economic governance recently adopted in the EU, including the Six-Pack (in force since December 2011) and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (entered into force on 1 January 2013).The most important elements involve obligations on the part of the euro area Members but still, at least some of them should work as a stabilizing anchor for non-euro area Members.

Adopting the euro and benefiting from full membership of the Economic and Monetary Union has been still among top priorities of the Polish government's economic policy. However, changes in the economic situation – throughout the world and, as a consequence in Poland – have made the prospect of introducing the common currency more distant. Taking into account the uncertainty as regards the date of meeting all criteria of the euro adoption and improving the situation in the euro area, Poland's government no longer declares a concrete timetable for euro adoption. Many preparations, including improvement of economic situation to meet convergence criteria and institutional actions have been continued. At the same time, however, recent turbulences in the EU and in the world have caused the government to adopt a kind of additional criterion for euro adoption, namely the stabilization of the euro area.

References

European Commission (2012). Six-pack? Two-pack? Fiscal compact? A short guide to the new EU fiscal governance, (accessed May 24, 2013), [available at: http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm].

European Commission (2012a). Commission Staff Working Document. Assessment of the 2012 national reform program and convergence program for Poland. *Accompanying the document.* Recommendation for a Council Recommendation on Poland's 2012 national reform program and delivering a Council Opinion on Poland's updated convergence program for 2012-2015, COM(2012) 323 final. May 30, 2012.

European Commission (2012b). Council Decision (104§12) abrogating the Decision on the existence of an excessive deficit, (accessed June 1, 2013), [available at: http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm].

European Commission (2013). Recommendation for a Council Decision abrogating Decision 2005/183/EC on the existence of an excessive deficit in Poland (presented by the Commission), Commission, , SEC(2008) 2011 final, Brussels, June 11, 2008.

European Commission (2013a). Recommendation for a Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Poland, COM (2013) 393 final., Brussels, May 29, 2013.

Eurostat (2013). Tables, Graphs, and Maps Interface (accessed June 6, 2013), [available at: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115].

Index Mundi (2011). Poland - Labor participation rate, (accessed June 1, 2013), [available at: http://www.indexmundi. com/facts/ poland/labor-participation-rate].

Kawecka-Wyrzykowska, E. (2009). New Member States of the Euro Zone. First experiences and lessons for Poland. *Working Papers No. 300*, Warsaw School of Economics.

Kawecka-Wyrzykowska, E. (2013). Enhanced Economic Governance In the EU: Alternative To a Political Union?, *International Journal of Management and Economics*, 37.

Ministry of Economy, Poland (2009). Analiza sytuacji gospodarczej Polski w I połowie 2009, (accessed May 24, 2013), [http:// www.mg.gov.pl/NR/rdonlyres/ C14A5DE8-7236-4770-A72D-44D7 A0454F93/ 56245/2q2009_pl.pdf].

Ministry of Finance, Poland (2012). Finanse publiczne w Polsce w okresie kryzysu, (accessed May 24, 2013), [available at: http://redir.atmcdn.pl/http/o2/tvn/web-content/m/p1/f/R/a/Raport_do_druku.pdf].

Ministry of Finance, Poland (2012a). Program konwergencji. Aktualizacja 2012, (accessed May 24, 2013), [available at: http://www.mf.gov.pl/ministerstwo-finansow/dzialalnosc/finanse-publiczne/sytuacja-makroekonomiczna-i-finanse-publiczne/ program-konwergencji;jsessionid=1CD81995A2F2AAB6259AC2532986EB7D].

Ministry of Finance, Poland (2012c). Conference on Economic Governance in the EU/ euro area: What lessons for Poland? July 16, 2012, (accessed May 24, 2013), [available at: http:// www.mf.gov.pl/dokument.php?const=1&dzial=4844&id =305520&lang=en].

PMR (2011). Tusk announces major reform agenda for new government, (accessed May 24, (accessed June 1, 2013), [available at: http://www.polishmarket.com/113484/Tusk-announces-major- reform-agenda-for-new-government.shtml].

Rae, G. (2012). Austerity Policies in Europe. The Case of Poland, Friedrich Ebert Stiftung, Economic Policy Analysis, August.

Trading Economics (2013). Labor participation rate; male (% of male population ages 15+) in Poland, (accessed June 1, 2013), [available at: http:// www.tradingeconomics.com/poland/labor-participation- rate- male-percent-of-male-population -ages- 15-plus--wb-data.html].

Author

Elżbieta Kawecka-Wyrzykowska
Warsaw School of Economics
Jean Monnet Chair of European Integration
ekawec@sgh.waw.pl

This paper has been prepared under the Jean Monnet multi-lateral research project "European Research Study Group on the Political Economy of the EMU" conducted in 2012-2014.