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**Public Expenditure
Management in Poland**

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Kwang-Yeol Yoo**

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ABSTRACT/RÉSUMÉ

Public Expenditure Management in Poland

This paper assesses the public expenditure system in Poland and the scope for its reform. Though a number of important steps to control the future evolution of spending, such as pension reform and healthcare reform, have already made in Poland, much more needs to be done. Indeed budget consolidation and the government's goal of increasing the economy's potential rate of growth can best be achieved by a far ranging re-evaluation and re-orientation of spending away from personal transfers that contribute to inactivity traps. In this regard, it is important to expand the scope of the State Budget to include much more of general government spending, abolishing the extra-budgetary funds, and improving the co-ordination of the budget planning process among different levels of government. Moreover, the authorities need to increasingly move towards a multi-year budgeting framework. Not only will this allow for better management of investment projects, but it will also help policymakers to see more clearly the longer-term consequences of their spending decisions. A medium-term budgetary system would in conjunction with a more resolute focus on the efficiency of programme spending, pave the way towards an output-orientation in government policy.

JEL classification: H0, H1, H4, H5, H6, H7

Keywords: Public expenditure, general government, creative accounting, extra-budgetary funds, accrual accounting, budgetary transparency, multi-year budgeting, contingent liabilities, program evaluation

La gestion des dépenses publiques en Pologne

Cette étude évalue le système de dépenses publiques en Pologne ainsi que les réformes à envisager. Afin de maîtriser l'évolution future des dépenses publiques, un certain nombre de réformes ont déjà été menées, comme celle portant sur le système de pensions et celle concernant le système de santé, mais beaucoup d'autres restent à faire. En fait, la consolidation budgétaire et l'augmentation du taux de croissance potentiel, objectif du gouvernement, pourraient être réalisées par des réévaluations exhaustives et la réorientation des dépenses comme celles concernant les transferts personnels responsables des pièges à inactivité. À cet égard, il est important d'élargir la portée du Budget de l'État pour y inclure de nombreuses dépenses générales, en supprimant les fonds extrabudgétaires et en améliorant la coordination des planifications budgétaires aux différents niveaux d'administration. Par ailleurs, il est nécessaire d'adopter progressivement un système de budget pluri-annuel. Celui-ci permettra aux responsables des politiques publiques non seulement une meilleure gestion des projets d'investissement, mais aussi de voir plus clairement les conséquences de leurs décisions à plus long terme. Un système budgétaire à moyen terme et une détermination plus résolue d'améliorer l'efficacité des dépenses de programme pourraient faciliter l'apparition des politiques publiques orientées sur les résultats.

Classification JEL: H0, H1, H4, H5, H6, H7

Mots-clés : Dépenses publiques, administrations publiques, comptabilité 'créative', fonds extrabudgétaires, comptabilité en tenant compte du fait générateur, transparence budgétaire, budgets pluri-annuels, engagements contingents, évaluation des programmes

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PUBLIC EXPENDITURE MANAGEMENT IN POLAND

Andrew Burns and Kwang-Yeol Yoo¹

1. Notwithstanding the decline in public expenditure between 1990 and 1995, government spending has remained a relatively stable and high share of GDP² (46 per cent in 2001). Moreover, the rapid rise in the general government deficit in 2001 and medium-term spending pressures suggest that a fiscal consolidation will be necessary in order to prevent the debt from reaching its constitutional limit of 60 per cent of GDP. A number of important steps to control the future evolution of spending, such as the 1999 pension reform and the more recent (and arguably less successful) healthcare sector reform, have already been made, but much more needs to be done. A further tax increase appears undesirable given the country's already high tax burden and evidence that associates this with slower growth. Rather, budget consolidation and the government's goal of increasing the economy's potential rate of growth can best be achieved by a far ranging re-evaluation and re-orientation of spending away from personal transfers that contribute to inactivity traps and towards productivity and employment augmenting policies. This, in turn, will require substantial improvements to public expenditure management systems so as to provide the authorities with the tools they need to identify and effectuate needed budgetary reallocations.

2. Against this background, this paper begins by briefly examining government spending patterns and trends in Poland, putting them into an international context. It then describes the main features of the current expenditure management system and provides an assessment of public spending outcomes in selected areas. Major policy challenges arising from this review are then identified and reform measures proposed.

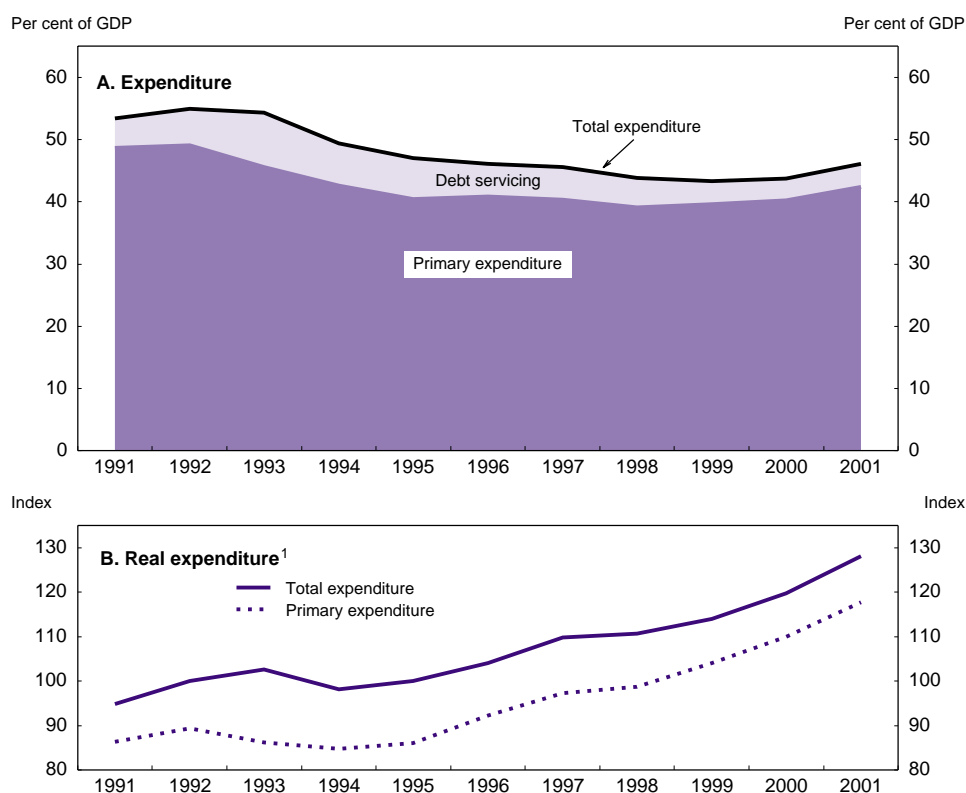
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1. An earlier version of this paper served as an input into the 2002 *OECD Economic Survey of Poland*, which was published in September 2002 under the responsibility of the Economic and Development Review Committee of the OECD. Andrew Burns is the head of France/Poland desk, while Kwang-Yeol Yoo, at the time of writing this paper, was an economist in General Economic Assessment Division in the Economics Department. The authors would like to acknowledge Val Koromzay, Mike Feiner, Andrew Dean, Yutaka Imai, and Isabelle Joumard for valuable comments on earlier drafts. The authors are also indebted to Joanna Dopierala who provided excellent research assistance and facilitated access to government officials. Without her help, this paper in its present form would not have been possible. Special thanks go to Roselyne Jamin and Chantal Nicq for technical assistance, and to Nadine Dufour for technical preparation. Finally this paper has benefited from discussions with numerous Polish experts in ministries responsible for policy-making in this area.
 2. Unless otherwise indicated government accounts in this paper are based on those derived from SNA93 definitions. Data for 2001 are OECD estimates.

Public expenditure in Poland

International comparisons and expenditure trends

3. Reflecting the heritage of the previous political regime, Poland entered the 1990s with a large general government sector, whose expenditures were equal to almost 60 per cent of GDP (Figure 1, Panel A). Since then they have declined substantially, falling to 47 per cent by 1995 and to 46 per cent by 2001.³ Much of the decline in the first half of the 1990s was due to the restructuring of Poland's debts and the associated 4 percentage points of GDP reduction in interest payments that was observed between 1993 and 1996. Primary expenditures (total spending less interest payments) also declined substantially in the first half of the decade before stabilising at about 40 per cent of GDP since 1995. Notwithstanding the fall in the relative size of the public sector, the rapid increase of GDP over the period meant that the volume of goods and services delivered by the authorities actually increased throughout most of the transition (Figure 1, Panel B).

Figure 1. Trends in public expenditure



1. Real total expenditure = 100 in 1995, using the implicit GDP deflator.
Source: Central Statistical Office and OECD.

3. Since the beginning of the 1990s the manner in which government spending is accounted for has changed dramatically, making comparisons over long time periods particularly difficult.

4. Moreover, the public sector in Poland represents a larger share of GDP than the OECD average and only somewhat less than the average for the Euro area (Figure 2, Panel A). Indeed, the spending share is much higher than in other currently lower income OECD countries and much higher than it was in other OECD countries when they were at Poland's level of development (Figure 2, Panel B). A number of studies have emphasised that the high tax burden required to finance a large government sector increases economic distortions and slows growth and the process of income convergence.⁴

5. Official data suggest that virtually all of the reduction in primary spending came through cuts to non-wage government consumption (Figure 3), although there may be some doubt as to the reliability of earlier data.⁵ GFS data suggests that on a functional basis, spending levels as a share of GDP have remained more or less constant since 1994. Spending as a share of GDP for merit goods such as health and education, public goods such as defence and police work and economic services are broadly in line with those observed in other OECD countries (Table 1). However, Poland spends substantially more than average on income transfers (more than 18 per cent of GDP in 2000). In particular, it spends a larger share of total output on disability pensions than any other OECD country, more than twice the average.⁶ In contrast, the share of considered other transfers to households, including those associated with social assistance and unemployment insurance is about average. Perhaps surprisingly, social assistance spending as a share of GDP has remained broadly constant despite a four fold increase in the unemployment rate and a 50 per cent increase in the incidence of non-employment from 30 to more than 45 per cent of the working-age population.⁷

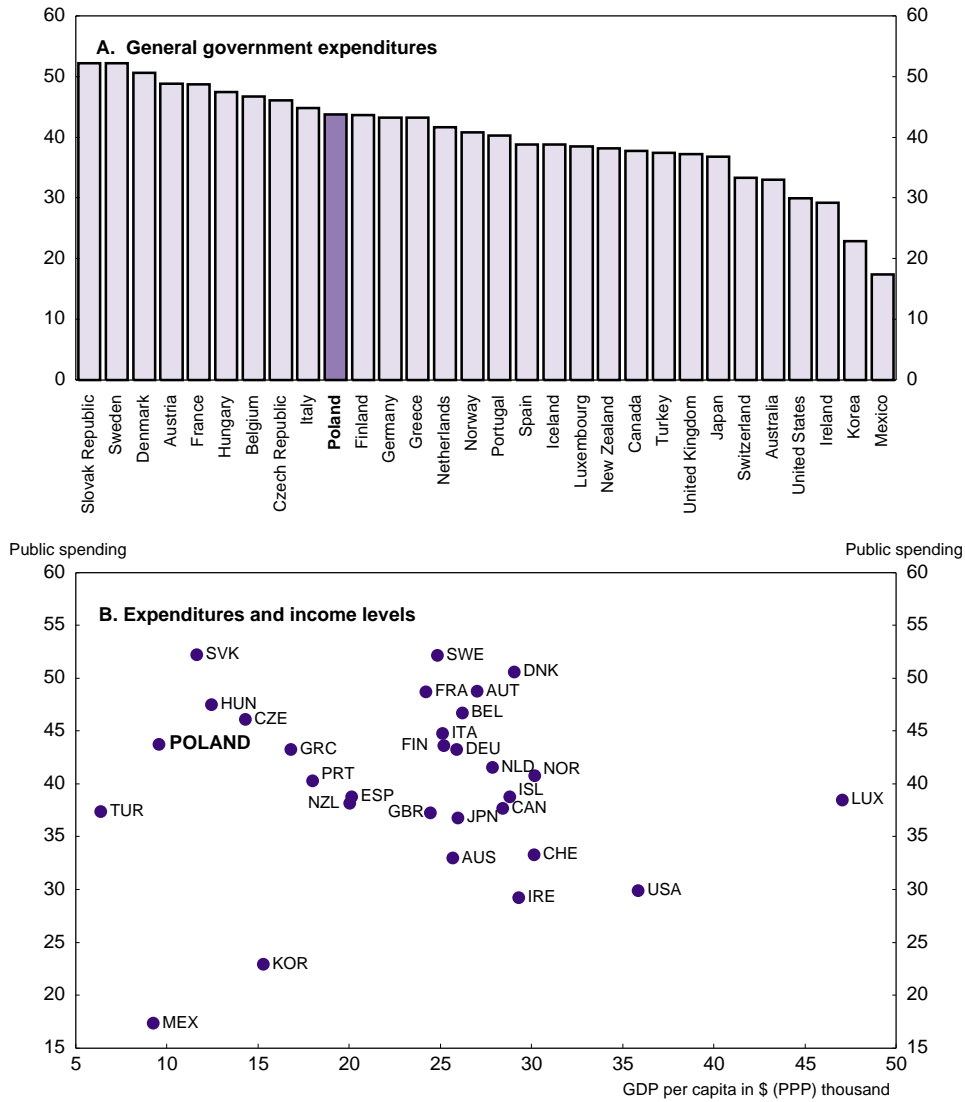
4. These include: King and Rebelo (1990), Englander and Gurney (1994), Slemrod (1995), Leibfritz *et al.* (1997) and Bleaney, M. *et al.* (2001). While some have found an insignificant relationship, recent work suggests a non-linear relationship between the impact of the tax burden and the level of development of a country.

5. Data before 1995 are based on an earlier National Accounts methodology. Moreover, experience with national income accounting was limited at that time, increasing the chances of misclassifications during this period.

6. In part, this reflects the fact that Poland extends disability pensions to those over 65. Nevertheless, it pays much more than countries with a similar programme profile and the incidence of disability pension receipt among those of working age is almost twice the OECD average (OECD, 2002c).

7. It is difficult to be sure this apparent anomaly does not reflect a statistical artefact due to the recategorisation of spending overtime, rather than any fundamental change in expenditures.

Figure 2. **Public spending in international comparison¹**
Per cent of GDP, in 2000



1. Public spending is defined as the sum of current outlays and net capital outlays. Data are based on SNA93/ESA95.

Source: OECD.

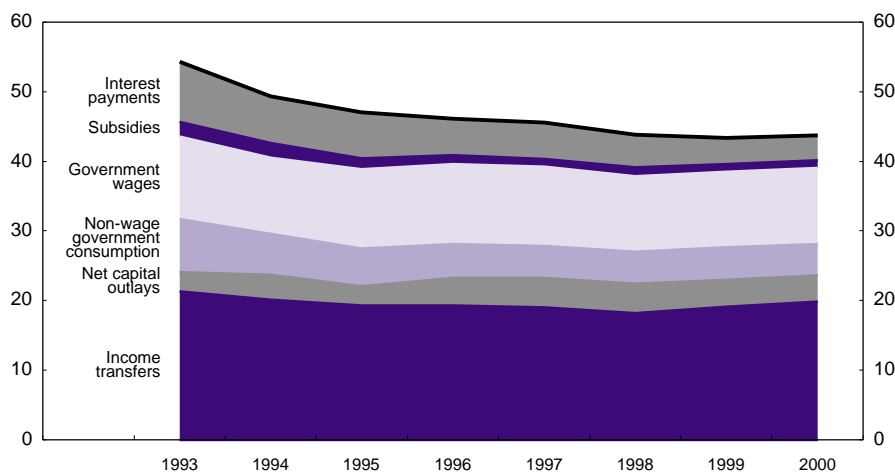
Table 1. International comparison of public expenditure categories¹

	Merit goods				Income transfers									
	Total	Educa-tion	Health	Other social services	Total	Pension		Disability			Labour market policies		Housing benefits	Other benefits
						Old-age cash	Surviv-ors	Disabi-lity	Sick-ness	Family cash benefits	Active	Passive		
Australia	10.9	4.3	5.4	1.2	10.2	4.0	0.2	2.1	0.0	2.2	0.4	1.0	0.1	0.1
Austria	13.8	6.0	5.8	2.0	19.0	9.9	2.9	2.3	0.2	1.9	0.4	0.9	0.1	0.3
Belgium	11.4	5.0	6.1	0.3	18.1	7.3	2.5	1.7	0.4	2.0	1.4	2.4	..	0.3
Canada	12.1	5.5	6.6	..	11.2	5.0	0.5	0.9	0.1	0.8	0.5	0.9	..	2.6
Czech Republic	11.1	4.1	6.5	0.5	12.7	6.7	0.9	1.8	0.9	1.6	0.2	0.3	0.1	0.2
Denmark	18.8	6.8	6.8	5.2	17.8	6.8	0.0	2.0	0.7	1.5	1.7	3.4	0.7	1.1
Finland	14.0	5.7	5.3	3.0	18.3	7.0	1.0	3.1	0.4	1.9	1.4	2.6	0.4	0.6
France	15.0	5.9	7.3	1.9	19.7	10.6	1.6	1.1	0.5	1.5	1.3	1.8	0.9	0.4
Germany	13.7	4.4	7.8	1.6	18.0	10.5	0.5	1.4	0.3	1.9	1.3	1.3	0.2	0.6
Greece	9.1	3.4	4.7	1.0	16.9	10.2	2.0	1.1	0.8	1.2	0.2	0.5	0.7	0.2
Iceland	16.8	6.5	7.0	3.2	8.2	3.8	0.5	1.5	0.1	1.2	0.1	0.4	0.1	0.4
Ireland	9.5	4.3	4.6	0.5	10.6	2.5	0.9	0.8	0.7	1.6	1.2	1.7	0.5	0.6
Italy	10.8	4.8	5.5	0.5	19.1	12.8	2.6	1.0	0.7	0.6	0.7	0.7	0.0	0.0
Japan	9.8	3.6	5.6	0.6	8.4	5.7	1.1	0.5	0.1	0.2	0.2	0.5	..	0.2
Korea	6.7	4.1	2.4	0.3	3.3	1.9	0.2	0.4	..	0.0	0.5	0.2	..	0.2
Luxembourg	6.3	..	5.4	0.9	15.2	7.8	0.9	2.4	0.7	2.3	0.2	0.5	0.1	0.2
Mexico	6.3	4.1	2.0	0.2	6.0	4.7	0.1	0.1	..	0.0	0.1	0.0	0.7	0.3
Netherlands	12.1	4.5	5.9	1.7	16.1	6.2	0.8	2.4	1.0	0.8	1.3	2.6	0.4	0.6
New Zealand	12.3	6.0	6.1	0.1	13.8	5.2	0.1	1.5	1.3	2.4	0.5	1.6	0.9	0.1
Norway	18.6	6.8	7.1	4.7	15.2	6.0	0.4	2.8	1.5	2.2	0.9	0.5	0.2	0.7
Poland	10.2	5.3	4.6	0.2	18.4	8.1	2.1	4.8	1.1	0.9	0.3	0.6	0.2	0.3
Portugal	11.3	5.6	5.1	0.6	12.5	6.3	1.4	1.9	0.5	0.6	0.7	0.8	0.0	0.3
Slovak Republic	0.5	0.5	13.3	5.3	1.0	2.0	1.2	1.8	0.0	0.8	0.0	1.2
Spain	10.2	4.4	5.3	0.4	13.9	8.1	0.8	1.3	0.9	0.3	0.6	1.5	0.1	0.1
Sweden	18.6	6.6	6.6	5.4	18.9	7.5	0.7	2.4	1.1	1.6	2.0	1.9	0.8	0.9
Switzerland	13.9	5.4	7.7	0.8	19.9	11.2	1.4	2.9	0.5	1.2	0.8	1.0	0.2	0.7
Turkey	8.2	2.9	5.0	0.2	9.1	5.1	1.2	0.2	0.0	1.0	0.1	0.9	0.0	0.5
United Kingdom	11.6	4.6	5.6	1.3	17.8	9.8	1.0	2.7	0.1	1.7	0.3	0.3	1.6	0.2
United States	11.0	4.8	5.8	0.3	8.2	5.1	0.9	0.9	0.2	0.2	0.2	0.3	..	0.5

1. Data concern 1999 or 1998, when not available. Education data always concern 1998.

Source: OECD, Social Expenditure Database and OECD, Education at a Glance.

Figure 3. **General government outlays by economic category**
Per cent of GDP



Source: OECD, revised GFS (Government Financial Statistics) accounts.

Tax expenditures

6. While not recorded as government spending, tax expenditures -- exemptions to standard rates -- promote policy objectives similar to those targeted by traditional expenditure and impose real costs. On the one hand, the revenue forgone by exemptions must be made up either as reduced expenditure or higher tax rates (on a smaller base), and on the other, they can introduce important distortions. Foregone revenues in the personal and corporate income tax accounted for 1.8 per cent of GDP and 4.3 per cent of general government revenue in 2000, while the low and zero rating of a wide range of goods and services in the VAT system cost 6.7 per cent of GDP (Table 2). The largest personal income tax (PIT) expenditure programme is a housing tax deduction, which accounts for 70 per cent of total PIT tax expenditures.

State aids

7. State aids are one of the most complicated components of Polish public expenditure. Although subsidy programs are a relatively small 1.5 per cent of GDP,⁸ they represent less than one third of state aids, with tax expenditures, capital transfers, preferential credits and credit guarantees making up the rest (Table 3). The 2001 Act on State Aid brings Polish law into line with European Union regulations, so that support levels should decline. Nevertheless, several exceptions to the Act remain, and the administrative capability to monitor and analyse various forms of state aid seems limited at present.⁹ State-owned enterprises in particular continue to receive substantial support in the form of unpaid tax and social security

8. State aid according to the Office for Competition and Consumer Protection represents 1.5 per cent of GDP, however, this excludes arrears on tax and social security contributions and environmental liabilities. Moreover, the state aid report on tax expenditures is not comprehensive (VAT exemption is not included and housing tax expenditure is not fully reflected) and the risk assessment of credit guarantees seems generous.

9. For example, the Act on State Aid is not applied to the infrastructure development, defence and agricultural sectors. Since entering into effect in 2001, all new state aids must conform to the act, although those passed before, have until 2003 to meet its requirements.

arrears and in the form of price supports.¹⁰ Indeed, accumulated tax and social security arrears in the coal sector are four times larger than their State Budget subsidy. Similarly, intercompany debt represents a mechanism by which these firms have been supported -- non-payment of fees by state-owned enterprises in the steel and coal mining sectors, was a principal source of the 0.5 per cent of GDP losses of the State railway in 1999 alone. In addition, the environmental liabilities of these firms, especially in the coal, steel, railway and defence sectors, may be substantial.¹¹ Finally, on many occasions the authorities have pledged the assets or equity of state-owned and partially privatised firms as collateral for bank loans.

Table 2. Tax expenditures

	1993	1997	1998	1999	2000
Zloty million					
Total tax expenditure	1 835	37 479	43 855	51 058	57 971
PIT	957	4 087	4 690	6 007	6 876
<i>Housing</i>	919	2 712	3 117	4 244	4 843
renovation	369	1 267	1 308	2 001	2 258
new construction	550	1 445	1 810	2 242	2 585
<i>Others</i>	38	1 375	1 573	1 763	269
CIT	878	4 292	4 865	7 049	5 343
Tax free	128	1 228	2 247	4 740	4 123
<i>of which:</i>					
Sale of immovable property			885	2 401	2 570
Income of non-profit organisation			989	1 716	1 541
Exemption or relief	750	3 064	2 618	2 309	1 220
VAT	n.a.	29 100	34 300	38 002	45 752
Per cent of GDP					
Total tax expenditure	1.2	7.9	7.9	8.3	8.5
PIT	0.6	0.9	0.8	1.0	1.0
<i>Housing</i>	0.6	0.6	0.6	0.7	0.7
renovation	0.2	0.3	0.2	0.3	0.3
new construction	0.4	0.3	0.3	0.4	0.4
<i>Others</i>	0.0	0.3	0.3	0.3	0.0
CIT	0.6	0.9	0.9	1.1	0.8
<i>Tax free</i>	0.1	0.3	0.4	0.8	0.6
<i>of which:</i>					
Sale of immovable property			0.2	0.4	0.4
Income of non-profit organisation			0.2	0.3	0.2
Exemption or relief	0.5	0.6	0.5	0.4	0.2
VAT	n.a.	6.2	6.2	6.2	6.7

Source: Ministry of Finance, OECD.

8. State guarantees have been subject to a well-defined regulatory process since 1997. Each year the Budget specifies a maximum volume of guarantees that may be issued and the official measure of the public debt includes risk-weighted guarantees.¹² While the law contains rules designed to minimise moral

10. The state-owned enterprises' arrears to the Social Insurance Fund (FUS) amounted to 15 per cent of their total arrears, and, in the coal sector, 40 per cent of arrears are to the pension system.

11. Given that Poland, on a GDP weighted basis, still produces nearly three times as much carbon dioxide as the European Union, associated environmental liabilities are predicted to be sizeable. Moreover, high coal price supports give the coal a further advantage.

12. The recently passed Act on State Aid harmonises rules with those of the European Union. Each budget law sets a limit on the number of new state guarantees (so-called targeted reserves) that can be issued during that year, and conformity with these limits is monitored on a regular basis. During the 1990s actual outlays on calls amounted to only 0.2 per cent of state budget

hazard in the issuance of guarantees,¹³ there has been an increasing tendency to resort to exceptions from the general rules governing their issuance.¹⁴ To a large extent, this reflects conditions imposed by international lending agencies such as the ERBD, IRBD and EBI. Moreover, the number of new guarantees, and, with the exception of 2001, the actual calls upon them, have been rising (Table 3). So much so, that in 2002 the volume of guarantees expected to be issued is 13 times the average during the period 1994-99 and more than twice the total of guarantees issued over the same period. Currently, more than 50 per cent of outstanding guarantees cover 100 per cent of the risk in contrast to the standard rules that would limit the guarantee to a maximum of 60 per cent of the total liability. Moreover, in some cases guarantees are used in lieu of explicit budgetary transfers to subsidise in a non-transparent manner the activities of various financially troubled state-owned enterprises and agencies without affecting the state budget deficit in the current year.¹⁵

expenditure and, as of the end of December 2001, the outstanding state guarantees amount to PLZ 27.2 billion, 3.8 per cent of GDP. One-fifth of outstanding guarantees are classified as high risk (a more than 50 per cent chance of default)

13. Guarantee recipients are supposed to provide collateral and pay a 2 per cent commission fee. In principle, the guaranteed portion of a credit or bond is limited to 60 per cent of the total.
14. At present a half of outstanding guarantees cover 100 per cent of risk including that from credit and interest payments. These include 100 per cent guarantees issued: to the Polish State Railways in 2000 and 2001; to banks to cover the repayment of housing credits provided to housing co-operatives; and to iron and steel industries for the repayment of credits drawn by the Agency for Industrial Development (up to 600 million -- expected in 2002). In addition, highway construction companies operating concessions were allowed to draw bank credits with state guarantees in 2000. Counter-guarantees issued to the Corporation for Credit Insurance (KUKI) for the repayment of its bank loans to support Polish exporters are not subject to the Act on Guarantees. Most recently the airway carriers were given the state guarantees for the damage occurred as a result of war or act of terror if the value of damage exceeds the US \$1 billion. Similarly, bonds issued by the Bank of national economy (BGK) to finance the housing credit facility are exempt from the commission fee.
15. Beneficiaries of such non-transparent state aids include firms in the mining, energy, food-trade, transport and environmental-protection sectors as a means of providing extrabudgetary support. Recently, the ratio of calls upon existing guarantees to newly granted ones is 12-13 per cent in the steel sector.

Table 3. State guarantees

	1994	1995	1996	1997	1998	1999	2000	2001	2002 ¹	
									Projections	Budget
Zloty million										
Actual calls	443	475	279	197	132	297	311	199		798
Outstanding guarantees	20 863	18 516	19 641	21 087	19 723	18 565	19 894	27 232		38 513
New	1 439	1 626	1 325	1 841	698	1 580	4 028	11 199	19 000	29 000
<i>of which</i>										
PKP S.A.	282	902	333	270	0	592	428	1 675	3 066	
highway construction							3 121		9 546	
<i>memorandum items:</i>										
Subsidies to PKP S.A.	717	806	951	1 066	798	941	980	1 202		456
Risk by category										
Low (0-30%)							6 524	11 423		
Medium (30-50%)							2 166	8 383		
High (50-80%)							10 390	4 859		
Very High (80-100%)							432	409		
100% risky							382	443		
Other ²								4 238		

1. 2002 Budget data are legal maxima while projections represent official expectations.

2. Guarantees to airway carriers for damages occurred as a result of war or act of terror (November 2001).

Source: Ministry of Finance.

Medium-term spending challenges

9. Economic and public-expenditure developments over the next decade are likely to continue to be dominated by the process of economic convergence. Indeed, the current weight of household transfers in total spending reflects past decisions to smooth the adjustment process by subsidising labour force withdrawal. As the data suggest, a significant proportion of this withdrawal was achieved by the generous allocation of early retirement and disability pensions. However, the resulting low rates of employment have set up a vicious circle. Increased social welfare expenditures to the non-employed and reduced tax revenues have forced the authorities to raise tax rates further, thereby exacerbating non-employment. While a serious problem, it also contains the seeds of a cure, as concrete steps to reduce labour-force-shrinking transfers and to increase employment could set up a virtuous circle whereby increasing employment rates would simultaneously reduce expenditures and increase revenues, creating room to reduce tax rates and further stimulating employment.

10. The coming to maturity of the London and Paris Club debt over the next several years (see Box 1) will place further pressure on the public purse, increasing expenditures without improving services. While privatisation revenues could be used to pay off some of this debt, progress of late has been slow¹⁶ and, unless the pace of privatisation picks up markedly, total debt-servicing charges are projected to rise by as much as 2½ per cent of GDP by 2009. The ageing of the population and the implications that this will have on health and pension spending are a further source of medium-term expenditure pressures. Over the longer term, the recent reform of the old-age pension system will help to limit the impact of ageing on government finances. However, for the moment it is actually worsening the general government balance as contributions that would have otherwise helped finance the pay-as-you-go system have been transferred to the new funded insurance pillar.¹⁷ At the same time, the recent reform of the health-sector appears to be experiencing difficulties and, at least for the moment, costs continue to grow more quickly than output.

16. Privatisation revenue grew gradually from less than 1 per cent of GDP in 1995 to 2.2 per cent in 1999 and 3.9 per cent in 2000 when the size of privatisation revenues peaked. As a substantial part of major profitable state-owned companies were sold and the government intends to use privatisation as a subset of industrial policies, the privatisation receipts are expected to dwindle. Privatisation revenue in 2001 recorded 1.4 per cent of GDP (PLZ 10 billion), short of the originally projected 2.5 per cent of GDP. The authorities forecast that the privatisation revenue will fall further to 0.8 per cent of GDP (PLZ 6.6 billion) and become negligible thereafter. Since 1998, privatisation revenue has been more or less earmarked, among others, to finance premium transfers to the newly created individual pension reform, modernisation of defence system, court-ordered compensation programs for employees and pensioners working in state-owned enterprises whose salaries and pensions were not indexed in 1990 and 1991.

17. The authorities' so-called "Economic deficit" attempts to correct for this factor. However, as an indicator of fiscal sustainability it is not very helpful because the transferred contributions represent a real loss for the government that has to be made up via increased debt, reduced expenditure or higher taxes.

Box 1. Debt restructuring and its principal impacts on debt-servicing costs

In 1991, with debt servicing charges rising to 58 per cent of exports in good and services and public debt at almost 90 per cent of GDP (of which foreign debt accounted for 64 per cent), Poland started a debt-restructuring programme. Two separate deals served to substantially reduce the debt servicing and current account burdens represented by these liabilities.

The first, the "Paris Club", deal saw the net present value of the debt owed to Poland's official creditors (among which are many OECD governments) reduced by 50 per cent, principally by lowering from 7 per cent to 1.9 per cent the interest rate payable on this debt. After a series of negotiations, a similar deal was struck in 1994 with the "London club" of some 500 commercial banks, which resulted both in a reduction in the principal of some debt and the issuance of a wide-range of low-interest rate "Brady bonds".

As from December 2001, the average nominal interest rate on outstanding Paris and London Club debt was 2.3 and 5.4 per cent respectively. The "Paris Club" low-interest rate instruments will be coming due over the next several years with the largest tranche of \$4.3 billion maturing in 2008. To the extent that this paper is rolled over, the interest charges associated with Poland's debt will increase significantly because market interest rates on Polish sovereign debt are much higher than the nominal rates currently paid on this debt.

As of September 2001, foreign debt constituted 35 per cent of state treasury debt, and the Paris Club and Brady bonds (London Club) accounted, respectively, for 66 and 16 per cent (\$20 and \$4 billion) of Polish external debt. Loans from international institutions such as the World Bank and the European Investment Bank accounted for another 10 per cent (\$2.5 billion).

11. In addition to the above mentioned medium-term pressures, a number of temporary, transition-related costs have been incurred over the past several years, and these have amounted to between 1 and 2 per cent of GDP since 1999 (Table 4). While some of these costs are likely to diminish in the future, they are also likely to be replaced by new demands on the public purse. For example, environmental clean up and investment costs associated with EU accession are expected to exceed \$4 billion annually (3 per cent of GDP) over the next three years (IMF, 2000),¹⁸ while more generally there is an urgent need to invest in public infrastructure to improve growth prospects. Indeed, Poland is very poorly endowed with motorways. Experience in other transition countries indicates that an efficient network of high speed, high volume roadways is an important necessary condition for regional development. By the same token, there is a growing need to expand investment in educational services -- especially as concerns the work-to-school transition (World Bank, 2001a).

18. Environmental clean up is estimated at to cost about \$3.5 billion per year until 2005, while operational and maintenance cost of environmental investments is estimated to reach US \$1.2-US \$4.7 billion over the same period. For details on environmental policies in Poland, see OECD (2001a).

Table 4. **Transitory costs**

	1999	2000	2001 ¹	2002 ²
	Per cent of GDP			
Social insurance	0.6	1.5	1.6	1.9
<i>of which:</i>				
Premium transfer to individual accounts	0.4	1.1	1.3	1.5
Health insurance	0.4	0.1	0.0	0.0
<i>of which:</i>				
Grant to regional health funds	0.3			
Write-off of loans to health fund	0.1			
Restructuring of health care service	0.0	0.1		
Education	0.0	0.2	0.2	0.0
Additional spending total	1.0	1.8	1.8	1.9
<i>Memorandum item:</i>				
State budget loans to pension funds	0.6	0.3		
State budget loans to health funds		0.1		

1. Preliminary.

2. Based on draft budget (June 2001).

Source: Ministry of Finance.

12. The remainder of this paper examines the public expenditure process. It begins by discussing expenditure management issues, analysing to what extent existing institutions permit policy makers to exercise effective control over government spending. The next section makes specific recommendations on steps that could be taken to improve the quality of outcomes and the capacity of policy makers to direct resources towards policy priorities.

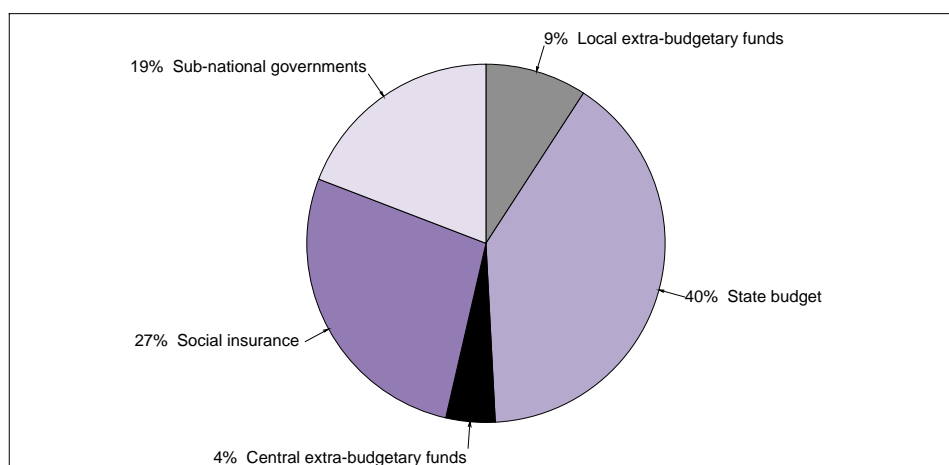
Expenditure management

Budgetary planning

13. Poland is a unitary state, which nevertheless has several levels of sub-national government: *gminas* (municipalities), *poviats* (counties) and *voivodships* (provinces or departments). While *gminas* and *voivodships* have a long history in Poland, *poviats* were only recently recreated (after having been abolished for many years) as part of a far ranging reform of the public administration, which also reduced the number and responsibilities of *voivodships* (Box 2). From the point of view of expenditure, the general government is comprised of the state budget, these sub-national groupings and more than 3 000 extra-budgetary funds -- both at the national and sub-national levels. Overall the state budget represents only 40 per cent of general government expenditure, while extra budgetary funds (including locally managed extra-budgetary funds) represent a further 40 per cent. The remaining 19 per cent of expenditure is accounted for by the activities of sub-national governments or 28 per cent if one includes the spending of their extrabudgetary funds (Figure 4). Generally speaking the budget process is only weakly integrated

across different government levels and between governments and their extrabudgetary funds.¹⁹ The role and activities of the various extrabudgetary funds, agencies and institutions is discussed in more detail below.

Figure 4. **Expenditure shares by level of government**
2000¹



1. Local extra-budgetary funds include regional healthcare funds.

Source: Ministry of Finance.

Box 2. Fiscal relations between levels of government in Poland

Poland's governmental structure has undergone a number of changes since the end of the Second World War -- although throughout this period it has remained a unitary state. During most of the past decade, there were two levels of government: the central government (central administration and 49 geographical units or *voivodships* and 268 auxiliary local offices) and local governments in the form of 2 489 *gminas*. While numerous, *gminas* are not excessively small. On average they are much larger than municipalities in the Czech Republic and Hungary (only 23 per cent of them have fewer than 5 000 residents, while more than 90 per cent of municipalities in the Czech Republic and Hungary fall below this threshold).

A major reform of the public administration was introduced in 1999, creating two new levels of sub-national government. While the reform retained a central government presence at the regional level with a *voivodship* administration, it reduced the number of *voivodships* from 49 to 16 and created a parallel and distinct *voivodship* level of self-government. In addition, the creation of some 315 *poviats* or county self-governments introduced another new level of government.

19. The 1998 Act on Public Finances describes the overall institutional framework governing the preparation, implementation and reporting of public-sector budgets. It outlines the relationships between the four levels of government in Poland and their various responsibilities.

The 1999 reform was accompanied by a significant devolution of expenditure responsibilities from the central to sub-national governments in the areas of education, roads and healthcare. *Voivodship* self-governments are responsible for regional development policies, higher vocational schools, larger cultural facilities and specialised regional hospitals. Moreover, they participate in the supervision of autonomous health funds. The *poviats*, as the lower-middle level of sub-national governments, are responsible for special lower secondary schools and high schools, police and fire protection, the operation of larger social assistance facilities and nursing homes, county-level roads and general hospitals. The *gminas*' main responsibilities include primary and lower secondary education; waste disposal; provision of electricity, heat and gas; operation of social assistance facilities; the disbursement of various allowances; maintenance of *gminas*' own housing stocks; primary healthcare clinics and local transport service among others. Even though they are territorially contained within *poviats* and *voivodships*, *gminas* are not financially or politically subordinate to them. However, they are encouraged to co-operate with higher levels of sub-national governments in carrying out certain tasks.

Central government

The State Budget process

14. The elaboration of the State Budget follows a process similar to that in most OECD parliamentary democracies. The Ministry of Finance proposes to the Council of Ministers budget guidelines that include spending and revenue aggregates. These are then revised by the cabinet and used as a basis for creating a detailed draft budget in conjunction with line ministries. This is aggregated and modified by the Cabinet before being submitted to parliament no later than 30 September for three readings. The Council of Ministers can determine the total amount of State Budget expenditures and revenues. Ministries enjoy substantial autonomy in allocating spending across programmes once their budget envelopes are decided within the more general budget process. If the budget is not approved by the 1st of January, the draft budget bill submitted for first reading serves as a basis for managing spending until the act is passed.

15. As compared with other OECD countries, budgetary rules are relatively few. The budget period is one year and the balance included in the budget law is binding upon the government. In the 2002 Budget, the government sought to break with this tradition in favour of a spending norm (1 per cent real growth of State Budget spending). Unfortunately, the constitution²⁰ indicates that it is only the deficit that forms a binding constraint on parliament, and, as a result, parliament passed an amendment adding an extra 1 per cent of expenditure, half of which was made conditional on stronger than expected revenues. Moreover, the CPI+1 rule has since been abandoned in favour of a much less ambitious rule limiting the growth of expenditures to what the state can afford. This is an unfortunate development as it once again implies a procyclical stance to fiscal policy with expenditure growing more (less) quickly when the economy and tax revenues are strong (weak). Moreover, it cancels the welcome built-in public expenditure restraint mechanism of the CPI+1 rule. As a result, there are no longer any rule-based pressures working towards budget consolidation and bringing expenditure back towards a sustained path. The budget may include a targeted reserve of as much as 5 per cent of expenditure to cover unforeseen liabilities of the State Treasury and a general reserve of up to 2 per cent of State Budget expenditure to cover unexpected spending needs. The Act itself and its annexed documentation contain relatively little information about the general government, making identification of the true stance of fiscal policy and public finances difficult. Only explicit transfers made from the State Budget to extrabudgetary funds and sub-national levels of government are indicated in the Act, although annexes include the budget plans for central government extrabudgetary funds. No information is provided about sub-national governments or their extrabudgetary

20. Article 220 of the Constitution.

funds. While the budget includes a 3-year projection of aggregate revenues and expenditures, this is not based upon a bottom-up analysis and no detail on chapters is provided. The projections mainly play an informational role and they do not impact the preparation of the next year's budget as they might in a multiyear framework. Finally, the impacts of policy changes implemented in the course of the year are not systematically included in the budget, nor are they aggregated. However, multiyear budgetary impacts of proposed changes to programmes must be provided when these changes are initially put before Parliament.

16. The constitution prohibits the public debt from exceeding 60 per cent of GDP. As a result, the Act on Public Finance includes specific mechanisms designed to prevent this limit from being reached (Box 3). In particular, it defines intermediate thresholds of 50 and 55 per cent of GDP and requires the authorities at both the State Budget and local-government levels to take steps to stabilise the debt at less than 50 per cent of GDP. These rules contain escape clauses (when the budgetary consolidation measures they require are deemed impossible), and do not provide explicit mechanisms by which the targets for securing a return to budgetary stability are to be achieved. Nevertheless, their existence does serve to force decision makers to come to terms with a deteriorating budgetary situation. Indeed, with debt fast approaching the lower 50 per cent threshold, the existence of such limits likely played a role in promoting recent efforts at expenditure control.

Box 3. Enforcing the constitutional limit on public debt

The Act on Public Finance both defines the public debt and the rules designed to ensure that the constitutional limit of 60 per cent of GDP is not exceeded. It specifies that whenever the public debt (general government) exceeds 50 per cent of GDP but is less than 55 per cent, the deficit (surplus), expressed as a per cent of total revenue, included in each of the State and local government budgets of the following year must not exceed (be smaller) than in the year when the limit was breached. Whenever the public debt exceeds 55 per cent the State Budget deficit for the following year must be consistent with a stable or falling State Treasury Debt¹, after taking account of expected calls on state treasury guarantees. The deficits of sub-national governments must be lowered as compared with the previous year by an amount equal to the extent to which the public debt exceeds 55 per cent of GDP². In addition, the Council of Ministers must present to Parliament a fiscal consolidation plan aimed at lowering the public debt. Finally if the public debt reaches 60 per cent of GDP, no new state guarantees may be issued and the Council of Ministers must submit a fiscal consolidation plan to the Parliament, while sub-national governments must pass balanced budgets.

However, there is an escape clause built into the rules allowing the procedure to be bypassed in the case of an emergency where the implementation of fiscal consolidation plan is deemed impossible.

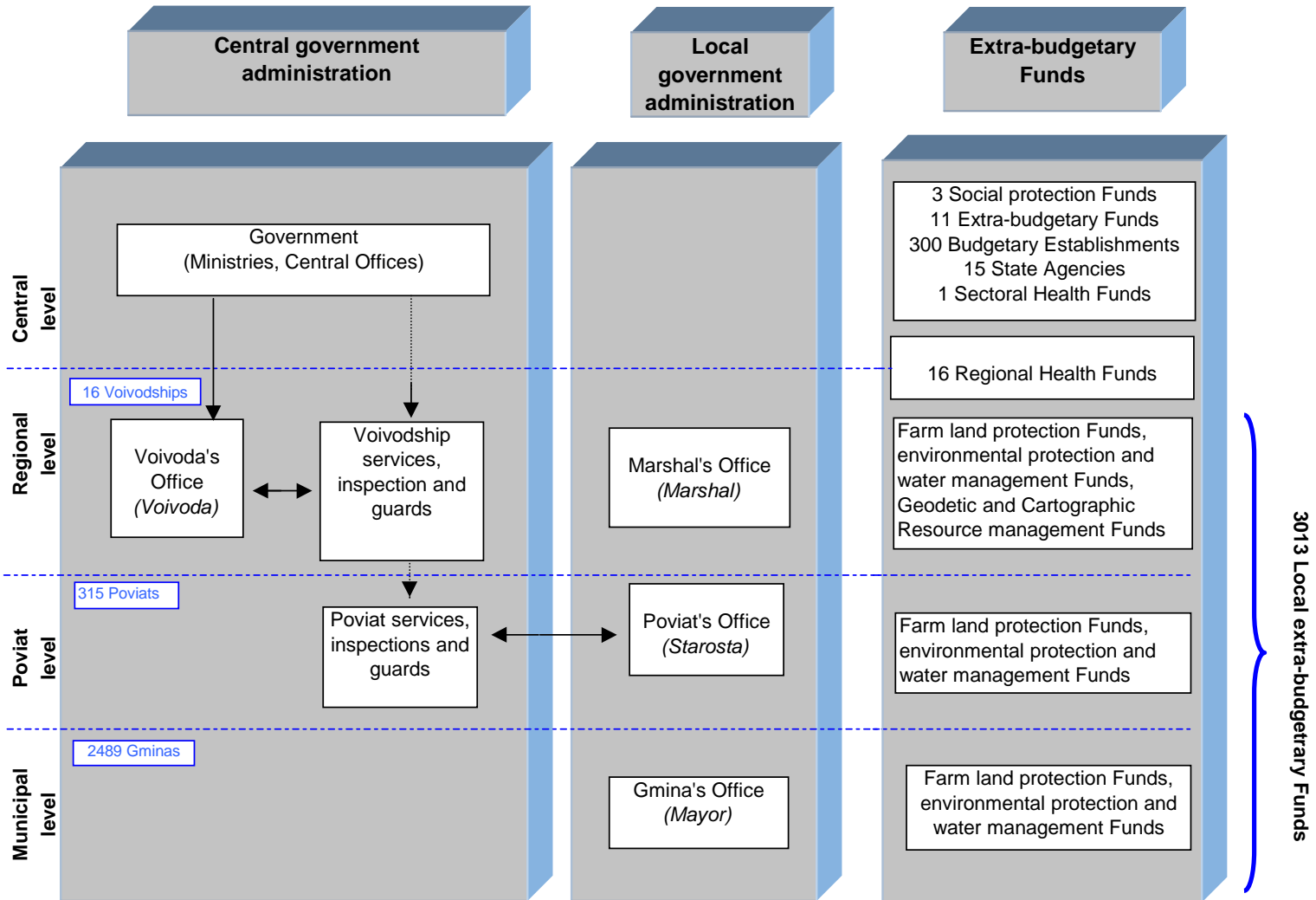
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1. The State Treasury Debt is defined as liabilities created by the Ministry of Finance (State Treasury) in order to finance the State Budget deficits and risk-adjusted guarantees. It differs from the notion of the public debt because it excludes the debts of extrabudgetary funds and the commitments of other general government sectors, including that of sub-national governments.
 2. Sub-national deficits are to be reduced by a factor R, where R is equal to $R = (0.6 - \text{public debt}/\text{GDP}) / 0.05$, which if applied to all of government spending would ensure that the deficit in the following year was equal to 55 per cent of GDP.

Extrabudgetary institutions

17. The existence of a wide range of extrabudgetary institutions contributes to the fragmented structure of the general government in Poland (Figure 5). In addition to the State Budget, the central

government consists of 3 social protection funds, 11 other extra-budgetary funds, a number of independent state agencies, 300 budgetary establishments and 400 ancillary budgetary enterprises (Box 4). Sub-national governments (see below) also have more than 3 000 extra-budgetary funds, including separate environmental funds at each level of sub-national government. Moreover, they are also allowed to create budgetary establishments and ancillary budgetary enterprises although detailed data on how many of these may exist are not available. A national and 16 regional health funds have something of a hybrid nature. While they remain central government instruments they have sub-national representatives on their governing boards and enjoy considerable autonomy from the central government.

Figure 5 Budget structure of general government



Source: Ministry of Finance.

Box 4. Extrabudgetary institutions

Extrabudgetary funds

The three largest extrabudgetary funds, the social insurance fund (FUS), the farmers' insurance fund (KRUS) and the Labour fund, account for two-thirds of total extrabudgetary spending, while regional health funds account for a further 15 per cent.

ZUS, the Social Security Institution administers FUS, which receives about 27 per cent of its revenue directly as state subsidies. ZUS is responsible for collecting mandatory contributions, maintaining individual pension accounts in the first-tier, notionally-defined contribution pay-as-you-go pension system; assessing individual's rights to pensions; the payment of benefits and the management of new reserve funds. As of 2006, it will also be responsible for operating a new experience-rated workers' injury-compensation scheme. ZUS also collects contributions for the second-tier fully funded mandatory pension scheme which are then distributed to the credit of individual's accounts at privately managed pension funds.

KRUS provides the same services as FUS but its benefits are directed towards farmers. Typically, the private-sector contributions towards KRUS are about one sixth those going to FUS. As a result, State Budget subsidies represent 95 per cent of its expenditures and this alone represents 8 per cent of State Budget expenditure. For this reason, KRUS is forbidden to borrow. KRUS also finances the Prevention and Rehabilitation Fund (that finances costs associated with prevention of accidents and rehabilitation of incapable farmers) and the Administrative Fund (that finances the administrative costs for social insurance management).

The *Labour Fund* is the main source of unemployment benefits, pre-retirement benefits and active labour market programs. In addition to the 2.45 per cent of gross wages contribution made by employers, State Budget transfers are an important source of financing. Their share in the revenues of the fund is expected to rise from 14 per cent in 1999 to 37 per cent in 2002. The Labour Fund is allowed to borrow from banks and issue debt. In 2000 and 2001, it took on additional obligations equal to 12.5 per cent of its planned revenues in order to pay unemployment benefits and pre-retirement benefits.

The 16 regional health funds are partially funded through a 7.75 per cent payroll tax levied on employees and a similar but effectively less onerous tax levied on the self-employed. A 17th fund is open to all workers but most of its adherents are or were state employees working in so-called "uniformed" positions such as medical, police, fire and armed services. Contributions for the unemployed, retired and non-employed are assured via central government transfers to the funds. An equalisation formula ensures that all funds receive equal per capita contributions, but this formula is not risk weighted so those funds with older or sicker participants operate under a disadvantage.

There are an additional 11 central government extrabudgetary funds under the supervision of line ministries. These include the Alimony Fund, the State Veterans' Fund, the National Environmental Protection and Water Management Fund, the State Agricultural Protection Fund, the State Land Surveying Cartographic Resource Management Fund, the Guaranteed Employee Benefit Fund, the National Fund for Rehabilitation of the Disabled, the Craftsmanship Promotion Fund, the National Fund for Credit Guarantees, the National Housing Fund and National Motorway Fund. Most recently, the National Housing Fund is expected to expand its size as it takes on an expanded house-loan subsidisation scheme, while the newly created National Motorway Fund is expected to facilitate the financing of motorway construction.

Sub-national extrabudgetary funds account for 9 per cent of general government spending and some 22 per cent of total extrabudgetary expenditure, with *regional health funds* accounting for about two-thirds of this amount. Each *voivodship* operates a Farmland Protection Fund, a fund for Geodetic and Cartographic Resources Management and the *Voivodship* Fund for Environmental Protection and Water Economy, which is financed mainly from environmental fees and fines. In turn, each *gmina* and *poviat* operates a Farmland Protection Fund and a fund for Environmental Protection and Water Management.

State agencies

A number of state agencies pursue policy goals with only limited ministerial supervision. These include former extrabudgetary funds that have accomplished their original objectives and institutions that are effectively separate funds, with separate banking accounts, earmarked revenues that they are allowed to carryover into the next fiscal year and in some cases the right to borrow money commercially with an implicit state guarantee.

Extrabudgetary establishments and enterprises

A final group of budget entities whose spending is only partially reflected in the general government account includes budgetary establishments, which provide policy-related services (such as training centres) and ancillary enterprises that provide services directly to the administration (*e.g.* cleaning services). At present there are 300 budgetary establishments and 400 ancillary enterprises within the central government and an unknown number at the sub-national level. These institutions can be established by ministers and heads of central offices as well as by their sub-national counterparts.

18. Extrabudgetary funds finance a substantial part of central government activities but only a portion of their activities is recorded in the State Budget. Transfers from the State Budget represent 31 per cent of their revenues (27 per cent of state Budget revenues), while the unconsolidated revenues of the social security and other central extrabudgetary funds are equal to almost 90 per cent of State Budget revenues. The programmes administered by extrabudgetary funds are not subject to the same budgetary rules as those operated by ministries within the State Budget. In particular, there is no direct parliamentary supervision of the budgetary process of extrabudgetary funds. Their financial plans are approved by the Council of Ministers and only annexed to the State Budget for information. Thus, although parliament is made aware of their activities it is not given an opportunity to influence the spending undertaken by extrabudgetary funds on behalf of the government. Furthermore, because of revenue earmarking it has only a limited ability to reallocate resources from or to these programmes as compared with programmes whose financing comes directly from the State Budget.

19. Moreover, extrabudgetary funds are subject to less stringent budgetary rules than normal programme spending. Most of them, unless specified otherwise, are allowed to carry over their annual surpluses into the next year, issue guarantees and loans and finance their deficits by selling their assets or taking on debt.²¹ Their substantial lending operations include implicit subsidies of about 0.1 per cent of GDP²² and their programme-related expenditures are not subject to public procurement rules although spending for their own use is. Moreover, there is considerable doubt about the quality of their loan portfolios and generally speaking they have yet to work out effective strategies for loan collection. In addition, they are subject to few restraints and can, therefore, allocate revenues across programmes and even create new ones without these decisions being subject to parliamentary oversight.²³ These features,

21. The deficit of those central extrabudgetary funds (1 per cent of GDP deficit) is less than a half of that of the State Budget (2.2 per cent of GDP deficit) and accounts for one-fourth of general government deficit. Creative accounting (*e.g.* loans from the State budget to the Social Insurance Fund) can reduce the official deficit figure of the State Budget and improve the cash-flow balance of the extrabudgetary funds. However, on a general government and accruals basis the transaction has no effect. Because the political and popular discourse revolves around the cash-based measures, this is an effective mechanism for reducing the apparent extent of budgetary shortfall.

22. The Office for Competition and Consumer Protection (2001) estimates that the total amount of implicit aid provided by various ministries, extrabudgetary funds and extrabudgetary agencies through low-interest loans was equal to PLZ 666 million or about 0.1 per cent of GDP.

plus their substantial earmarked own revenues means that their expenditures are not constrained by their initial budgets or revenues. These arrangements may have led some funds to pursue activities that lie outside of their official remit²⁴ and may be a factor linked to the corruption of some government officials.

20. The activities and budgets of State Agencies are also subject to less rigorous budgetary provisions. Many perform functions similar to extrabudgetary funds, receive direct transfers from the State Budget (about 4 per cent of the State Budget goes to Agencies as transfers) and have earmarked revenues that they can carry over to the next fiscal year.²⁵ Although their budgets have tended, on aggregate to be in balance, they often make ends meet by drawing loans with implicit state guarantees and using the proceeds from the privatisation of state assets in their care.²⁶ Moreover, in the past there has been evidence suggesting corruption in the management of some of these agencies.²⁷ Rules governing the transfer of profits from the wide range of autonomous budgetary establishments and ancillary enterprises to the State Budget are relatively clear.²⁸ More than 97 per cent of their revenues derive from the fees they charge both private- and public-sector clients and, in total, these revenues represent about 2 per cent of State Budget revenues in 2000. However, as instruments of ministries there is very little political oversight of their activities, with the result that there is a tendency for the administration to use these vehicles to pursue public policy goals without a clear democratic mandate or supervision.

Monitoring and execution of central government expenditure

21. The Ministry of Finance State Budget Department only monitors and manages the expenditures and revenues of the State Budget. Outside of the State Budget these watchdog activities are much less well developed. Centrally-operated extra budgetary funds provide monthly summary reports on their expenditures and revenues and more detailed reports on a quarterly basis with a 3-month delay. Sub-national government reporting is even less frequent. While budget execution data for both the local and central governments is presented to Parliament in May, consolidated general government accounts on a GFS basis are normally not available until August of the following year. This contrasts sharply with the situation in the Czech Republic and Hungary where such estimates are available on a monthly basis with less than a month's delay. Although estimates of the position of the consolidated central government are available monthly, over the years their reliability as an indicator of the overall stance of fiscal policy is variable and regularly differs substantially from that reported in the GFS. Moreover, the volatility of

23. For example, the Labour Fund has authority to allocate its revenues between passive or active labour market measures at its sole discretion. However, as indicated in the main text, in reality this power is circumscribed in the present situation by the mandatory nature of unemployment insurance expenditures which effectively crowds out all other programme spending.

24. For example, *voivodship*-level environmental funds often use their resources to purchase shares of companies at above market prices, sometimes without the approval of supervisory board. In addition, audits indicate that they have subsidised projects not associated with environmental protection. At the National Environmental Fund, similar problems were identified by the National Audit Office (2001).

25. For example, the Agricultural Marketing Agency intervenes in agricultural product markets in an effort to smooth farm-gate price fluctuations, using its surpluses in boom years to offset deficits in lean years.

26. The Agricultural Property Agency, the Military Property Agency and the Military Housing Agencies regularly supplement their current revenues with privatisation receipts, which are not recorded as a part of state budget revenue. While such spending shows up in the general government accounts it is neither reported nor controlled within the political process.

27. The National Audit Office reports that frequent cases of unjustifiable increase in salaries (by 60-90 per cent) and substantial losses from share purchases. The reports does not indicate whether this is a result of incompetence or inadequate supervision or if some form of self-dealing might be involved.

28. The Act on Public Finance limits central government transfers to budgetary establishments and ancillary enterprises to less than 50 per cent of their income and they are supposed to pay half of their profits into the budget. The Act allows over-spending by those organisations only when revenues are higher than projected and repayments to the State Budget are not affected. However, it prohibits spending overruns when revenues fall short of expenditures or repayment into the budget is diminished.

revenues and expenditures during the course of the year makes it difficult to judge the stance of policy at any given point in time (Figure 6).

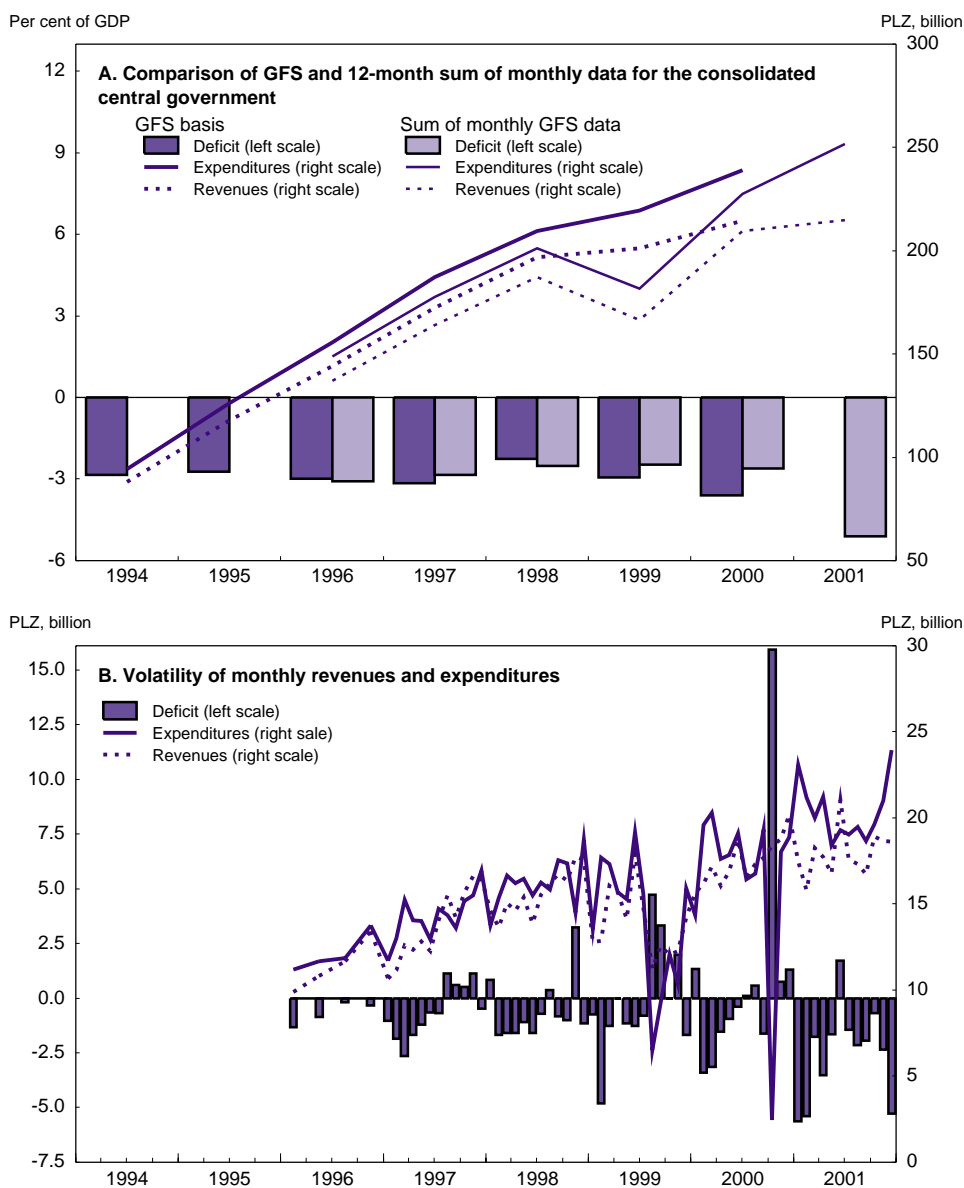
22. In cases of emerging imbalances, the authorities have limited scope for cutting discretionary expenditures such as investment spending or freezing wages. The Ministry of Finance can recommend that line ministries cut spending or can delay payments of budget allocations to them or other budgetary institutions, but only with their consent. Moreover, line ministries can only reallocate up to 5 per cent of the expenditures of a budgetary chapter or paragraph. Given the binding nature of the State Budget deficit, revenue shortfalls and expenditure overruns in the past have often been met by creative accounting, most typically involving the transfer of expenditures to the extrabudgetary sector. For example, in recent years recorded State Budget expenditures were reduced by extending loans to some extrabudgetary funds (repayment of which has yet to be made) instead of more transparent transfers. Had these expenditures been properly accounted for, the State Budget deficit would have been higher by 0.5 and 0.4 per cent of GDP in 1999 and 2000 respectively.²⁹ In other instances, extrabudgetary funds with extra financial resources have lent money to independent government agencies to prevent a rise in the deficit of the State Budget.³⁰ Most recently, compensation paid to public-sector employees for the non-indexation of salaries and pension benefits in 1991-92 was recorded “below the line”, therefore reducing the size of the state budget deficit. Finally, the government has systematically resorted to delaying payments in order to minimise the State Budget deficit. This mechanism is allowed by the Act on Public Finance in instances where spending programmes span multiple years,³¹ but in recent years it has been frequently used in order to reduce the recorded deficit by as much as some 0.4 to 0.7 per cent of GDP.

29. In 1999, a PLZ 0.8 billion loan was extended (and then written-off) from the state budget to regional health funds and 1 billion additional loan was provided in 2000. The Social Insurance Fund (FUS) also received from the state budget, loans of 4 and 2 billion in 1999 and 2000 respectively. See Center for Social and Economic Research Foundation (2001).

30. For example, to pay higher-than-budgeted amounts of miners' severance payments in 1999, the Labour Fund provided the necessary financing to the Industrial Restructuring Agency which then made the severance payments.

31. According to the Act on Public Finance, the expenditure that does not expire at the end of year includes the expenditure financed from foreign credits and expenditure allocated for cofinancing of programs whose implementation is financed by foreign loans. Moreover the Council of Ministers may, in consultation with relevant committee in the *Sejm*, establish a list of the expenditures that can be carried over to the next fiscal year.

Figure 6. Reliability of monthly central government accounts¹



1. Annual data exclude privatisation revenues.
 Source: Ministry of Finance.

Sub-national government

23. The budgets of sub-national governments are prepared with only limited input from the central government, although important control mechanisms are in place. While preparing the State Budget, the Ministry of Finance informs local governments as to the revenues that they can expect from shared taxes and central government transfers by mid-October. However, because these revenues form such a large share of their revenues, local governments only begin preparing their budgets at that time and as a result, these are not finalised until March, *i.e.* three months into the fiscal year. Although local governments have

significant budgetary authority, they are required to submit their draft budgets to Regional Clearing Chambers (RIOs), which are instruments of the central government. The RIOs assess the draft budgets to ensure that each sub-national government has the means to finance any proposed deficit and makes an overall assessment of the sustainability of their liabilities. The opinion of the RIO must be published within one month following the submission of a draft budget: if it is negative, the budget in question must be amended as directed by the RIO.

24. Sub-national governments are also subject to specific limits concerning the size of their deficits and debt loads. In particular, their debt-servicing expenditures and the stock of their debt may not exceed 15 and 60 per cent of their total revenues, respectively. While these limits are welcome, they are not currently binding for most sub-national governments, because the *voivodships* and *poviats* are quite new and, therefore, have limited debt and most *gminas* have not incurred substantial debt in the past (Table 5). As a result, if sub-national governments were to increase spending, these rules could not forestall a significant increase in sub-national and therefore general government debt and (at least temporarily) deficits.³² Indeed, rising deficits and substantial reliance on one-off privatisation revenues to finance their current expenditures suggests that many sub-national governments may soon be obliged to exploit more fully the borrowing room provided for by the law.³³

25. The RIOs also monitor the execution of sub-national governments and are empowered to intervene if lower-level authorities deviate substantially from their approved budgets. While some RIOs report that they now have comprehensive electronic monthly reporting from sub-national governments, this information is not currently integrated into the general government accounts. In Warsaw, quarterly reports on local government finances are only available with a one quarter lag, while their extrabudgetary activities are only reported twice a year, also with a one quarter lag.

The planning horizon

26. While practice concerning the evaluation of the budgetary impact of draft laws and amendments varies, in general the process takes insufficient care to evaluate the effectiveness and longer-term consequences of programmes. Drafts of new legislative initiatives include estimates of their budgetary impacts but these are by and large restricted to one year, which in the case of programmes with longer-term expenditure implications is inadequate. Longer-term analyses are conducted from time to time, for example with the introduction of the old-age pension reform in 1999. For the moment, such budgetary impacts tend to include only the direct costs, and additional analysis of second- and third-round effects is limited. Currently, the Ministry of Finance is improving its capacity to perform more sophisticated budgetary simulations but has yet to develop tools that would allow for a systematic assessment of the distributional consequences of policies. Finally, policies are not subject to systematic *ex post* evaluations, nor is there widespread use of sunset clauses or other tools to ensure that existing programmes are constantly evaluated.

32. If they were to take on debt equal to that provided for in the legislation the general government debt would rise by 6.3 per cent of GDP. Assuming that this process took place over a period of 10 years, the general government deficit would on average be 0.6 per cent of GDP higher.

33. Sub-national governments disposed of PLZ 2 billion assets during 2000 (0.3 per cent of GDP) up from 66 million in 1995.

Table 5. Sub-national government revenues by source

	Voivodships	Poviats	Towns with poviat status	Gminas
	In per cent of local government revenue			
Own revenues	15.9	7.9	48.4	52.5
Shared taxes	14.6	1.4	17.3	15.9
CIT	2.5			1.6
PIT	12.1	1.4	17.3	14.3
Own taxes	0.0	0.0	11.6	15.1
Real estate tax			11.0	12.2
Agricultural tax			0.0	2.1
Transportation tax			0.6	0.8
Fees and others	1.4	6.5	0.0	21.5
Stamp duties			3.2	3.8
Others	1.4	6.5	-3.2	17.7
<i>of which:</i>				
Revenues derived from property	0.4	2.7	9.0	n.a.
Earmarked grants	46.2	44.4	20.3	13.7
Delegated tasks	9.6	24.5	13.4	7.2
Own tasks	30.5	15.9	5.9	4.4
Tasks based on the agreement	6.1	4.0	1.0	0.3
General subsidies	37.7	47.7	31.2	33.7
	PLZ million			
<i>Memorandum items</i>				
Total revenues	3 705.0	12 555.0	21 766.0	34 584.0
Budget balance	-2.2	-0.9	-6.0	-4.7
Liabilities	2.8	3.0	17.3	14.8

Source: Ministry of Finance.

Investment

27. The budget process for longer-term projects such as investment is also problematic. There is no mechanism for ensuring that funding for projects that have begun is continued until their completion. Because investment spending is one of the most important components of discretionary expenditure available to the authorities,³⁴ there has been a tendency for investment projects to be interrupted repeatedly as the government seeks to meet its deficit targets. While this has kept overall investment spending levels low, it has resulted in substantial delays, a substantial increase in the costs of individual projects and a trend of underinvestment.³⁵ Moreover, because of cuts in State Budget funding, project managers have

34. The authorities estimate that the share of mandatory expenditure amounts to 70 per cent of state budget expenditure (including subsidies to the extrabudgetary funds).

35. A review of 21 investment projects undertaken in the period 1994–1997 revealed that none was completed according to its original timetable and that their final cost was three times that originally estimated (National Audit Office, 2001). In the case of the creation of regional hospitals at the *voivodship* level, project deadlines were postponed 17 to 20 times, and the original 3-5 year plans actually took from 13 to 18 years to complete.

resorted to bank loans (with implicit state guarantees) to finance projects. Indeed, 32 per cent of the projects completed in the period 1995-98 were financed in this way, and only PLZ 168 million of the PLZ 2.2 billion (0.3 per cent of GDP) in such guarantees offered over this period was repaid. The remainder had to be refinanced or paid for from the State Budget reserve.

28. Part of the problem derives from poor initial estimates, preparation and implementation of investment projects. However, a lack of technical and financial expertise and loose monitoring of investment are also to blame for the sub-par record (National Audit Office, 2001). Recently some progress was made to improve the planning and implementation of investment spending. Thus, proposed investments exceeding PLZ 55 million must have specific project descriptions, including estimated costs for the two following years, and these details are attached to the State Budget.

Agenda for public expenditure reform

29. For most of the transition period the general government deficit has come in at a reasonable 2 per cent of GDP, and the country has so far avoided the large-scale fiscal imbalances that have provoked economic crises in some of its neighbours. However, a number of factors suggest that there is room for improvement. In particular, the significant slippage that occurred in 2001 and the substantial confusion that existed over the actual stance of fiscal policy that year suggest that oversight and control mechanisms need strengthening. Moreover, the limited progress made since 1995 in reducing the size of the government and the inertia that has characterised spending shares suggest that policy makers may be having difficulty influencing the evolution of public spending in line with changing priorities.

30. In view of a number of looming medium-term fiscal challenges the capacity to plan and implement a multiyear public spending strategy is likely to be of increasing importance to Poland's long-term growth prospects. Pressures on spending from the rising debt-servicing burden, the urgent need to allocate resources towards priority expenditures, such as reducing youth employment infrastructure and human capital investment; and ageing-related cost pressures will all make budgetary management over the medium term more difficult. The following paragraphs propose a number of policy directions that should be pursued to meet these challenges. They seek to give policy makers the tools necessary to exercise control, while at the same time continuing to offer an appropriate range of services to its citizens in a cost-effective way.

Improving the efficiency of social policy expenditure

31. More than one third of general government spending goes towards personal transfers, even more if tax expenditures are included in the total. A large share of this expenditure is financed by payroll taxes, which represent some 60 per cent of labour costs and contribute importantly to the extensive non-employment and hidden activity. At the same time, many of the social benefits offered in Poland exacerbate the problem by making paid-work economically unattractive. As Poland looks forward, one of its most important challenges will be to make better use of its resources, to re-employ those currently out of work and thereby to raise the level of potential output. A reform of social expenditure could help eliminate poverty and unemployment traps and make room for a reorientation of government expenditure towards growth-enhancing programmes such as infrastructure development and education. Indeed, as emphasised in the previous survey, because employment is one of the best cures for poverty, any reform that succeeds in reducing non-employment will likely have important impacts on social welfare -- even if it implies a reduction in transfer spending.

32. The overall efficiency of social spending could be improved by further tightening of the eligibility criteria for disability and pre-retirement pensions as well as sickness allowances and reductions

in the level of sickness benefits. Notwithstanding important efforts to restrict access to new disability pensions (inflows were down 44 per cent in 2001 as compared with 1999 and sick days down 32 per cent) currently high overall pension outlays mainly reflect non-employment. In this regard, early retirement and disability pensions continue to be used as mechanisms for absorbing excess labour supply. As a result, disability pensioners represent more than one third of the overall number of pension beneficiaries (Table 6). Indeed, 12 per cent of the working age population are receiving disability benefits, the highest ratio in the OECD and at about twice the modal level (OECD, 2002c). Similarly, access to sick leave benefits needs to be more closely monitored. The combination of the benefits they confer and the immunity they provide from lay off has led to an explosion both in terms of expenditure and beneficiaries, which is only now beginning to reverse itself. Not only would further restrict access to these programmes to those genuinely in need permit a more generous treatment of these people, it would allow significant savings to be realised. Indeed, a rough estimate suggests that such savings could finance an almost 50 per cent drop in payroll taxes³⁶ -- even before any second round effects are taken into account.

Table 6. **Personal transfers, selected indicators**

	1990	1995	1998	1999	2000	2001
	Thousands					
Number of old-age pension beneficiaries	3 404	4 488	4 636	4 630	4 630	4626
Non-agricultural sector	2 353	3 230	3 497	3 532	3 574	3612
Agricultural sector (KRUS)	1 051	1 258	1 139	1 098	1 056	1014
Number of disability pension beneficiaries	2 628	3 391	3 531	3 536	3 472	3 353
Non-agricultural sector	2 187	2 629	2 735	2 740	2 678	2 565
Agricultural sector (KRUS)	441	762	796	796	794	788
Number of survivor pension beneficiaries	1 029	1 179	1 268	1 287	1 311	1 331
Non-agricultural sector	1 015	1 150	1 234	1 252	1 274	1 292
Agricultural sector (KRUS)	14	29	34	35	37	39
	Per cent					
Benefits (per cent of earnings)						
Old-aged pension benefits		72.8	67.8	65.0	62.5	64.5
Disability benefits and family allowances		51.7	48.3	46.5	44.8	46.3
Survivor pension benefits		61.7	58.4	56.0	53.7	55.4
Total spending (per cent of GDP)	8.8	16.6	15.6	15.7	15.1	15.9
Old-aged pension	3.4	6.4	6.4	6.4	6.3	6.6
Disability pension	2.5	3.7	3.5	3.6	3.4	3.4
Survivor pension benefits	1.1	1.9	1.9	2.0	1.9	2.0
Farmers' pension (KRUS)	1.5	2.4	2.2	2.1	2.1	2.1
Sickness benefits	0.1	1.0	1.2	1.1	0.8	0.8
Unemployment benefits	0.2	1.2	0.4	0.5	0.7	0.9

Source: Ministry of Finance, OECD Social Expenditure Database.

33. The efficiency of the overall pension system would almost certainly be enhanced by integrating the farmers' pension system (KRUS) with the general system administered by FUS. Indeed, insofar as the programmes administered by the two systems are similar, important administrative economies could be gained. However, efforts would need to be extended to ensure that during the transition period to the general system, current adherents to the heavily subsidised KRUS system receive equivalent income

36. On average personal transfers represent 10.3 per cent of GDP in the OECD as compared with 18.1 in Poland. The implied saving from reduced transfers would be PLZ 25 billion or 18.5 per cent of the wage bill.

support via existing social assistance programmes. Integration of the two systems would have the additional important advantage of doing away with some of the worst distortions generated by KRUS. Unlike the general system KRUS is heavily subsidised. It spends about 2 per cent of GDP, 95 per cent of which comes from the State Budget. As a result, contributions towards a KRUS pension are small, relative to benefits, and quite naturally attractive. This, coupled with the requirement that a programme participant own at least 1 hectare of farm land, has forestalled the necessary consolidation of Polish Farm land. Indeed, rather than shrinking, the number of uneconomic small farms during the past decade has increased.³⁷ So large is the apparent distortion that KRUS benefits account for 35 per cent of farming-related income, although as a share of the total income of farming households it represents only 13 per cent.

34. With the unemployment in excess of 20 per cent of the labour force, there is clearly substantial room for improving the performance of Polish labour market policy. Social assistance programmes need to be revised so as to reduce the unemployment and poverty traps that they form in conjunction with the tax system. The need is most acute for households with children where social security benefits are high as compared with both the minimum and average wages. These ills are not borne by workers alone: high labour costs reduce firms' profitability, and their margins for future investment, and in this manner slow growth overall. Given that employment is probably the most effective means of combating poverty, these generous benefits are triply inefficient. Non-earned income for a household with three children is 135 per cent of the minimum wage and 68 per cent of the average wage (Figure 7). Moving from unemployment to a job paid at minimum salary can imply only a small increase in income once benefit withdrawal and income taxes are taken into consideration and estimates suggest that the effective marginal tax rate could be as high as 83 per cent³⁸ (OECD, 2000). These high effective tax rates provide strong incentives to underground work. Fully 10 per cent of benefit recipients report working in the underground economy, while using their participation in benefit programmes to maintain their entitlement to pension and social benefits, which they would otherwise lose (Labour Force Survey, 1999). This situation is especially prevalent in rural areas where 14 per cent of old-age pensioners, 19 per cent of disability pensioners and 6 per cent of unemployment benefit recipients reported having worked underground.

35. Overall tax expenditures and social transfers need to be more closely examined to reduce the extent of unnecessary revenue churning. OECD analysis using the household consumption survey indicates the low or zero-rating of a wide range of goods and services tends to benefit all categories of workers approximately the same in percentage terms but in absolute terms benefits the richest segments of society the most (Figure 8). Similar analyses of the impact of both social and tax expenditure policy indicates that here too targeting could be improved. Previous work (OECD, 2000 and Cavalcanti and Li, 2000) indicates that tax relief programs, notably the housing tax relief program, primarily benefited high-income individuals. Indeed, even though the housing tax deduction represents more than 0.5 per cent of GDP in foregone revenue, prior to the World Bank study the authorities had never assessed its cost effectiveness and income redistribution effects. To some extent this distortion has been addressed by a 2001 reform to the personal income tax system that placed a cap on these deductions.³⁹

36. As in other OECD countries there is scope for more effective use of health expenditure, but exploiting potential benefits is not straightforward. Poland launched a bold reform in 1999 that introduced a social insurance system operated through 17 health funds as the main vehicle for purchasing health

37. The share of farms with 1 to 5 ha of land increased from 53 to 56 per cent of all farms between 1990 and 1998, while that of farms with more than 10 ha increased somewhat less from 17 to 19 per cent over the same period. The share of mid-sized farms (5-10 ha) declined from 30 to 25 per cent (World Bank, 2001b).

38. Calculated as income tax paid on minimum wage plus benefits lost because of taking up employment divided by pre-tax earned income.

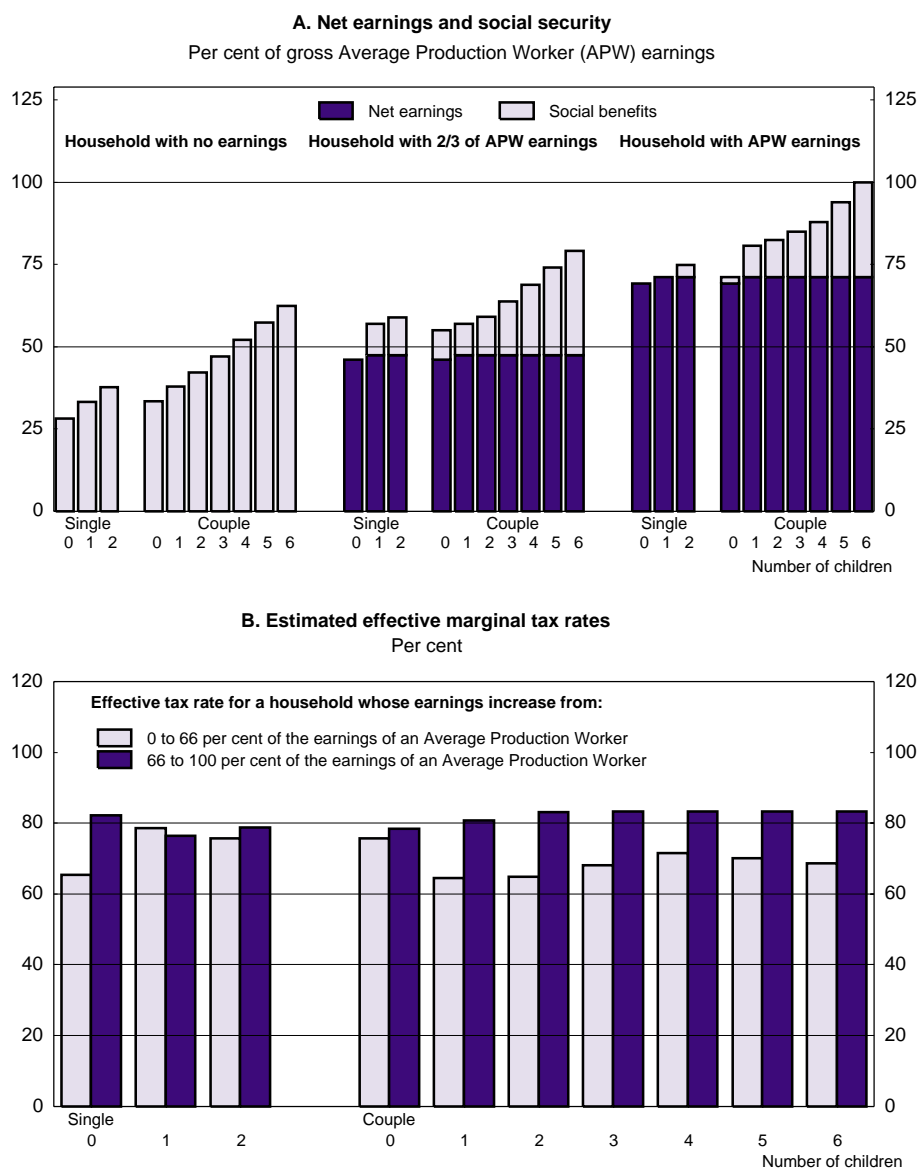
39. The authority expects the budgetary saving of 198 million and PLZ 1 billion in 2002, and 2003 respectively.

services through contracting with healthcare providers.⁴⁰ Although presented as a social insurance system, contributions are levied on employees, pensioners and the self-employed only -- with the State paying the contributions of the unemployed and those receiving various benefits. Moreover, contributions are credited against individuals' personal income tax liabilities, implying that the system is almost entirely financed via tax expenditures.

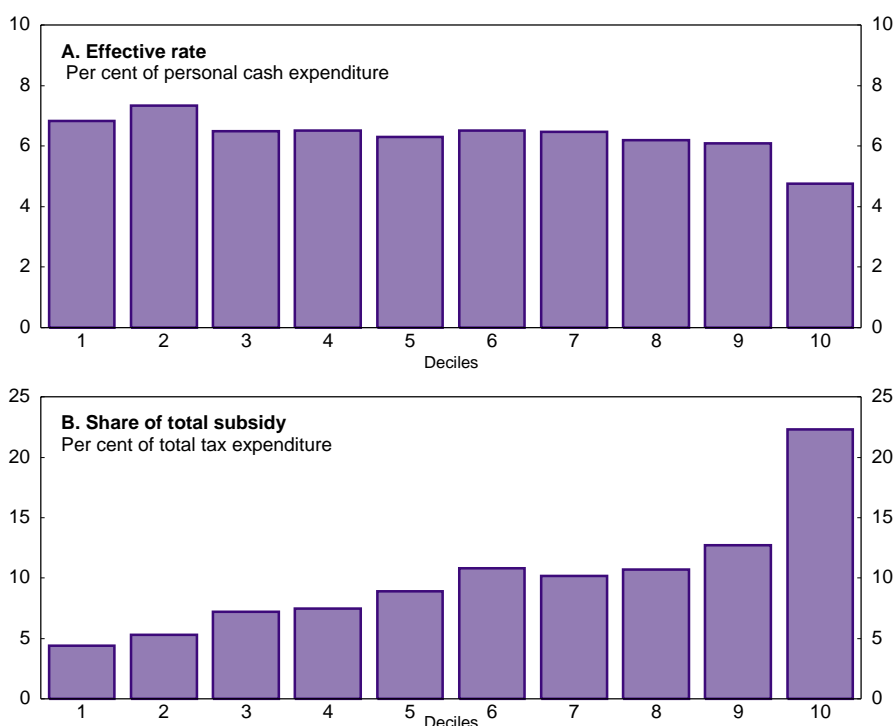
37. Although overall access has improved and family practitioners are playing a greater role as gatekeepers, the decentralised system of health funds has experienced teething problems. The equalisation mechanism that was put in place does not take into adequate account differences in the health risks of Fund participants. In addition, poor governance of some regional health funds and the absence of a clear definition of basic coverage has led to varying degrees of coverage and access to care across funds, which is perceived as unfair. Most important from the point of view of public expenditure would be the introduction of a clear statement of such a minimum services that the regional funds would be obliged to provide. This would not only make the system less arbitrary, but it would also serve to limit future cost pressures and provide an avenue for more private-sector co-financing of healthcare.

40. See OECD(1999) for more details.

Figure 7. Social assistance and work incentives



Source: Ministry of Labour and OECD.

Figure 8. **Distributional impact of non-standard VAT tax expenditures¹**

1. Data calculated by the OECD using individual household records from the 2000 Q2 Consumer Expenditure Survey and VAT rates supplied by the Ministry of Finance.
Source: Central Statistical Office, Ministry of Finance and OECD.

Making the budget process more comprehensive

38. In order to improve the authorities' capacity to evaluate the stance of policy *ex ante*, the government should take steps to raise the profile of the general government within the budget process. Indeed, it is impossible for policy makers to have an accurate sense of the stance of fiscal policy unless budget documents are placed in a general government framework. Given the relatively small share of the State Budget in overall public spending, reliance upon it alone can give a misleading representation of both the stance and direction of fiscal policy. Indeed, even if the authorities were to reintroduce and implement firm expenditure norms on the state budget, these would be unlikely to be an effective constraint on central government spending unless similar restrictions were to be placed on extra-budgetary funds.

39. Perhaps as importantly, keeping the activities of various funds like the Labour Market Fund, Social Insurance Fund (FUS), Farmers Pension Fund (KRUS), and the other social assistance funds outside of the budgetary process unnecessarily and undesirably restricts the capacity of parliament to allocate resources according to changing priorities. Including in the Budget a more comprehensive statement of the activities of such extrabudgetary funds⁴¹ would improve overall governance by subjecting their activities to the same level of oversight as other government spending programmes and make it easier to communicate policy priorities to the various funds.

41. FUS and the labour market fund prepare annual financial plans, which are annexed to the State Budget as well as *ex post* financial statements.

40. In addition, the comprehensiveness of budgetary reporting should be increased both during the budget process and as outturns are monitored in the course of the year. This would improve the transparency of government operations and perhaps also shed some light on some of the Funds' less transparent activities, such as their borrowing, lending and guarantee activities. Moreover, it would provide parliament with an opportunity to review their activities in a systematic way during the course of the closing of the accounts. While funds might retain some of their current independence they would be directly accountable to parliament for deviations from budgets, and they could be subjected to clearer and more transparent rules. An integrated reporting of Ministerial and extrabudgetary spending would also improve the ability of policy makers to redirect financial resources towards priorities independent of whether they fell into the purview of a fund or a ministerial programme. Similar benefits could be obtained by systematically including *ex ante* and *ex post* reports on tax expenditures. While in some cases, tax exemptions are in place in order to promote important social goals or to correct market failures, not discussing them within the annual budget process tends to place them on an unequal footing with other measures that pursue similar goals.

41. In the same vein, policymakers' appreciation of the overall stance of fiscal policy would be enhanced if the budget processes at the central and sub-national levels were better co-ordinated. While the desire to afford sub-national governments with greater autonomy and thereby the flexibility to respond to local needs precludes the central government dictating budgets to lesser levels, budgets at both different levels should be developed simultaneously so that decisions can be taken in a co-ordinated manner. As a first step, expected tax revenues and transfers to be directed to sub-national levels of government could be communicated in the summer when initial revenue estimates are made, rather than, as at present, in late autumn when estimates are finalised. Local governments would then be in a position to submit preliminary budgets to the RIO in early autumn and these could be revised when the expenditure side of the central government budget is frozen. As a result, local budgets could be finalised shortly after the central one and could be expected to deviate only slightly from the general government spending and revenue estimates that would be included in the Budget.

Extrabudgetary funds could be fully integrated into the State Budget

42. Dealing more thoroughly with extrabudgetary revenues and expenditures in the State Budget would go a long way to improving the ability of policy makers to visualise the totality of public expenditure. However, three fundamental governance problems would be resolved by abolishing the funds and reintegrating their programmes into the State Budget.

43. *First*, abolishing the extrabudgetary funds and fully integrating their activities and revenues into the State Budget would reduce the distortions and inertia that their reliance on earmarked taxes brings with it. For example, reliance on a payroll tax subjects the spending programmes of the Labour Market Fund to procyclical pressures. During a downturn, revenues decline with employment losses and mandatory expenditures, mainly passive income support for the non-employed, increase. This normal (and countercyclical) operation of automatic stabilisers squeezes the resources available for the Fund's discretionary activities -- principally active labour market policies -- causing expenditures in this area to shrink. Since the Fund has long since exhausted its initial financial allocation and no longer builds up resources during up turns, unless it receives special cabinet approval to take on debt its overall spending varies procyclically. Moreover, bringing fund programmes on to the same footing as those currently financed from within the budget would improve overall resource allocation. It would do so, by ensuring that when expenditures in a specific area decline, the freed resources could be brought to bear anywhere in the full-range of government activity, not just the limited sphere of competence of a given fund.

44. *Second*, bringing these activities into the State Budget would subject their programmes to the same degree of parliamentary and ministerial oversight as other programmes. It would require that they compete directly with other government priorities for funding and would increase the authorities capacity to redirect spending towards its most pressing needs. Indeed, rather than subsidising farmers' retirement incomes as the current system does (almost 95 per cent of KRUS expenditures come directly from the State Budget) an amalgamation and equalisation of contributions would open the way for using that money to improve rural infrastructure and productivity. More generally, provision can be made for carrying over funding for those activities where there are clear multi-year commitments, while the funding of deficits generated by mandatory expenditures would follow normal procedures, by passing the current situation where funds sell off assets to cover shortfalls. Under such a governance system, the authorities would have better control over spending levels and the creation of liabilities. They would no longer be able to create new programmes or extend activities just because their budgets permit it. Moreover, bringing the funds into the government would subject their lending and purchasing activities to public procurement and State Aid regulations.

45. *Third*, abolishing the funds and integrating their programmes into the State Budget would also help reduce administrative costs. Both FUS and KRUS, respectively the general and farmers pension authorities, provide virtually identical services but operate parallel bureaucracies. By the same token, integrating the tax collection activities of the umbrella extrabudgetary fund organisation ZUS would improve overall efficiency. Currently incentives to declare income to ZUS are relatively strong, because future benefit levels are tied to them. By integrating collections the incentives to understate income in the personal income tax system will be reduced. In addition to reducing labour costs, this would have the further advantage of decreasing opportunities for tax evasion that derive from poor information sharing between the two agencies. This said, the abolition of the Funds as independent Budgetary institutions need not imply important changes in their administrative operations. Indeed, the current structure and responsibilities of their various bureaucracies could well be preserved without diminishing the advantages to be reaped from integrating their activities and their oversight into the State Budget.

46. The logic in favour of reintegrating health expenditure into the State Budget is reinforced by the fact that, in large measure, the current healthcare system is only notionally insurance-based. Coverage is virtually universal, with the state paying the contributions for large groups of non-workers and practitioners receiving payment from the state, whether or not the patient is "covered". Indeed, direct transfers from the State Budget cover 27 per cent of the spending of health funds. Moreover, as indicated above, premia are almost entirely paid for via tax expenditure. A better solution might envisage integrating the financing function into the Ministry of Health and paying health expenditure from general revenues. This could be financed by applying a low tax rate to a wide base (*i.e.* all of personal income) and dropping the health-related payroll tax. The advantage incurred by the visibility of the healthcare tax could be preserved by labelling a portion of the wider-based tax as a healthcare tax --without necessarily earmarking the associated revenues. The argument for abolishing the various PAYG pension funds is even stronger. Although special extrabudgetary pension funds have been created in some countries in order to accumulate temporary surpluses (in isolation from political spending pressures) so as to defray future liabilities, the first-tier system runs a deficit. While the authorities have created special reserve funds, for the moment these are financed from general revenues. Nor would integrating the pensions into the State Budget imply an end continued accumulation of such demographic reserve funds.

Improve the timeliness, quality and comprehensiveness of budget execution data

47. Independent of whether or not the extrabudgetary funds are integrated into the State Budget process, the authorities need to improve both the quality and timeliness with which public finances are reported. To ensure that policy makers have a clear and timely understanding of fiscal developments, three steps appear necessary. *First*, more detail concerning the activities of extrabudgetary funds needs to be included in the monthly accounts of fiscal developments -- especially as concerns their reporting of their lending, borrowing and privatisation activities. At least part of the recent turmoil in monthly data appears to derive from problems at this level. *Second*, as an initial step, the scope of reporting should be increased to cover all the central government extrabudgetary funds. *Third*, with the increased weight of the sub-national governments in the general government the frequency of their reporting should be increased so that accurate estimates of the stance of the general government can be made.

48. In this regard, the authorities should consider creating a single government account for all central government activities and establishing a centralised treasury function in order to subject all the revenues and expenditure (both current State Budget and extrabudgetary funds) to comprehensive and up-to-date monitoring. Experience in other OECD countries indicates that such an account can play a critical role in tracking spending and revenue developments and signalling deviations before they become problems. Particular care should be taken to ensure that lending and borrowing activities of the extrabudgetary activities are correctly accounted for -- especially in the case where below-market-rate loans are used as a form of implicit state aid by some funds.

49. As these steps are pursued, the authorities should consider what model they wish to pursue in data reporting. Currently, central government data are reported on a cash-flow basis while that of the social security funds are recorded on an accruals basis and converted into cashflow terms for the purposes of the GFS and monthly accounts. While many countries report on a cashflow basis, it may be just as easy to move to an accruals-based integrated system as a cashflow system. Indeed, the most recent version of the GFS manual (IMF, 2001) has been made more consistent with accrual-based and SNA accounting practices and the major extrabudgetary funds already report on this basis.⁴² This would have the particular advantage of ensuring that the longer-term implications of spending decisions that extend beyond current-year budget appropriations would be included in the accounts when made. As a first step towards such a system, the Budget and execution reports should include complete information on expenditure arrears on both a central- and general-government basis.

Adopting a medium-term economic framework

50. Placing the annual Budget process within a medium-term framework would enhance fiscal transparency and the ability to reallocate spending towards medium-term priorities. Such a move would have the additional advantage of facilitating the integration of extra-budgetary funds into the State Budget by allowing explicitly for rolling over unspent appropriations for programmes where commitments are multiyear (investments) or very cyclical in nature (labour market programmes). It would also help plan the rational use and absorption of EU structural funds. The planning horizon implicit in a Medium-term economic framework (MTEF) would provide the medium-term budgetary stability that extrabudgetary funds are supposed to provide, while still subjecting programmes to a political process where their expenditures have to be justified and compete with alternative priorities. Although the existing system of spending control has not translated into spending overruns and a tangible threat to sustaining public finance, it has also failed to reduce the size of the spending. The advantages of introducing a multi-year

42. A revised version of the GFS manual (2001) changes its accounting principle from the cash-basis (in 1986 GFS manual) to the accrual-basis in order to better harmonise it with SNA93.

budget framework would be particularly evident in the area of investment by insulating essential investment projects in areas such as infrastructure from the kind of *ad hoc* budgetary cuts that have plagued them to date. Moreover, by including explicit *ex ante* processes for specifying, evaluating and financing large-scale investment projects would along with *ex post* oversight help reduce the risks of substantial costs overruns and inappropriate expenditures.

51. A MTEF would have the additional advantage of giving policy makers the necessary confidence in the economy's longer-term budgetary sustainability to allow automatic stabilisers to work. Armed with a better sense of future budgetary prospects, politicians would be better positioned to resist temptations to vary spending pro cyclically. As a result, positive surprises could be used to help pay down debt, while during negative ones automatic stabilisers could be allowed to work -- thereby limiting the precipitous cuts in discretionary expenditures that have characterised such episodes in the past.⁴³ Similar benefits could accrue to sub-national governments if they too were to adopt elements of MTEF budgeting.⁴⁴

Reducing fiscal risk associated with contingent liabilities

52. With Poland's public debt approaching the 60 per cent of GDP constitutional limit and given the medium-term cost pressures facing the economy, there is a risk that rather than reallocating expenditure towards priorities, political pressures may lead the authorities to accumulate liabilities off budget. While existing rules covering state guarantees provide for significant levels of disclosure and include reasonable prudential provisions, they are neither sufficiently comprehensive nor binding. As a result, there has been a tendency in recent years to increase the levels of guarantees offered and to use guarantees to finance public-policy goals that would be better more transparently and less expensively addressed through direct subsidies or other measures. Current practice could be improved in three ways.

1. To make limits more binding and reduce the temptation to incur future liabilities for short-term political gain, an annual and binding limit on the size of newly issued guarantees and on the total stock of outstanding guarantees should be included in the act on Public Finances. The limit should be stated as a per cent of GDP or of current revenues and be made to apply to all guarantees whether provided by the government or extrabudgetary funds and agencies. The current practice of setting the limits on guarantees annually means that a government that wishes to pursue policy goals off-budget via guarantees needs only increase provisions for them (as indeed was done in the 2002 budget).
2. The guarantees issued by all government agencies must be subjected to the same procedural and prudential rules as well as and quantitative limits. Currently this is not the case as the guarantees issued by State Budget are subject to relatively tight prudential and procedural rules and quantitative limits, while those offered by a number of extrabudgetary Funds and agencies are not so constrained.
3. The practice of using state guarantees to finance various off-budget public policy goals should be abandoned and proscribed. Guarantees should only be used to counteract clearly

43. The budget estimates under the MTEF should be derived as baseline estimates from the explicit macroeconomic assumptions, current policy commitments and government policy priorities. These baseline estimates could be rolled forward and revised in line with changes in macroeconomic conditions and policy priorities during the preparation of the later budgets. For technical details of the MTEF, see OECD (2001b).

44. Not all the countries include the sub-national governments under the MTEF. However a number of the OECD countries found that the MTEF on a general government basis improves fiscal planning and control. For example, Austria where a substantial amount of transfers are provided to the sub-national governments uses the MTEF to improve overall spending control. In Germany where fiscal decentralisation is substantial, the MTEF is used as an instrument to reach an agreement on the distribution of deficit targets between the different levels of governments.

identified market failures and, then, only after a careful evaluation of the relevant merits of alternative policy instruments (including subsidies) has been made. A risk assessment should be integrated into this process, and its results made public. Too often guarantees are used as a substitute for subsidies to firms (especially state-controlled ones) or to finance other kinds of programme spending.

53. In this regard, the proposed use of guarantees to help finance the construction of motorways needs to be carefully examined (Box 5). Given the size of the expenditures envisioned, the programme certainly constitutes a possibly serious risk to medium-term fiscal sustainability. At a minimum, the guarantees to be issued by the State Motorway Fund should be subject to the same procedures and prudential rules as other guarantees and included in the overall quota to be provided for in the Public Finance Act. Moreover, a programme placing more emphasis on upgrading and repairing the existing road network would be more cost effective than the current proposals to build autoroutes (World Bank, 2002).

Box 5. Concession-based motorway construction

Despite early recognition of the importance of improving its highway infrastructure, since the beginning of the transition Poland has only succeeded in completing some 170 Km of the 2 000 Km of multi-lane highway originally planned for completion by 2015.

Recognising the failure of the earlier concession-based construction model in 2000, the authorities prepared an amendment to the Toll Motorway Act, which creates a legal basis for private and public-sector partnerships and a state-owned Motorway Fund. The fund is expected to receive revenues from the State Budget, vehicle duties, toll fees and loans taken by the General Directorate for Public Roads and Motorways.. The fund is to provide grants and interest-free loans to private-sector operators who will operate the motorways as concessions, repaying their loans from their profits.

The government has made provisions to provide substantial state guarantees perhaps as much as PLZ 14 billion (about 1.8 per cent of GDP) in 2002 to finance road construction. This could rise to as much as PLZ 38 billion if guarantees are provided for the full amount of foreign and private capital that the government expects to attract to the project.

54. Another source of contingent liabilities is represented both by the existing and future debts of the wide range of loss making state-owned enterprises. While legally the state is not obliged to cover the debts of state-owned firms, it has already extended significant guarantees to a number of them and several others benefit from implicit guarantees. Moreover, many of these firms have amassed large tax and social security arrears that are unlikely to be collected, and some continue to fail to meet their tax obligations. With a combined debt of around 6 per cent of GDP, the loss-making state-controlled companies in the coal, steel mill and railway sectors have little chance of long-term survival unless this debt-burden is taken on by the state. Unless these firms are privatised quickly, these liabilities can be expected to increase at the same time as the market value of the firms continues to deteriorate -- making an acceleration of the privatisation process all the more urgent.

Improving efficiency at the local level

55. The existing rules governing sub-national government budget preparation and monitoring as well as the limitations placed upon deficits and debts appear comprehensive and should ensure that no important fiscal risks emerge from them over the longer term. Sub-national governments deliver a large share of

general government services but there are few mechanisms in place to ensure the quality of the services delivered. In this respect, there appears to be a mismatch between the spending responsibilities of *gminas* and their ability to effectively allocate resources to meet the needs of their population. The problem arises principally because the current grant system is strongly biased towards specific-purpose grants. As a result, sub-national governments have only a limited capacity to reallocate funds according to local requirements and the system provides inadequate incentives to sub-national governments to manage their spending efficiently. Because the resources they have for any given project is determined by formula, they do not feel fully responsible for the services they provide and tend to use inadequate financing as an excuse for poor services.

56. In response to this problem, the authorities are considering substantially increasing the shared tax revenues made available to sub-national governments, while simultaneously reducing specific-purpose grants.⁴⁵ Such a move has the advantage of making local authorities' resources more fungible and should increase local authorities' incentives to reduce programme delivery costs, improve services and concentrate on the programmes that are important to local populations. Such a result could also be achieved by removing the restriction on the uses to which grants can be put. In instances, where national standards are deemed important, performance grants could be instituted that are conditioned on reaching certain levels of service or improvements in performance.

57. Among the tax sharing options under consideration is one that would give *gminas* a share of corporate income tax revenues from firms in their jurisdiction and the right to charge lower rates in order to attract firms. While such a system would give them another tool for attracting economic activity, the corporate income tax does not seem to be a good instrument for introducing healthy tax competition. The principal problem derives from the fact that corporate income tax is assessed on all of a firms' activity but is paid only by the head office whose location need not bear a strong relationship to where the brunt of its economic activity occurs. As a result, such a regime could result in intra national tax havens where firms place fictive head offices in order to benefit from low tax regimes to the detriment of the regions where they are actually active. Moreover, the corporate income tax base tends to be very volatile as compared with personal income. Additionally, if *gminas* are given the opportunity to offer lower tax rates, then it will be important that in calculating the amount of regional equalisation grants, that the total tax base available to a *gmina* is considered instead of its actual revenues. If *gminas* are granted more autonomy in how they spend their shared revenues it will be critical that the resources of the National Audit Office (NIK) be expanded so that it can perform more *ex post* audits at the sub-national level.

58. Finally, efforts should also be extended to increase the financial and legal incentives for *gminas* to merge or provide services in association with other *gminas*. While there are relatively few very small municipalities in Poland, two thirds have fewer than 10 000 people -- much smaller than what is considered a minimum efficient size of 20 000 to 30 000 inhabitants. Although the joint provision of some services is widespread at the *gmina* level (*i.e.* sewage disposal), there are relatively few instances of *gminas* forming joint-venture associations to provide common services and little co-operation at the *poviat* level. Providing such associations with a legal status as contractors would help in this regard. Currently, there are no financial incentives for joint provision of services -- except if two *gminas* merge, in which case larger *gminas* receive a greater per capita proportion of shared taxes. Thus it may be necessary to increase incentives or adopt a more coercive approach to promote municipal co-operation. Obviously, the newly created *poviats* could provide an important facilitating role, but for the moment this has not happened to an appreciable degree.

45. A new draft law on local budgets calls for raising *gminas*' share in personal income tax revenue from 27.6 to 44 per cent and in corporate income tax from 5 to 8.5 per cent. For *poviat's* the shares would rise from 1 to 8.7 per cent of PIT revenues and zero to 1.5 per cent of CIT. Finally among *voivodships*' share in PIT revenues are proposed to rise from 1.5 to 7 per cent and its CIT from 0.5 to 9.2 per cent.

Systematic evaluation of programmes and output-oriented indicators

59. While some evaluations of spending effectiveness are undertaken, such as active labour market programs, most spending programs are not subject to systematic review, nor are programs designed with an eye toward their evaluation and feedback. Performance is measured only by the extent to which line ministries and agencies respect the expenditure estimates in compliance with legal regulation. Budget chapters do not include result-oriented indicators to monitor and measure the success of programs. *Ex post* evaluation mainly takes the form of audits made by the NIK. While in some areas the NIK carry out value-for-money audits, the input-oriented legal and financial compliance audit still dominates its activities and its capacity to perform value-for-money audits is limited both in manpower and legal terms.

60. In order to shift the focus of the policy formation and budgetary review processes from costs alone to costs and benefits, the government should take steps to systematically integrate output indicators into the budgetary and policy-making processes. Existing ones are too concerned with measuring inputs and too little oriented towards monitoring and evaluating the impact of these inputs. Only when elected officials and ministerial policy-makers are armed with concrete information on the effectiveness of alternative programmes will they be able to make rational choices about how to use public money in the most cost-effective way. Although conceptually simple, in practice, measuring the output of government programmes is difficult and demanding of a country's public service. While it is probably not feasible to introduce a full-fledged output-oriented budgeting system in Poland immediately, over the near term a number of relatively simple changes could be introduced that would make such a transition substantially easier in the future.

61. As a first step, specific-task spending programmes should be introduced with sunset clauses that require them to be abandoned after a set period of time (typically several years), unless parliament renews their mandate. Such a simple measure, which can be introduced retroactively, helps prevent programme and spending inertia from developing. It increases the ability of politicians to re-orient spending as policy priorities change and protects against the development of a culture of *droits acquis*, which can substantially constrain a government's room for manoeuvre. To be most effective, programmes subject to sunset clauses should be designed in such a way that their outputs can be measured. In particular, the performance of specific purpose programmes such as household transfers, tax expenditures, subsidies and labour market programmes should be evaluated regularly and required to justify their continuation. Moreover, legislation governing larger programmes such as pensions and healthcare should be modified to require periodic reviews and regular presentation to parliament of long-term projections of both demands and expected costs.

62. While measures such as sunset clauses and the more systematic evaluation of programme efficiency will help improve public expenditure, for the process to be truly effective the results of these evaluations need to be included in budgetary materials so that politicians can better weigh spending options. Indicators should be reported *ex ante* in the form of goals and *ex post* as a means of verifying performance. Many Ministries make such evaluations for internal purposes but integrating them into the budgetary process would increase transparency and serve to make budgetary institutions more accountable for their use of public funds and the services they provide. Such integration would imply major changes to the budgetary and policy formation processes, however, and would take some time to implement. Nevertheless, movement in this direction is clearly desirable and feasible, implying that the number and nature of indicators in State Budget chapters will need to be gradually expanded. As outcome-oriented budgeting and policy-making becomes more common, the NIK should be able to place greater emphasis on value for money audits.

63. Recently the Polish government made a step forward by creating an administrative unit for financial control and internal audit within each government administration in order to strengthen financial

control and management, on the one hand, and standardise the procedures associated with tendering process on the other hand. Though the primary objective of this institutional change seems the intensification of *ex ante* financial audit, this unit could be developed into the institutional apparatus for introducing the output or outcome-oriented budgeting and *ex post* performance audit at later stage. Indeed the NIK is involved in preparing the standardised manual for financial control and audit from its initial stage and provides an avenue for the development of a fully-fledged output-oriented budgeting system.

64. Efforts to build in an output orientation into public expenditure management will necessarily require substantial changes in the corporate culture and human resources policies of the government. In this regard, clearer career paths for civil servants and better performance incentives would help. Indeed, poor personnel management in the public sector and nepotism have been identified as sources of inefficiency in some areas of public administration (OECD, 2002b). To be most effective managers and employers need to be rewarded for improving outputs rather than managing inputs. This would require giving discretion to managers on spending within the predetermined totals, setting expected outputs in advance, maintaining comprehensive performance reporting and auditing systems and linking managers' pay to performance. While elements of this kind of flexible management system already exist in the Poland, they need to be expanded and incentives and control mechanisms carefully designed. More immediately, improved remuneration of managers and highly-educated personnel so as to improve the government's capacity to attract and retain high-quality officials should be a priority. In this respect, limiting political appointments to the highest level of the civil service would improve continuity in the provision of services and could be consistent with a more flexible management style. While it is important for a government to be able to trust those who are asked to execute its policies, wholesale changes of personnel down to the director level can be counter-productive. Not only can they hurt staff morale, they make the retention of talented young staff difficult and are destructive of institutional memory.

Summing up

65. While Poland has avoided the kind of fiscal problems that have contributed to economic instability among its neighbours, the foregoing discussion makes clear that a comprehensive reassessment of the public expenditure system is necessary. Not only could such a step help to improve the efficiency of programmes, it could also be used to help reduce the deficit, thereby contributing to both internal and external balance and making room for a necessary reorientation of spending away from transfers and towards growth enhancing expenditures. The need for such an evaluation is made all the more pressing by expected increases in debt-financing costs as well as ageing and EU-integration related costs over the medium term. Given the high tax burden already facing Poles and the implications that this may have on potential growth rates, reducing public expenditure should be a priority. To do so while retaining an adequate level of service will require that the authorities improve the way public expenditure is managed. Box 7 summarises the recommendations of this paper.

66. The relevance of these recommendations is attested to by the important degree to which they overlap with a number of the measures being considered within the authorities' *Entrepreneurship-Development-Employment* plan (Box 6). As the authorities seek to translate the goals and principles of their plan into concrete policy, it will be important that they combat the fragmented nature of government spending by moving towards a more integrated budgeting of the central government. This implies expanding the scope of the State Budget to include much more of general government spending, abolishing the extrabudgetary funds, repatriating into general revenues their earmarked funds and improving the co-ordination of the budget planning process among different levels of government. Without a more comprehensive notion of government spending, the authorities desire to replace the current deficit target with a spending norm, is unlikely to reduce overall spending and address the medium-term challenges posed by rising debt-servicing charges, the ageing of society and the need to improve the infrastructure.

Box 6. The *Entrepreneurship-Development-Employment* medium term plan

In February 2002, the Council of Ministers approved a medium-term economic programme, known as *Entrepreneurship-Development-Employment*. It seeks to enhance real GDP growth from 1 per cent this year to 5 per cent by 2004. The coverage of the package is broad and ambitious, ranging from tax and labour market measures to administrative simplification. Its principal measures are listed below. Implementing the package will necessitate a large number of legislative changes as well as ministerial decrees, some of which have already been introduced.

Fundamental goals of the plan

- ◆ To achieve and sustain real GDP growth of 5 per cent by 2004 compared with 3 per cent under a no policy change scenario. Structural reforms would permit inflationary pressures to remain subdued and the current account deficit manageable -- while the strong growth will boost employment.
- ◆ Public sector reforms (see below) should yield expenditure savings in the order of ½ a per cent of GDP per year. However, the deficit is projected to remain at some 5 per cent of GDP because of increased infrastructure spending.

“Public finance strategy”

- ◆ To underpin fiscal discipline, the programme initially sought to abandon the State Budget *deficit target* and to replace it with an *expenditure norm* of 1 per cent real growth in State Budget spending. Since then this rule has also been abandoned in favour of one whereby state expenditure are to grow in accordance with the authorities’ ability to pay.
- ◆ To reinforce the credibility of fiscal policy, the plan identifies *measures to shrink the size of the public sector*, most notably through lower public employment, reducing the number of ministries, consolidating extra budgetary funds, liquidating inefficient state agencies and eliminating fringe benefits in some areas.
- ◆ The above changes are to be accompanied by *measures to rationalise social transfers*, including tightening disability rules, accelerating the increase in the early retirement age, changing the pension index mechanism, reducing sickness benefits, KRUS reform.

“Entrepreneurship First of All”

Measures to improve the business environment

- ◆ Accelerate the *reduction of red tape and administrative obstacles*, by simplifying registration procedures and lowering licence and permit requirements. A major target is to reduce the high levels of discretion currently wielded by local administrators. The authorities are also determined to expand the use of e-devices as tools for public service delivery.

- ◆ Pushing ahead the *reform of the tax system*. *Inter alia*, the government is committed to introducing a uniform income tax from all economic activity (personal and business), to offer tax holidays for new entrepreneurs and to lower stamp duties charged to entrepreneurs. One important measure expected to reduce administrative costs is the simplification of social security-related forms and allowing some self-employed workers to file quarterly instead of monthly returns as present.

Restructuring and privatisation

- ◆ The authorities are committed to accelerating the *privatisation* process so that the state-owned sector is brought down to about the OECD average by 2005, *i.e.* between 10 and 15 per cent of GDP. It remains committed to its *restructuring-prior-to-privatisation approach* and its special emphasis placed on coal mining, energy, gas, steel, defence, chemical and the railways. It has been explicitly announced that State Treasury will maintain control over four 100 per cent state-owned banks: BGK (specialised in the management of guarantee funds), PKO BP (saving bank), BGZ (agriculture bank) and Bank Pocztowy (postal saving bank).

“First Job”

- ◆ To *lower labour costs and make employment relations more flexible* the programme seeks substantial revisions of the Labour Code, which will be introduced in consultation with the social partners.
- ◆ Planned changes include:
 - Removing requirements that even very small firms appoint special workplace health and safety regulations and establish wage rules and work codes.
 - Temporarily, until Poland becomes a member of the EU, increasing the number of successive fixed term contracts permitted before a worker is automatically deemed a permanent employee.
 - Amendments to overtime work premium, which would increase from 2 to 4 the number of hours of overtime that can be paid at the lower overtime premium of 150 per cent.
 - A relaxation of rules regarding work dismissal in small firms are expected and severance pay will be tied to the employee's current tenure of employment, rather than his/her total work history.
 - Finally, the employer's obligation to pay dismissed employees during their job search will be limited.
- ◆ Special initiatives destined to improve employment prospects for recent graduates. These include paying part of graduates social security charges from the State Budget; special provisions for graduates that create their own businesses; tax and social security breaks.

“Infrastructure – key to development”

- ◆ To support accelerated real GDP growth, the authorities plan to invest in housing and roads. Between 2002 and 2005, the authorities expect to spend PLZ 180 billion or (25 per cent of GDP) with 60 per cent of the total going to housing and 22 per cent to roads. This expenditure is to be co-financed from the budget, the EU and the private sector -- backed by public guarantees.

67. In order to give themselves the tools necessary to effectuate the kind of reorientation in spending away from transfers and towards programmes that contribute to the economy's growth potential, the authorities need to increasingly move towards a multi-year budgeting framework. Not only will this allow for better management of investment projects, but it will also help policymakers to see more clearly the longer-term consequences of their spending decisions. This would reduce the temptation to make decisions or creative accounting solutions that superficially improve fiscal outturns in the current year but at the

expense of future budgetary sustainability. Moreover, a medium-term budgetary system would facilitate the integration of the extrabudgetary funds into the whole of government and could in conjunction with a more resolute focus on the efficiency of programme spending, pave the way towards an output-orientation in government policy.

68. Indeed, there is a clear need to build into the expenditure oversight process much greater emphasis on the effectiveness of spending. If the governments' new growth-enhancing policy priorities are to be effective, the authorities will need to have measures by which they can judge them and the relative merits of different spending options. Thus, it is essential that the authorities invest in the kind of analytical expertise necessary to conduct cost-benefit studies and that the results of these are included in budgetary documents. Indeed, arguably it is unlikely that parliament would retain the highly distorting exemptions and low-rating of goods and services under the current VAT scheme if it was aware of the limited redistributive impact of the 6.5 per cent of GDP in tax expenditures that the programme represents. Looking at labour market policy and the vicious circle created by high payroll taxes and low employment rates there is a very real necessity to examine closely the effectiveness and desirability of social spending programmes. Some of these appear to be simultaneously contributing to work disincentives by offering out of work benefits that are more financially interesting than paid employment and, contributing to reduced demand for work by forcing the authorities to increase labour taxes to pay for these benefits. In this regard, early retirement programmes, excessive use of disability benefits and high out-of-work benefits for families with many children appear to be contributing to problems rather than their solution.

Box 7. Summary of recommendations

Budgetary reform

- The authorities should adopt a strict expenditure rule along the lines of the abandoned CPI+1 per cent rule, but apply it to all of government expenditure. The current rule, like its predecessor of the deficit target, is clearly procyclical and does not contribute towards medium-term budget consolidation and fiscal sustainability.
- In order to ensure adequate control and monitoring of central government programmes, the financial activities of extrabudgetary funds should be included directly in the State Budget and subjected to the same kind of *ex post* and *ex ante* controls as other programmes.
- To improve policymakers' ability to plan and engineer expenditure restructuring, a medium-term expenditure framework should be introduced.
- The practice of assigning earmarked taxes to extrabudgetary funds should be abandoned in order to combat inertia in public spending and avoid distortions in spending patterns caused by fluctuations in such revenues. All of the activities currently performed by extrabudgetary funds could as easily be managed within budget, especially in the context of a medium-term economic framework.
- Results of programme evaluations should be integrated into budgetary chapters as indicators of programme outputs with an eye to developing an output-oriented budgetary system.

- Local government budgets should be drafted in co-ordination with that of the central government and the reporting of outturns improved so that estimates of the stance of fiscal policy at the general government level can be made in a timely manner.
- The resources of the State Audit Office should be expanded in order to assure better *ex post* monitoring of sub-national public expenditure.
- Incentives for joint-delivery and merger at the *gmina* level should be enhanced so as to promote efficiency in the delivery of programmes at the local level.

Improve the efficiency of social policy expenditure

- The authorities should tighten eligibility criteria and their enforcement for disability and pre-retirement pensions and for the sick leave programme in order to reduce distortions in the labour market and to provide fiscal space for reductions in payroll taxes.
- Health spending and in particular the growth of health spending could be rationalised by introducing a clear statement of minimum services that would be covered by the state system, leaving others to the private sector.
- Specific spending programmes and tax expenditure should be subject to systematic evaluation and sunset clauses should be introduced retroactively to ensure that programmes are regularly reviewed.
- A number of steps could be taken in the near term to improve the efficiency of government expenditure. These include: a review of tax expenditures in general and of the tax treatment of social-security benefits and contributions in particular; a review of the impacts of subsidies and guarantees; and a revision of the minimum *living standard*.

Further steps to improve transparency

- Substantial progress in dealing with and reporting contingent liabilities should be extended by including estimates of the risk of their realisation and adding sub-national liabilities to the inventory.
- Steps need to be taken to combat the worrisome expansion in the use of guarantees and the increasing resort to exemptions from existing prudential rules. A share of GDP or revenue-based limit on the issuance of new and on the total of outstanding guarantees should replace the current *ad hoc* yearly limits. This would eliminate the temptation to use guarantees to hide current expenditure and, thereby, reduce the risk of a potentially destabilising build up of contingent liabilities.
- To overcome temptations to engage in "creative accounting" and to rationalise spending, the authorities should revise the constitutional provision making the governments budget deficit binding. Furthermore, a move to accrual accounting would reduce the scope for papering over budgetary overruns.

GLOSSARY OF ACRONYMS

BGK	Bank of National Economy
EC	European Commission
EU	European Union
FUS	Social Insurance Fund
GDP	Gross Domestic Product
GFS	Government Financial Statistics
GUS	Central Statistical Office
IMF	International Monetary Fund
KFPK	National Credit Guarantee Fund
KRUS	Farmers' Insurance Fund
KUKE	Corporation for Credit Insurance
MTEF	Medium-Term Economic Framework
NIK	National Audit Office
PAYG	Pay-As-You-Go pension system
PIT	Personal Income Tax
PLZ	Zloty, Polish currency unit
RIO	Regional Clearing Chamber
SNA	System of National Accounts
UOKIK	Office for Competition and Consumer Protection
VAT	Value Added Tax
ZUS	National Insurance Fund which acts as the umbrella extra-budgetary fund organisation

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