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R2014-0086/1

June 10, 2014

**Closing Date: Tuesday, July 1, 2014
at 6 p.m.**

FROM: The Corporate Secretary

**Poland
First Resilience and Growth Development Policy Loan
Program Document**

Attached is the Program Document regarding a proposed First Resilience and Growth Development Policy Loan to Poland (R2014-0086), which is being processed on an absence-of-objection basis.

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Report No. 86950-PL

**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
PROGRAM DOCUMENT**

**ON A PROPOSED LOAN
IN THE AMOUNT OF EURO 700 MILLION
(APPROXIMATELY US\$965.8 MILLION EQUIVALENT)**

**TO THE REPUBLIC OF POLAND
FOR THE
FIRST RESILIENCE AND GROWTH DEVELOPMENT POLICY LOAN**

April 24, 2014

Poverty Reduction and Economic Management
Europe and Central Asia Region

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REPUBLIC OF POLAND

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of March 31, 2014)

EUR 1.00: USD 1.38

ABBREVIATIONS, ACRONYMS & TERMS

| | | | |
|--------------|---|---------------------|---|
| AROP | At-risk-of-poverty (Eurostat) | OECD | Organization for Economic Cooperation and Development |
| CPI | Consumer Price Index | OPF | Open Pension Fund |
| CPS | Country Partnership Strategy | PER | Public Expenditure Review |
| CRD | Capital Requirements Directive IV | PFA | Public Finance Act |
| DPL | Development Policy Loan | PFM | Public Finance Management |
| EC | European Commission | PIT | Personal Income Tax |
| ECA | Europe and Central Asia Region | <i>Powiat</i> | County administrative unit (379) |
| ECB | European Central Bank | PLN | Polish Zloty |
| EDP | Excessive Deficit Procedure | PTE | Pension Fund Association |
| EDevP | Enterprise Development Program | RER | Regular Economic Report |
| ESA | European System of Accounts | SGP | Stability and Growth Pact |
| ESF | European Social Fund | SGOP | Smart Growth Operational Program |
| EU | European Union | SME | Small and Medium Enterprises |
| FCL | Flexible Credit Line | TA | Technical Assistance |
| FDI | Foreign Direct Investments | VAT | Value-Added Tax |
| GDP | Gross Domestic Product | <i>Voivodeships</i> | Province administrative unit (16) |
| <i>Gmina</i> | Municipality/commune administrative unit (2,478) | ZUS | Social Insurance Institution |
| GNI | Gross National Income | | |
| GUS | National Statistical Office | | |
| HBS | Household Budget Survey | | |
| IBRD | International Bank for Reconstruction and Development | | |
| IFIs | International Financial Institutions | | |
| IMF | International Monetary Fund | | |
| KNF | Financial Supervision Authority | | |
| LFS | Labor Force Survey | | |
| LM | Labor Market | | |
| M&E | Monitoring and Evaluation | | |
| MOF | Ministry of Finance | | |
| MTO | Medium Term Objective | | |
| NBP | National Bank of Poland | | |
| NDC | Notional Defined Contribution | | |

| | |
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REPUBLIC OF POLAND
FIRST RESILIENCE AND GROWTH DEVELOPMENT POLICY LOAN (DPL1)
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LOAN AND PROGRAM SUMMARY

REPUBLIC OF POLAND

FIRST RESILIENCE AND GROWTH DEVELOPMENT POLICY LOAN

| | |
|---|--|
| Borrower | REPUBLIC OF POLAND |
| Implementation Agency | MINISTRY OF FINANCE |
| Financing Data | <p><i>Amount: EUR 700 million</i></p> <p><i>Terms: Flexible Loan in Euro, at six-month Euribor for EUR plus Variable Spread, with 28 years of total maturity, including 7.5 years of grace, and level repayment of principal</i></p> <p><i>Front end fee: 0.25% of loan amount to be financed from own resources</i></p> |
| Operation Type | Programmatic (1st of 2), single-tranche |
| Main Policy Areas | Public finance, labor markets, financial sector, growth and private sector development |
| Program Development Objective(s) | <p>This is the first in a series of two development policy loans (DPL) structured around three pillars:</p> <ul style="list-style-type: none"> (i) Enhancing macroeconomic resilience, by reducing the general government fiscal deficit and debt levels toward the Medium Term Objective (MTO) and bolstering macro-prudential oversight; (ii) Strengthening labor market flexibility and employment promotion; and (iii) Improving private sector competitiveness and innovation. <p>The proposed DPL series is central to the Bank's engagement in the areas of public finance, labor markets and private sector development, as described in the Country Partnership Strategy, presented to the Board on July 15, 2013.</p> |
| Result Indicators | <ul style="list-style-type: none"> (i) By the end of 2015, the public debt-to-GDP ratio (ESA definition) is lower than 52 percent of GDP, including pension fund changes, and the general government deficit is 3 percent of GDP or lower. (ii) By the end of 2015, the number of registered long-term unemployed is reduced by at least 30,000 persons, i.e. from 1,107 thousands in 2013 to less than 1,077 thousands. (iii) The Doing Business Report 2016 shows an improvement in the time taken to start a business (25 days or fewer) and total spending on R&D rises from 0.9 percent of GDP in 2012 to 1 percent in 2014. |
| Overall risk rating | Moderate |
| Operation ID Number | P146243 |

**IBRD PROGRAM DOCUMENT FOR A PROPOSED
FIRST RESILIENCE AND GROWTH DEVELOPMENT POLICY LOAN
TO THE REPUBLIC OF POLAND**

I. INTRODUCTION AND COUNTRY CONTEXT

1. **This proposed first loan in a programmatic series of two development policy loans (DPLs) is structured around three pillars.** These are: (i) enhancing macroeconomic resilience, by reducing the general government fiscal deficit and debt levels toward the Medium Term Objective (MTO) and bolstering macro-prudential oversight; (ii) strengthening labor market flexibility and employment promotion; and (iii) improving private sector competitiveness and innovation. The proposed DPL series is at the core of the Bank's engagement in Poland, as described in the Country Partnership Strategy presented to the Board on July 15, 2013. The proposed amount for the loan (DPL1) is EUR 700 million (around USD 966 million).

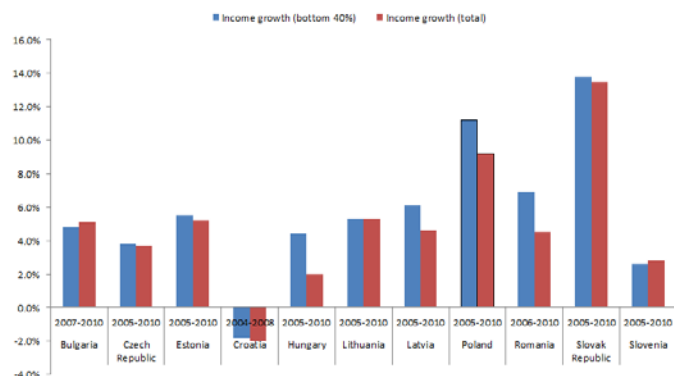
2. **Sound macroeconomic policies helped Poland sustain economic growth during the global downturn.** During 2008-10 and 2013, the authorities adopted counter-cyclical fiscal and monetary policies to cushion the impact of the slowdown. The general government deficit increased from 3.9 percent of GDP in 2012 to 4.5 percent of GDP in 2013 and despite a decline in domestic demand, particularly investment; Poland is the only EU country that has grown continuously over the last six years. The country is closely tied through production, trade and finance with the Euro area, particularly Germany, and other global supply chains, which spreads the risk from adverse global developments. However, challenges remain to achieve additional fiscal consolidation and a sustainable growth path based less on lower costs and more on a diversified, productive and innovative economy.

3. **To safeguard access to capital markets and sustain recovery, the authorities have prioritized strengthening public finances, the macro prudential framework, labor markets and competitiveness.** As the recovery started to take hold in the second half of 2013, the Government announced that it will recommence gradual fiscal consolidation in 2014 that does not hamper the recovery, but rebuilds fiscal buffers while structural reforms of the labor market and business environment promote growth and innovation. The new macroeconomic economic framework will help Poland cope with future shocks, while strengthening labor markets, the business environment and innovation is critical to ensure that the economy remains competitive as it seeks to continue to increase productivity and diversify into new product markets. Continuing to bolster macro prudential supervision will also support a more sustainable recovery in credit and further reduce risks from internal and external factors, such as the gradual tapering of quantitative easing in the US or regional instability.

4. **Prime Minister Tusk began a second term in office in November 2011, with the next general election scheduled for late 2015.** The coalition government has a small majority in the Parliament, but was elected with a strong mandate for reform, particularly in the areas of public finance, financial markets, labor markets, business climate and innovation. This second term in office provides an opportunity to continue necessary, albeit politically difficult, reforms. Through this DPL series the Bank continues to support the implementation of complex and innovative policy measures backed by complementary analytic and advisory services that help foster greater global knowledge exchange.

5. **Measures to bolster economic growth have raised the living standards of the bottom 40 percent in Poland.** During 2005-2010 the share of the population with incomes below the US\$5/day threshold decreased from 14.8 percent to 5 percent.¹ The period has also been characterized by relatively high income growth of the bottom 40 percent of the population, both relative to the mean growth rate and relative to other countries in the region (Figure 1). However, according to Eurostat, the at-risk-of-poverty (AROP) rate remains high, particularly among the unemployed and the inactive, as well as among the youth, families with several children, and households in small towns and rural areas. There is also a relatively large cohort of working poor: at 10.4 percent in 2012 the AROP rate among employed people is the fifth highest in the EU. While all other groups have recorded some gains since 2008, the income per capita of the lowest decile remained largely unchanged.

Figure 1: Shared prosperity indicators in EU New Member States



Source: Staff estimates based on EU-SILC data.

Figure 2: Shapley decomposition of the growth of incomes of the bottom 40 percent (2005-2010)



Source: Staff estimates

6. **Growth of incomes of the bottom 40 percent has mainly been driven by labor market attachment and growing earnings, highlighting the importance of labor market reforms.** During 2005-2010 the growth of incomes of the bottom 40 percent was primarily due to the growth in average earnings, which contributed roughly half of the overall income growth (Figure 2). The bottom 40 percent have much higher shares of unemployed, inactive, or residing in low work intensity households, or holding temporary contracts, or working in elementary occupations.

7. **Gender gaps also persist in labor market outcomes.** In 2012, female labor force participation was 59.7 percent against 73.3 percent for men (aged 15-64 years). This gap was particularly large during child bearing years even though more women (43 percent) than men (29 percent) completed tertiary education. About 40 percent of inequality in access to full time work is due factors beyond an individual’s control, such as parentage, with a quarter being due to gender (World Bank 2013). Access to affordable childcare remains a key constraint to employment for women. The gender pay gap is estimated at about 10 percent at median earnings.

¹ Extreme poverty, defined as income per capita below US\$ 1.25 per day, is very low, at only 0.35 percent of the population in 2010. Eurostat’s at-risk-of-poverty (AROP) rate has similarly decreased from 16 percent in 2005 to 6.1 percent in 2010 (see http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_li22&lang=en)

II. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

8. **Economic growth slowed considerably in 2012 and 2013.** Overall GDP growth declined from 4.5 percent in 2011 to 1.9 percent in 2012 and 1.6 percent in 2013 amid slowing domestic demand. Investment declined as fiscal consolidation and lower EU co-funded investments curbed public investment, while private consumption was lackluster as a result of Euro Area recession, falling corporate and consumer confidence, high unemployment and subdued wage growth. Net exports, supported by the performance of German economy (Poland's main trading partner) were the sole driver of growth from late 2012 to mid-2013.

9. **The economic recovery strengthened in the second half of 2013.** Following first quarter real GDP growth of 0.5 percent, year-over-year, growth steadily increased to reach 2.7 percent in the fourth quarter, supported by improving real wages, generous pension indexation, low inflation and relaxed credit conditions for mortgage and consumer loans. Investment began to pick up, driven by high rate of capacity utilization in the manufacturing industry and the recovery of global demand despite falling public investment due to continued fiscal austerity and lower EU funding.

10. **Labor market conditions remain challenging.** The unemployment rate stabilized at around 10.5 percent in the first half of 2013 before falling to 10 percent at the end-2013, although the share of long-term unemployed rose close to 45 percent (Labor Force Survey data, LFS). Employment picked-up slightly in the enterprise sector, notably in export-oriented sectors. Labor market conditions remain difficult for the youth, with an unemployment rate close to 27 percent in 2013.

11. **External imbalances have narrowed, but vulnerabilities remain.** The current account deficit narrowed from 5 percent of GDP in 2011 to 3.7 percent in 2012 and further to 1.3 percent of GDP in 2013, driven by an improvement in the trade balance. The current account deficit was financed by EU capital transfers. External debt stabilized at around 73 percent of GDP, over 15 percentage points higher than in the pre-crisis period, largely reflecting increased government indebtedness. The share of short-term debt in total external debt remains broadly stable, at around 20 percent, with international reserves equivalent to 5.7 months of imports of goods and services.

12. **Monetary policy remains accommodative.** The Monetary Policy Council (MPC) started an easing cycle in November 2012, cutting rates by a total of 225 bps, bringing the reference rate to 2.5 percent, a record low. With economic activity below potential, weak labor markets and subdued consumer demand, annual headline inflation dropped to record low of 0.2 percent in June 2013. Since then, the inflation rate has increased to around 1 percent, which is still well below the National Bank of Poland's (NBP) target band of 1.5-3.5 percent. According to the IMF, Poland's real effective exchange rate is broadly consistent with fundamentals.

13. **The banking sector has remained well capitalized, liquid, and profitable, but credit growth has been weak.** Capital adequacy is strong (at 15.7 percent in September 2013, 90 percent of which is Core Tier 1 capital), and liquidity is high. In the first nine months of 2013,

the profit of the banking sector stood at PLN 12 billion, which is in line with results in previous years. The deleveraging of the Euro area banks continued in an orderly fashion: the fall in foreign funding was offset by rising domestic deposits. Private sector credit growth was slightly above 4 percent in December 2013, due to an increase in household credit, in particular consumer credit, and despite a decline in credit to the corporate sector.

14. **The financial sector remains vulnerable.** While these are not of a systemic nature, they stem from: (i) a large, albeit falling, overhang of FX-denominated mortgages (42 percent of total residential mortgages in September-2013); (ii) a high level of nonperforming loans (NPLs), at around 8.5 percent of the loan portfolio in September 2013, concentrated in consumer credit and corporate loans to small and medium enterprises; and (iii) possible pressures on bank funding from volatility of capital flows and EU-wide asset quality review. Yet, stress tests suggest that even under severe scenarios, the share of assets at risk is small, liquidity sufficient and contagion risks limited.

15. **Weak domestic demand led to a significant drop in revenues in 2013, partly reversing fiscal consolidation of the previous two years.** The nominal fiscal adjustment was close to 3 percentage points of GDP in 2011 with a further 1.1 percentage points in 2012, bringing the general government deficit to 3.9 percent of GDP (Poland's structural deficit declined from 5.3 percent of GDP in 2011 to 3.6 percent of GDP in 2012). Despite further consolidation measures in 2013², the pro-cyclicality of CIT and weaker domestic demand, which lowered VAT revenues, resulted in a higher than expected fiscal deficit. The government allowed automatic stabilizers to operate, in part, and the fiscal deficit increased to 4.5 percent of GDP in 2013, despite additional fiscal measures being introduced mid-year to control expenditures (equivalent to about 0.5 percent of GDP). Recognizing the weak growth, the EU extended the deadline for correction under the Excessive Deficit Procedure (EDP) by one additional year, to 2015, while average debt costs fell and the average maturity increased.

2.2. MACROECONOMIC OUTLOOK

16. **Economic growth is projected to double in 2014.** Poland is expected to benefit from a gradual pick up in both global and Euro area demand in 2014, with growth in global trade and industrial production starting to increase. The improvement in the external situation is expected to lead to a rebound in confidence, and consequently domestic demand, despite the modest contribution from public sector demand due to the continued fiscal consolidation. Gradual increase in real wages, supported by low inflation, and improvement in the labor market are expected to lead to recovery in household consumption. Domestic investment is also expected to recover in 2014, growing by 3.2 percent, having contracted by 1.7 and 0.4 percent in 2012 and 2013, respectively, driven by improved investors' confidence and supported by the EU funds. Overall growth is therefore expected to rise to 3 percent in 2014, and strengthen further to some 3.5 percent by 2016. Growth in investment and consumption are likely to remain robust in the

² On the revenue side: a freeze in PIT thresholds, increases in disability contributions; on the expenditure side: a temporary expenditure rule of CPI+1, a freeze in wages in the budgetary sphere, and an abolition of early retirement schemes.

medium term, albeit rising gradually and unemployment levels are expected to continue declining gradually in 2014.

17. **Monetary policy is expected to continue to anchor inflation expectations.** The CPI is expected to rise from an average of 0.9 percent in 2013, to 1.5 percent in 2014 before stabilizing around the target rate of 2.5 percent over the medium-term. Given the low inflationary outlook, both domestically and in the Euro area, and muted economic recovery, expectations are for a protracted monetary tightening cycle. In addition, the Zloty (PLN) has not been particularly affected by the reduction of quantitative easing in the US and emerging market volatility. The Financial Supervision Authority, along with the NBP and Ministry of Finance (MOF), continue to monitor the stability of the financial sector, and have taken measures to limit foreign currency lending to households.

Table 1: Economic and Fiscal Developments and Prospects 2010-2016

| | 2010 | 2011 | 2012 | 2013 (e) | 2014 (f) | 2015 (f) | 2016 (f) |
|--|--|---------|---------|----------|----------|----------|----------|
| Real economy | Annual percentage change, unless otherwise indicated | | | | | | |
| GDP (billion zloty) | 1,416.6 | 1,528.1 | 1,595.2 | 1,631.8 | 1,713.6 | 1,809.6 | 1,918.1 |
| Real GDP | 3.9 | 4.5 | 1.9 | 1.6 | 3.0 | 3.2 | 3.5 |
| Per Capita GDP (In US\$ Atlas Method) | 12,340 | 12,310 | 12,650 | 13,080 | 13,470 | 14,100 | 14,860 |
| Growth | | | | | | | |
| Consumption | 3.4 | 1.6 | 1.0 | 1.1 | 2.4 | 2.7 | 2.9 |
| Investment | -0.4 | 8.5 | -1.7 | -0.4 | 3.2 | 6.0 | 7.1 |
| Net exports (contribution to growth) | -0.7 | 0.9 | 2.0 | 1.8 | 0.9 | -0.4 | -0.4 |
| Imports of goods and services | 13.9 | 5.5 | -0.7 | 0.7 | 4.1 | 7.0 | 7.3 |
| Exports of goods and services | 12.1 | 7.7 | 3.9 | 4.3 | 5.5 | 6.6 | 7.0 |
| Unemployment rate (ILO definition) | 9.6 | 9.6 | 10.1 | 10.3 | 10.4 | 10.1 | 9.8 |
| CPI (average) | 2.6 | 4.3 | 3.7 | 0.9 | 1.5 | 2.4 | 2.5 |
| Fiscal Accounts | Percent of GDP, unless otherwise indicated | | | | | | |
| Expenditures | 45.4 | 43.4 | 42.2 | 41.9 | 41.3 | 41.3 | 41.4 |
| Revenues | 37.5 | 38.4 | 38.3 | 37.4 | 37.9 | 38.3 | 38.7 |
| General Government Balance | -7.9 | -5.0 | -3.9 | -4.5 | -3.4 | -3.0 | -2.7 |
| Primary Balance | -5.2 | -2.3 | -1.1 | -1.8 | -1.2 | -0.8 | -0.5 |
| General Government Debt (ESA95) | 54.8 | 56.2 | 55.6 | 57.3 | 49.1 | 49.5 | 49.4 |
| General Government Debt (national methodology) | 52.8 | 53.4 | 52.7 | 53.9 | -- | -- | -- |
| Selected Monetary Accounts | Annual percentage change, unless otherwise indicated | | | | | | |
| Broad Money | 8.8 | 12.5 | 4.5 | 6.2 | -- | -- | -- |
| Credit to non-government (eop) | 8.4 | 13.4 | 1.5 | 4.2 | -- | -- | -- |
| Interest (key policy interest rate, eop) | 3.50 | 4.50 | 4.25 | 2.5 | -- | -- | -- |
| Balance of Payments | Percent of GDP, unless otherwise indicated | | | | | | |
| Current Account Balance | -5.1 | -5.0 | -3.7 | -1.3 | -2.5 | -2.8 | -3.0 |
| Exports of goods and services | 42.2 | 45.1 | 46.7 | 47.9 | 48.0 | 48.6 | 49.2 |
| Imports of goods and services | 44.1 | 46.7 | 46.8 | 46.0 | 46.8 | 47.8 | 49.1 |
| Foreign Direct Investment | 1.4 | 2.4 | 1.1 | -0.2 | 1.8 | 1.9 | 2.0 |
| Gross Reserves (in billions US\$, eop) | 93.5 | 97.9 | 108.9 | 106.2 | -- | -- | -- |
| External Debt | 67.5 | 62.7 | 74.7 | 73.5 | 70.3 | 69.1 | 67.5 |
| Terms of Trade (Index 1995=100) | 97.7 | 96.2 | 94.7 | 94.2 | 93.7 | 94.4 | 95.4 |
| Exchange Rate to USD (average) | 3.02 | 2.96 | 3.26 | 3.16 | -- | -- | -- |
| Exchange Rate to EUR (average) | 3.99 | 4.12 | 4.19 | 4.20 | -- | -- | -- |
| Memo items | | | | | | | |
| GDP nominal (in billions of US\$) | 469.7 | 515.7 | 489.8 | 516.3 | -- | -- | -- |
| GDP nominal (in billions of EUR) | 354.6 | 370.9 | 381.2 | 388.7 | -- | -- | -- |

Source: World Bank staff calculations based on Central Statistical Office, National Bank of Poland, Ministry of Finance, IMF.
Note: Main difference between national and ESA definitions of public debt is that the former excludes the National Road Fund.

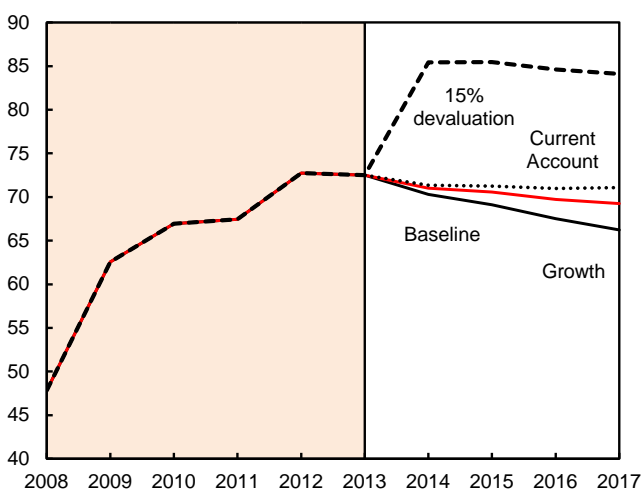
18. **On the external side, the current account deficit is expected to stay below 3 percent of GDP over the medium term.** The current account deficit is projected to be financed mostly by FDI inflows and EU transfers. External debt is expected to have peaked at around 73 percent of GDP in 2012, before falling below 70 percent in 2015 and declining over the medium term. The sustainability of the external debt position is generally robust according to a range of standard stress scenarios (Table 3), including lower GDP growth, higher current account deficits and remains manageable under an adverse exchange rate shock. Private sector flows and continued favorable access to international capital markets suggest that external financing needs can be met. The IMF arrangement provides an additional buffer against external shocks.

Table 2: Balance of Payments: Financing Requirements and Sources 2012-2016

| | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|--------|---------|--------|---------|---------|
| BOP financing requirements and Sources | | | | | |
| Financing requirements (EUR) | 94,579 | 79,033 | 87,331 | 80,122 | 84,678 |
| Current account deficit | 14,191 | 5,906 | 10,206 | 12,071 | 13,709 |
| Short term debt amortizations | 54,912 | 49,694 | 51,458 | 48,441 | 50,379 |
| Medium and Long term debt amortization (excl. IMF) | 25,475 | 23,433 | 25,667 | 19,610 | 20,591 |
| Financing Sources (EUR) | 94,579 | 79,033 | 87,331 | 80,122 | 84,678 |
| FDI and portfolio equity investments (net) | 6,737 | 1,172 | 7,348 | 8,191 | 9,139 |
| Capital grants | 6,855 | 9,601 | 11,337 | 12,186 | 13,027 |
| Short term debt disbursements | 49,694 | 51,458 | 48,441 | 50,379 | 51,890 |
| Medium and Long term debt disbursements (excl. IMF) | 31,959 | 34,645 | 20,271 | 31,709 | 33,294 |
| Change in reserves | -666 | -17,842 | -67 | -22,343 | -22,673 |
| IMF credit (net) | - | - | - | - | - |

Figure 3: External Debt Sustainability

External Debt Sustainability Analysis



External Debt Composition in 3Q 2013

| | EUR, bln | Share of total debt | % of GDP |
|-------------------------------|--------------|---------------------|-------------|
| Monetary authorities | 5.3 | 1.9 | 1.4 |
| General government | 110.5 | 39.6 | 28.4 |
| Banks | 50.9 | 18.2 | 13.1 |
| Other sectors | 112.3 | 40.3 | 28.8 |
| of which intercompany lending | 66.3 | 23.8 | 17.0 |
| Total external debt | 278.9 | 100.0 | 71.6 |
| long-term | 218.9 | 78.5 | 56.2 |
| short-term | 60.0 | 21.5 | 15.4 |

Source: World Bank staff calculations based on National Bank of Poland and IMF

Notes: The shaded area reflects historical values. Depreciation shock assumes a 15 percent depreciation in the first year. Real GDP growth is at baseline minus one-half standard deviation in the first year. Current account is at baseline minus one-half standard deviation.

19. **The Government intends to continue fiscal consolidation and pursue structural reforms to entrench the sustainability of social spending.** The fiscal deficit is projected to decline to around 3.4 percent of GDP in 2014 and 3 percent in 2015 in line with Poland's obligations under the EDP (Table 4). The Government plans to gradually reduce the structural fiscal deficit toward its Medium Term Objective (MTO) of a structural deficit of 1 percent of GDP. In 2014, the authorities will continue to contain wages, social assistance and other spending, while increasing demand should lead to a recovery in consumption taxes needed to generate fiscal space for strategic infrastructure and human capital investments. The Government has specified additional fiscal measures in 2014 to accelerate the reduction in the structural deficit to comply with the EC's EDP recommendations of December 2013. The measures announced so far include: introduction of social security contributions on labor contracts under a civil-law arrangement, additional tax and dividends from the State Forest Company, and measures to improve tax compliance, including for fuels and VAT declarations.

Table 4: Fiscal Developments and Prospects 2010-2016
(percent of GDP unless otherwise indicated, ESA'95, General Government)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|------------------------------------|------|------|------|------|------|------|------|
| <i>Overall Balance</i> | -7.9 | -5.0 | -3.9 | -4.5 | -3.4 | -3.0 | -2.7 |
| Primary balance | -5.2 | -2.3 | -1.1 | -1.8 | -1.2 | -0.8 | -0.5 |
| <i>Total Revenues (and grants)</i> | 37.5 | 38.4 | 38.3 | 37.4 | 37.9 | 38.3 | 38.7 |
| Tax revenues | 20.5 | 20.8 | 20.1 | 19.3 | 19.5 | 19.8 | 19.9 |
| PIT | 4.5 | 4.5 | 4.6 | 4.5 | 4.6 | 4.6 | 4.6 |
| CIT | 2.0 | 2.1 | 2.2 | 1.9 | 2.0 | 2.0 | 2.1 |
| VAT | 7.6 | 7.9 | 7.2 | 6.7 | 6.9 | 7.1 | 7.0 |
| Excises | 4.0 | 3.9 | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| Other taxes | 2.4 | 2.4 | 2.3 | 2.4 | 2.3 | 2.3 | 2.4 |
| Social security contributions | 11.1 | 11.4 | 12.3 | 12.4 | 12.7 | 13.0 | 13.1 |
| Sales | 2.3 | 2.1 | 2.1 | 2.1 | 2.1 | 2.0 | 2.1 |
| Other current revenue | 2.3 | 2.3 | 2.5 | 2.3 | 2.3 | 2.3 | 2.4 |
| Capital revenue | 1.3 | 1.8 | 1.3 | 1.3 | 1.3 | 1.2 | 1.2 |
| <i>Expenditures</i> | 45.4 | 43.4 | 42.2 | 41.9 | 41.3 | 41.3 | 41.4 |
| Current expenditures | 38.5 | 36.7 | 37.0 | 37.0 | 36.3 | 36.2 | 35.9 |
| Wages and compensation | 10.2 | 9.7 | 9.7 | 9.7 | 9.7 | 9.8 | 9.7 |
| Goods and services | 6.2 | 5.7 | 5.6 | 5.6 | 5.7 | 5.7 | 5.6 |
| Interest payments | 2.7 | 2.7 | 2.8 | 2.7 | 2.2 | 2.2 | 2.2 |
| Social benefits | 17.0 | 16.2 | 16.4 | 16.6 | 16.5 | 16.4 | 16.4 |
| Other current expenditure | 2.4 | 2.4 | 2.5 | 2.4 | 2.2 | 2.1 | 2.0 |
| Capital expenditures | 6.9 | 6.7 | 5.2 | 4.9 | 5.0 | 5.1 | 5.5 |
| Capital investments | 6.2 | 6.0 | 4.5 | 4.2 | 4.3 | 4.4 | 4.8 |
| Capital transfers | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |

Source: Ministry of Finance, IMF, World Bank.

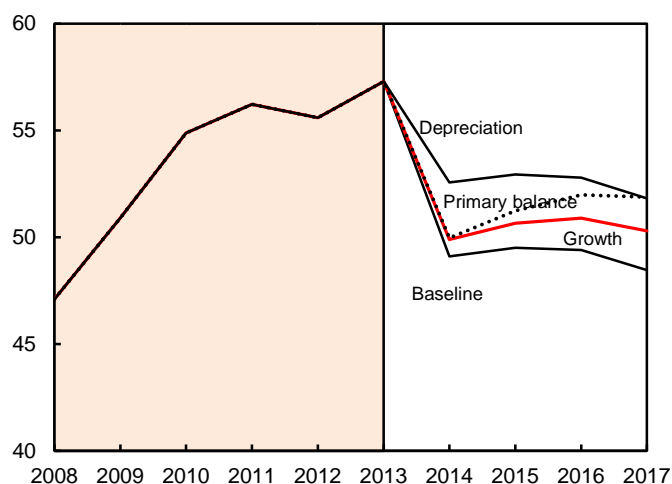
Note that under ESA95, for 2014 the planned reduction in government bonds currently held by private pension funds, equivalent to around 8.5 percent of GDP, would be counted as revenue, thus generating a fiscal surplus. However, under the new ESA2010 it would not and this treatment is used here.

20. **Changes to the second pension pillar will reduce the general government deficit and debt levels.** On February 3, 2014, the Government implemented the following changes to the Polish pension system: (i) Government bonds held by Open Pension Funds (OFE) were transferred to the State Social Insurance Institution (ZUS) and redeemed and OFEs were banned

from investing in Government bonds; and (ii) funds from OFE accounts of each individual will be transferred to ZUS over a ten-year period ahead of a contributor’s retirement. From April 1, 2014, the insured have a choice on where they want a 2.92% portion of their future pension contributions to be transferred – to OFE or ZUS. Those who do not decide before July 31, 2014 will have their contributions transferred to ZUS. These changes represent a partial reversal of the 1999 pension reform, which introduced a defined-contributions scheme based on a multi-pillar system: (i) a mandatory pay-as-you-go scheme based on notional defined contribution (NDC) accounts and run by ZUS (“first pillar”); (ii) a mandatory fully-funded defined contribution scheme run by OFEs (“second pillar”); and (iii) a voluntary private pension scheme (“third pillar”). The change followed public concerns about the high costs and low levels of fund returns and the public debt required to finance the buildup of pension assets. The changes reduced public debt by about 8.5 percent of GDP, while the annual budget savings, in contributions and debt service, are estimated at around 0.5-1.0 percent of GDP (depending on future participation rates). In the short term, the changes may cause some capital market volatility and reduce access to long-term financial instruments for investments. However, over the long term the low level of replacement ratios and increasing dependency ratio remains the central challenge faced by the Polish pension system given demographic projections.

21. Public debt is expected to peak in 2013 and then decline. Fiscal consolidation, together with better fiscal institutions, and the one-off transfer of assets from the second pillar pension system, will help to keep public debt at the levels close to 50 percent of GDP. According to the ESA’95 methodology, general government debt amounted to around 57 percent of GDP in 2013 and is then projected to decline to around 50 percent by the end of 2016—the initial decline is due to the one-off transfer of assets from the second pillar pension system (8.5 percent of GDP) although debt levels are expected to decline over the medium-term. This would ensure that public debt remains below the Maastricht ceiling of 60 percent of GDP and the key national debt thresholds (as calculated according to national methodology).³ Public debt sustainability analysis suggests that the debt path is highly sensitive to a growth shock⁴, but it is not expected to put the level of public debt above the threshold of 60 percent of GDP (Figure 4).

Figure 4: Public Debt Sustainability Analysis



Source: World Bank staff calculations based on Ministry of Finance and IMF

Notes: The shaded area reflects historical values. Depreciation shock assumes 15 percent depreciation in the first year. Real GDP growth is at baseline minus one-half standard deviation in the first year. Primary balance is at baseline minus one-half standard deviation

³ The Public Finance Act prompts corrective action when the public debt reaches 55 percent of GDP, in addition to the constitutional ceiling for public debt at 60 percent of GDP.

22. **The macroeconomic policy framework is considered adequate.** The macroeconomic policies implemented during and after the global financial crisis partially mitigated the negative effects of external shock in 2012-13, while keeping external imbalances in check and maintaining an adequately capitalized financial system. These policies, combined with the structural measures supported by this DPL, are also being calibrated to accommodate a gradual recovery of external and domestic demand while ensuring a macro economy that is resilient to future shocks.

23. **Nonetheless, the downside risks to the macroeconomic outlook remain considerable.** They include further instability in the Euro area, instability in the region and contagion from sovereign debt volatility in emerging markets, particularly as developed countries start to tighten monetary policy, which may be transmitted through external trade and financial links. Poland remains vulnerable to external debt deleveraging, which may slow credit growth, through parent bank funding of local subsidiaries. At the same time, weaker demand in the EU—which constitutes around 70 percent of FDI flows and over half of exports—and globally could undermine the anticipated pick-up in exports, investment and ultimately domestic demand.

2.3. RELATIONS WITH THE IMF

24. **The Executive Board of the IMF approved a successor two-year arrangement for Poland under the Flexible Credit Line (FCL) in the amount of US\$33.8 billion in January 2013.** The most recent review by the IMF Executive Board, in January 2014, concluded that the Polish economy “has a robust fiscal framework that balances short-term economic considerations with the need to preserve long-term fiscal sustainability, and an effective financial supervisory framework that has safeguarded financial stability.” The FCL has allowed for a more flexible policy response to the global crisis while preserving favorable access to international capital markets. The IMF Board concluded that Poland continues to meet the qualification criteria for access to FCL resources, which the authorities intend to continue to treat as precautionary. An IMF-World Bank FSAP mission took place in February-March 2013.

III. THE GOVERNMENT’S REFORM PROGRAM

25. **Strengthening public finances and the macro prudential safeguards, sustaining economic growth and facilitating job creation and innovation are key priorities.** Across all these issues, the Government is concerned about addressing the short-term challenges, which are the legacy of the global financial crisis and the recent economic slowdown, as well as medium to long-term structural rigidities. The short-term actions are aimed at rebuilding fiscal buffers and bolstering economic resilience, while medium and long-term structural reforms are targeted at lifting potential growth. Multi-pronged policy action has been launched to achieve these goals:

26. **Public finance: The immediate reform agenda in the area of public finance relates to Poland’s obligations under the Stability and Growth Pact.** In 2012, with a general

⁴ In this scenario real GDP growth rate is at baseline minus 2 percentage points in each year of the projection period.

government deficit close to 4 percent of GDP, Poland did not comply with the deadline for the correcting of the excessive deficit. Economic slowdown in 2013 and a significant drop in budgetary revenues (mainly due to high pro-cyclicality of VAT and CIT revenues) resulted in an increase in the fiscal deficit to around 4.5 percent of GDP compared to the original plan of 3.5 percent of GDP. A fiscally prudent budget for 2014, prepared in line with the new permanent fiscal rule, is an important step in bringing down the fiscal deficit to below 3 percent of GDP in 2015 and achieving MTO by 2016. While immediate fiscal consolidation efforts are largely based on changes to the second pension pillar, over the medium term, the Government is concerned about the quality of public finances, issues related to expenditure efficiency, revenue mobilization and coordination of policies across different tiers of the government.

27. Economic Growth: Weak economic activity in the Euro Area and fiscal consolidation during 2011-12 affected Poland's growth in 2012-13. In his speech of October 2012, the Prime Minister announced a series of measures to boost economic growth and improve competitiveness in a fiscally neutral way. These measures are centered on three sets of issues: (i) bolstering resilience of the financial sector, (ii) supporting investment activity, and (iii) improving the business climate and innovation. Reforms of the financial sector include improved macro-prudential oversight and a sound bank resolution framework; better supervision over cooperative banks, investment and hedge funds; and implementation of the EU's Capital Requirements Directive of July 2013. Investment is supported by an off-budget medium-term investment program (Polish Investments Program) and a guarantee scheme for SMEs. The Government also recognizes the need to pursue further reforms to improve the business environment for Poland to stay internationally competitive. The so called "Fourth Deregulation Package", which follows liberalization reforms from 2008, 2009 and 2011, and the planned changes to the Construction Law, are aimed at addressing constraints to business activity in the areas of starting a business, dealing with construction permits, and closing a business. The authorities are also working on enhancing the frameworks for insolvency to promote rehabilitation (rather than liquidation) of viable debtors.

28. Jobs: Government's short-term actions on labor markets are focused on enhancing labor market flexibility and providing support to the unemployed. Temporary measures from 2010/11 aimed at mitigating the impact of the global crisis on the labor market, including greater flexibility to adjust working hours and a part-time work subsidy scheme. These became permanent features of the Labor Code in 2013. The Government also increased spending through the Labor Fund to support active labor market programs, such as training and wage subsidies (including apprenticeship schemes) for disadvantaged groups. Medium- and longer-term structural reforms are aimed at improving the effectiveness of public employment offices, providing better services for the unemployed through profiling, and introducing new instruments to support job creation and re-integration, including for women re-entering the labor market after child birth. In parallel, a large scale profession deregulation reform is taking place to facilitate access to over 200 professions, many of which are attractive for youth.

IV. THE PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

29. **This is the first of two lending operations in a series aimed at supporting priority areas under the Polish National Development Strategy (NDP) 2020.** The operation is structured around three pillars to:

- i. Enhance macroeconomic resilience, by reducing the general government fiscal deficit and debt levels toward the Medium Term Objective (MTO) and bolstering macro-prudential oversight;
- ii. Strengthen labor market flexibility and employment promotion; and
- iii. Improve private sector competitiveness and innovation.

30. **These reforms are designed to help bolster Poland's economic recovery by creating a dynamic economy able to weather future shocks.** The DPL supported measures will help create the fiscal space to increase investments in infrastructure and human capital, as well as bolster the ability to respond to future shocks. While restoring job growth requires strong economic growth, structural reforms are also critical for reducing barriers and promoting participation, especially given Poland's historically high structural unemployment and low participation rates. Improving insolvency and restructuring, macro prudential oversight and support for innovation, will also enable Poland to diversify and become more productive.

31. **Lessons learnt from the previous DPL series suggest that for best results the Bank should focus its support on areas with a strong analytical foundation and that are of strategic relevance to the government.** The policy actions supported under this DPL build on the previous DPL series, and continue to support critical reforms such as fiscal consolidation, and economic growth through the labor market and private sector reforms. Progress is predicated upon strong Government leadership, in particular in the case of difficult reforms (such as labor issues and pensions). The Bank supports the reforms also with technical analytic and advisory work, such as on appropriate fiscal rules, macro-prudential regulation, insolvency/restructuring, and innovation.

4.2. PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

PRIOR ACTIONS AND RESULTS

Pillar 1: Enhancing macroeconomic resilience

DPL1 Prior Action #1: *Enact amendments to the Public Finance Act to introduce a permanent fiscal rule limiting growth of public expenditures to trend GDP growth to foster compliance with its obligations deriving from the Treaty on the Functioning of the EU in the area of budgetary policy; and (b) the Budget Law for 2014 in line with the new permanent fiscal rule as set forth in the Public Finance Act.*

32. **The new permanent expenditure rule is designed to put the fiscal deficit on a sustainable downward path toward the MTO and rebuild fiscal buffers, while allowing greater scope for counter-cyclical policies when required.** The Public Finance Act sets out two thresholds for public debt—55 percent and 60 percent of GDP—with breaches to thresholds automatically triggering successively more restrictive deficit cuts. However, severe deficit cuts would have undermined Poland’s ability to take counter cyclical measures during the recent downturn and a 50 percent threshold was suspended in 2013 to enable the functioning of automatic fiscal stabilizers. To address these problems the Government enacted a new fiscal rule based on limiting public expenditure growth to the average of GDP growth in eight consecutive years—growth in six previous years, forecasted growth in the current year and the following year’s projected growth—combined with an adjustment mechanism that would tighten rules if public finances breached the targets specified in the Stability and Growth Pact and/or in the Public Finance Act.

33. **The fiscal rule also includes escape clauses which automatically suspend the adjustment mechanism in case of severe economic shock to allow for anti-cyclical fiscal responses.** The two public debt thresholds currently in place, at 55 and 60 percent of GDP, remain unchanged. However, two new lower ones have been added to the spending rule, at 43 and 48 percent of GDP, to compensate for the changes to the pension system described above, that will still trigger downward corrections in spending, though this will be a milder sanction than the previous requirement to balance the budget or ban new borrowing. The rule was subject to a broad consultation process before adoption to ensure it had widespread support and markets understood that it strengthened fiscal management. The rule will apply to central and to local governments in 2015.

DPL2 Indicative Trigger #1: *Enact Budget Law for 2015 in line with the new permanent fiscal rule, limiting growth of public expenditures to trend GDP growth to foster compliance with Poland’s obligations deriving from the Treaty on the Functioning of the European Union in the area of budgetary policy.*

34. **The fiscal rule is expected to facilitate the move toward the MTO by further limiting Poland’s structural deficit.** The central government budget expenditures should be consistent with the permanent fiscal rule in 2015 and are expected to meet the threshold of 3 percent of GDP that would see Poland exit the EU’s EDP.

DPL1 Prior Action #2: *Enact amendments to the Law on Value Added Taxes (VAT) to defer reduction in VAT rates in 2014-16 to support fiscal consolidation.*

35. **The Government has deferred the reduction in VAT rates to balance fiscal consolidation between revenue and expenditure measures.** One reason for the widening fiscal deficit has been the weakening of indirect and direct taxes as demand and employment have fallen. To bolster revenue, the 2014 budget deferred the planned reduction of the VAT rate back to its pre-2011 level until the end of 2016, i.e. the changes were implemented across the tax brackets (7 to 8 percent and 22 to 23 percent). In addition, the lower tax rate on unprocessed food at 3 percent was replaced with a new rate at 5 percent, as per EU VAT directive. . The decision to defer tax rates reduction will prevent a revenue loss of at least 0.4 percent of GDP in both 2014 and 2015. The Government also intends to maintain the income tax thresholds, which will raise an additional 0.1 percent of GDP per annum. These measures will help to restore the fiscal balance more quickly and efficiently than relying solely on expenditure cuts. The effect of these changes on households differs depending on the composition of expenditures, but it not expected to have a significant impact on the bottom forty percent of the population (see section 5.1).

DPL2 Indicative Trigger #2: *Enact a Tax Ordinance Act to introduce a General Anti-Avoidance Rule*

36. **Poland has started work on a general anti-avoidance rule (GAAR) and the simplification of tax procedures.** Despite recent efforts to transform the revenue administration into an efficient, electronic service-oriented regime, there are still numerous challenges related to the functioning of tax administration reflected in the time needed to comply with tax requirements, high administrative cost of revenue collection and incidence of tax evasion and avoidance. The Government has started to address these challenges by drafting a new Tax Ordinance that includes a GAAR and a more comprehensive tax compliance strategy, with stronger anti-avoidance rules and simplification measures that are designed to improve the efficiency of tax collection and lower tax evasion, which will raise revenues from the existing tax structure.

DPL1 Prior Action #3: *Enact an amendment to the Public Finance Act implementing a fiscal rule for local governments to ensure debt sustainability at the local level and effective absorption of European Union funds.*

37. **Keeping a prudent fiscal stance over the medium term requires the Government to constrain the deficits of both central and local governments.** The permanent fiscal rule and MTO requirement for a structural deficit not exceeding 1 percent of GDP applies to the general government budget balance (i.e. the aggregated balances of local and central governments). Thus, the budgetary performance and debt of local governments (LGs) over the medium term is subject to limits, controls, and monitoring by the central government. LG debt is currently a relatively small fraction of general government debt, amounting to 4.2 percent of GDP in 2012, although the pace of increase, which exceeds that of central government debt, raises concern about future sustainability.

38. **Starting from 2014, the uniform ceiling on LG debt (60 percent of revenue) has been removed and the new fiscal rule will limit LGs ability to incur new debt depending on its**

debt-servicing ratio. This will allow more flexibility between different local government units, while maintaining the principle of long-term sustainability. Under the revised Public Finance Act from 2009, debt servicing expenditure/total revenue cannot exceed the last three years' average current balance plus revenue from asset sales/total revenue. A LG that has not generated operating surpluses for the period 2011-2013 will not be allowed to contract debts in 2014. In late 2013, the Government adjusted the new rule to exempt EU-funds co-financed investment to facilitate the absorption of EU-funds by local governments.

DPL2 Indicative Trigger #3: *Enact the Law to Improve the Provision of Services by Local Governments to introduce shared services centers at the local level.*

39. **Improvements in public administration, policy design and delivery continue to be crucial to enhance the effectiveness of the public sector.** The new law on the provision of Services by Local Governments will facilitate the creation of shared services centers at the local level. Under the provisions of this law, budgetary units within and across local governments are able to establish centers to provide common services (accounting processes, IT, payroll, personnel). This measure is likely to generate fiscal savings and free up resources for growth enhancing expenditures. Additional effects are a change in the organization of work and customer service, improving the efficiency of administration, and support for regional cooperation.

DPL2 Indicative Trigger #4: *Enact a Law on Macro-Prudential Oversight to establish the Systemic Risk Board and enact a Law on the Bank Guarantee Fund to establish a framework for orderly liquidation of banks.*

40. **DPL2 will support the implementation of the new macro prudential framework and bank insolvency regime.** This includes the establishment of a *Systemic Risk Board* and a new framework for the *Bank Guarantee Fund*, which will seek to limit public sector liabilities in the case of insolvency and measures to enforce the EU's Capital Requirements Directive. A new draft law has been developed that will address the treatment of banks in insolvency and includes the establishment of the institutional arrangements to oversee systemic risks and resolutions, setting out the resolution triggers, and resolution instruments. The draft law is currently under legal review, to ensure the balance of rights between various parties.

41. **The inadequacy of the existing bank insolvency regime has its origins in legal frameworks that do not distinguish between corporate and banking failures.** The recent global financial crisis has highlighted the need to develop resolution mechanisms that can deal with the systemic risks posed by interconnected financial institutions. Traditional insolvency frameworks are often too slow, do not address problems early enough or safeguard operations, and do not recognize the particular position of bank depositors, distinct from other creditors. Numerous countries are therefore creating separate rules and procedures to enable an orderly resolution for insolvent banks, with the EU finance ministers having agreed on a general

approach to a formal Directive on bank recovery and resolution in 2013⁵. The new draft law is consistent with this directive.

Expected Results:

42. **The overarching aim of fiscal rules and policies is to reduce and subsequently stabilize the deficit and public debt.** The general government deficit is projected to improve from 4.5 percent in 2013 to 3 percent of GDP in 2015 (the cyclically adjusted fiscal deficit would be around 1.5 percent of GDP in 2015). Public debt would be lower than the current level of 55.6 percent of GDP by 2015 and is expected to be on a downward trend. While it is difficult to measure the immediate results of improvements in the macro prudential and bank insolvency frameworks, given that the expected economic pickup should reduce demand for such services in the short-term, reforms should improve the flexibility and confidence in the economy's ability to manage future shocks and bolster investment and growth.

Pillar 2: Labor market resilience and employment promotion

DPL1 Prior Action #4: *Enact amendments to the Labor Code to increase flexibility of labor markets by extension of the calculation period for employees' working time.*

43. **The recent economic slowdown resulted in a rise in the unemployment rate, especially among the young, and stagnating real wages, partly driven by the nominal freeze on public sector salaries, contributing to a slowdown in poverty reduction.** Compared to other EU countries labor costs are relatively low, labor taxes are moderate and labor regulations provide for a substantial degree of flexibility⁶. Nonetheless, as mentioned earlier, there are concerns about growing youth and long-term unemployment, and low participation rates of women and older cohorts in the workforce.

44. **The DPL has supported changes to the Labor Code designed to improve the flexibility and the ability of the labor market to create more jobs.** The main changes are in the organization of employee working time, which came into force on August 23, 2013. The new regulations introduced changes that were long-awaited by employers and include: (i) the possibility to extend employees settlement period (probation) by up to 12 months; and (ii) provisions to permit more flexible working hours. The above changes are designed make working time significantly more flexible and help organizations adapt to meet changing economic and technological needs.

DPL2 Indicative Trigger #5: *Enact amendments to the Law on Promotion of Employment and Labor Market Institutions to strengthen employment services and to promote employment amongst vulnerable groups.*

⁵ At the ECOFIN Council of 27 June 2013, finance ministers of the Member States agreed on a General Approach on the draft directive establishing a framework for the recovery and resolution of failing banks.

⁶ See EU Assessment of the 2013 national reform and convergence programs for POLAND (2013).

45. **In addition to greater labor market flexibility, the DPL series supports policies to improve services for job seekers.** The key elements of the Law on promotion of Employment and Labor Market Institutions are: (i) strengthening the role of provincial governments in occupational career services; (ii) tailoring services provided by Public Employment Services (PES) to the specific needs of the unemployed through enhanced profiling, case management, combining vocational counseling with job search assistance, outsourcing the ‘hard to place unemployed’, improving the sharing of information on job vacancies; (iii) developing new instruments to support job creation and re-employment (including for women re-entering the labor markets), such as telecommuting grants, hiring subsidies, loans for new job or start-ups, regional training programs; and (iv) stronger support for youth and older (50+) employment, such as temporary suspension of social security contributions, partial wage subsidies. The law will also create a National Training Fund to support firms with the provision of training, and as such to promote skills development.

DPL1 Prior Action #5: *(a) implement the first professions deregulation tranche through enactment of the Law Amending Laws on Access to Certain Professions thereby deregulating access to fifty one (51) professions; and (b) approve, through a Decision of its Council of Ministers, the draft Law on the Easing of Access to Certain Regulated Professions and the draft Law Amending Laws on Access Conditions to Certain Professions for the second and third professions deregulation tranches.*

46. **Easing the access to professions is a priority to lower the cost of services and to enhance employment opportunities, especially for youth.** A survey in November 2011 concluded that Poland had the highest number of regulated professions and activities among EU Member States with around 300 professions, accounting for almost 0.5 million workers.⁷ Many restrictions were considered unnecessary, leading to higher prices, inefficient job-worker matching, lower quality, and reduced employment levels. Reducing the restrictions—i.e. lowering educational requirements, shortening certificate periods and experience, or lifting some prior checks—would help improve access to these professions, particularly by the young and less advantaged groups. This in turn can shorten the duration of unemployment and improve worker-job matching. Due to the broad scope the deregulation was divided into three tranches, with the first 51 professions being deregulated in 2013 following the approval of the law in June 2013. This included taxi drivers, driving instructors, attorneys at law, legal counselors, notaries, real estate agents, and tour guides.⁸

DPL2 Indicative Trigger #6: *Deregulate around 190 professions by implementing the second and the third professions deregulation tranche.*

47. **DPL2 will continue supporting the deregulation process.** The second (91 professions) and third (104 professions) tranches of professions are under the Ministry of Finance and

⁷ A database was compiled by the Ministry of Science and Higher Education (MSHE) with experts from the Ministry of Justice, in accordance with EU Directive 2005/36/EC. The full list can be found on the MSHE and Ministry of Justice websites along with the EU evaluation on national regulations on access to professions (2013).

⁸ While there have been some protests from existing professions, for example by taxi drivers, the Public Opinion Research Center (CBOS) found a majority of respondents were supportive of the change, even among professionals performing regulated tasks (survey in June 2012).

Ministry of Transport, Construction and Maritime Economy, and covers professions such as engineers, architects, tax advisors, insurance agents, and customs agents. The Ministry of Justice will evaluate ex-post the effect of deregulation on the legal sector, which will indicate the social as well as economic impact of these reforms and suggest possible further deregulation.

DPL1 Prior Action #6: *Enact amendments to the Law on Early Childcare to facilitate return of parents to the labor market.*

48. **The DPL supports measures to improve parents' access to labor markets.** This will address the problem of low labor market participation rates by women and single parent headed households, which face a greater risk of falling into poverty. The Government has already introduced a 'Toddler Program' to boost the number of nurseries by relaxing existing restrictions—with numbers almost doubling over the past two years, though still well below the demand. Additionally, such programs can reduce early achievement gaps to boost shared prosperity.

49. **Amendments to the Law on Early Childcare are aimed at facilitating the creation of early childcare facilities to increase the access and facilitate parents return to work.** In particular, the law: (i) provides for financial support to municipalities to open early child care facilities, (ii) enables private individuals to run early child care facilities; and (iii) provides opportunities for joint financial, administrative and organizational operation of early child care facilities with existing schools or other educational institutions.

Expected Results

50. **While job growth requires strong economic growth, structural reforms are also critical for reducing obstacles to job creation and promoting access to employment, especially given Poland's historically high structural unemployment rate.** The ultimate goal of the reforms supported by this DPL series is a reduction in the number of long-term unemployment in total registered unemployment by 30,000 from 1,107 (average) in 2013, to less than 1,077 in December 2015.

Pillar 3: Enhancing private sector resilience, promoting competitiveness and innovation

DPL1 Prior Action #7: *Resolution by the Cabinet of Ministers to approve Poland's Enterprise Development Program (EDevP) to create clearer institutional arrangements and increase support for early stage innovation and technological startups to enhance innovation through focused support programs in this area.*

51. **Poland suffers from low innovation and R&D spending, which is a risk to long-term growth.** Poland spent only 0.9 percent of GDP on R&D in 2012, well below the EU average of 2 percent. The more efficient enterprise R&D represented only 0.3 percent of GDP, trailing behind regional peers and Europe's leading economies such as Germany or Sweden. Only 16 percent of Polish enterprises introduced a technological innovation in 2010, compared to one third of all

enterprises in the Czech Republic and two thirds in Germany.⁹ Poland also scores low in all innovation rankings, including the European Innovation Scoreboard 2013, where it is classified among the four least innovative economies in the EU, or the World Economic Forum's Global Competitiveness Index, which ranks Poland only in 65th place in terms of innovation and 103rd in terms of enterprise R&D.

52. The DPL supports the new program to enhance the efficiency of public support for innovation. EDevP is a national program that implements the *Strategy for Innovation and Efficiency*, adopted in January 2013, with about 10 billion euro of EU and budget funds for innovation and R&D in 2014-2020. The objective is to increase R&D spending to 1.7 percent of GDP by 2020, of which at least half would come from the private sector. EDevP increases support for early stage innovation and technological start-ups, rather than the previous focus on technology adoption, through measures that include R&D (and investment) grants, venture capital funds, support for intellectual property rights, and consortia between enterprises and higher education research institutions etc. EDevP also sets out the institutional arrangements for each program, including Polish Agency for Enterprise Development (PARP), the National Economy Bank (BGK), the National Capital Fund (KFK) and the Ministry of Economy. EDevP guides the development of more detailed Smart Growth Operational Programs (SGOP) for innovation to be financed under the 2014-2020 EU budget perspective.

DPL2 Indicative Trigger #7: *Commence implementation of the new Smart Growth Operational Program (SGOP) to guide EU co-financed programs with more focused, streamlined and business centered programs for innovation, with a revised M&E framework.*

53. DPL2 will continue supporting the development of new national programs to promote innovation. According to the draft Partnership Agreement, Poland has €8.6 billion in EU funds plus an additional €1.5 billion from national budgetary co-financing to support innovation programs in 2014-2020. This will be allocated through a "Smart Growth Operational Program" (SGOP), which should help improve innovation outcomes by streamlining the innovation support programs, reducing them to around 20 for the 2014-2020 period, relative to 29 in the current Innovative Economy Operational Program for the 2007-2013 EU budget perspective, strengthening institutional capacity, and putting the private sector at the center of the innovation support system. It is also expected to support the establishment of a new M&E framework that would improve the alignment between program objectives and indicators. The SGOP should be finalized, following agreement with the EU, by end-2014.

DPL1 Prior Action #8: *Decision by the Cabinet of Ministers to approve a concept ("assumptions") of a new General Restructuring Law dealing with insolvency and restructuring in the corporate sector.*

54. An efficient corporate and personal insolvency system is critical to resolve a distress. Efficient exit systems are as significant as entry systems for economic growth and entrepreneurship, as they serve to free both entrepreneurs and capital for more productive uses. While the reform of the Polish bankruptcy regime has been ongoing for some years, the number

⁹ Hausner, Jerzy et al. 2013. *Towards a Competitive Poland. How Can Poland Climb the World Economic League Table?* The Economy and Public Administration Foundation, Krakow.

of legal proceedings for bankruptcy has been low; the process time-consuming and costs excessive with outcomes heavily biased toward liquidation. Bankruptcy cases are also often considered by lower level courts, where capacity is low. Consequently the system neither adequately protects creditors' rights nor offers a viable rescue mechanism for viable debtors.

55. The DPL supports the development of a new insolvency framework, with a focus on restructuring. The law should enable companies to enter the process at an earlier stage and with more specialized legal services, including trained practitioners, time limits for decisions, better trustee remuneration, greater participation for creditors, the introduction of tax deductions for forgiven debt, special out-of-court restructuring available for some SMEs and more public awareness campaigns. The first stage was for the Cabinet of Ministers to approve the above main features of the draft law, the 'assumptions', which will provide authority for the broader consultative process for the law.

DPL2 Indicative Trigger #8: *Enact the insolvency law for the corporate sector (General Restructuring Law).*

56. DPL2 will support the enactment of the new general restructuring law described above. This should both reduce the compliance costs (and speed) for exits and restructuring as while additional measures will also be required to reduce the stigma associated insolvency and restructuring.

DPL1 Prior Action #9: *Submission to the Cabinet of Ministers standing committee a draft Law on Facilitating Access to Business Activity (alternatively referred to as "Fourth Deregulation Law") and through a Decision of the Council of Ministers approval of draft amendments to the Law on the National Court Register aimed at improving business environment through streamlined procedures, including port clearance, business startups and enterprise transactions.*

57. Although the business environment has improved in recent years impediments remain. Poland was ranked 45 in the 2014 Doing Business Report, but 116th in terms of the ease of starting a business, with 30 days needed to register a new company. Furthermore, analysis suggest that job creation and innovation have been more dynamic among newer firms (so-called "gazelles") and recent job losses more pronounced in pro-cyclical sectors such as construction and new start-ups¹⁰.

58. The DPL supports the development of a new law and amendment of an existing law to tackle impediments for companies' ease of doing business. The so called Fourth Deregulation Law (the Law on Facilitating Access to Business Activity) will enact around forty legal changes, which the Government estimates will generate around Euro 200 million of annual savings for entrepreneurs. The law includes the following measures: (i) a "Port Package" - extending the deadline for the settlement of VAT on imports by Authorized Economic Operators, and shortening border controls; (ii) exempting free legal assistance from VAT to increase the availability to the poor; (iii) reducing the cost of starting a business by streamlining VAT requirements; (iv) extending guarantees and finance to more entrepreneurs through the National

¹⁰ See *Back to Work: Growing with Jobs in Europe and Central Asia*, World Bank, 2013.

Fund for Environmental Protection and Water Management and the provincial FOŚiGW investment fund; and (v) exempting employees from paying income tax on transport schemes organized by employers. The Amendment of the Law on the National Court Registry introduces the automatic exchange of information on newly registered companies between the National Court Registry, Social Security Office, Tax Office and Statistical Office.

DPL2 Indicative Trigger #9: *Enactment of the Amended Law on the National Court Registry for quicker business registration and approval by the Cabinet of Ministers of the assumptions to the Construction Code to provide a comprehensive framework for construction activity.*

59. **The DPL2 will continue supporting reforms aimed at promoting job creation through easing the processes for starting a business or construction project.** As economic growth rates gradually start to improve, the potential for new businesses and construction is likely to grow. The amended Law on the National Court Registry and the new construction code should help cut the time and procedures involved in business registration and dealing with construction permits.

Expected Results

60. **This DPL aims to support priority reforms to enhance the business environment and promote innovation** The reforms should remove impediments to doing business, with a reduction in the time it takes to start a business, from the current 30 days to 20 days or fewer by 2015, and for dealing with construction permits, from the current 161 days to under 140 days in 2015. The reforms should also help increase R&D spending to at least 1 percent of GDP in 2014.

ANALYTICAL UNDERPINNINGS

61. **Extensive analytical work and policy dialogue underpin the policy areas supported by the DPL series.** Table 7 summarizes the main analytical and TA activities and their linkages to prior actions. In all areas the Bank has carried out expert discussions and prepared policy notes with recommendations to enhance the design and implementation of reforms.

Table 7: Prior actions, Triggers and Analytical Underpinnings

| Selected prior actions and triggers | Analytical underpinnings |
|--|--|
| <i>ENHANCING MACROECONOMIC RESILIENCE</i> | |
| Enact amendments to the Public Finance Act to introduce a permanent fiscal rule limiting growth of public expenditures to trend GDP growth to foster compliance with its obligations deriving from the Treaty on the Functioning of the EU in the area of budgetary policy; and (b) the Budget Law for 2014 in line with the new permanent fiscal rule as set forth in the Public Finance Act. | <i>(i) Public expenditure review (PER 2010): on needed fiscal consolidation and on strengthening fiscal framework through expenditure ceilings; (ii) Fiscal Rules Policy Note and advice on the sub-national rule and the permanent expenditure rule (2012); (iii) EU New Member States Regular Economic Reports (RERs 2011-): on deficit control, debt stabilization and gradual debt reduction; (iv) a savings and investment CEM (ongoing); and (v) Public Pay Review (TA) (FY13)</i> |
| Enact amendments to the Law on VAT to defer reduction in VAT rates in 2014-16 to support fiscal consolidation. | <i>(i) Public expenditure review (PER 2010): on needed fiscal consolidation and on strengthening fiscal framework and TA on tax expenditures (2010).</i> |
| Enact an amendment to the Public Finance Act implementing a fiscal rule for local governments to ensure debt sustainability at the local level and effective absorption of European Union funds. | <i>(i) Public expenditure review (PER) (2010); (ii) Fiscal Rules Policy Note with advice on the sub-national rule (2012); Debt management workshop for sub-national governments (FY12); Lubelskie: Support for Regional Development Strategy (ESW) (FY12); Training for Swietokrzyskie and Kujawsko-Pomorskie voivodships on regional/local strategy development and implementation (FY 12); and (iii) TA on debt management for local governments, including on fiscal risks, fiscal rules and debt management (FY13). TA on multi-year financial forecasts of local governments (ongoing).</i> |

| | |
|--|---|
| Law on Macro-Prudential Oversight to establish Systemic Risk Board | Policy Note: The Polish Bank Insolvency Regime: issues and Assumptions for the Design of an upgraded Bank resolution framework (TA, 2012); ROSC - Financial Sector Assessment Program (2013). |
| LABOR MARKET RESILIENCE AND EMPLOYMENT PROMOTION | |
| Enact amendments to the Labor Code to increase flexibility of labor markets by extension of the calculation period for employees' working time. | "Europe 2020. Fueling Growth and Competitiveness in Poland through Employment, Skills, and Innovation" (ESW, 2011); Employment Entrepreneurship and Human Capital Development, PL2-PL3 (FY9-10); and Human Capital Development Strategy (HCDS) TA, including workshop on Lifelong Learning (FY12). "Towards greater social inclusion in Poland—a qualitative assessment in three regions" (ESW, 2013). Support to Ministry of Justice in developing methodology for impact evaluation of professions deregulation (ongoing). Dialogue with the Ministry of Labor on the productive employment agenda (ongoing). |
| (a) implement the first professions deregulation tranche through enactment of the Law Amending Laws on Access to Certain Professions thereby deregulating access to fifty one (51) professions; and (b) approve, through a Decision of its Council of Ministers, the draft Law on the Easing of Access to Certain Regulated Professions and the draft Law Amending Laws on Access Conditions to Certain Professions for the second and third professions deregulation tranches | |
| Enact amendments to the Law on Early Childcare to facilitate return of parents to the labor market. | |
| ENHANCING PRIVATE SECTOR RESILIENCE AND PROMOTING COMPETITIVENESS | |
| Resolution by the Cabinet of Ministers to approve Poland's Enterprise Development Program (EDevP) to create clearer institutional arrangements and increase support for early stage innovation and technological startups to enhance innovation through focused support programs in this area. | ESW: (2011) "Europe 2020: Fueling Growth and Competitiveness in Poland through Employment, Skills, and Innovation"; (2012) "Poland Enterprise Innovation Support Review"; (2013-14) Review of the national <i>Smart Growth Operational Program</i> for the Ministry of Infrastructure and Development (MID). TA: (2013) assessment of quality, coherence, and fulfillment of ex ante conditionalities for national and regional Research and Innovation Strategies (RIS3), (2014) External evaluation of selected innovation support programs with NCBR. |
| Decision by the Cabinet of Ministers to approve a concept ("assumptions") of a new General Restructuring Law dealing with insolvency and restructuring in the corporate sector. | Policy Note: "Towards a stronger contract enforcement and insolvency in Poland" (TA, RAS), completed in FY 2013. |
| Submission to the Cabinet of Ministers standing committee a draft Law on Facilitating Access to Business Activity (alternatively referred to as "Fourth Deregulation Law") and through a Decision of the Council of Ministers approval of draft amendments to the Law on the National Court Register aimed at improving business environment through streamlined procedures, including port clearance, business startups and enterprise transactions. | Improving the business regulatory environment in five Doing Business areas where Poland lags the most (TA) (RAS). "Review of Public Enterprise Innovation Support Systems" (TA) (EFO). "Back to Work: Growing with Jobs in Europe and Central Asia" (2013). |

4.3. LINK TO COUNTRY PARTNERSHIP STRATEGY AND OTHER OPERATIONS

62. **The DPL series is central to the Bank's engagement in Poland, as highlighted in the 2014-17 Country Partnership Strategy (CPS).** The CPS, discussed by the Board on July 15, 2013 has the following four *strategic areas of engagement* to reduce poverty and boost shared prosperity: (i) *economic competitiveness*, with a focus on business environment (CPS Goal 1, DPL Pillar 3), innovation, and public finance effectiveness (CPS Goal 3, DPL Pillar 1); (ii) *equity and inclusion*, with a focus on inclusive labor markets (CPS Goal 4, DPL Pillar 2), balanced regional development (CPS Goal 5, DPL Pillar 1) and strengthened health care and health prevention in an aging society; (iii) *climate action*, with informed climate change policy making, adaptation and flood protection, and resource efficient infrastructure; and (iv) *Poland as a global development partner*, focusing on Poland's contribution to development cooperation and global public goods. Actions supported by the DPL series are also aligned with the CPS's focus on lending that: (i) support reforms in the implementation phase (as a follow up to advisory services in the design phase); (ii) highlights economic reforms where Poland is a leader; and/or (iii) enhances institutional capacity, including through the development of new legislation.

4.4. CONSULTATIONS AND COLLABORATION WITH IMF AND OTHER DONORS

63. **All legislative measures and reforms are subject to a thorough consultation process with social partners, civil society and groups likely to be impacted.** Public consultations are compulsory by law for all new policy initiatives. According to the regulatory guidelines for this process, stakeholders need to be involved throughout the policy-making and legislative preparation processes. Various methods were used for these consultations, including public hearings and meetings, citizen’s panels, surveys, electronic consultation (e.g., government websites) and media. In particular, on the measures related to labor market changes, the authorities held consultations with a wide range of social partners, civil society, trades unions, the EU and affected groups. In addition, changes to the banking resolution framework have been discussed with various internal stakeholders and external partners in the World Bank, EU, ECB and IMF. Regular updates to the process are posted in government websites. Amendments to the insolvency and restructuring law have been widely debated and consulted with trade unions, employer organizations, as well as with NGOs and think tanks. Inputs of this consultation were reflected in the amendments.

COLLABORATION WITH IFIs AND OTHER DEVELOPMENT PARTNERS

64. **The Bank has collaborated closely with the IMF and the European Commission (EC) on this program.** The measures under the proposed DPL program have been discussed with both the IMF and the EC to ensure that they reinforce and complement their support to Poland.

V. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY, SOCIAL AND GENDER IMPACT

65. **The overall poverty, social and gender impacts of policy measures supported by this DPL series are expected to be positive.** Several policy measures will improve the living standards of the poor, provide greater opportunities to women to participate in the labor market, and contribute to the income growth of the bottom 40 percent, both directly through reforms to unemployment services and the reduction of restrictive labor practices, and indirectly through improved stability and solvency of public finances, which increases the scope to smooth economic downturns, and measures to enhance the business environment for sustained growth. Only the postponement of the VAT reduction will have a negative impact on the bottom forty percent, albeit very small and less than many alternative measures to reduce the fiscal deficit.

66. **Enhancing macroeconomic resilience, through the gradual reduction of fiscal deficits and strengthening the macro prudential framework, are integral for shared prosperity.** The new permanent fiscal rule will enable a gradual rebuilding of fiscal buffers. As evidenced after 2008, this will bolster the government’s ability to deploy counter-cyclical measures and minimize volatility, which particularly hurts the bottom of the income distribution.¹¹ Similarly, strengthening the macro prudential framework should also enhance the

¹¹ Birdsall, N. (2007). “Reflections on the macro-foundations of the middle class in the developing world.” Center for Global Development Working Paper No. 130.

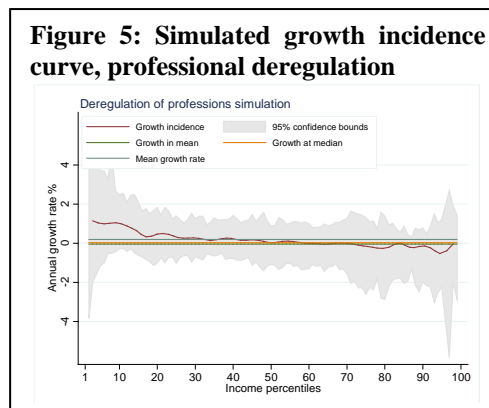
ability to mitigate macroeconomic shocks by addressing systemic risks. A stable macroeconomic environment should also promote investment, growth and shared prosperity.

67. **The fiscal adjustment measures are not expected to have any perceptible negative effect on poverty or shared prosperity.** The largest share of the consolidation in 2014 will derive from the changes in the funding arrangements of the second pension pillar, and the changes will not necessarily alter future benefit levels. The ongoing civil service wage freeze is expected to affect a total of 470,000 employees, or roughly 1 percent of the population, mostly in the upper half of the income distribution and simulations suggest that it is not expected to have a negative effect on poverty or shared prosperity.

68. **Postponing the VAT reduction from 2014 to 2016 will help to reduce the fiscal deficit in a way that mitigates the welfare loss on the bottom forty percent.** Households at the bottom of the expenditure distribution spend a higher proportion of their budgets (42 percent in the 1st decile) on goods taxed at the lower 5 percent rate, which applies primarily to basic foods, compared to households at the upper end of the welfare distribution (18 percent in the 10th decile). A simple simulation¹² suggests that returning to pre-2011 VAT rates would allow additional consumption of about 1.2 percent of current expenditures (before VAT), slightly higher at the bottom of the welfare distribution, but the differences are small and in monetary terms would constitute about USD 1 per capita per month for the first decile. However, it is important to note that the Government would not be able to reduce the 5 percent tax rate to its pre-2011 rate, as it this would contravene an EU-wide directive. After 2016, unprocessed food will therefore continue to be taxed at the rate of 5 percent, instead of 7 percent, which will have positive impact on the consumption of the bottom forty percent. Consumption taxes are also one of the best means to reduce the fiscal deficit while minimizing the impact on shared prosperity.¹³

69. **Labor market reforms supported by the DPL are expected to enhance shared prosperity.** Attachment to the labor market has been a key driver of the growth of incomes for the bottom forty percent during 2005-2010. The prior actions are designed to reduce the restrictions to a range of professions¹⁴, provide better services to the unemployed through profiling, and promotion of early childcare facilities to support the return of parents to the labor market, and can additionally reduce early achievement gaps to boost shared prosperity.

70. **The Deregulation of professions is expected to benefit those at the bottom of the income distribution.** Two key direct effects include: (i) relaxing educational and certification requirements should improve access among the young and less advantaged groups—Government estimates deregulation will create an additional 50,000–100,000 jobs, with a moderate share at the lower end of the



¹² Which does not include substitution or cross-price elasticities by VAT categories, which are expected to be small.

¹³ See IMF Fiscal Monitor, Taxing times, October 2013.

¹⁴ The 51 professions in the first tranche of deregulation include: lawyers, solicitors, notaries, bailiff, clerk of the court and Prosecutor's Office, real estate agent and appraiser, property manager, counselor, job club leader, surveyor, driving instructor and examiner, detective, security guard, tourist guide, sports instructor, librarian, welder.

income distribution¹⁵; and (ii) those currently employed in the regulated professions may lose some of the 10-15 percent job premia.¹⁶ A simple simulation of the joint employment and wage effects indicates they are pro-poor.¹⁷

71. Policy measures to improve financing of child care centers are expected to reduce gender differentials in labor force participation rates. Poland has set a target to offer a place in preschool education for every eligible child by 2016 and the amendments to the law on early childcare facilities should increase the supply of formal child care. Results from a 2010 survey on reconciling work and family life in Poland suggest that the availability and cost of formal child care are important reasons for women working part time or not working at all. In addition, such programs can reduce early achievement gaps to boost shared prosperity.

72. Enhancing the business environment is also expected to have a beneficial impact on poverty and shared prosperity. Addressing major constraints to business and innovation, in terms of enabling companies and individuals to restructure their debts or move more swiftly through insolvency, as well as reducing the obstacles to starting a business or adopting new innovative technologies and practices are expected to boost job creation, in particular for small and medium enterprises that are key to the economic opportunities of the bottom 40 percent. Recent research shows that rules-based bank insolvency resolution policy has a positive effect on firm growth.¹⁸ Altogether, these reforms aim to enhance Poland's long-term growth prospects.

5.2. ENVIRONMENTAL ASPECTS

73. The specific policies supported by the DPL series are not likely to have significant effects on the environment, forests, water resources, habitats or other natural resources. The risk of unanticipated adverse effects to the environment and natural resources is small. Credible scenarios for direct or indirect negative impacts appear unlikely. Poland has adequate controls and environmental legislation and regulations are closely aligned with EU environmental directives. Poland has adopted the EU's guidelines on integration of environmental assessments into the planning and programming of projects and the EU's Environmental Liabilities Directive setting out liability for damage to property and natural resources.

5.3. IMPLEMENTATION MONITORING AND EVALUATION

74. The Bank continues to work closely with the Ministry of Finance, Prime Minister's Office and sector ministries to monitor and assess reform progress and impacts during the course of the program. Monitoring and evaluation will be supported by the various ministries as well as budgetary, legislative and economic data provided by the authorities and verified in official disclosures, directives and regulations. Baseline and updated data are provided by the

¹⁵ Analysis suggests that 2.5 percent of these employees are in the bottom income decile and 19 percent in to bottom 40 percent of the population.

¹⁶ Kleiner (2011). Occupational licensing: Protecting the Public Interest or Protectionism? W.E.Upjohn Institute for Employment Research, Mich.

¹⁷ Assuming a 10 percent wage effect for those in deregulated professions, an additional 65,000 jobs created (i.e. the low end of the Government estimate), an implied own wage elasticity of labor demand of about 1.3, with jobs accruing to younger individuals in the 16-35 age group who are currently unemployed, hired with wages at the 33rd percentile of the current wage distribution in respective occupational categories.

¹⁸ Korte, J. (2013). "Catharsis – the real effects of bank insolvency and resolution." Deutsche Bank Discussion Paper No. 21.

respective specialized agencies and tracked according to the indicators and outcome measures shown in the monitoring and results framework of the policy matrix (Annex 1.).

5.4. FIDUCIARY ASPECTS

75. **The overall fiduciary risk from Poland's public financial management system (PFM), the use of budget resources and its foreign exchange environment as controlled by the NBP is moderate.** Following significant improvements during EU accreditation, the PFM system enhanced budget transparency, predictability. Poland has introduced a performance-oriented four year rolling budget plan with a binding annual cash-based budget, cash management consolidation, and strengthened internal audit, and management control over public spending and debt via fiscal rules. Public procurement is based on EU Directives with the most recent update in 2012 on defense and security directive. Further efforts are expected to streamline the flow of funds processes, harmonize public sector accounting, reporting standards and practices on an EU level, supported with further integration of IT systems.

76. **The MoF discloses publicly the state budget act along with monthly and quarterly execution reports based on a national cash methodology covering main revenue and expenditure aggregates within 1-2 months after the end of a period.** It also publishes quarterly aggregate reports on budget execution by LGs. Annual cash based reports on central state budget execution are published after being audited by the Supreme Audit Office (NIK) within 6 months after the end of the year. Accrual based ESA'95-compliant reports for the general government are available on a quarterly basis on the website of the MoF, the Central Statistical Office, and Eurostat within 3-4 months from the end of the quarter.

77. **In the area of external audit, Poland has a well-functioning public financial accountability and assurance mechanism for the legislature and the public.** Poland is advanced in the availability of the audit reports to the public, and independence of the NIK. At the LG level, 16 Regional Accounting Chambers the responsibility to supervise and control financial, fiscal and procurement activities of self-governing entities. The PFA also requires that annual financial statements prepared by large LGs be audited by independent statutory auditors. In the area of internal audit, a Public Finance Sector Audit Department of the Ministry of Finance coordinates management control and internal audit in public finance sector units, which follow International Standards for the Professional Practice of Internal Auditing.

78. **The NBP accounting and reporting policies are defined by the Monetary Policy Council, and are in line the guidelines of the European Central Bank.** In managing the foreign exchange reserves, while striving to maximize returns, the NBP manages credit and liquidity risks. An independent auditor selected by the Monetary Policy Council regularly audits the NBP's annual financial statements. The most recently available audit reports (for 2004-2012) have unqualified audit opinions. The IMF latest limited scope safeguard assessment report of 2009 confirmed that the control environment of the NBP is satisfactory.

5.5. DISBURSEMENT AND AUDITING

79. **Loan proceeds will be disbursed in one single tranche to the foreign currency national budget account at the NBP, which forms part of the country's foreign currency**

reserves, and of the country's budget management system. Disbursements will not be linked to specific purchases, thus no procurement requirements will be necessary. The Bank will not require an audit of the deposit account but will require the Government to provide confirmation to the Bank on the amounts deposited in the foreign currency account within 30 days of receipt.

VI. SUMMARY OF RISKS AND MITIGATION

80. **The overall risk of the operation is considered to be moderate:**

81. **Political risks could arise from public discontent with reforms, which in turn could undermine support.** For example, the deregulation of labor markets risks protests from affected professions. This could reduce the Government's ability to implement and sustain the fiscal and structural reforms. Ensuring support within the coalition Government will be key for the successful implementation of the envisioned reform agenda.

82. **The Government's strong electoral mandate and track record for reform mitigate this risk.** Albeit with a small majority, some splits with major political figures and a recent cabinet reshuffle, the ruling coalition has been effective in securing political support to maintain the reform agenda. The Government's strong commitment to strengthening public finances was demonstrated through the 2014 budget, while strong governance and institutional capacity have helped to build a track record of sustained reform.

83. **Macroeconomic risks stem largely from potential shocks to the global economic outlook and regional instability.** A global, Euro area or regional shock, particularly as global interest rates rise or stemming from regional energy supply disruptions, could undermine the gradual improvement in economic growth in Poland, and jeopardize fiscal outcomes. Moreover, financial sector vulnerabilities remain, reflecting uncertainties from the sovereign stress in the rest of Europe or emerging markets. Poland remains vulnerable to external debt deleveraging through parent bank funding of local subsidiaries and tighter access to capital. Further, the nominal stock of NPLs continued growing over the last year, particularly within forex-denominated mortgage loans and construction.

84. **Mitigating factors against downside macroeconomic risks include the improving outlook in key trading partners, a track record of sound macroeconomic management and growing energy security.** Although Germany remains Poland's most important trading partner, the expansion of exports into non-EU markets is spreading the economic risks. Poland's energy security has also improved with the development of alternative supply routes and greater storage capacity. Flexible monetary policy, especially a flexible exchange rate, continues to cushion the impact of external shocks. A new round of EU structural funds should also boost investment in 2014-20. The solid track record of macroeconomic management will help market confidence and access to international financial markets, based on medium-term fiscal and structural reforms. Adequately capitalized, liquid, and profitable banks as well as effective and strong financial supervision are key mitigating factors against financial risks. The authorities could also draw on the FCL with the IMF to smooth a shock.

85. **As highlighted in the PSIA section, the poverty and share prosperity impacts of policy measures supported under this DPL series are expected to be either positive or negligible.** At the same time, there are few risks arising from the program on Poland's environment, forests, water resources, habitats or other natural resources. Fiduciary risks are moderate due to the advanced PFM system and management of foreign exchange by the Central Bank.

ANNEX 1: POLICY AND RESULTS MATRIX

| Draft Prior actions and Triggers | | Results |
|--|---|---|
| Draft Prior Actions under DPL 1 | Draft Triggers for DPL 2 | |
| <i>Pillar A--- ENHANCING MACROECONOMIC RESILIENCE</i> | | |
| Prior action #1: The Borrower has enacted: (a) an amendment dated November 8, 2013 to the Public Finance Act to introduce a permanent fiscal rule limiting growth of public expenditures to trend GDP growth to foster compliance with its obligations deriving from the Treaty on the Functioning of the EU in the area of budgetary policy; and (b) the Budget Law for 2014 in line with the new permanent fiscal rule as set forth in the Public Finance Act. | Trigger # 1: Enact Budget Law for 2015 in line with the new permanent fiscal rule, limiting growth of public expenditures to trend GDP growth to foster compliance with its obligations deriving from the Treaty on the Functioning of the European Union in the area of budgetary policy | <p>Result Indicator A1-- baseline Fiscal deficit in 2013:-4.5 percent of GDP Public debt in 2013: 57.3 percent of GDP</p> <p>Result Indicator A1— target Fiscal deficit in 2015: 3 percent of GDP Public debt in 2015: lower than 52 percent of GDP</p> |
| Prior action #2: The Borrower has enacted the amendments dated November 8, 2013 to the Law on Value Added Taxes (VAT) to defer the reduction in VAT rates in the period of 2014-16 to support fiscal consolidation. | Trigger # 2: Enact Tax Ordinance Act to introduce a General Anti-Avoidance Rule | |
| Prior action #3: The Borrower has enacted an amendment dated November 8, 2013 to the Public Finance Act implementing a fiscal rule for local governments to ensure debt sustainability at the local level and effective absorption of European Union funds. | Trigger # 3: Enact the Law to Improve the Provision of Services by Local Government Units to introduce shared services centers at the local level | |
| | Trigger # 4: Enact Law on Macro-Prudential Oversight and establishment of the Systemic Risk Board and enact Law on the Bank Guarantee Fund to establish a framework for orderly liquidation of banks | |

| Draft Prior actions and Triggers | | Results |
|---|--|---|
| Draft Prior Actions under DPL 1 | Draft Triggers for DPL 2 | |
| <i>Pillar B--- LABOR MARKET RESILIENCE AND EMPLOYMENT PROMOTION</i> | | |
| Prior action #4 The Borrower has enacted amendments dated July 12, 2013 to the Labor Code to increase the flexibility of the labor market by extending the calculation period for employees' working time. | Trigger # 5: Enact amendments to the Law on Promotion of Employment and Labor Market Institutions to strengthen job seeker services and promote flexible employment | <p>Result Indicator B1-- baseline The number of registered long-term unemployed is at 1,107 thousands (average) in 2013.</p> <p>Result Indicator B1 -- target The number of registered long-term unemployed is reduced by at least 30,000, i.e. from 1,107 thousands in 2013 to less than 1,077 thousands in December 2015.</p> |
| Prior action #5 The Borrower has: (a) implemented the first professions deregulation tranche through enactment of the Law Amending Laws on Access to Certain Professions thereby deregulating access to fifty one (51) professions; and (b) approved, through a Decision of its Council of Ministers, the draft Law on the Easing of Access to Certain Regulated Professions and the draft Law Amending Laws on Access Conditions to Certain Professions for the second and third professions deregulation tranches. | Trigger # 6 Deregulate around 190 professions by implementing the Second and the Third Professions Deregulation tranche | |
| Prior action #6 The Borrower has enacted amendments dated May 10, 2013 to the Law on Early Childcare to facilitate parents' re-joining labor force. | | |
| <i>Pillar C--- ENHANCING PRIVATE SECTOR RESILIENCE AND PROMOTING COMPETITIVENESS</i> | | |
| Prior action #7: The Borrower, by way of resolution of its Council of Ministers, has approved Poland's Enterprise Development Program (EDevP) to create clearer institutional arrangements and increase support for early stage innovation and technological startups to enhance innovation through focused support programs in this area. | Trigger # 7: Commence implementation of the new Smart Growth Operational Program (SGOP) to guide EU co-financed programs with more focused, streamlined and business centered programs for innovation, with a revised M&E framework | <p>Result Indicator C1-- baseline Starting a business – 32 days (DB 2013) Total R&D spending – 0.9 percent of GDP in 2012</p> <p>Result Indicator C1-- target Starting a business – 25 days (DB 2016) Total R&D spending – 1 percent of GDP in 2014</p> |
| Prior action #8: The Borrower, through a Decision of its Council of Ministers dated February 11, 2014, has approved a concept ("assumptions") of a new General Restructuring Law dealing with insolvency and restructuring in the corporate sector. | Trigger # 8: Enact the insolvency law for corporate sector (General Restructuring Law) | |
| Prior action #9: The Borrower, through the Ministry of Economy, has submitted to the Council of Ministers Standing Committee, a draft Law on Facilitating Access to Business Activity (alternatively referred to as "Fourth Deregulation Law") and through a Decision of the Council of Ministers dated January 8, 2014, has approved draft amendments to the Law on the National Court Register aimed at improving business environment through streamlined procedures, including port clearance, business startups and enterprise transactions. | Trigger # 9: Creation of "one-stop-shops" for quick business registration and approval by the Cabinet of Ministers of the assumptions to the Construction Code to provide a comprehensive framework for construction activity in Poland. | |

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Warsaw, April 8, 2014



REPUBLIC OF POLAND
MINISTER OF FINANCE
Mateusz Szczurek

DZ1/912/2-3-4/LHU/14/RD-33334

Mr. Jim Yong Kim
President
World Bank
1818 H Street NW
Washington D.C. 20433
United States of America

Dear Mr. President,

Allow me first to express my gratitude for the World Bank's continued support over the past few years to the reform process in Poland. Budgetary support operations, technical assistance projects and knowledge activities continue to play a significant role in supporting the economic and social reforms undertaken by the Polish Government amid a turbulent and uncertain external environment.

With that in mind, I am writing to request your approval for the programmatic Resilience and Growth Development Policy Loan (DPL) in the amount of EUR 700 million. The loan is the first in a series of two lending operations aimed at strengthening macroeconomic resilience and promoting economic expansion, which are key to fostering income growth, particularly of the bottom forty percent of the population. The loan, prepared in close collaboration with the World Bank, builds on the Government's strategic priorities of reinvigorating economic growth, promoting jobs and innovation in Poland.

Macroeconomic Framework

In the past four years, in spite of the uncertain external environment, Poland's economic fundamentals have remained strong, underpinned by sound macroeconomic policies. Poland has enjoyed the highest economic growth among EU countries. This strong performance can be credited to the considerable diversification of Poland's economy, limited external imbalances prior to the crisis and prudent macroeconomic policies. Counter-cyclical policies were vital to lessening the economic slowdown. However, this resulted in higher fiscal deficit and public debt levels. The fiscal consolidation effort initiated in 2011 reduced the general government deficit from 7.9 percent of GDP in 2010 to 3.9 percent in 2012 and stabilized the public debt level. In 2013, in light of weak economic growth, automatic stabilizers were allowed to operate and the fiscal deficit increased to an estimated 4.5 percent of GDP. Going forward, the Polish Government is committed to maintaining a balanced approach of pursuing sustainable fiscal policy while actively supporting economic growth in the private sector. These efforts are aimed at further trimming the deficit to allow Poland to exit the Excessive Deficit Procedure in 2015 and reducing the structural deficit towards Poland's medium-term objective.



Government Program

The Government is committed to continuing the reform program announced after the parliamentary elections in October 2011 and reiterated in the Prime Minister's speech to Parliament in autumn 2012. Given the prolonged uncertainty in the external environment and the slowdown in the Polish economy, the reform agenda is focused on strengthening public finances and macroprudential safeguards, facilitating job creation and sustaining private sector-led economic growth and innovation to build a competitive economy for the future.

In 2014 and beyond, in order to **strengthen public finances**, the Polish Government will manage budget spending through a new permanent fiscal rule, limiting the growth of expenditures to a rate not exceeding trend GDP growth. The rule will foster further fiscal consolidation and reinforce the long-term stability of public finances. In addition, the Polish Government has deferred the planned reduction in VAT rates, maintained a nominal freeze of the public sector wage bill and frozen PIT thresholds. The fiscal consolidation strategy is also based on changes to the second pillar of the pension system, which are aimed at eliminating the inherent inefficiencies and are expected to bring about fiscal savings of close to 1 percent of GDP annually and reduce the public debt to GDP ratio to below 50 percent. Going forward, the Polish authorities' plan is to focus on further reforms of public finance, including on the revenue side, both through improvements in tax policy (by increasing the tax burden on civil-law labor contracts) and tax administration with the emphasis on tax compliance. In the area of local government finance the fiscal rule has been modified to allow for increased absorption of EU structural funds from the new multiannual financial framework for 2014-2020 and measures have been taken to improve the cost-effectiveness of local governments by allowing them to create shared service centers for IT, payroll administration and personnel, which should help them free up resources for growth enhancing expenditures.

The Polish Government is committed to continuing reforms to **establish sound macroprudential safeguards**. As a first step, there is a plan to establish a Systemic Risk Board, which would be the macroprudential decision-maker, responsible for systemic risk identification and analysis and authorized to request that other agencies take measures to control or limit systemic risk. With help from the World Bank the Polish Government has also been continuing its efforts to finalize the legislative proceedings regarding the bank resolution framework.

One of the main priorities for the Polish Government is to **enhance labor market flexibility and facilitate job creation**. Protracted recession and the resulting protracted recovery in the Euro Area, coupled with the slowdown in the Polish economy have strained the labor market with rising unemployment. While restoring job growth requires strong economic growth, structural reforms are also critical to reducing structural barriers and promoting participation. Reforms have been launched aimed at supporting employment by increasing the flexibility of the Labor Code, deregulating access to certain professions and facilitating labor market re-entry for young mothers. The Government is also planning to launch a comprehensive revamp of the Public Employment Services to support job seekers through better profiling and targeting.

Spurring private sector growth and innovation remains at the core of the Government agenda. Support to SMEs shall be continued through the successful "De Minimis" program aimed at mitigating credit constraints for enterprises and through a government investment fund "Polish Investments". In addition, further improvements to the ease of doing business are being introduced by creating one-stop shops for business start-ups and by reducing other barriers to

doing business, including in obtaining construction permits. With help from the World Bank, the Polish authorities have also been working on enhancing the framework for insolvency to promote rehabilitation rather than the winding-up of viable debtors. The Government is also committed to promote enterprise innovation through increased private and public spending on R&D. Work is currently being carried out on two strategic documents - the Enterprise Development Program and Smart Growth Operational Program - which are aimed at making R&D spending more streamlined and effective.

In light of the above, I strongly believe that the World Bank can provide valuable support to the Polish Government's reform program and its financial assistance and expertise will serve as a crucial impetus towards the fulfillment of the program's objectives.

Yours sincerely,



Mateusz Szczurek

ANNEX 3: IMF RELATIONS

IMF Executive Board Completes Review of Poland's Performance under the Flexible Credit Line

Press Release No. 14/05
January 8, 2014

The Executive Board of the International Monetary Fund (IMF) today completed its review of Poland's qualification for the arrangement under the Flexible Credit Line (FCL) and reaffirmed Poland's continued qualification to access FCL resources. The Polish authorities have indicated that they intend to continue treating the arrangement as precautionary.

The IMF has supported the authorities' policies with four successive FCL arrangements. The current two-year FCL arrangement for Poland was approved by the IMF's Executive Board on January 18, 2013 (see [Press Release No. 13/17](#)) in an amount equivalent to SDR 22 billion (about US\$ 33.7 billion). Poland's first FCL arrangement was approved on May 6, 2009 for an amount of SDR 13.69 billion (about US\$ 21 billion) (see [Press Release No. 09/153](#)). Successor arrangements were approved in July 2010 (see [Press Release No. 10/276](#)) and in January 2011 (see [Press Release No. 11/15](#)).

Following the Executive Board discussion on Poland, Mr. David Lipton, First Deputy Managing Director and Acting Chair, made the following statement:

“Poland continues to have in place sound macroeconomic management and strong fundamentals, including a well-established inflation targeting regime, a robust fiscal framework that balances short-term economic considerations with the need to preserve long-term fiscal sustainability, and an effective financial supervisory framework that has safeguarded financial stability.

“The FCL arrangement with the IMF has reinforced Poland's capacity to deal with adverse external shocks, providing the authorities with needed flexibility to implement their macroeconomic framework, while rebuilding policy buffers and continuing structural reforms. Today, the Executive Board reaffirmed that Poland continues to meet the qualification criteria for access to FCL resources.

“The Polish economy is beginning to recover from a sharp slowdown. However, external risks remain elevated, including the possibility of increased financial stress in the euro area, a protracted period of low growth in broader Europe, and a sudden reversal of capital flows as advanced countries exit from unconventional monetary policies.

“Poland's FCL arrangement, which the authorities continue to treat as precautionary, provides added insurance against these risks. The authorities intend to exit from the FCL arrangement as soon as external conditions allow.”