

Warsaw, September 29, 2004

Opinion of the Monetary Policy Council concerning the draft 2005 Budget Act

I. General remarks

The draft of the 2005 Budget Act envisages lowering of the central budget deficit to 35 billion zloty (3.7% of GDP), down from around 43.71 billion zloty (4.9% of GDP) in 2004. Together with the assumed reduction in deficits of other units of general government, this will allow for the negative tendency of growing fiscal imbalances, observed in recent years, to be reversed. According to estimates of the National Bank of Poland, fiscal stance² will tighten by around 0.9% of GDP in 2005. Despite the reduction in the cyclically adjusted general government balance in 2005 relative to the current year, this balance will nevertheless remain higher than observed in 2003. This means that the improvement in the situation of public finances in 2005 is largely due to the effect of increased base, i.e. a significantly higher deficit in 2004.

Moreover, the planned reduction of budget deficit does not stabilise the ratio of public debt to the GDP. The increase in this ratio by 2.5 percentage points, i.e. to 56.1% of GDP in 2005 projected in the document, means that the second prudential threshold will be exceeded, assuming that the current definition of public debt is retained.

The draft state budget for 2005 and measures already approved by Parliament, which result in around 30% of the savings planned in the government *Public Expenditure Reform and Reduction Programme*, constitute the beginning of the public finance consolidation process. In order for government plans declared in the *Convergence Programme* concerning deficit reduction by 2007 to become feasible, further fiscal reforms aimed at reducing the structural deficit are required. In view

1 Projected performance.

2 Measured, in line with the universal practice in EU countries, as the change in the cyclically adjusted primary deficit of the public finance sector after allowing for one-time factors.

of the already high level of fiscal burden, any further increase in this respect would be detrimental to long-term economic growth. However, it would be desirable to simplify the tax system and introduce measures aimed at broadening of tax bases. Above all, however, in order to maintain the state public debt below the level of 60% of GDP, it is necessary to introduce further measures to reduce public expenditure.

The stability of public finances is a fundamental prerequisite of sustainable economic growth. Resolute implementation of the public finance reform programme is also very important from the point of view of assessment of economic conditions by financial markets, foreign investors and domestic businesses. Moreover, it is particularly important to implement the public finance consolidation programme as rapidly as possible because this constitutes a key condition of adopting the common European currency and thus opening new development opportunities for the Polish economy.

II. Macroeconomic assumptions

1. The 2005 budget is based on two fundamental assumptions:
 - the increase in the average annual consumer price index will be 3%,
 - the gross domestic product will rise by 5%.

The Monetary Policy Council will continue to work towards a relatively rapid fall in the inflation rate to the inflation target level (i.e. an inflation rate of 2.5% against the same month of the previous year). Lowering the inflation rate from its current level to the inflation target level should ensure that the average annual inflation in 2005 remains close to the 3% level assumed in the state budget draft. Therefore government assumptions concerning average annual inflation in 2005 constitute a reliable basis for wage negotiations for social partners. In general, the assessment of development trends in the Polish economy in the years 2004–2006 presented in the discussed document, which is based on the assumptions of the Convergence Programme submitted to the European Commission, is in line with the macroeconomic forecast of the NBP.

2. GDP growth forecasts (ca. 5.7% in 2004 and 5% in 2005 according to the *Act* draft) approximate those in the NBP forecast (ca. 5.6% in 2004 and 4.9% in 2005). There are only some insignificant discrepancies concerning the structure of GDP growth in 2005. The NBP predicts a stronger growth in domestic demand, particularly with regard to gross fixed capital formation. The NBP estimates that the contribution of net exports to GDP growth will be negative and amount to around 0.5% of GDP, while according to the government forecast net exports will have nil contribution to GDP growth in 2005.

III. Public finances in 2005

Receipts

3. According to the *Act* draft presented, general government revenue excluding non-returnable EU funds should be 9.4% higher in nominal terms in 2005 than in the present year, which means an increase by 6.2% in real terms. Central budget receipts will rise by 11.3% in nominal terms and by 8.1% in real terms. The ratio of general government revenue to GDP will be 38.8% against the projected performance of 38.2% in 2004. The amount of central budget receipts projected for 2005 is a consequence of assumptions concerning dynamic economic development, the average annual inflation rate and the planned increase in excise tax rates as well as the inclusion of special funds in the central budget. The *Act* draft assumes a significant increase in central budget tax receipts (by 12.9% in nominal terms and 9.6% in real terms), primarily from VAT, which is partly related to the temporary drop in these receipts in 2004 linked to EU accession. The forecast amount of revenue in this area is optimistic and may be difficult to achieve, especially with regard to the component related to the assumed increase in receipts due to the “simplification of the tax system and the elimination of pathologies linked to the grey economy.” Achieving the assumed amount of receipts may be additionally jeopardised if the Parliament passes acts resulting in reduction of general government revenue (including the act introducing VAT refunds in non-profit construction industry).
4. The *Act* draft assumes that no fundamental changes regarding personal income tax will be introduced. The fact that tax thresholds will remain frozen means an increase in tax burdens on persons whose incomes rise and thus an increase in tax progression.
5. In the *Budget Act* draft, the forecast transfer of earnings from the NBP in 2005 amounts to 4,626.1 million zloty, i.e. is in line with the NBP forecast. The change in accounting principles introduced pursuant to the Act on the NBP, which adjusted these principles to ECB standards, has had a significant impact on the bank’s income in 2004. It has contributed to a one-time increase in NBP earnings in 2004, which will translate to a large transfer of earnings to the Treasury in 2005.

Expenditure

6. The performance of the state budget draft as presented means an increase in the expenditure of the general government sector (excluding expenditure funded by non-returnable EU assistance) by 4.6% in nominal terms and by ca. 1.5% in real terms. Central budget

expenditure will rise by 4.4% in nominal terms and by ca. 1.4% in real terms. The moderate increase in expenditure and the high GDP growth rate mean that the ratio of general government expenditure to GDP will decrease by 1.3 percentage points in 2005 in comparison to 2004. However, the level of central budget expenditure (21.9% of GDP) and the entire general government sector expenditure (43.3% of GDP) remains high and detrimental from the point of view of long-term economic growth.

7. The planned increase in central budget expenditure in 2005 is largely caused by the expenses related to Poland's accession to the EU. Other expenditure, excluding the contribution to the EU budget, will increase by around 2.3% in nominal terms (of which 0.5 percentage points result from the inclusion of some of the special funds in the central budget), while in the current year the projected increase will amount to 8.2%. The increase in such expenditure in 2005 will be largely caused by national defence (11.4%), higher education (7.6%) and justice system expenditure (9.9%).
8. The high proportion of legally determined expenditure in total central budget expenditure will persist in 2005. According to the *Justification of the Act* draft, it will amount to 58.8%. A significant increase in EU budget contributions is one factor contributing to the persistent high level of rigid expenditure. On the other hand, the passing of certain acts forming part of the *Public Expenditure Reform and Reduction Programme*, including new principles of indexing old age and disability pensions, has contributed to reducing the amount of rigid expenditure. It should, however, be noted that this is only a temporary improvement because in the year in which pensions are indexed, the subsidies for the Social Security Fund and the Farmers' Social Security Fund, which belong to legally determined expenditure, will have to be increased. If pensions are indexed in 2006, old age and disability pension expenditure may rise by as much as ca. 0.8% of GDP.
9. In line with earlier declarations, the budget draft assumes a reduction in administration expenditure. The total amount of administration expenditure planned is 5.8% higher than in 2004, but this a result of a systemic change which will be introduced in 2005, consisting in including certain special funds (ca. 1 billion zloty) in the central budget. On a comparable basis, the total amount of expenditure in the Public Administration section in 2005 will probably be slightly lower than in the current year. The reduction in administration expenditure will not affect the offices of supreme state authorities, audit institutions, law enforcement and the judiciary – expenditures in this area will rise by 15.0%; after adjusting for the expenses

related to the organisation of parliamentary and presidential elections, the increase will amount to 5.9%.

Deficit

10. The predicted cyclically adjusted imbalance of general government in 2005, is significantly worse than the one recorded in 2003, as shown in the table below.

Measures of general government imbalance (in % of GDP)

	2003	2004	2005
Central budget balance	-3.3*	-4.9	-3.7
General government sector balance	-4.6	-6.3	-4.6
Primary balance of the general government sector	-1.5	-3.1	-1.5
Cyclically adjusted balance of general government	-3.8	-5.7	-4.3
Cyclically adjusted primary balance of general government	-0.7	-2.6	-1.2

* The amount has been reduced by the transfer of funds covering contributions transferred to open pension funds, in line with the methodology used since 2004.

Source: NBP estimates.

11. The reduction of the central budget deficit in 2005 will be accompanied by a decrease in negative primary balance, which determines changes in the amount of public debt. Primary deficit will amount to ca. 0.8% of GDP in the next year, i.e. 1.2 percentage points less than in 2004. The NBP points out that achieving a primary surplus in the central budget as soon as possible is essential in order to reverse the rapid upward trend in public debt.
12. According to the draft presented, the net borrowing requirement of the central budget will amount to ca. 46.5 billion zloty in 2005 against 50.8 billion zloty in 2004. The decrease in this category is significantly lower than the drop in budget deficit due to the reduction in projected privatisation receipts in comparison to 2004, higher pre-financing of transfers from the EU as well as a loan extended to public health care establishments. The *Act* draft for 2005 assumes a significant increase in the amount of Treasury bonds issued in the domestic market (by 9.5%).
13. The estimated amount of transfers from structural funds in 2005 (8.8 billion zloty) raises certain doubts. An increase by 3.7 billion zloty over 2004 is achieved due to optimistic assumptions concerning the utilisation ratio of such funds. On the basis of earlier experience concerning the Phare programme and the current status of preparatory work linked to the future

utilisation of structural funds, there are reasons to suppose that the assumed amount of transfers is overestimated.

14. Estimates concerning the utilisation of funds from the Cohesion Fund are also optimistic. It is assumed that 2.1 billion zloty will be transferred in 2005 (to be compared with the estimated amount of 0.6 billion zloty in 2004). The current status of contract preparation within the framework of the ISPA programme (modelled on the Cohesion Fund) indicates a danger that the actual amount of funds received will be much lower.
- As a summary, it may be said that transfers of funds to Poland in 2005 are probably overestimated. This does not refer to the transfers which constitute central budget receipts but to those allocated to other beneficiaries (local government authorities, the private sector).

Dedicated funds

15. In 2005, as a result of the planned phasing out of special funds, apart from including certain such funds in the central budget it is planned to transform the remaining special funds into 13 new dedicated funds (this issue has not yet been formally regulated). From the point of view of the transparency of state finances and control over public funds a better solution would be to include those funds in the central budget as well. The deficit of this group within the general government sector projected for 2005 (ca. 0.5 billion zloty) is also worrying.
16. The assumptions concerning the Social Security Fund and the Farmers' Social Security Fund also raise serious doubts due to:
- a very optimistic collection ratio of social security contributions assumed for 2005;
 - an increase in appropriations for the operations of the Social Security Institution, which must be justified.

Public debt

17. It is assumed that in 2005 public debt together with the risk-weighted value of state guarantees, i.e. calculated according to the methodology currently utilised, will exceed 55% of GDP. The proposed changes in the debt calculation method do not solve the problem of dangerous debt accumulation and an increase in the costs of servicing it. It is necessary to

implement further required reforms of the general government sector in order to achieve fiscal stability and minimize the threat of the public debt exceeding 60% of the GDP.

18. The 2005 forecast of the remaining deficit of the general government sector (excluding the central budget) assumes that this deficit will amount to 7.5 billion zloty (0.8% of GDP), of which around 39% will be caused by the so-called “remaining bodies”, including e.g. health care establishments for which a government institution is a founding or supervisory body, the Polish Academy of Sciences, certain research and development institutions and state-owned cultural establishments. The very rapid increase in the deficit of this group within the sector from ca. 0.4 billion zloty in 2003 to 1.7 billion zloty in 2004 and 2.9 billion zloty in 2005 is worrying. No detailed information is available about the financial standing of individual entities.

19. The amounts of Social Security Fund and Farmers’ Social Security Fund deficits planned for 2005 take into account the consequences of act drafts prepared by the government which affect the financial standing of those funds. The passing of the abovementioned legislation by the Parliament is necessary in order to maintain the deficits of those institutions at the assumed level and thus to avoid an increase in state public debt.