Warsaw, 12 October 2005

Opinion of the Monetary Policy Council

on the Draft *Budget Act for the Year 2006*

I. General comments

The draft *Budget Act for the Year 2006* envisages a central budget deficit of PLN 32.6 billion (3.3% of GDP), as compared with the expected 2005 outturn of PLN 30.8 billion (i.e. 3.3 of GDP). The deficit adopted by the Government could be lower if it was not for the results of some bills passed by the Parliament in the summer which significantly increase the public expenditure.

The presented draft of the *Act* provides for the reduction in the flexible expenditure of the central budget, while the total spending will be significantly raised as a result of the obligation to perform indexation of old-age and disability pensions in 2006 and the necessity to co-finance EU-funded projects. In the assessment of the National Bank of Poland, the higher rate of economic growth expected in 2006 should be an incentive to limit the state budget deficit, mainly through cuts in spending. It has to be pointed out with considerable concern that the above mentioned acts passed in 2005 extend the scope of public expenditure.

The draft accounts for a drop in the general government deficit from 4.5% of GDP in 2005 down to 4.0% of GDP in 2006, which should be seen as difficult to accomplish in view of the risk of deficits of dedicated funds rising above their expected levels. What raises doubts is, among others, whether the assumed drop in expenditure on disability pensions from the Social Security Fund will actually occur despite the scheduled indexation of these benefits. In spite of the fact that a reduction in the public finance sector deficit has been accounted for, the public debt is still going to accrue up to the vicinity of the second prudential threshold, i.e. 54.6% of GDP in 2006.

In order to comply with the deficit reduction obligations accepted under the Convergence Programme it would be necessary to take additional action curbing the deficit. Even though in 2004 the reported general government deficit as calculated using ESA 95 methodology reached a much lower level than it had been planned, this was largely the result of one-off factors which caused a favourable disparity between the deficit in cash terms and the deficit in accrual terms. These factors will most probably not occur in 2005 and 2006[1] and if they do, their scale will be definitely smaller. Thus, achieving ESA 95 deficit at the level of 3.4% of GDP in 2005 and 2.8% of GDP in 2006 is going to be a serious challenge.

In order to consolidate the foundations of long-term economic growth, comply with the obligations following from the *Treaty establishing the European Communities* and to bring the public debt down to the level that would eliminate the risk of breaching the constitutional ceiling, it is necessary to implement broad systemic reforms that would decisively limit the structural deficit of the public finance sector. Due to the high tax burden, in particular on the income from work, the reform should focus on curbing public expenditure. Moreover, if such public finance reforms are implemented fast and efficiently, this would allow Poland to adopt the common European currency and the Polish economy to take full advantage of the involved opportunities of development.

II. Macroeconomic assumptions

1. The 2006 budget is based on two fundamental assumptions:
   - the increase in the average annual consumer price index will be 1.5%,
   - the gross domestic product will rise by 4.3%.

   The forecasts for GDP and inflation growth accounted for in the draft budget bill are consistent with NBP forecasts. The assumed level of inflation for 2006 fits in the range of NBP forecasts and within the tolerance band for deviations around the inflation target. The forecast of economic growth assumed by the Ministry of Finance should be assessed as realistic.

[1] The sizeable disparity between the deficit in cash and accrual terms in 2004 was to a large extent the result of two factors connected with Poland's accession to the European Union and only visible in the first year of membership, i.e. the shifting of some VAT revenue from December 2004 to January 2005 and the delay in the payment of direct subsidies to farmers from the domestic budget.

III. Public finances in 2006

Receipts

2. According to the presented draft *Budget Act*, general government revenue should be, in nominal terms, 6.3% higher[2] in 2006 than in the present year, which means an increase of 4.7% in real terms. Central budget receipts will rise by 6.9% in nominal terms and by 5.4% in real terms[3]. The ratio of general government revenue to GDP will be 42.4%, against the projected performance of 42.1% in 2005. The amount of central budget receipts projected for 2006 is a consequence of the assumptions concerning the economic growth, average annual inflation rate and the planned systemic changes in the tax on goods and services and excise tax. In the NBP's assessment the forecast tax, and particularly VAT, receipts will be rather difficult to achieve. The draft *Act* envisages as much as PLN 5 billion in additional revenue arising from the increased effective VAT rate combined with better collection ratio, without mentioning any solutions that would ensure better tax enforcement. It is worth pointing out here that a rise in VAT collection ratio had also been taken for granted in the budget acts for 2003 and 2004, yet the expected results were not actually achieved.

3. The draft *Act* assumes that no fundamental changes regarding personal income tax will be introduced. However, the fact that tax thresholds will remain frozen implies heavier tax burdens on persons who are raising their income and thus will result in increased tax progression in this group of taxpayers.

4. In the background document to the *Budget Act for the Year 2006* there is no information on the rise in excise tax for gasoline that is planned for 2006 in the view of the currently lowered excise rate (the planned rise in 2006, as mentioned in the background document, refers to the excise rate as it was before the reduction, i.e. before 15 September 2005). In the case the excise rate for gasoline is returned to its level before the reduction and increased at the same time, in line with the background document

[2] A methodological change has been introduced into the draft consisting in the way central budget and general government expenditure is expressed. In 2006 the amounts were increased by the pre-financing of funds from the EU, which came to approx. PLN 2.1 billion. In comparable terms the rise in the general government receipts between 2005 and 2006 will amount to 5.7% in nominal terms and 4.2% in real terms.

[3] In comparable terms the rise in the central budget receipts between 2005 and 2006 will amount to 5.8% in nominal terms and 4.2% in real terms.

(Table 3), its rise and thus the resultant one-off inflationary effect may be stronger than if it resulted solely from the planned excise tax increase.

5. The profit accounted for in the *Financial Plan of the NBP for the Year 2005* amounts to PLN 475.8 million. This means that the amount of profit of the NBP transferred to the central budget in 2006 will be equal to PLN 452.0 million. This is also the amount that was included in the 2006 budget draft.

   The decrease in the planned net earnings in 2005 – as compared to the previous years – primarily results from the harmonisation of NBP accounting principles with the guidelines of the European Central Bank and the impact of non-permanent factors in 2000-2004, which increased the net earnings in that period, such as a change in NBP accounting principles, income from depreciation adjustments, positive exchange rate differences and favourable economic indicators. In adjustment for these factors, the forecast net earnings of the NBP for 2005 roughly correspond to the results achieved in the second half of 1990s.

   The NBP accounting principles, which have been in force since 1 January 2004, require current market appraisal of the value of assets. This is conducive to a high vulnerability of net earnings to the shifts in market interest rates and exchange rates.

Expenditure

6. The implementation of the *Budget Act* in its current state implies a rise in the public sector finance of 5.1% in nominal terms[4] and approx. 3.5% in real terms. In turn, central budget expenditure will rise by 6.8% in nominal terms[5] and by approx. 5.2% in real terms. In 2006, the ratio of general government sector expenditure to GDP will decrease by 0.2 percentage point in relation to 2005. However, the level of central budget expenditure (22.9% of GDP) and the entire general government sector expenditure (46.4% of GDP) remains high and detrimental from the point of view of long-term economic growth, as it implies a heavy tax burden. Among countries at a similar level of economic development, Poland stands out not only on account of the high level of public

[4] In comparable terms, in 2006 the year-on-year rise in general government expenditure will amount to 4.6% and 3.1%, in nominal and real terms, respectively.

spending but also because of its unfavourable structure, which is dominated by social expenses.

7. The proportion of legally determined expenditure in total expenditure (73.3%) will increase in 2006. This is 1.7 percentage point more than in 2005. The reasons for its rise include increased subsidies to the FUS (Social Security Fund) and KRUS (Agricultural Social Insurance Fund), an increase in public debt servicing costs, higher expenditure on national defence, increased subsidies for local governments and also the inclusion in the central budget of expenditure on pre-financing payments from EU funds. The significant growth in subsidies for FUS and KRUS as well as a high increase of total social spending (8.4%) mainly result from a two-year accumulation of the indexation of old-age and disability pensions. The budget draft also implies a high growth rate in capital expenditure, which, however, largely results from including in the budget the expenditure financed from structural and Cohesion funds.

8. The budget draft expects a rise in spending on public administration of 3.8% in nominal terms (2.3% in real terms). This means that no further action is intended to cut the operating cost of public administration, which used to be one of the main postulates of the *Public Expenditure Reform and Reduction Programme*.

Deficit

9. Setting the state budget deficit at the level of 3.3% of GDP in 2006 is a result of an optimistic forecast of central budget revenue (mainly from indirect taxes), and on the other hand, of reducing the subsidies to the Social Security Fund, Scholarship Fund, and expenses on the National Housing Fund. This creates the risk of an increase in overdue liabilities in the coming years.

10. The stabilisation of the central budget balance in 2006 is accompanied with a small decrease in negative primary balance. The primary deficit will amount to approx. 0.4% of GDP next year, i.e. 0.1 percentage point less than in 2005. The NBP points out that a

[5] In comparable terms, in 2006 the year-on-year rise in state budget expenditure will amount to 5.6% and 4.0%,

quick achievement of a primary surplus in the central budget is essential in order to reverse the upward trend in public debt.

Forecast measures of public finance imbalance in cash terms from the background document to the draft *Budget Act* (% of GDP)

	2004	2005	2006	2007
Central budget balance	-4.7	-3.3	-3.3	
General government sector balance	-5.0	-4.5	-4.0	-2.7
Primary balance of the general government sector	-2.2	-1.3	-0.8	+0.3
Cyclically adjusted balance of general government *	**-4.5**	**-3.8**	**-3.5**	**-2.4**
Cyclically adjusted primary balance of general government *	-1.8	-0.6	-0.3	+0.6
General government balance according to ESA 95 (Open Pension Funds included)	-3.9	-3.4	-2.8	-2.0
General government balance according to ESA 95 (Open Pension Funds excluded)	-6.0	-5.4	-4.8	-3.9

* NBP estimates[6]

11. The tightening of fiscal policy planned for 2006, which is evidenced by the expected reduction in the deficit in cyclically adjusted terms, will be effected through decreasing the deficit of the remaining general government sector entities. The assumed deficit reduction in these units from PLN 0.6 billion in 2005 down to PLN 6.3 billion next year, may prove rather difficult to achieve, just like it was the case in the 2005 budget act[7].

12. Similarly to the general government deficit in cash terms, the forecasts of general government deficit according to ESA 95 seem to be difficult to achieve. This is primarily the result of the assumed level of dedicated fund deficit, and also of the adopted methodological changes adjusting the cash deficit to the accrual terms.

13. The estimated amount of transfers (expenditure) from structural funds and the Cohesion Fund in 2006 raises certain doubts: transfers of PLN 8.5 billion and PLN 3.3 billion, respectively (Appendix 16, Table 2). Data on the first eight months of 2005 indicate that Poland only managed to absorb 26% of the amount from structural funds planned in the 2005 budget act, and as little as 14% of Cohesion funds, while the amount of these funds

in nominal and real terms, respectively.

[6] Cyclically adjusted balance was estimated using the NBP estimates of output gap and budget balance elasticity vis-à-vis the cycle, which amounts to 0.4. This elasticity was estimated in NBP studies and is consistent with the value estimated by the OECD – 0.44.

[7] In the 2005 *Budget Act* it was assumed that the deficit of other general government sector entities would be PLN 7.5 billion, while the expected implementation is actually higher by PLN 3.1 billion.

accounted for in the 2006 budget bill is very close to that envisaged for 2005. Thus, it can be feared that the assumed level of transfers is overestimated. This does not refer to funds received under the Common Agricultural Policy or transfers which belong under the income of the central budget, but only to transfers allocated for other beneficiaries (local governments, private sector).

Dedicated funds

14. The Social Security Fund will most probably record a considerable deficit in 2005, which is mainly due to lower than anticipated own income, largely resulting from the fact that the Parliament has rejected bills intended to increase revenues in this respect. In 2005 the spending of the Social Security Fund will rise considerably in connection to the requirement to carry out the indexation of old-age and disability pensions. In this context, it is rather doubtful whether the expenses on pensions paid from the disability pension fund[8] will indeed be brought down, as scheduled by the Fund. The background document to the draft *Budget Act* does not offer any explanation as to this assumption. However, even if such a low level of the Fund's expenditure could be accepted, its deficit in cash terms in 2006 is to reach PLN 1.6 billion, which means an undervaluation of the subsidy from the state budget.

15. In 2006, a deficit is envisaged in the so-called special funds (created with the liquidation of special resources). Despite the postulates to dissolve special resources and then special funds and include them under central budget assets, the draft envisages the operation of new funds (Commission of National Education Fund, National Fund for Technological Credit). This had been provided for by applicable acts adopted by the Parliament on 29 July 2005.

Public debt

[8] In 2005, with no indexation, they are expected to fall by approx. PLN 0.4 billion. When the indexation is effected in 2006 the drop is expected to reach as much as PLN 0.9 billion. The implementation of this secenario would involve a structural change in the number of benficiaries, which, however, is not accounted for in the draft *Act.*

16. It is assumed that as at the end of 2006 the public debt together with the risk-weighted value of state guarantees will amount to 54.6 % of GDP and so will come dangerously close to the second prudential threshold. The anticipated increase in debt (by 2.6 percentage points of the GDP) primarily stems from the amount of the state budget credit needs, in the face of limited receipts from privatisation.

17. It is expected that in 2006 the financial strategy related to the state budget borrowing requirement, regarding the use of funds coming from foreign sources, will change significantly. Namely, it is foreseen that a part of these funds will be allocated to finance the central budget's zloty expenditure. The proposed change entails serious economic consequences. As compared with the current strategy, it causes an increase in foreign currency debt and also its share in the total amount of the public debt. Under the conditions of the observed volatility of zloty exchange rate, the risk of instability of the ratio of public debt to GDP increases.

    The MPC would also like to emphasise that the use of currencies coming from foreign issues not only to service foreign debt, but also to finance state budget current expenses by selling them in the market, would disrupt the system of the floating exchange rate. The sale of foreign currencies in the market would strengthen the exchange rate and also strengthen market expectations of its further appreciation. The overall result of such activities would be unfavourable for the economy. The sale of currencies in the market by the Ministry of Finance in 2005 coupled with the announcement of its intention to continue this practice contributes to the strengthening of the zloty exchange rate.

    Meanwhile, selling currencies to the National Bank of Poland would lead to the increase in excess liquidity and – as a result – to the increase of open market operation costs and to the decrease of the NBP profit payable to the central budget.