

## **Opinion**

### **on the Own Amendment to Draft *Budget Act for the Year 2006***

#### **I. General comments**

The *Own Amendment to the draft Budget Act for the year 2006* assumes a central budget deficit of PLN 30.5 billion (i.e. 3.1% of GDP), i.e. PLN 2.1 billion less than the figure adopted in the draft budget act for 2006 presented in September 2005. The reduction in the central budget deficit was achieved through increasing central budget revenues (by PLN 2.9 billion) with a parallel increase in expenditure (by PLN 0.8 billion). In the opinion on the initial draft of the Act, the Monetary Policy Council indicated probable risks for the performance of forecast-based central budget revenues in 2006. The *Own Amendment* assumes even higher revenues while macroeconomic assumptions remain unchanged and no essential systemic changes have been introduced on the revenue side of the budget.

The Monetary Policy Council maintains its opinion that Poland's following the path of a fast long-term economic growth requires actions limiting the structural deficit of the public finance sector. Due to the high tax burden, in particular on the income from work, such actions should focus on curbing public expenditure. In addition, if public finance reforms are implemented rapidly and effectively, Poland will be able to meet the criteria of nominal convergence entitling it to join the euro area and enabling the Polish economy to take full advantage of the underlying growth opportunities.

It is unclear whether the fact that the *Own Amendment* lacks information about the situation of the public finance sector as a whole and makes no reference to the fiscal policy strategy for the next three years means that the forecast presented in the previous draft act has been maintained.

## II. Comments maintained from the previous opinion

The *Own Amendment* is convergent on a number of issues with the draft *Budget Act* presented in September 2005. The Monetary Policy Council maintains the earlier comments to these aspects of the budget.

1. The structure of the *Own Amendment to the draft Budget Act for the year 2006* is based on the assumed increase in the average annual consumer price index of 1.5% and the gross domestic product rise by 4.3%. The forecasts of GDP and inflation growth accounted for in the draft budget act are consistent with the NBP forecasts.
2. According to the *Budget Act*, its execution in the presented form will be connected with an increase in public debt. Despite a recent revision of national accounts by the Central Statistical Office, which brought the public debt-to-GDP ratio below 50%, the risk of exceeding the regulatory prudential threshold in the coming years remains real. In spite of the forecast of a good macroeconomic situation in 2006, the primary balance of the state budget, which significantly determines the public debt, will, for a subsequent time – from 1999 – be negative.
3. The initial draft of the budget act assumed a doubtful increase in budgetary revenues from increased tax collection. The draft of the *Own Amendment* is also based on the assumption of “better performance of the fiscal authority”.
4. The level of government sector expenditure at 46.4% of GDP assumed in the initial draft of the act<sup>1</sup> continues to be high and disadvantageous from the point of view of long-term economic growth as it leads to a high tax burden. Among countries with a comparable level of economic development Poland stands out both in terms of high level of public expenditure and its disadvantageous structure, in which the dominant role is played by social expenditure.
5. The original draft *Budget Act* assumes further growth of contribution of legally determined expenditure in the total central budget expenditure to the level of 73.3% against 71.6% in 2005. The presented *Own Amendment* results in even higher increase

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<sup>1</sup> As mentioned at the beginning, the *Own Amendment* does not comprise information about the forecast revenues and expenditure of the public finance sector but in connection with the increase in government expenditure assumed in the *Own Amendment* there are no premises to expect that the level of public finance expenditure will be lower than the level assumed in the initial draft of *Budget Act*.

of this ratio due to the extension of certain legally determined categories of expenditure (subsidy to FUS – the Social Security Fund) and the announced enactment of certain acts introducing new categories of such expenditure (additional financing of agricultural fuel).

6. The fact that personal income tax thresholds will remain frozen implies heavier tax burdens on persons who are increasing their income.
7. The *Own Amendment* provides for further increase of foreign financing as compared to the original draft *Budget Act* (by PLN 0.5 billion). The Monetary Policy Council maintains its opinion that financing of the central budget expenditure in PLN with funds generated from foreign debt issue, assumed for 2006, will negatively affect the economy. In view of the observed volatility of the zloty exchange rate, higher share of foreign debt in the total amount of public debt increases the risk of instability of public debt-to-GDP ratio. The Monetary Policy Council would also like to emphasise that the use of currencies coming from foreign issues not only to service foreign debt, but also to finance central budget current expenditure by selling them on the market, disrupts the floating exchange rate regime. The sale of foreign currencies on the market in 2005 by the Ministry of Finance coupled with the announcement of the Ministry's intention to continue this practice contributes to the strengthening of the zloty exchange rate. In turn, selling currencies to the National Bank of Poland would lead to an increase in excess liquidity and – as a result – higher open market operation costs and a decrease in NBP profit payable to the central budget.

### **III. Comments to the changes introduced by *the Own Amendment***

8. According to *the Own Amendment*, general government receipts from Value Added Tax should reach the level of PLN 84.8 billion against PLN 82.5 billion assumed in the original draft *Budget Act*. Justification of this forecast makes reference to the higher growth rate of sales in construction industry resulting from the implementation of the program of social housing construction. VAT receipts in 2006 exceeding the level accounted for in the draft *Budget Act* may be achieved as a result of shifting VAT receipts from December 2005 to January 2006. Such operations reduce transparency of public finance and do not contribute to any permanent improvement in the public

finance situation. Doubts are also raised by the presented justification of PLN 0.5 billion growth of the general government receipts from personal income tax.

9. An important change as compared to the original draft *Budget Act* is the proposed reduction by PLN 497 million in subsidies to the State Fund for Rehabilitation of Disabled Persons (PFRON). Reduction in subsidies to PFRON requires statutory amendments since under art. 46a of the Act on Professional and Social Rehabilitation and Employment of Disabled Persons, PFRON is granted a specific subsidy from the general government budget to support the financing of remuneration paid to disabled persons in the amount allowing to implement the task. (by approx. PLN 1 billion annually). Since 2006 there have been proposals to limit the extent of financing of this task from the general government funds<sup>2</sup> through introducing the provision under which 75% of funds for the task implementation would come from PFRON. Adoption of such a solution would reduce the rigidity of the general government expenditure.
10. General government expenditure would be increased in *the Own Amendment* by a number of new categories of legally determined expenditure. Their increase will hinder the narrowing of the budget deficit in future. In the category of expenditure broken into basic economic groups, changes proposed in *the Own Amendment* increase subsidies (from 7.4% of GDP to 7.5% of GDP) and current expenditure of general government entities (from 4.8% of GDP to 4.9% of GDP). The latter means increased expenditure on financing the operating costs of public administration.
11. *The Own Amendment* assumes that 2006 will see a significant rise in EU transfers to Poland, resulting mainly from increased implementation of programs financed with EU structural funds and projects financed from the Cohesion Fund as well as completion of pre-accession programs. It assumes higher absorption of EU funds (by 132.1% as compared with the 2005 projected level, to PLN 9.1 billion). Implementation of this task requires definite changes aimed to facilitate the spending of funds received from the above sources and ensure adequate funds for co-financing.

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<sup>2</sup> By 75% as compared with the current legal situation and 30 p.p. as compared with the situation in 2004 and 2006. Under art. 68a of the Act on Professional and Social Rehabilitation and Employment of Disabled Persons, in 2004 and 2005 this task could be financed with PFRON funds, in addition to specific subsidy from the general government budget up to 45% of funds allowing the task implementation.