NBP

National Bank of Poland
Monetary Policy Council

Warsaw, 6 October 2006

Opinion of the Monetary Policy Council on the Draft *Budget Act for the Year 2007*

General comments

1. The submitted draft of the *Budget Act for the Year 2007* anticipates the central budget's revenue at the level of PLN 226.8 billion, expenditure at PLN 256.8 billion and deficit at PLN 30 billion. In turn, general government receipts are expected to reach the level of PLN 458.6 billion and expenditure the level of PLN 485.4 billion with the general government deficit at PLN 26.9 billion, which means that, at the assumption of real GDP of 4.6%, the relations between these values will be as follows:

	2005	2006	2007	2005	2006	2007
	PLN billion			*% of GDP*		
Central budget revenue	179.8	196.5	226.8	18.3	19.0	20.6
Central budget expenditure	208.1	225.8	256.8	21.2	21.8	23.4
Central budget balance	-28.4	-29.3	-30.0	-2.9	-2.8	-2.7
General government revenue	384.5	416.6	458.6	39.2	40.2	41.7
General government expenditure	410.0	445.2	485.4	41.8	43.0	44.1
General government balance	-25.5	-28.7	-26.9	-2.6	-2.8	-2.4

Source: The background document to the draft *Budget Act for the Year 2007* (not adjusted for the impact of including EU funds under receipts and expenses in 2007)

2. The factor determining the shape of the *Budget Act for the Year 2007* is fast growth of central budget expenditure, which in nominal terms amounts to 8.4%.[1] This growth means that the total growth rate of general government expenditure will be high enough (at 6.3% in nominal terms, 4.3% in real terms) to cause a rise in the ratio of government spending to GDP (from 42.7% to 42.8%). Public spending will remain high, in spite of the fast rate of economic growth, creating

[1] Unless otherwise indicated, the calculations were performed in comparable terms, i.e. adjusting the revenue and expenditure of the central budget and general government sector in 2007 for the impact of including EU funds.

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favourable conditions for expenditure reduction. The ratio of general government revenue to GDP will rise from 40.0% to 40.4%, while the ratio of central budget receipts to GDP – from 18.7% to 19.3%. Thus, the fiscal burden on the economy will increase.

3. In the draft *Act* a slight drop has been envisaged in the ratio of central budget deficit (from 2.8% of GDP in 2006 to 2.7% in 2007), and also a decrease in the deficit of the whole public finance sector from 2.8% down to 2.4% of GDP, which is the result of adopting an optimistic assumption of a rising surplus in other than the central budget units of the government sector.

Public finance sector situation in 2005-2007
(cash data, excluding the costs of pension reform)

(% of GDP)	2005	2006	2007
General government balance	-2.6	-2.8	-2.4
Interest payments	2.7	2.9	2.7
Primary balance	0.1	0.1	0.3
Structural balance	-1.6	-2.1	-2.0
Primary structural balance	1.1	0.8	0.7
Public debt	47.7	49.2	50.6

Source: The background document to the *Budget Act for the Year 2007*, structural balance – NBP estimates

4. A fundamental consequence of the rapid growth of general government spending accompanied by a lack of a substantial reduction of the deficit will be the perpetuation of the sector's borrowing requirement at a high level. This is tantamount to the continuation of an unfavourable rising trend of the public debt, whose relation to GDP is expected to rise, according to the *Act*, from 49.2% in 2006 to 50.6% in 2007 and so is bound to exceed the first prudential threshold specified in the Public Finance Act. If the high rate of economic growth is sustained, as assumed in the *Public Debt Management Strategy for 2007-2009*, it can be expected that in the nearest years the relation of debt to GDP will be gradually stabilising at the level of 50%-51% of GDP. On the other hand, if the GDP growth rate were to decelerate – which cannot be ruled out – then, even with interest rates at the level assumed in the draft *Act*, this relation would rise. This could lead to serious fiscal tensions, especially if the ratio of the public debt were to exceed 55% of GDP, which is the second prudential threshold specified in the Public Finance Act. In such a situation it would be necessary to undertake drastic corrective measures provided for in this act.

5. The background document to the draft *Budget Act* stipulates that the primary balance[2] of the general government will only improve by 0.2 percentage point of GDP. According to NBP

[2] The primary balance of the central budget or general government sector stands for the budget balance after deducting interest payments. The primary balance is a key variable for the analysis of future dynamics of public debt.

estimates, this improvement will result exclusively from the beneficial impact of the business cycle, while the primary structural balance[3] will deteriorate in 2007 by approx. 0.1 percentage point of GDP. The worsening of the primary structural balance of the public finance sector in the situation of high economic growth means that the fiscal policy may be exerting a procyclical impact on the economy.

6. Additionally, the lack of improvement in the primary structural balance of the public finance sector means Poland's non-compliance with European fiscal rules. As an EU Member State currently subject to an Excessive Deficit Procedure, Poland should correct its primary structural balance of the public finance sector by at least 0.5 percentage points of GDP every year. 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 significantly reduce the structural deficit of the public finance sector. In view of the heavy tax burden, these steps should focus on containing 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 ensuing growth opportunities.

Macroeconomic assumptions

7. The 2007 budget is based on two fundamental assumptions:
   - the gross domestic product will rise by 4.6%,
   - the average annual consumer price index will increase by 1.9%.

   GDP and inflation growth forecasts accounted for in the draft *Budget Act for the Year 2007* fit within the range of the forecasts of the National Bank of Poland.

General government revenue

8. According to the presented draft *Budget Act*, general government revenue should be, in nominal terms, 7.2% higher in 2007 than in 2006, which means a rise of 5.2% in real terms. Central

[3] The structural balance of the public finance sector stands for the balance adjusted for the impact of business cycle, which in the periods of favourable economic climate has a positive effect on tax revenue and decreases the expenditure on some social benefits, and during recession brings about a drop in receipts and increase in spending, thus contributing to increased deficit. By eliminating the impact of the business cycle it is possible to assess how the deficit is directly affected by fiscal authorities' decisions. The change in the primary structural balance, additionally adjusted for the impact of changes at the level of debt servicing, is a commonly used measure of change in the fiscal stance, i.e. its loosening or tightening.

budget receipts will rise by 9.3% in nominal terms and by 7.3% in real terms. The ratio of general government revenue to GDP is expected to reach 40.4% (41.7% of GDP including EU funds) against the projected performance of 40.0% in 2006 (40.2% including EU funds). Attention should also be drawn to the rise in fiscal burden due to taxes and social security contributions, which in line with the draft *Act* will increase by approx. 0.8 percentage points of GDP from 31.6% in 2006 to 32.4% in 2007.[4]

9. The forecast of tax revenue of the central budget for 2007 presented in the draft *Act* should be considered optimistic, particularly as regards the receipts from the tax on goods and services (VAT). The high growth rate of VAT revenue (a rise of 11.4% in nominal terms and of 9.3% in real terms) may be only partly explained by the assumed microeconomic situation (the real growth in total consumption at 3.7%, average annual growth in the prices of consumer goods and services at 1.9%) and by the legislative changes planned for this tax.

10. In the draft *Act* (both in the Appendix 1 on page 1/1 and in the background document to the draft *Act* on pages 44 and 45) the NBP profit transfer in 2007 has been envisaged at the level of PLN 1,974.2 million. The *Financial Plan of the National Bank of Poland for 2006* adopted on 20 December 2005 assumes the earnings of the central bank in the amount of PLN 1,657.1 million, which means that the forecast amount of NBP profit transfer to the central budget in 2007 equals PLN 1,574.3 million. However, the revenue of the NBP, which mainly derives from the revenue from foreign currency reserves, is sensitive to foreign exchange rate and interest rate fluctuations in the international financial market and so the actual realisation of profit may diverge from the planned value. It will only be possible to determine the amount of the NBP's profit transfer more precisely when the year 2006 is over.

General government expenditure

11. The implementation of the *Budget Act* in its current state implies a rise in the public finance sector's expenditure of 6.3% in nominal terms and approx. 4.3% in real terms. In turn, central budget expenditure rises by 8.4% in nominal and by approx. 6.4% in real terms. In 2007, the

[4] This calculation, however, raises certain doubts, as it seems that the contributions usually considered to be a kind of taxation, such as contributions to the Labour Fund, have not been included under social security contributions. According to Eurostat data, Poland's revenue from taxes and contributions in 2005 amounted to 34.8% of GDP, while the background document to the draft suggests that this value was merely 30.4%. This discrepancy is not explained by a potentially different treatment of contributions to Open Pension Funds, which accounted for approx. 1.3% of GDP.

ratio of general government sector expenditure to GDP will increase by 0.1 percentage point (in comparable terms) as compared to 2006. Thus, the level of central budget expenditure (22.0% of GDP and 23.4% of GDP if EU funds are included) and the spending of the entire general government sector (42.8% of GDP and 44.1% of GDP including EU funds) will remain high and detrimental from the point of view of long-term economic growth, as it necessitates a heavy tax burden. For the first time since 2001 central budget spending is expected to increase at a significantly faster rate than the potential and forecast rate of economic growth accounted for in the draft budget structure. The Polish economy is currently at the stage of a dynamic economic growth, which should be taken as an opportunity to contain the excessive deficit of the general government by reducing the ratio of spending to GDP.

12. In view of the presented draft *Budget Act* Poland will still be characterised by an unfavourable structure of central budget expenditure. In 2007 the legally determined expenditure will account for 73.1% of total expenses scheduled for 2007, compared with 73.0% in 2006.

13. Important reservations are raised by the expenditure of other (than the central budget) units of the public finance sector, as envisaged in the draft. The draft suggests that in 2007 these expenses are expected to increase at the rate of approx. 4.2%, while the same rate in 2006 was more than twice as fast (9.5%). Such a slow rate of expenditure growth may partly result from the adoption in the forecast of a different amount of expenditure than that following from the financial plans attached to the draft *Budget Act for the Year 2007*, an issue which was pointed out in the background document to the draft budget bill, in the chapter on the public finance sector. The justification offered for this was that in the past some general government units had planned significantly higher expenditure than was actually spent subsequently. However, it is worth pointing out that at least in the last two years this might have resulted from a considerably lower than expected rate of EU fund utilisation. This factor does not have to repeat in 2007. A higher expenditure level in non-central-budget units of the public finance sector than that envisaged in the draft would mean that the rise of expenditure of the whole sector would be higher than accounted for in the draft *Act* (6.3%).

14. There is an inconsistency between the legislative proposal of the Government concerning the changes in the system of old-age and disability pension indexation on the one hand, and parallel provisions of the draft *Budget Act* on the other. In the former document the indexation of old-age and disability pensions has been assumed at the level of 102.0%, in the latter at 101.4%. Moreover, the draft *Act* assumes raising the amount on which the benefits of the so-called “old portfolio” were based, up to the level of 94.5% of the average wage, while in the draft of the act regulating this issue the amount equalled 98%. If the Parliament passed the Government's proposals for the amendments of the act on old-age and disability pensions paid from the Social Security Fund and some other acts, then the expenditure of the Social Security Fund on pensions and other benefits of the so-called "old portfolio" envisaged in the draft *Act* would prove underestimated (by approx. PLN 2 billion).

Public finance sector deficit and public debt

15. Maintaining the central budget deficit at the level of PLN 30 billion in 2007 means that the primary balance will not improve. The primary balance of the central budget will remain negative next year at approx. 0.2% of GDP, i.e. a similar level to that recorded in 2006. The NBP points out that a quick achievement of a primary surplus in the central budget is a necessary condition to halt the upward trend of the public debt and to its reduction in the future.

16. As a consequence of the assumptions described in Point 7 concerning a low growth rate of spending by other than the central budget general government units, their financial performance in 2007 is to improve significantly as compared to 2006. This improvement, however, raises certain doubts in view of the expected further acceleration in EU funds' utilisation, which will require increased outlays for their co-financing, among others, by local governments.

17. Due to the above mentioned reservations, the analysis of the structural deficit of the general government sector has been prepared in two versions. The starting point for the first variant is the forecast of general government deficit presented in the draft *Act*. In the alternative variant it has been assumed that in 2006-2008 that the surplus of non-central-budget units of the public finance sector will not grow, but that their budgets will be balanced. In this variant, the balance of the general government is thus equal to the balance of the state budget.

Cash and structural balance* of the public finance sector without costs of old-age pension reform

	2004	2005	2006	2007	2008
Variant of increasing budget surplus of other units					
General government balance (billion zloty)	-41.9	-25.6	-28.7	-26.9	-25.9
General government balance (% of GDP)	-4.5	-2.6	-2.8	-2.4	-2.2
Structural balance (% of GDP)	-3.6	-1.6	-2.1	-2.0	-2.0
Primary structural balance (% of GDP)	-1.0	1.1	0.8	0.7	0.7
Variant of balanced budgets of other units					
General government balance (billion zloty)	-41.9	-25.6	-29.3	-30.0	-30.0
General government balance (% of GDP)	-4.5	-2.6	-2.8	-2.7	-2.5
Structural balance (% of GDP)	-3.6	-1.6	-2.2	-2.3	-2.4
Primary structural balance (% of GDP)	-1.0	1.1	0.7	0.4	0.4

* Structural balance is calculated with OECD method, with the use of OECD-estimated Poland's budget balance elasticity in relation to the economic cycle at the level of 0.44.

As shown in the Table above, even in the rather optimistic variant adopted in the draft assuming an increase in the surpluses of other than the central budget units of the public finance sector, the primary structural balance of the general government sector will deteriorate in 2007 by 0.1 percentage point of GDP. By contrast, in the variant assuming the maintenance of a zero balance in other units of the sector, the primary structural balance will worsen by 0.3 percentage point of GDP. These values indicate that 2007 will see some loosening of the fiscal policy. In the situation of a fast economic growth this means that the fiscal policy may have a procyclical impact on the economy.

18. At the end of 2007 it is expected that the public debt will amount to 50.6% of GDP and thus exceed the first prudential threshold (50% of GDP). The anticipated increase in debt (by 1.4 percentage points of the GDP) primarily stems from the size of the central budget's borrowing requirement.

19. In the draft *Act* it was assumed that the receipts from privatisation in 2007 will be approx. PLN 3.0 billion, i.e. three times as much as the performance expected in 2006. The low realisation of revenue from privatisation in 2006 raises doubts whether the assumed amount of privatisation revenue will also be achieved in 2007 and a failure in this respect would increase the borrowing requirement of the central budget as written in the draft *Budget Act*.

20. In line with the draft *Budget Act* the year 2007 is expected to bring, apart from the increase in the public debt, also a substantial growth (of 35.5%) in the potential liabilities due to guarantees granted by the Treasury. This poses additional threat of increased public debt in the future.

Funds from the EU budget

21. According to the drafted amendment of the act on public finance, which has not been adopted by the Parliament yet, the proposed draft of the *Budget Act* accounts for the inclusion of all funds flowing from the EU budget under the central budget's revenue and expenditure. The way of introducing this change raises reservations as not being sufficiently transparent. The economic classification of central budget expenditure has been expanded with the category "Financing projects with participation of EU funds". The category joins together the spending financed from EU funds with the expenses financed from the resources of the central budget.

Therefore, the draft budget fails to make it clear what part of expenses in particular areas will be financed with domestic funds, and what with EU funds.

Reservations are also raised by the following inconsistency: the planned revenue of the central budget fails to include the first tranche (approx. PLN 5.5 billion) of the advance payment that Poland is to receive in 2007 for projects implemented in the framework of structural funds from the new Financial Perspective 2007-2013. This issue is discussed in the background document to the draft *Act* (Chapter 4, Settlements with the EU, p. 266 and 269).

22. Some doubts are raised by the value estimated for 2007 of this part of central budget revenue that comes from the EU budget (PLN 14.7 billion). In particular, these reservations concern the planned amount of revenue at PLN 7.2 billion, which is to be obtained as a refund of the outlays for the implementation of projects financed from structural funds and the cohesion fund. On the basis of the level of structural funds' utilisation by ultimate beneficiaries recorded since the accession to the EU (PLN 5.9 billion, i.e. 16.9% of the funds granted for 2004-2006) it may be feared that the assumed level of transfers from the EU, and thus the assumed level of central budget revenue, is in fact overestimated.

23. Moreover, the inclusion of EU funds under revenues and expenditure accounted for on a cash basis may have the effect of the deficit level being distorted by differences in time between the inflow of EU funds and the realisation of expenses financed with them. Such short-term distortions will impede the analysis and assessment of the actual level of the deficit.

24. The inclusion of all EU funds under central budget revenue and expenditure results in a discrepancy between the way these funds are shown in domestic reporting and ESA'95 methodology. This discrepancy applies to the EU funds received by entities outside the public finance sector, such as direct subsidies for farmers. In line with the 2005 decision of the Eurostat, such funds are not registered in non-financial accounts (revenue and expenditure of the public finance sector), but rather in financial accounts. As a result, for the purpose of Poland's preparation of statistics on an ESA'95 basis it will be necessary to exclude this part of assets from budget revenue and expenditure and put them "below the line".