



N a t i o n a l B a n k o f P o l a n d
M o n e t a r y P o l i c y C o u n c i l

Warsaw, 30 October 2007

**Opinion of the Monetary Policy Council
on the Draft *Budget Act for the Year 2008***

The submitted draft of the *Budget Act for the Year 2008* will be implemented against the background of rapid growth of the Polish economy and a significant reduction of the tax burden on labour income, resulting from bills passed by the Parliament. Moderate growth in expenditure envisaged in the Draft *Act* and fast economic growth will lead to a decline in the ratio of public spending to GDP. However, the magnitude of adopted cuts in social contributions and taxes is so large, that in 2008 the central budget deficit is expected to rise in relation to GDP, despite favourable macroeconomic conditions. This entails the risk of a deepening imbalance of the whole general government, and, as a result, an increase of its structural deficit. In an environment of high economic growth this would lead to a procyclical impact of fiscal policy on the economy. Moreover, the sector's borrowing requirement will increase, causing a rise in the ratio of public debt to GDP, despite the fast economic growth.

I. General remarks

1. In line with the macroeconomic assumptions of the submitted Draft *Budget Act*, which do not significantly deviate from the NBP's forecasts, 2008 will see further rapid growth of the Polish economy, exerting a favourable impact on public finances. There are expectations of a dynamic rise in tax revenues and a drop of these components of social spending, which directly depend on the financial condition of households.

ul.Świętokrzyska 11/21, 00-919 Warszawa Poland phone (48 22) 826 37 60,
fax (48 22) 826 99 35
telex 814 681 nbp.pl

2. Another major factor, apart from macroeconomic conditions, determining the shape of the submitted Draft *Act* are the bills passed this year which will considerably reduce the tax burden on labour income. In June 2007 the Parliament decided to reduce the disability insurance contribution by a total of 7 percentage points of income, and at the beginning of September 2007 to significantly increase child allowance in personal income tax. The reduction of the disability insurance contribution should have a positive impact on employment growth through reducing the tax wedge. Yet, the reduction of the tax burden will also result in a considerable drop in the general government revenues likely to amount to approx. 2.0% of GDP in static terms.
3. Measures aimed at reducing the tax burden have not been fully offset by cuts in the public spending.¹ Nonetheless, the rate of growth of public expenditure (EU funds excluded) will amount to 5.8%, thus, will be markedly lower than envisaged for 2007 (8.5%). In cash terms, EU funds excluded, the ratio of the general government expenditure to GDP is expected to decrease from 41.5% in 2007 to 40.6% in 2008.²
4. Despite favourable macroeconomic conditions and a drop in the ratio of public spending to GDP in 2008, the magnitude of reduction of the fiscal burden is large enough to boost the central budget deficit from PLN 23.0 billion envisaged for 2007 to PLN 28.6 billion (2.0% and 2.3% of GDP respectively). It should be noted that according to the submitted Draft central budget spending plans envisaged in the *Budget Act for the Year 2008* shall be fully executed. Considering the low level of expenditure incurred in the period until September 2007 as compared with the budget plans, this assumption may be difficult to meet, causing the central government deficit to be lower than envisaged in the Draft *Act*. This may translate into the public finance sector achieving a lower deficit in ESA'95 terms, than assumed by the Ministry of Finance (3.0% of GDP).
5. Considering the above, in the view of the Monetary Policy Council, there is a risk of a rise in the ratio of general government deficit to GDP in 2008. This would mean a deterioration of the structural deficit of the general government following its reduction in 2007, according to NBP estimates. In the present phase of the business cycle, this sort of change would lead

¹ Economic theory, as well as the results of empirical studies, including simulations conducted at the NBP with the use of a computable general equilibrium model, indicate that lowering the taxation of income from work brings the largest benefits for economic growth in the medium and long-term perspective, if it is offset by a reduction of public expenditure.

² The rate of expenditure growth will be lower not only from the nominal GDP but also from the growth rate of potential GDP. This favours the realisation of the medium-term target of reducing the structural deficit of general government by its adjustment on the expenditure side.

to a procyclical impact of fiscal policy on the economy. In the short run, a fiscal expansion may lead to a rise in inflationary pressure and, as a consequence, to the worsening of the relation between the fiscal and the monetary policy (policy mix). An increase in structural deficit would also mean a partial reversal of the improvement of the situation of public finance, which took place in recent years. In a medium-term perspective it would mean a worse state of preparation of public finances for the period of much worse economic climate.

6. Another significant consequence of the increase in the general government deficit is the increase in its borrowing requirement. The level of public debt in 2008 is expected to rise to such an extent that in spite of the forecasted quick economic growth, the ratio of public debt to GDP according to the ESA'95 standard will increase from 47.1% in 2007 to 47.7% in 2008.³
7. In the assessment of the Monetary Policy Council, the answer to the above described risks of reversal of the tendency to reduce the general government deficit observed in recent years and of the continued accumulation of public debt, should consist of structural reforms in the domain of public expenditure. They should aim at a systematic reduction of the general government deficit, so that it reaches in the possibly shortest time the level of medium-term budgetary objective⁴ specified in the Convergence Programme as a structural deficit at the level of 1% of GDP.

³ The relation of public debt according to home methodology is also expected to rise - from 47.0% of GDP in 2007 to 47.4% in 2008.

⁴ According to the provisions of the Stability and Growth Pact, the medium term budgetary targets are determined individually for the EU member states in structural terms, ranging from the deficit equal to 1% of GDP to a budgetary surplus, depending on macroeconomic conditions (potential growth rate) and the level of public debt and perspectives of long-term sustainability of public finances.

II. Macroeconomic assumptions

8. The assessment of the economic situation and economic assumptions for 2008 presented in the *Budget Act* are broadly consistent with the October projection of the NBP. The Ministry of Finance has a similar assessment of the main factors determining the economic growth in the period in question (consumption and investment), and also assumes a negative contribution of net exports to GDP growth. The draft *Budget Act* and the NBP projection do not differ significantly in their assessment of the developing trends on the labour market, although they differ in the assessment of the scale of those developments.
9. Taking account of the October NBP projection and the newest data from the labour market, it seems that the growth of average wages in 2008 may exceed the values adopted in the draft. The Monetary Policy Council shares the view that the already introduced and planned reductions in the disability insurance contribution can constrain the wage pressure in the coming quarters. Nevertheless, the rapid decline in unemployment and the visible tension on the labour market suggest that a drop in the growth of gross wages from 8.4% in 2007 to 5.9% in 2008 is unlikely. Consequently, the relation between the wage growth and labour productivity may turn out to be less favourable than assumed in the *Draft* resulting in a higher inflation than assumed by the Ministry of Finance.
10. The analysis of expectations concerning the supply and demand on the goods market leads to similar conclusions. The growing household incomes, a strong rise in the volume of lending and the risk of rise of the general government deficit in 2008 in comparison to 2007 (an additional fiscal impulse) suggest that the scale of imbalance between aggregated demand and supply may be bigger than shown by the estimate assumed in the *Draft*, resulting in a higher deficit on the current account or a rising inflationary pressure. On the other hand, the aftermath of the observed turmoil on world financial markets and the possible worsening of economic climate in the countries being Poland's main trade partners may constitute a threat for economic growth.

III. Public finances in 2008

Receipts

11. In accordance with the submitted draft of the *Budget Act for the Year 2008* the central budget's receipts (EU funds excluded) in 2008 are anticipated to reach a level 8.9% higher than in the present year, which - considering the assumed annual average inflation at the

level of 2.3% - means its real rise by 6.4%. The ratio of the budget receipts (EU funds excluded) to GDP in 2008 is expected to be at the level of 19.7% , i.e. to rise with respect to the projected performance in 2007 by 0.1 percentage point. It should be noted though that this is the result of the increase in tax revenue in GDP (by 0.4 percentage points), mainly from the expected high level of revenue from indirect taxes and the assumed decrease of the relation of non-tax revenues to GDP (by 0.3 percentage points), mainly owing to the lack of NBP profit transfer in 2008.

12. The submitted draft of the *Budget Act* anticipates that the general government receipts (EU funds excluded) will increase in 2008 by 5.8% in nominal terms (with the inclusion of EU funds the figure is 10.3%). The ratio of the general government revenue (excluding EU funds) to GDP is expected to drop from 39.5% in 2007 to 38.5% in 2008, which is to a large extent the result of the reduction of social security contribution (by 7 percentage points).
13. The forecast of central budget revenues for 2008 is realistic. It is consistent with NBP estimates with respect to the overall level of budgetary revenue, differing slightly with respect to the structure of tax revenue. Forecasts prepared by the NBP indicate that in 2008, the excise tax revenues may be slightly higher than the ones assumed in the Draft *Act* while the corporate income tax revenues – lower.
14. The forecasted central budget receipts from EU funds for 2008 in the amount of PLN 35.3 bn may be difficult to achieve. The Budget Act for 2007 assumed receipts from this source at the level of PLN 14.7 bn while now the assumed performance is forecasted to amount to PLN 9.3 bn. It means that revenue from this source is expected to increase almost fourfold in 2008.

Expenditure

15. Since 2007, EU funds and non-refundable funds from other sources have been incorporated into the central budget and are also included in the consolidated balance for the general government. The draft *Act* and the *Background document to the Draft Act* lack specific information concerning the expected performance in 2007 and the forecast for 2008 with respect to the expenditure financed from EU funds. The way of their presentation reduces the transparency of public finances and make it difficult to assess their expenditure side.
16. The assumption of equal amounts of EU funds on the revenue and expenditure side of the budget in cash terms raises some doubts, as the dates for flows related to EU funds are different – expenditures take place first, and their refund on the revenue side later. It is also

worth mentioning that in accordance with the calculation of the ESA'95 general government balance presented in the *Background*, the EU funds on the expenditure side of the general government sector will be much higher than funds on the revenue side.⁵

17. In the submitted Draft *Budget Act* budget expenditure is expected to be performed in 2007 within limits determined in the budget act. In the light of budget performance observed so far this year, this assumption raises serious doubts.⁶
18. Against the background of the structure and growth of the central budget total expenditure, the growth of outlays on science and education for 2008 is low. Their growth is anticipated to stand at 4.0%⁷ in nominal terms, i.e. significantly below the growth rate of nominal GDP. Outlays on science alone will admittedly rise by 11.0% but will stay at a very low level of PLN 4.1 bn (ca. 0.3% GDP)⁸. It means that the submitted Draft *Act* does not contribute to building a competitive, knowledge-based economy.
19. Total outlays from the central budget in 2008 are to increase in a comparative framework, i.e. excluding EU funds, by 12.6%. Without taking into account the budget transfer to the Social Insurance Fund, which rises significantly due to the reduction of the disability insurance contribution (not to the increase in the expenditure of the Fund), the rate of central budget expenditure growth amounts to 7.4%. The quickest rise is recorded among the outlays on infrastructure projects, including those co-financed by EU funds. Similarly, a significantly higher growth rate than the GDP growth is expected in health care (growth by 25.5% y/y), public safety (16.4%) and the justice system (12,4%).⁹ Traditionally, outlays on defence and the contribution to the EU budget will grow at a rate close to the GDP growth

⁵ The correction of the sector result by the flow of EU funds is positive and amounts to 0.5 percentage points of GDP. Taking into consideration that within the ESA'95 framework the amounts of EU funds on the revenue and expenditure side must be equal, such a correction indicates that in cash terms the funds on the expenditure side will be larger.

⁶ After September this year the performance of the budget plan stood at 67.5%, i.e. ran significantly below amounts recorded in previous years. Low performance of central budget expenditure is being explained by postponing a part of planned expenses to the late months of this year, resulting from delay in tendering procedures for public procurement orders and protracting verification procedures regarding applications for financing from EU funds. The fulfilment of this assumption seems unlikely, which entails underestimated indexes of central budget expenditure growth in 2008. In previous years the ratio of expenditure performance with respect to plan oscillated between 97.3 - 99.3%.

⁷ Joint growth rate of expenditure in the domain of science, higher education, school education and education, educational care and educational subsidies.

⁸ According to Eurostat, outlays on research and development from public funds in 2004 (the last year with available data) amounted to 0.31% of GDP and were among the lowest in the EU – the average for the EU was 0.75% of GDP. Among EU countries, the highest level of investment in this domain was recorded in Finland - 1.01% of GDP, while in the United States this level was even higher and stood at 1.08% of GDP.

⁹ The growth rate of expenditure including specific provisions.

rate, which stems from the mechanisms of shaping this expenditure, contained in relevant legal provisions.

20. It is worth pointing out that there are a number of important mandatory expenditure items, which are assumed to grow at a very slow rate or even decline, thus contributing to a lower rate of growth of overall expenditure. This is due to favourable macroeconomic conditions and fiscal measures adopted in the past.¹⁰ This factor is notable in, among others, expenditure on interest payments (a drop by 0.2%), disability benefits paid from social assistance and pre-retirement benefits (drop by 15.3%), social assistance (drop by 0.3%) and general subsidy for local governments (growth by 5.5%). In some cases these favourable conditions are likely to be reversed in the future. This is for example the case of expenditure on interest payments, whose low growth is to a large extent the consequence of the drop of yields on Treasury securities, which took place in 2003 and 2005. Since then, yields have risen, which - with an adequate delay - will translate to the growth in interest payments.
21. There is a relatively big share of specific provisions in the expenditure of the central budget (10.6% against 8.6% in the *Budget Act* for 2007). It concerns in particular mandatory expenditures, which should be assigned to relevant chapters and sections (e.g. medical rescue operations in the chapters 'health' and/or 'voivodship budgets' in the section 'health care'). It is worth noting that the draft of *New Public Finance Act* prepared by the Ministry of Finance postulated a significant reduction of specific provisions in the central budget.

The Deficit and Deficit Financing

22. In the opinion of the Monetary Policy Council the way of presenting EU funds in the consolidated general government budget makes it difficult to assess the size of the deficit in nominal and structural terms in 2007 and 2008. These amounts constitute the basis for the formulation of the assessment of the impact of fiscal policy on real and inflationary processes in the economy.
23. For 2007, the Ministry of Finance anticipates that the central budget deficit will amount to PLN 23.0 bn. This forecast takes into account higher central budget receipts than the ones adopted in the *Budget Act for 2007*, while making the assumption that the expenditure plan

¹⁰ The project does not contain information about the share of legally determined expenditure in the total expenditure of the central budget. This share will probably grow in 2008, which is due mainly to a significant growth of subsidies to the Social Insurance Fund, related to the reduction of the disability pension contribution.

of the *Act* will be realized in full. It is likely though that the expenditure of the central budget will turn out to be lower than expected, which may lead to a smaller central budget deficit than PLN 23.0 bn in 2007. As a consequence of a lower central budget deficit, the general government deficit in ESA'95 terms in 2007 may also be lower than the assumed 3.0% of GDP. Assuming that the proposed spending plans for 2008 are fully executed, this would imply a rise of the general government deficit in relation to GDP.

24. Maintaining in 2008 the ratio of the general government deficit to GDP at the same level as in 2007 in the present phase of the business cycle, let alone its deterioration, would mean a deepening of the structural deficit of public finances. According to NBP estimations, the cyclical component of the budget balance will improve in 2008 by 0.1-0.3 percentage points of GDP, depending on the adopted method of its estimation, which coupled with unchanged nominal balance means a worsening of structural balance by the same amount.
25. The central budget deficit in 2008 is expected to run at PLN 28.6 bn, which means its growth with respect to the anticipated realisation of 2007 by almost PLN 5.6 bn (from 2.0% to 2.3% of GDP). As a consequence of the nominal budget deficit increasing, and the simultaneous stabilisation of interest payments at the level similar to last year's, 2008 will see a significant worsening of the original balance from the positive amount of PLN 4.9 bn to the negative amount of PLN 0.8 bn, i.e. by 0.5 percentage points of GDP. The Monetary Policy Council would like to stress, that in the conditions of high economic growth, it is desirable to achieve a primary surplus in the central budget. The primary surplus in the central budget is an indispensable condition for stopping the public debt level from rising and for its reduction in the future.
26. It is anticipated that the net borrowing requirement of the central budget will increase to PLN 45.5 bn from PLN 39.6 bn anticipated for 2007, i.e. by 15.2%. The increase in the borrowing requirement of the central budget entails further rise of public debt with negative consequences for the state of public finance in the future.