



N a t i o n a l B a n k o f P o l a n d
Monetary Policy Council

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Opinion of the Monetary Policy Council on the Draft *Budget Act for the Year 2009*

This opinion on the Draft *Budget Act for the Year 2009* was prepared at the time of serious tensions and turmoil in the international financial markets which constitute a source of high uncertainty about the future economic developments in Poland and abroad. Looking from today's perspective, 2009 is expected to bring a slowdown in economic growth in Poland. This slowdown is likely to be deeper than anticipated in the macroeconomic assumptions of the Draft *Budget Act* prepared at the beginning of September 2008. Therefore, meeting the set objective of reducing the ESA'95 general government deficit to 2.0% of GDP will be considerably hindered. A potential deeper and protracted economic slowdown could threaten Poland's compliance with the general government deficit criterion defined in the Maastricht Treaty in the coming years.

I. General remarks

The submitted Draft *Budget Act* is based on macroeconomic assumptions adopted prior to the occurrence of serious turmoil in the global financial markets which led to a considerable revision of growth forecasts for major world economies. The assessment of the macroeconomic situation presented in the *Background document* to the Draft *Budget Act* did not deviate considerably from the forecasts formulated prior to those developments, including forecasts constituting the basis for the *Monetary Policy Guidelines for the Year 2009*. However, from today's perspective, macroeconomic assumptions of the Draft *Budget Act* should be assessed as overly optimistic.

In the light of the adopted macroeconomic assumptions also the forecast of the central budget revenue presented in the Draft *Act* may be assessed as optimistic. Moreover, forecasts of tax receipts imply that these receipts will continue to increase at a higher rate than the one

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resulting from the growth rate of major macroeconomic categories and the effects of the fiscal measures. Such a phenomenon was observed in the years 2005-2007 which may be explained by improvements in tax collection which usually accompany an economic recovery. In the light of the anticipated slowdown in economic growth, a similar effect may not occur in 2009.

The submitted Draft *Budget Act* assumes favourable changes in the structure of the central budget expenditure involving an increased share of pro-growth expenditure, as well as maintaining of discipline in current budget expenditure. Current budget expenditure net of EU funds and interest payments which do not depend on the government's current decisions, is expected to rise by approx. 3.5% in nominal terms, while the planned increase in capital expenditure amounts to 8.9%. This is driven partly by the planned low growth of own spending of central budget entities, but also by some expenditure being transferred to other general government entities. Subsidies of the central budget allocated to the Social Insurance Fund have been planned in the amount insufficient to fully finance the Fund's spending, while the expenditure on pre-retirement benefits has been transferred from the central budget to the Labour Fund.

The Draft *Budget Act* envisages a reduction in the central budget deficit from the anticipated amount of PLN 22.9 billion in 2008 to the amount of PLN 18.2 billion in 2009 i.e. from 1.8% of GDP to 1.3% of GDP respectively. At the same time, in line with the *Background document* to the Draft *Budget Act* the general government deficit (in cash and ESA'95 terms) is expected to be reduced to the same extent as the central budget deficit i.e. by 0.5 percentage point of GDP. In the light of the information about the planned special purpose fund deficits, it may be difficult for general government entities other than the central budget to achieve a similar result in 2008 and 2009. The Draft *Act* assumes a deterioration in the balances of the Social Insurance Fund and the Labour Fund by the total of approx. 0.5 percentage points of GDP. Moreover, the introduction of two rates of personal income tax will lead to a reduction in own revenues of local government entities by approx. 0.3 percentage points of GDP. Thus, it may be assessed that even under the assumption of a favourable economic situation, the submitted Draft *Budget Act* may be insufficient to achieve the objective of reducing the general government deficit by 0.5 percentage point of GDP.

High uncertainty about the future macroeconomic developments makes it difficult to present a comprehensive assessment of the planned fiscal policy and its impact on the economy. According to the NBP's estimates, the general government deficit will deteriorate in 2009 as a result of the negative impact of economic slowdown on tax receipts and

expenditure on unemployment benefits. On the other hand, the structural deficit may remain at the level close to the one estimated for the year 2008.

II. Macroeconomic assumptions of the Draft *Budget Act for the Year 2009*

The developments in the financial markets observed in the past few weeks have led to a considerable revision of the outlook for global economic growth, and, consequently, the outlook for economic growth in Poland. This has found its reflection in the October projection of inflation of the NBP. Against its backdrop, the assumption concerning economic developments in Poland in real and nominal terms, presented in the Draft *Budget Act* may be assessed as overly optimistic¹.

In the NBP's opinion, as a result of a strong slowdown in the global economy, the growth rate of GDP may be considerably lower than envisaged in the Draft *Budget Act*. In particular, the growth rate of gross fixed capital formation as expected by the Ministry of Finance seems too high from today's perspective. On the other hand, the price increase in 2009, as measured with CPI, despite a fall in commodity prices in the world markets observed recently might be stronger than assumed in the Draft *Budget Act*.

Also the assessment of the outlook for the labour market situation contained in macroeconomic assumptions of the Draft *Budget Act* differs from the NBP's assessments. In the NBP's assessment, due to limited ability of enterprises to adjust wages quickly, in the coming quarters the adjustment of this sector to the slowing economic growth will mainly take place through falling labour demand. With the simultaneous growth in the size of the active population, mainly as a result of demographic factors, will lead to a noticeable growth in unemployment rate. On the other hand, the wage growth will be adjusted, with a certain time lag, to the slowing economic growth. As a result, with falling GDP growth, the growth rate of labour costs in 2009 will remain relatively high, largely affecting the price growth in the economy.

III. Detailed remarks

1. In line with the Draft *Budget Act for the Year 2009*, the overall central budget revenue (excluding EU funds and other non-refundable funds) is expected to rise in 2009 by 8.9% y/y in nominal terms, which, considering the average annual inflation planned at

¹ This assessment is not altered by the fact that deviations in the forecasts of GDP and inflation growth between the NBP's projection and the assumptions of the Ministry of Finance result partly from certain differences in forecasting methods and tools.

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the level of 2.9%, means that this revenue will rise by 5.9% in real terms. The central budget revenue may turn out lower than assumed in the Draft *Budget Act* which is connected, among other things, with the NBP's forecasts of the economic situation in 2009.

2. In line with the submitted Draft *Budget Act*, general government revenue from taxes and social contributions is expected to rise in 2009 by 8.2% i.e. at a rate slightly higher than the nominal economic growth rate. The total ratio of this revenue to GDP in 2009 is expected to amount to 32.3%, i.e. exceed by 0.1 percentage point the 2008 ratio despite the introduction of the new personal income tax schedule, with reduced rates of 18% and 32% which will result in the reduction of the general government revenue by approx. PLN 8 billion i.e. 0.6 percentage point of GDP.
3. The nominal growth in the central budget expenditure (excluding expenditure financed with EU funds) assumed for the year 2009 at the level of 5.3% i.e. 2.3% in real terms, will be considerably lower than that anticipated in 2008 (11.8% y/y in nominal terms² and 7.1% y/y in real terms). Expenditure growth has mainly been curbed in the category of current expenditure, net of expenditure co-financed with EU funds and interest payments. The low growth rate of current expenditure amounting to 3.5% results, among other things, from the assumption of a decrease in benefits paid to individuals (by 9.2% y/y)³ and moderate growth of subsidies and grants (by 3.8% y/y)⁴ and EU own funds (by 4.1% y/y).
4. The ratio of general government expenditure to GDP is expected to decline by 0.4 percentage point of GDP, among other things, in connection with the planned decrease in the ratio of social expenditure by 0.3 percentage point of GDP. This plan takes into account financial effects of the government's draft of the Bridging Pensions Act whose implementation has not been decided yet. This threatens, to a certain extent, the

² The growth rate of the central budget expenditure in 2008 was exceptionally high due to a large increase in subsidies to the Social Insurance Fund which resulted from a decrease in the disability pension contributions rather than from the increase in expenditure of the Social Insurance Fund. Without subsidies to the Social Insurance Fund, the central budget expenditure were supposed to increase by 6.9% in 2008 (as compared to the Draft *Budget Act* for the year 2008 with envisaged performance for 2007).

³ The major factor behind the decrease in this category of expenditure is the shift of expenditure on social assistance and pre-retirement benefits from the central budget to the Labour Fund. In 2008 the central budget expenditure in this respect was planned to amount to approx. PLN 3.5 billion.

⁴ Low growth rate of this category of expenditure results, among other things, from subvention to the Social Insurance Fund planned at the amount insufficient to finance the Fund's total expenses which will cause a deficit exceeding PLN 4 billion (as compared with a slight surplus envisaged for 2008) as well as cuts in subventions to local government entities for the purpose of financing social assistance (which might be justified by the anticipated favourable economic situation).

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implementation of the submitted Draft *Budget Act*, but primarily the stability of public finance in the medium- and long-term.

5. Special attention should be paid to the increased outlays on human capital and infrastructure envisaged in the central budget which boost the development potential of the economy. The expenditure on science largely exceeds GDP growth - its growth is expected to amount to 22.5% in real terms. Apart from the science expenditure, fast growth is expected in infrastructure expenditure (among other things, in connection with the preparation and implementation of EURO 2012 projects). High expenditure growth has also been envisaged for projects in the field of education – real growth of 5.2% and higher education – of 2.7%.
6. Amidst tensions and turmoil in the global financial markets, a number of governments of EU member states have undertaken extraordinary measures to support the banking sector. Also the government of the Republic of Poland, following the guidelines of the ECOFIN Council, has decided to raise the limit of bank deposit guarantee from EUR 22.5 thousand to EUR 50 thousand. In the assessment of the Monetary Policy Council, in the light of the good condition of the Polish banking sector, these measures do not constitute a risk for the Treasury to assume an additional burden. Therefore, in line with ESA95 principles⁵, there are no reasons to make any additional amendments to the Draft Budget Act. Meanwhile, it would be advisable to consider whether in the present situation requiring special attention of the Financial Supervision Authority, the planned decrease in the central budget financing of this authority is justified.
7. It is expected that in 2009 the central budget deficit will reach PLN 18.2 billion (1.3% of GDP) as compared with the envisaged outturn in 2008 estimated at PLN 22.9 billion (1.8% of GDP). Assumption of such level of the central budget deficit may be insufficient to achieve the objective set in the *Convergence Programme. 2007 Update* of reducing the overall general government deficit to 2% of GDP (in ESA'95 terms). Taking into account the transfers to the Open Pension Fund (OFE) in the amount of approx. 1.6% of GDP, achieving such a level of deficit would require the general government entities other than the central budget to achieve a positive balance. Meanwhile, it follows from the data presented in the Draft *Act* that the largest special purpose funds (the Social Insurance Fund and the Agricultural Social Insurance Fund)

⁵ In line with the ESA'95 standard applicable in the EU (as well as the Polish Public Finance Act), in the situation when the disbursements under government guarantees are unlikely, the mere fact of giving such guarantees does not affect the deficit and the general government debt.

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are most likely to record deficits in 2009. The balance of special purpose funds, excluding funds financed with the proceeds from privatisation⁶, is expected to worsen and decrease from the surplus of PLN 3.5 billion in 2008 to the deficit of PLN 3.2 billion in 2009. Moreover, there is a high uncertainty about the condition of local government entities which in 2009 will obtain lower own revenues as a result of the introduction of two-level taxation scale with reduced personal income tax rates; on the other hand, those entities are most likely to increase their involvement in the use of UE funds within the framework of the new Financial Perspective 2007-2013.

8. As a result of a reduction of the general government deficit amidst the expected considerable rise in interest payments on public debt (by more than PLN 5 billion) in 2009, the primary balance of the general government will remain positive and will increase from 0.9% of GDP to 1.7% of GDP. Such a significant improvement of the primary balance has positive effects on the growth rate of public debt, however, in the light of the previously presented doubts about the planned reduction of the general government deficit, also improvement of the primary balance to the assumed extent is uncertain.
9. In 2009 the net borrowing requirement of the central budget is expected to decrease to PLN 39.1 billion from the amount of PLN 42.7 billion anticipated in 2008, i.e. by 8.4% which is connected with the assumption of a lower budget deficit. Another important factor contributing to lowering the borrowing requirement are the proceeds from privatization which are expected to reach the total amount of PLN 12 billion i.e. five times more than the amount planned for 2008, out of which PLN 6.8 billion⁷ for the central budget deficit financing. This objective seems difficult to meet in the light of the proceeds obtained in the past few years, the absence of a detailed description of privatization plans in the *Background document* to the Draft Act, and, above all, unfavorable conditions in the financial markets.
10. Similarly to the previous years, the Draft *Budget Act* envisages a considerable increase in the use of EU funds both on the revenue side of the central budget as well as on the expenditure side. The expected growth in expenditure under the National Strategic Reference Framework 2007-2013 for Poland from the anticipated performance at the

⁶ In the economic sense and in ESA'95 terms, proceeds from privatisation do not constitute revenue of the general government but a financial transaction, which finances the borrowing requirement.

⁷ The remaining part of the proceeds from privatisation will be allocated to special purpose funds, such as the Reprivatisation Fund and the Entrepreneurs' Restructuring Fund.

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level of PLN 9.3 billion⁸ in 2008 to PLN 25.1 billion in 2009 i.e. by 169.9% is of considerable importance. At the same time, the expected utilisation of EU funds in 2008, both on the revenue and on the expenditure side is considerably lowered than initially planned (42.9% and 79.0% respectively⁹). The envisaged growth in expenditure on financing projects with the use of EU funds in 2009 is partly justified in the light of the growing pace of submission of applications for additional financing, observed in 2008 and signing of contracts as well as the system of pro-development subsidies, which has been put in place, enabling the transfer of the whole or part of financing to the beneficiaries in advance. Nonetheless, the experience from the past few years suggests there is a risk for the realisation of the planned utilisation of EU funds. It should also be emphasised that in the light of the existing low utilisation of funds under the National Strategic Reference Framework 2007-2013 for Poland and the applicable rule $n+3$ ¹⁰, further delays would create a serious risk of losing part of EU funds granted to Poland.

11. The *Background document* to the Draft *Budget Act* for 2009 contains a description of the draft central budget in a task-oriented framework. Such presentation of the budget is supposed to improve the planning and management of public finance and is aimed at a more effective spending of public funds. The task-oriented plan of expenditure for the year 2009, presented for the first time in the *Background document* to the Draft *Act*, drafted according to the fundamental functions of the state (e.g. management of the state, educational, instructive and protective activities of the state, supporting of physical culture, protection of the natural environment and improvement of its condition) constitutes a step towards such an improvement. However, in order to fully benefit from the advantages offered by the task-oriented budget, it is necessary to make the amounts of planned expenditure more dependent upon the set objectives and tasks. Effective implementation of the task-oriented budget should take into consideration the degree of achievement of the set objectives when reviewing the budget execution.

⁸ In the period January – August 2008, payments from programme accounts under the National Strategic Reference Framework 2007-2013 reached merely PLN 0.3 billion.

⁹ Comparison on the expenditure side concerns amounts including domestic co-financing.

¹⁰ In line with this rule, limits of the particular year's commitment must be used not later than within the following three years, e.g. for the 2007 limits the last year to use these funds is the year 2010.