NBP

National Bank of Poland

Monetary Policy Council

Warsaw, 27 October 2009

Opinion of the Monetary Policy Council on the draft *Budget Act for the Year 2010*

The draft *Budget Act for the Year 2010* envisages a rise in the central budget deficit from PLN 27.2 billion in 2009 to PLN 52.5 billion[1] in 2010 and an increase in public finance deficit calculated according to domestic methodology from 3.3% to 5.9% of GDP. In turn, the general government deficit according to ESA95 methodology, which is binding when the compliance with the fiscal Maastricht criteria is assessed, may rise from 6.3% of GDP in 2009 to over 7% of GDP in 2010[2].

The rise in the general government deficit anticipated for 2010 will primarily result from the effect of automatic stabilisers in the phase of a downturn, which in principle are considered to be desirable for the economy. What is a real problem, however, is the alarming size that the deficit is bound to reach, which is to a large extent connected with the persistently high structural deficit. The latter primarily results from the cuts in social insurance contributions and taxes introduced over the past few years which were not accompanied by a matching reduction in public expenditure. The very high level of the nominal deficit of the public finance sector will lead to an increase in public debt, creating the risk of the debt to GDP ratio breaching subsequent prudential thresholds set by the Public Finance Act and also the constitutional ceiling.

[1] Starting form 2010, in line with the amended Public Finance Act, European funds will be excluded from the central budget, which makes the levels of deficits incomparable. The level of expected deficit implementation in 2009 includes a surplus of EU fund revenues over EU fund expenditure, while the deficit of European funds in 2010 envisaged at PLN 14.4 billion does not increase the planned budget deficit for that year.

[2] Source: the autumn Excessive Deficit Procedure notification and the NBP's estimates; in contrast to previous years, the background document to the draft *Budget Act* does not contain anticipated deficit levels in ESA95 terms.

The government's forecasts see the level of public debt at the end of 2010 at just below 55% of GDP. In line with the draft *Budget Act*, the achievement of this target is conditional on obtaining exceptionally high privatisation receipts, which are one-off by nature and their materialisation at the envisaged level is subject to a high risk. Another important risk factor for breaching the prudential thresholds is zloty exchange rate depreciation, while its potential appreciation may also prove insufficient to permanently halt the accrual of the debt. Therefore, even if public debt in 2010 does not breach the threshold of 55% of GDP, there remains a serious threat that this will happen in the following year. In line with the provisions of the Public Finance Act, this would necessitate the implementation of major and far-reaching adjustments in the budget for 2012 or 2013.[3]

Likewise, it is doubtful whether Poland will comply with the obligations imposed by the Council of the European Union under the excessive deficit procedure (EDP) which stipulate that the ESA95 deficit should be cut to under 3% of GDP by 2012. At the same time, the Council recommended that the required fiscal adjustments were started in 2010 and that the scale of structural deficit reduction by 2012 was not smaller than 1.25 percentage points of GDP in average annual terms. The submitted draft *Budget Act* does not provide for measures limiting the structural imbalance in public finances.[4] According to the NBP's estimates, the structural deficit in 2010 will pick up slightly, among others, due to a relatively high growth rate of expenditure on disability and old-age pension benefits. With the assumption of no systemic changes in the public finance, the structural deficit in 2010-2011 will remain above 6% of GDP. This means that without significant adjustment measures being taken, the

[3] Pursuant to Article 86 of the Public Finance Act (Journal of Laws No. 157/2009, item 1240), when the value of the ratio of the state public debt to GDP in year t is:

- higher than 50% and lower than 55%, then the deficit to revenue ratio planned in the draft budget act for year t+2 cannot be higher than in year t+1,
- higher than 55% and lower than 60%, then the draft of the budget act for year t+2 should provide for at least a balanced central budget or such a central budget balance that would ensure the lowering of the ratio of public debt to GDP at the end of year t+2 in relation to the end of year t. Moreover, the budget cannot include an increase in the wages of government sector employees and the indexation rate of disability and old-age pensions cannot exceed inflation. Apart from that, the budgets of local governments must be balanced, except for the expenditure on co-financing EU funds,
- higher than 60%, then the central budget is bound by the same provisions as in the case of the 55-percent threshold. Moreover, the government is obliged to present a sanation plan within one month of the announcement of the debt to GDP ratio, public finance sector entities must not grant any guarantees and local government budgets must not assume any deficit.

[4] According to the background document to the draft *Act*, "the forecasts of the fiscal path encompassing the measures resulting from the fact that Poland is subject to the excessive deficit procedure will be presented in the currently prepared update of the Convergence Programme."

reduction of the public finance sector's deficit to below 3% of GDP by 2012 does not seem possible.

In this context, the Monetary Policy Council assesses that it would be desirable to present a credible medium-term plan of adjustment measures that would allow a permanent reduction in the public finance sector's deficit. The presentation of such a plan will also be of crucial importance for Poland's compliance with the obligations arising from both domestic and European fiscal rules, for sustaining its credibility in the financial markets and for the secure financing of its record-high borrowing needs.

Macroeconomic assumptions

1. The assumptions presented in the draft *Budget Act* concerning the developments of Poland's economic situation in 2010 and 2011-2013 are generally consistent with the scenario presented by the NBP in the October projection.
2. The rate of GDP growth in 2010 assumed by the Ministry of Finance is slightly lower than indicated in NBP estimates (1.2% in the draft *Budget Act* as compared to 1.8% accounted for in the projection). This mainly results from a more pessimistic MF assessments of the effect of the pass-through of a deteriorated labour market situation (which is assessed similarly to the NBP's projection) into individual consumption developments and anticipated stronger dampening in investment growth. In particular, the draft expects the growth rate of private consumption in 2010 to be lower than in the NBP's projection (0.9% in the draft *Budget Act* compared to 2.1% accounted for in the projection) and a weaker growth of gross fixed capital formation (0.2% compared to 2.2%). Higher assumed growth rate of collective consumption (1.6% in the draft *Budget Act* as compared to 0.4% accounted for in the projection) only partially compensates for the more cautious forecast of individual consumption and investment outlays.
3. In the NBP's projection, a slightly faster forecast economic recovery is followed by a little higher CPI inflation in 2010 than that assumed in the draft *Act* (1.5% in the projection against 1.0% in the draft).
4. The NBP's assessment of the outlook for labour market situation in 2010 is similar to that of the Ministry of Finance. In the NBP's opinion, economic downturn in 2009 will

translate into a drop in the number of working persons and a lower growth rate of nominal wages, even though it will remain in the positive territory. The growth in the BAEL (LFS) unemployment rate in 2010 as forecast in the October projection of the NBP amounts to 2.4 percentage points in year-on-year terms. This forecast differs slightly in scale from the macroeconomic assumptions for the *Budget Act*, which envisages an increase of registered unemployment rate by approx. 2 percentage points in 2010. In the NBP's opinion, the discouragement effect among the unemployed (resignation from job seeking and joining the economically inactive group) caused by deterioration in labour market situation may actually prove weaker than accounted for in the draft *Budget Act* and, thus, will offset the rise in economic activity due to Polish emigrants' returns to Poland in the search of employment to a considerably lesser extent. Additionally, the crisis situation may create incentives, both for employers and employees, to enter into unregistered job contracts in the shadow economy in order to cut operational costs. Thus, it may turn out that at the end of the day the rise in the scale of registered unemployment will be higher then unemployment growth as reported in BAEL surveys.

5. The analysis of differences between the scenarios presented in the draft *Act* and in the NBP's projection reveals a slightly different assessment of the outlook for zloty exchange rate developments. In contrast to the path presented in the draft *Act*, the October projection of the NBP assumed that starting from 2010 the exchange rate of the zloty may be depreciating, among others, due to the increased country risk amid deteriorating public finance standing.

Central budget revenue

6. In accordance with the submitted draft *Budget Act for the Year 2010,* the central budget's receipts (excluding EU funds) in 2010 will be 4.1% higher than the expected budget implementation in 2009, which – considering the assumed average annual inflation at the level of 1.0% – means a 3.1% increase in real terms. With no significant systemic changes affecting the level of tax revenue of the central budget, its expected level will be primarily the effect of the envisaged macroeconomic situation. In the light of macroeconomic assumptions presented in the draft *Act*, the increase in the central budget's tax revenue in 2010 envisaged at 6.0% y/y seems optimistic. In particular, this applies to the planned receipts from the tax on goods and services

(VAT) and the corporate income tax. The high level of VAT receipts assumed in the draft (a rise of 8.9% in nominal terms and 7.8% in real terms) does not seem to find justification in the envisaged macroeconomic situation and the small scale of systemic changes implemented in 2009 and planned for 2010.

Central budget expenditure

7. In accordance with the Public Finance Act of 27 August 2009, the funds coming from EU budget and other non-recoverable funds, except for technical assistance funds, shall not be accounted for in the central budget's revenue or expenditure but in the budget of European funds instead. The submitted draft *Act* includes under expenditure the funds for co-financing projects with the participation of EU funds (domestic contribution) and EU funds granted under technical assistance. The above-mentioned changes make it difficult to compare the figures presented in the draft *Budget Act for the Year 2010*. However, the creation of the budget of European funds should be assessed positively as a step towards increasing the transparency of EU fund utilisation. Moreover, such presentation of EU funds allows the central budget deficit to be separated from the balance of EU fund flows in a given year. This balance is the effect of technical circumstances and should not be taken into consideration when assessing the fiscal policy, as it will be close to zero in the medium term.

8. In accordance with the draft *Act*, the total expenditure of the central budget and the budget of European funds are to grow by 19.1% y/y in 2010, compared to 8% in 2009. The main source of this growth is the expected higher EU fund utilisation, as a result of which, expenditure on funding projects with EU fund participation is set to increase by 95.5%. The growth rate of other categories of expenditure will be markedly lower, at 8.4% y/y. Capital expenditure is to rise by 15.2%, though this growth rate would be lower in comparable terms.[5] It should also be noted that the major part of investment expenses in 2010 will be made from the budget of European funds and the National Road Fund. In turn, current expenditure of central budget entities are to increase by 4.2% y/y, despite the fact that wages in the budget sector will only rise by 1.0%. Subsidies to local governments will report a similar rate of growth (at 4.1% y/y),

[5] The amount of property expenditure in 2010 no longer includes the funds for the implementation of the National Road Construction Programme for 2008-2012, which in 2009 were presented in position “financing projects with EU fund participation”.

though it should be noted that the rise in teachers' wages of 7% starting from 2010 will only make a more significant contribution to this spending item in 2011.

9. The draft of the *Budget Act for the Year 2010* contains a task-based plan of central budget spending broken down by functions, tasks and subtasks (together with measures gauging the degree of their implementation) plus the specification of priority tasks. This form of budget presentation is ultimately meant to streamline the planning and management of public finances in order to ensure a more effective spending of public funds. At the current stage, however, the presentation of the amount of expenses on a task-based basis is not very clear and difficult to interpret. In several items, there are very large differences in expenditure planned for particular years without any explanation offered. For example, the expenses under function "social security and family support" are to increase from PLN 44.9 billion in 2009 to PLN 84.8 billion in 2010 and then fall back again to PLN 45.6 billion in 2011. In turn, the expenses under function "construction, extension and maintenance of transport infrastructure" surge from PLN 7.5 billion in 2010 to PLN 42.2 billion in 2011. It is hard to imagine that an increase of this scale is indeed planned in the outlays for transport infrastructure, so this change most probably results from methodological factors, which makes the presented amounts of expenditure in particular years incomparable.

Public finance sector deficit, financing and public debt

10. In accordance with the background document to the draft *Act*, the deficit of the public finance sector in cash terms will rise from 3.3% to 5.9% of GDP. These figures, however, do not represent the real picture of the situation in the public finance sector due to methodological imperfections of this measure of public finance imbalances.[6] A more comprehensive measure of public finance imbalance, which is commonly used while analysing the public finance situation in EU countries, is the balance expressed in ESA95 terms. However, in contrast to draft budget acts of previous year, the submitted draft does not include the forecast of deficit size in 2010 in ESA95 terms.

[6] The level of deficit measured in this way is distorted, among others, by the receipts from privatisation (in the part going to funds connected with privatisation and constituting their earnings), EU fund balance and the fact of not accounting for the balance of the National Road Fund. This is because, pursuant to the Public Finance Act, the National Road Fund does not belong to the pubic finance sector.

According to the autumn EDP notification submitted by the GUS to Eurostat, the ESA95 deficit may amount to 6.3% of GDP. In turn, the NBP's estimates indicate that in 2010 its level will exceed 7% of GDP.

11. In 2010 the net borrowing requirement of the central budget is to rise significantly – from PLN 57.0 billion forecast in 2009 to PLN 82.4 billion (a rise of 44.6% y/y[7]) in net terms and from PLN 163.2 billion to PLN 201.6 billion (a rise of 23.6% y/y) in gross terms. The main source of growth in borrowing requirement is the almost two-fold planned increase in the central budget deficit and the emergence of deficit in the budget of European funds. In turn, very high privatisation receipts in 2010 (planned at PLN 25.0 billion[8]) are to be a factor conducive to a reduction in the borrowing requirement. Nevertheless, it should be noted that the privatisation plans of the government are subject to a considerable risk. Lower receipts than those accounted for in the draft *Act* would translate into a higher level of public debt and, consequently, into an increased risk of breaching the prudential 55-percent threshold of the debt to GDP ratio in 2010. The high level of borrowing needs planned for the next year may result in higher yields on Treasury securities and, consequently, higher cost of debt servicing.

EU funds in central budget

12. The draft *Budget Act for the Year 2010* envisages almost a two-fold rise in expenditure on projects co-financed with EU funds – from PLN 36.9 billion in 2009 to PLN 72.1 billion in the next year.[9] This high expected growth rate of spending may be primarily the result of a significant acceleration in EU fund absorption by the beneficiaries of operational programmes in the last months of 2009 and an expected continuation of this tendency in 2010.[10] Moreover, in 2010 the expenditure on the implementation of tasks under the Common Agricultural Policy will be significantly increased, among

---

[7] In accordance with the draft *Budget Act*, net borrowing needs are to be financed in 74% from domestic sources and in approx. 25% from the issuance of bonds in the foreign markets and loans drawn from international institutions.

[8] Of which net revenue which will be PLN 9.4 billion. The remaining amount will feed special purpose funds (Demographic Reserve Fund, Enterprise Restructuring Fund, Reprivatisation Fund, State Treasury Fund and Polish Science and Technology Fund).

[9] In order to ensure comparability of data, both values of expenses include, apart from EU contribution, domestic contribution and technical assistance expenditure.

[10] The acceleration results from the time schedule of operational programme implementation and the streamlining of procedures, both on the part of the European Commission and the Polish administration.

others, due to a surge in expenses on direct payments of approx. 40% – from approx. PLN 9.0 billion in 2009 to PLN 12.7 billion in 2010, resulting from an increased rate of direct payments[11] and a weaker zloty exchange rate used while converting the amounts of euro subsidies into the zloty.[12] Considering the amount of funds available under the Financial Perspective 2007-2013 and a relatively low absorption level in 2009, the assumption that their utilisation will accelerate in 2010 seems justified. However, the implementation of the plan of expenses presented in the draft *Budget Act* is conditional on many factors[13] and thus it is difficult to assess ex ante the feasibility of the assumed scale of growth in EU fund utilisation.

13. Moreover, it should be pointed out that, in line with the draft *Budget Act*, the spending on financing projects with the participation of EU funds is to reach even higher levels in the years to come. It is forecast that in 2011 this spending (including the domestic contribution) will rise to approx. PLN 109.0 billion, i.e. almost three times more then the amount planned for 2009. It will be a considerable challenge to achieve this level of absorption, both from the administrative perspective and in view to the provision of necessary co-financing.

14. The draft *Budget Act for the Year 2010* envisages a rise in receipts from the EU in 2010 of 8.2% y/y, i.e. to the level of PLN 45.2 billion.[14] The materialisation of revenues at the assumed level will be to a large extent conditional on the implementation of the plan of expenses on projects co-financed from EU funds and the path of EUR/PLN exchange rate in 2010. The relatively low growth rate of receipts from the EU in 2010 partially results from feeding the revenue account of the central budget in 2009 with advance payments received from the European Commission for

[11] In 2010 farmers will receive 90% of the payment rate binding in old EU countries (together with domestic subsidies). In line with the provisions of the Treaty of Accession, starting from 2004 the rate was increased by approx. 5 percentage points each year and from 2008 it rises by 10 percentage points.

[12] The funds are paid to farmers on the basis of the most recent exchange rate set by the European Central Bank prior to 1 October of the year in which a draft budget act is prepared (Article 45 of of Council Regulation (EC) No 1290/2005 of 21 June 2005 on the financing of the common agricultural policy). In 2009 subsidies were paid to farmers at the exchange rate of 3.3967 EUR/PLN, while in 2010 direct payments will be converted and paid at the rate of 4.2295.

[13] It depends, among others, on economic situation, availability of credit to private and public entities (e.g. the National Road Fund), effectiveness of the administration supervising the implementation of operational programmes, streamlining the implementation of large infrastructural and environmental projects, etc.

[14] In order to ensure comparability of data, the receipt of EU funding presented in the budget of European funds has been increased by the revenue obtained as technical assistance and expiring projects (included under domestic revenues of the central budget).

the implementation of operational programmes from the new financial perspective.[15] The expenses in this respect will also be incurred next year. Moreover, some expenses incurred at the end of 2010 will be reimbursed to Polish administration by the European Commission only in 2011. These two phenomena will add to the creation in 2010 of a deficit in European funds in the amount of PLN 14.4 billion. In accordance with the draft *Act*, the budget of European funds will report a significant deficit (of PLN 15.7 billion) in 2011 as well, which means further growth in net borrowing needs and, consequently, public debt.

Situation of other entities of public finance sector

15. The financial plan of the Social Security Fund envisages a significant increase in subsidies from the central budget in 2010 (of 24.7%) in relation to 2009 and additional feeding of the Fund with a transfer of PLN 7.5 billion from the Demographic Reserve Fund. This is a highly controversial measure, considering the fact that the fiscal costs generated by population aging will only materialise in the coming decades. Thus, the recourse to assets of the Demographic Reserve Fund as early as 2010 may set a dangerous precedent and ultimately endanger the long-term sustainability of public finances. Moreover, there is a risk that the receipts from insurance contributions forecast in the Social Security Fund's plan may prove overoptimistic and, consequently, the indebtedness of the Fund to banks will increase.

16. In connection to the systemic changes introduced over the past few years and the implemented anti-crisis measures, the Labour Fund is expected to report a deficit in the amount of PLN 3.2 billion in 2010, which will lower the balance of the Labour Fund to PLN 1.9 billion at the end of 2010. The continuation of unfavourable situation in the labour market in the years to come may necessitate additional central budget subsidies or force to Fund to draw bank loans.

[15] In years 2007-2008 the Minister of Finance applied the principle that currency conversion and transfer of funds paid in advance could only be effected once the expenditure under the projects co-financed with those funds has been approved for incurring.