NBP
National Bank of Poland
Monetary Policy Council

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Opinion of the Monetary Policy Council on the *Draft Budget Act for the Year 2011*

The fiscal policy in 2011 is strongly affected by the large magnitude of fiscal imbalances in Poland over the recent years, which are mainly the result of the lack of structural reforms, sizeable reductions in tax and social contribution burden, as well as the continued significant increase in expenditure, including spending on co-financing of EU projects. In the period of a profound economic slowdown, these processes led to a rise in the ESA95 general government deficit in 2010, to the level close to 8% of GDP.[1] The risk of public debt breaching subsequent prudential thresholds laid out in the Public Finance Act has also increased. A possible continuation of the fiscal imbalance deepening tendency observed in the past few years would mean failure to comply with the obligations arising from national and European fiscal rules.

The presented *Draft Budget Act for 2011* (further called: the Draft) foresees a reduction in central budget deficit from the expected realisation at the level of PLN 48.3 billion in 2010 to PLN 40.2 billion in 2011. Most importantly, however, the deficit of the whole general government sector, as defined in ESA95 terms, is to be reduced – from the expected realisation in 2010 at the level of 7.9% of GDP to approx. 6.5% of GDP in 2011.[2] Apart from the forecast economic recovery, the planned reduction of the sector's deficit in 2011 will also be supported by structural fiscal policy tightening, the scale of which may be estimated at approx. 1 percentage point of GDP. Despite this tightening, the structural deficit of the general government sector in 2011 will remain high, at the level exceeding 6% of GDP.

[1] After the general government deficit in ESA95 terms had reached 1.9% of GDP in 2007, it was rising in the following years – to 3.7% of GDP in 2008 and 7.2% of GDP in 2009, though the rise resulted both from cyclical and structural factors. Factors that have most significantly contributed to deepening the structural deficit over the past few years include the reduction in the disability pension contribution and personal income tax rate (change in the tax scale of this tax and introduction of the child raising tax allowance), the total effect of which may be estimated at approx. 2.7% of GDP. Moreover, the rise in general government deficit has been driven by increased expenditure on co-financing of EU funds in the recent years. In 2009, this expenditure of the central budget and local government units totalled approx. 1.1% of GDP.

[2] Source: 2010 – *Autumn EDP fiscal notification*; 2011 – statement by the Minister of Finance of 7 October 2010. The Draft Budget Act does not contain information on the expected amount of general government deficit in ESA95 terms.

The presented Draft therefore represents a step in the direction of reducing the excessive general government deficit. Nevertheless, neither the Draft itself nor the Multi-Annual Financial Plan of the State adopted by the Government in August 2010 present measures whose scale would ensure lasting sustainability of public finances in the medium term**.** With a view to the most probably gradual process of world economic recovery, large fiscal imbalances and significant price volatility in government securities markets, it is not only necessary to initiate a consolidation process, but also to propose credible mid-term strategies for reinstating permanent fiscal sustainability. Such strategies should contribute to upholding the confidence of financial markets and economic agents alike, and pave the way for the return of stable economic growth in the medium term.

Alongside the central budget deficit reduction, the submitted Draft foresees a significant reduction in the net borrowing requirement of the central budget, from PLN 79.1 billion down to PLN 56.3 billion. It has to be emphasised, however, that the borrowing needs in 2011 are significantly affected by one-off factors, such as high proceeds from privatisation, improved liquidity management in the public sector and extraordinary non-tax revenues. The one-off nature of these factors implies that they will not warrant a permanent halting of the rate of public debt build-up.

The fiscal tightening planned for 2011 is to be achieved mainly by raising the public finance revenue. On the expenditure side, apart from some modest savings arising from previously introduced legislative measures and those that are to enter into force in 2011[3], the Draft expects the introduction of a rule curbing the growth in discretionary expenditure. In the assessment of the MPC, the introduction of a fiscal rule is, in principle, a desirable solution. As evidenced by the experience of many countries, as well as the results of empirical studies, fiscal rules may constitute an effective instrument supporting the maintenance of public finance discipline. Such are the effects of rules which are clearly defined, simple and transparent. However, the so-called temporary rule provided for in the Draft seems not to meet these conditions fully, primarily due to the lack of a unequivocal criterion of dividing spending items into legally determined and discretionary ones. Moreover, the rule only applies to a part of expenditure of the central budget, while the shape of fiscal policy is determined by all the expenditures of the general government sector. According to the background document to the Draft, despite the effect of this rule, the sector's expenditure in cash terms is set to grow from 45.9% to 46.6% of GDP.

[3] Public expenditure should be lowered by reforms implemented in the past, including the phasing out of early retirement in the general pension system. The scale of savings in this respect – though still small in the next year – will be rising in the years to come.

I. Macroeconomic assumptions

1. A important factor affecting the Polish economy is economic growth of its main trading partners, especially in Europe. Following a strong decline in economic activity at the turn of 2008 and 2009, since the second half of 2009 the global economic climate has been improving. In the NBP's assessment, the forecast rate of economic growth in the euro area in 2011 accounted for in the background document for the *Draft* may be considered realistic. However, it has to be emphasised that the materialisation of those forecasts is subject to significant risk factors. The main source of uncertainty connected with economic activity in the world economy are the effects of large fiscal imbalances in those economies and of the expected measures aimed at their reduction.
2. The assumptions concerning the development of Poland's economic situation in 2010-2012 presented in the Draft *Budget Act for the Year 2011* are similar to the NBP's assessment. The NBP shares the expectations presented in the background document to the Draft that domestic demand will play a leading role in shaping economic growth. Public investments will be a key factor sustaining total investment growth. Both the Ministry of Finance and the NBP expect a stable increase in individual consumption in these years, yet the NBP expects consumption growth to be lower in 2012. Among others, this difference results form less optimistic forecasts of labour market developments, assumption of greater propensity of households to stabilise their consumption growth in time (especially the consumption of non-durable goods) and a moderate – in the opinion of the NBP – growth of the remaining components of disposable income of households (except for revenues from paid employment). The scenario presented in the background document to the Draft, which points to deterioration in the trading balance in 2011-2012, is consistent with the NBP assessment.
3. In the NBP's assessment, the rate of employment growth and a drop in the unemployment rate in 2011 may prove lower than assumed in the Draft. It should be expected that the growth of employment will be accelerating relatively slowly due to a limited decline in the number of working persons in the period of economic slowdown at the turn of 2008 and 2009. At the same time, the growth rate of wages in the Draft is consistent with the NBP's assessment.
4. According to NBP analyses, the growth of agricultural commodity prices abroad and the increase of VAT rates may temporarily step up the rate of price growth, thus the rate of

inflation in 2011 may transitorily run at a slightly higher level in relation to the path foreseen in the Draft.[4]

II. Central budget revenue

5. In line with the submitted Draft Budget Act for the Year 2011, the tax revenues of the central budget will be approx. 8.8% higher than the anticipated realisation for 2010, and their relation to GDP will rise from 15.8% to 16.2%. Both the anticipated realisation of tax revenues in 2010 presented in the Draft *Budget Act for the Year 2011* and the forecast of tax revenue for the next year contained therein may be considered realistic.
6. The expected growth in the relation of tax revenues to GDP will be the effect of planned modifications to the tax system, including especially the increase in rates of tax on goods and services. According to NBP estimates, in the general government sector as a whole, the total effect of new legislative measures in the area of tax revenues in 2011 will reach approx. 0.6 percentage point of GDP, thus accounting for the major part of the anticipated fiscal adjustment.
7. The majority of the planned increase in tax burden planned for 2011 will be in the area of indirect taxes. The scale of the inflation impulse following from VAT and excise tax changes planned for 2011 will be relatively minor and, in line with NBP estimates, will amount to approx. 0.3-0.5 percentage point. Even though this impulse will be transitory in nature, it may bring about an increase in inflation expectations.
8. The Draft also envisages a considerable increase in non-tax revenues of the central budget in 2011 (21.6% higher in relation to the expected outturn in 2010). This growth, however, will result from two one-off measures, amounting to raising the current revenues at the expense of diminishing government assets or future budget revenues. The most important transaction of this kind will be payments from state-owned BGK bank, classified in the ”Payments, fines, interest and other non-tax revenue“ item[5], which are to generate revenues in the amount to almost PLN 5 billion. Moreover, the increased contribution of the Agricultural Property Stock of the State Treasury to be paid in 2011 to the central budget will result both from transferring the surplus for 2010

[4] The latest projection of inflation and GDP will be published in the October *Inflation Report*.
[5] See: Background document to the Draft, page 38.

(PLN 0.66 billion) and the down payment of the surplus for 2011 (additional PLN 1.5 billion).[6]

9. To a lesser extent, non-tax revenue growth will be stimulated by the systemic change consisting of the inclusion of auxiliary units and budgetary establishments in the central budget, both on the revenue and expenditure side.[7]

III. Central budget expenditure

10. The proposed Draft envisages a rise in central budget expenditure from the PLN 301.2 billion[8] level set out in the *Budget Act for the Year 2010* to PLN 313.5 billion in 2011, i.e. a rise of approx. 4.1%. The 2011 spending plan has been prepared with the use of the so-called temporary expenditure rule, which provides that the real growth rate of discretionary expenditure and new legally determined spending should not exceed 1%.

11. Limiting the scope of application of the proposed rule to discretionary expenditure only is problematic. The division of expenditure into legally determined and discretionary ones is not clear-cut. This is evidenced by the differences between the specifications of the categories of legally determined expenditure contained in the background documents to the budget acts for 2000-2007 and the Draft for 2011. Moreover, the list of legally determined expenditure items presented in the background document to the Draft differs from that contained in the Act Amending the Public Finance Act and Some Other Acts.[9]

[6] It seems, at the same time, that ESA95 rules suggest that both the above mentioned transactions should be classified as revenues financing the deficit, which may mean that they will not decrease the general government sector's deficit according to this classification. In line with those rules, the detailed presentation of which can be found in *ESA95 Manual on Government Deficit and Debt* published by Eurostat, a large and extraordinary payment from the reserves of a state-owned enterprise that significantly diminishes the amount of own capital should be treated as below-the-line deficit financing. Meanwhile, the principle of accrual accounting means that the surplus of the Agricultural Property of the State Budget paid for two years (2010 and 2011) should not constitute revenue of the general government sector within one year.

[7] The Draft contains a specific prevision for the results of systemic changes following from Article 94 of the Provisions Implementing the Public Finance Act, in the amount of PLN 1.16 billion.

[8] It is foreseen in the Draft that the budget expenditure in 2010 will be realised at the level of 98.9% of the plan presented in the *Budget Act for the Year 2010*. Thus, the expenditure limit provided for in the Draft for 2011 is 5.2% higher than the expected realisation in 2010.

[9] Additionally, the reduction in the domestic co-financing of direct subsidies for farmers contributes quite noticeably to the slowing growth rate of discretionary expenditure in 2011. Considering the fact that this reduction is obligatory and results from the schedule (agreed on in the course of pre-accession negotiations) for increasing the level of EU-budget subsidies for farmers from new member states, treating this category of expenditure as discretionary raises some doubts.

12. It should also be noted that both the theory and findings of empirical studies indicate that expenditure rules are primarily useful as an instrument for maintaining the already achieved fiscal discipline and preventing pro-cyclical fiscal policy developments. In countries where the operation of expenditure rules is deemed effective, they have been introduced only after a fiscal tightening took place.[10] Meanwhile, these rules themselves do not have a significant contribution to reducing the budget deficit.[11] The limited scope of application of the expenditure rule means that in the general government sector as a whole, the relation of expenditure (in cash terms) to GDP will rise from 45.9% in 2010 to 46.6% in 2011, which will primarily be the effect of higher capital expenditure, connected with EU-fund utilisation. Since Poland acceded to the European Union in May 2004, the share of gross fixed capital formation in public expenditure has significantly surged – its relation to GDP rose from 3.3% in 2003 to 5.2% in 2009.

IV. Situation in the general government sector

13. According to the background document to the Draft, the general government deficit in cash terms will fall in 2011 from 6.3% of GDP, recorded in 2010, to 5.0% of GDP. A more comprehensive and methodologically consistent measure is the ESA95 balance[12], which is commonly applied in analysing the public finance situation in EU countries. In line with the autumn EDP notification submitted by the Central Statistical Office to Eurostat, in 2010 the deficit in ESA95 terms may reach 7.9% of GDP. In turn, in 2011, according to the latest announcements of Government representatives, it is expected to amount to 6.5% of GDP.[13] In the light of the latest data and forecasts, the above scenario seems to be realistic.

14. The implementation of the Draft in its present form will imply the continuation of the practice observed over the past years of shifting the deficit from the central budget to

[10] Ljungman G., *Expenditure Ceilings – A Survey*, IMF Working Paper 282, 2008

[11] X. Debrun, L. Moulin, A. Turrini, J. Ayuso-i-Casals, M. S. Kumar, *Tied to the mast? National fiscal rules in the European Union*, Economic Policy, Vol. 23, Issue 54, 2008

[12] Due to methodological imperfections, the deficit in cash terms does not give the true picture of the situation in the general government sector. This measure of the deficit is distorted, among others, by the privatisation proceeds (in the part earmarked to privatisation-related funds and constituting their revenue) and the balance of EU funds. Moreover, the above measure does not include the balance of the National Road Fund, which reports an ever rising deficit due to growing road investment. It should also be emphasised that, in cash terms, the flows of funds accumulated in the Demographic Reserve Fund to the Social Security Fund in 2010-2011 are treated as revenue lowering the deficit of the Social Security Fund, while in accrual terms it represents a transfer of funds between units of the sector, and thus does not affect the balance of the sector.

other general government units. The Draft provides for a rise in the Social Security Fund deficit, resulting from the adoption of the central budget subsidy at a level that is insufficient for closing the gap between own income of the Fund and its expenditure on benefit payments. Moreover, the Draft implies the maintenance of the current model of financing the construction of public roads by incurring liabilities by the National Road Fund.[14] The practices of burdening other units with expenditure earlier executed by the central budget, as well as of lowering of the central budget deficit by one-off revenues, reduce the transparency of public finances and hamper the analysis of the fiscal policy pursued by the Government.

15. In line with the presented Draft, the combined deficit of extrabudgetary funds will increase from PLN 4.7 billion in 2010 to PLN 6.3 billion in 2011, which will mainly be driven by the negative balance of the Social Security Fund. The difference between revenues of the Social Security Fund – including the refunding of contributions transferred to second-pillar Open Pension Funds and the transfer from the central budget – and overall expenditure of the Fund, which was close to zero in the years 2005-2007, in 2009 reached approximately – 15 billion. Such a profound imbalance was connected with the assumed amount of the central government budget transfer to the Social Security Fund, insufficient to finance the consequences of the reduction in the disability pension contribution, with the gap further worsened by the deterioration in contribution revenues of the Social Security Fund resulting from the economic slowdown. According to the financial plan of this fund, envisaged in the draft *Budget Act*, this gap will be maintained at the level of approx. PLN 11 billion in the years 2010-2011. Therefore, the document assumes that the central government budget subsidy in 2011 will again be insufficient to cover the difference between the Fund's revenues from contributions and the Fund's expenditure. It is assumed that the Fund will again be

[13] Therefore, it will prove higher than the value planned for 2011 in the *Convergence Programme. Update 2009* (i.e. 5.9% of GDP).

[14] In line with the Polish methodology, the National Road Fund is not included in the general government sector, while it belongs to the sector according to ESA95 rules. Neither the draft *Budget Act for the Year 2011* nor reports on budget act implementation for previous years contain information on the amount of expenditure and liabilities of the National Road Fund. In 2009 the expenditure of the National Road Fund totalled PLN 13.4 billion, while at the end of year its debt reached PLN 19.0 billion. In 2010 its expenditure are to close at PLN 32.3 billion, while its proceeds from loans and bond issues will be PLN 18.9 billion. (Source: Data for 2009 – *Analysis of central budget and monetary policy implementation in 2009*, Supreme Audit Office; 2010 - answer of the Undersecretary of State in the Ministry of Infrastructure to the parliamentary question No. 12564, presented in the lower chamber of the Polish Parliament (Sejm) on 30 November 2009).

supplied with the transfer from the Demographic Reserve Fund.[15] Considering the fact that the funds collected in the Demographic Reserve Fund were supposed to mitigate the fiscal effects of the ageing population whose intensification will be felt in the subsequent decades only, the spending, for the second consecutive year, of considerable funds gathered at the Demographic Reserve Fund for the on-going service of old-age pension benefits does not support long-term sustainability of public finance. The scheduled transfer from the Demographic Reserve Fund would not balance the fund of the Social Security Fund. As planned, the Social Security Fund in 2011 will become indebted with the central government budget and with commercial banks. As a result, at the end of 2011 the total debt of the Social Security Fund with the central government budget is supposed to reach PLN 13.9 billion and that with commercial banks PLN 1.6 billion.

16. In line with the draft *Budget Act*, the deficit of the local government sector will remain at a high level (0.7% of GDP in cash terms). Financial condition of local government entities has deteriorated considerably over the past few years, among other things, due to the economic slowdown limiting tax revenues and a decline in personal income tax proceeds, resulting from legislative changes in the tax system[16] (the total impact on revenues of local government entities of approx. 0.6% of GDP). At the same time, expenditure growth of local government entities has remained at a high level, largely due to co-financing of the EU projects.[17] Situation of this sector both in 2010 as well as in 2011 constitutes a potential risk factor for the growing public finance sector deficit as compared with the predictions.

V. Task-based budget

18. Similarly to previous years, the background document to the draft *Budget Act for the Year 2011* contains a list of scheduled central budget expenditures broken down by tasks. As compared to the previous budget presentations, this structure of expenditures will include two new elements. The first one will be the identification of the amount of funds allocated to a specific task from the EU budget funds and identification of the

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[15] In 2010 the transfer from the Demographic Reserve Fund to the Social Security Fund amounted to PLN 7.5 billion; the transfer of PLN 4.0 billion is planned for 2011.

[16] Change in the PIT tax rate schedule and implementation of the child raising tax allowance.

[17] In accordance with the report on central budget implementation in 2009, the expenditure of the local government entities on co-financing of EU programmes and projects totalled PLN 4.6 billion.

funds administrator. This allows to ascertain the extent to which the EU funds are committed to the fulfilment of tasks assigned to particular priority government functions. Another new solution is an attempt to discuss the risks connected with the implementations of tasks included in the task-based presentation of the central government budget. However, these risk assessments are not precise, which results, on the one hand, from the pioneer character of assessments presented in the project, and, on the other hand, from the method of selection of indicators for measuring task implementation.

19. Majority of tasks are carried out by several funds administrators at the same time. Each of them individually determines the indicator to assess activities carried out and financed by such an administrator. As a result, the number of indicators describing the task is the function of the number of funds administrators involved in the financing of a particular task. Frequently, so determined indicators are not coherent. Thus, it is not clear whether disbursement of funds allocated to carrying out a task by one of funds administrators may be equivalent to the carrying out of the task envisaged in the draft budget act. At this point, a question arises how such partial implementation, and more strictly, funds disbursement should be assessed.

20. Description of the central government expenditure on a task-based basis should, at the current stage of implementation of this method of the central government budget presentation – be assessed as another step en route to development of a coherent concept of a task-based budget, however, bearing in mind the weaknesses of this concept. The first weakness results from the structure of division of competences between organisational entities of the public finance sector, in particular, between central government entities. Preparation of the draft version of the task-based budget act should be preceded by the analysis of the chart of competences with a view to reducing the number of contractors involved in the implementation of particular task or indicating which of the funds administrators should coordinate the group of contractors. The second weakness is connected with the method of formulating objectives and selecting indicators for assessing their performance. In the case of groups of contractors, indicators should be selected in a way, which would allow an assessment, on the basis thereof, whether public funds have been disbursed effectively by each of the funds administrators.

21. The Public Finance Act assumes that already in 2013 the central government budget will be presented, adopted and implemented on a task-based basis, therefore there is a need to continue intensive works to establish the structure of the budget act presenting revenues and expenditures of the central government budget in the new form.

VI. Borrowing requirements and public debt

22. The draft *Budget Act for the Year 2011* envisages a reduction in the net borrowing requirement of the central government budget from the level of PLN 79.1 billion in 2010 to PLN 57.1 billion in 2011, following its dynamic rise in the years 2008-2010. Assessment of the trends in the development of this budget category as compared to the previous years is hindered by one-off factors and introduction of a systemic change. Those factors have a key impact on the level of net borrowing needs of the central government budget in 2010 and 2011. First, the planned level of revenues from privatisation in 2010-2011 is considerably higher than in the previous years. Moreover, transfers from gross proceeds from privatisation to the Reprivatisation Fund and the Entrepreneurs' Restructuring Fund[18] have been reduced, which results in a growing share of net proceeds in gross proceeds. Second, the transfer of resources from the Demographic Reserve Fund to the Social Insurance Fund is conducive to the reduction in net borrowing needs in 2010. A similar measure is scheduled for 2011. Third, 2009 saw a systemic change as a result of which the burden of financing the investments envisaged in the National Road Construction Programme for the years 2008-2012 was transferred from the central government budget to the National Road Fund which resulted in the reduction in the level of borrowing needs of the central government budget.[19]

23. Reduction in net borrowing needs of the central government budget in 2011 to the scale envisaged in the draft *Budget Act*, is subject to certain risks. Decline in borrowing needs will be largely conditioned upon the scheduled realisation of privatisation proceeds and

[18] Under the Act of 29 April 2010 Amending the Commercialisation and Privatisation Act and the Provisions Implementing the Public Finance Act (Journal of Laws No. 108/2010, item 685), the amount of transfers in the years 2010-2011 was reduced: in the case of the Reprivatisation Fund from 5 to 1.5 percent, and in the case of the Entrepreneurs' Restructuring Fund from 15 to 3 percent. Starting from 1 January 2012, changes in the amount of transfers to those funds will be set forth in the Budget Act.

[19] Under the Act of 22 May 2009 Amending Some Acts on Toll Motorways and on the National Road Fund and Some Other Acts (Journal of Laws No. 86/2009, item 720).

raising of additional funds in the amount of PLN 19.8 billion due to the improvement in liquidity management in the public sector.[20]

24. It should be noted that legal regulations providing for the introduction of a single treasury account, accumulating funds in an account of the Ministry of Finance, are now at a preliminary stage of the legislative process[21], which poses a certain risk for the success of the project. The draft version of the amendment to the Public Finance Act will be supplemented with respective decrees of the Minister of Finance which will create the framework for the operation of a new liquidity management mechanism. Some of the projected solutions may weaken the incentives for frugal management by entities to which this mechanism applies. This would adversely affect the budget deficit and public debt in the long-term perspective.

25. According to the draft *Budget Act for the Year 2011*, public debt according to the domestic definition is to reach a level of 54.2% of GDP at the end of 2011.[22] Therefore, there is a serious risk of public debt exceeding the second prudential threshold, envisaged in the Public Finance Act. Keeping public debt in 2011 below 55% of GDP may be threatened by a number of factors: (i) possible depreciation of the zloty against major currencies, (ii) lower than assumed GDP growth, iii) failure to realise the planned proceeds from privatisation or obtain additional funds resulting from the operation of a new liquidity management mechanism in the forecast amount, (iv) higher than projected local government deficit in 2010 and 2011.

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[20] The new mechanism will be conducive to the reduction of net borrowing needs in 2011 only.

[21] See draft of the Act of 22 October 2010 Amending the Public Finance Act and Some Other Acts. It provides for a new form of investment of free funds (with the exception of amounts constituting central government subsidies) – a deposit with the Ministry of Finance:

- obligatory in the case of administrators of state-owned purpose funds (except for those administered by ZUS (Social Insurance Institution) and KRUS (Agricultural Social Insurance Fund), the National Health Fund, executive agencies and other state-owned legal entities established to carry out public tasks, with the exception of enterprises, research and development centres, banks and commercial law companies and the State Forests - National Forests Holding;
- non-obligatory in the case of local government entities and their associations, ZUS (Social Insurance Institution) and KRUS (Agricultural Social Insurance Fund) and funds administered by them, independent public health care institutions, public universities, Polish Academy of Sciences (and organisational units established by it), central government and local government cultural institutions, central government film production enterprises, other local government legal entities.

[22] According to the Ministry of Finance's document: *The Strategy of public debt management in the public finance sector in the years 2011-2014*, public debt in 2012 will amount to 54.3% of GDP.