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 2012*

Budget policy in Poland, like in most European Union countries, is facing the challenge of implementing fiscal adjustments necessary to maintain credibility in the financial markets, amidst weakening and highly uncertain economic growth. In view of this challenge, the *Draft 2012 Budget Act* has been based on conservative assumptions concerning future macroeconomic developments and provides for significant measures to curb the public finance deficit. According to the NBP estimates, the adopted legislation changes should reduce the 2012 general government deficit by approx.1.7 percentage points of the GDP.

The general government deficit ceiling of PLN 35.0 billion, as set out in the draft *Act,* is lower than the figure adopted in the *2011 Budget Act*, yet higher than the anticipated deficit out-turn in 2011 (of PLN 30.2 billion). At the same time, the government envisages a reduction in the out-turn for the general government deficit according to the national definition from 4.2% of the GDP anticipated for this year, to 2.9% in 2012. Furthermore, government officials declare a reduction in the general government deficit as defined in ESA95 terms, from 5.6% of the GDP[1] in 2011 to approx. 3.0% of the GDP in 2012, in line with the obligations imposed upon Poland by the EU Council under the Excessive Deficit Procedure.

According to the NBP estimates, the extent of the reduction in the ESA95 deficit planned for 2012 resulting from the adopted legislation changes will be slightly lower than the effect recorded in 2011 (approx. 2.0 percentage points of the GDP). When taking into account the less favourable macroeconomic circumstances anticipated in 2012, the achievement of the magnitude of deficit reduction assumed by the government is subject to considerable risk and strongly contingent on discretionary measures. The envisaged tightening relies heavily on reining in expenditure not covered by the government budget, which negatively impacts the transparency of fiscal policy. The decrease in the ESA95-terms deficit is to result, to a considerable extent, from narrowing the gap in the balance of the National Road Fund (Krajowy Fundusz Drogowy, KFD) – whose financial plans and reports are not attached with the *Draft Budget Act* or *Report on State Budget Execution* - as well as a reduction in the deficit of local government units. However, since these units conduct an autonomous budget policy, their plans also are not incorporated in the *Draft Act*. Another aspect that may be seen

[1] The expected out-turn of the ESA95-terms deficit as laid out in the *2011 Convergence Programme Update,* and confirmed in the *Autumn EDP Fiscal Notification* submitted to the Eurostat (October 2011).

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as lacking in transparency is the way the *Draft Act* treats the temporary expenditure rule, in force as of 2011: the document does not provide any information on the planned expenditure level falling under this rule.

According to the NBP estimates, the fiscal tightening planned for 2012 is supposed to be driven to a larger extent by an increase in the general government sector revenue rather than cuts in its expenditure[2]. Meanwhile, empirical studies suggest that in order to achieve a durable effect, fiscal adjustments should preferably focus on the expenditure side.

In the subsequent years, it will be necessary to implement further measures aimed at a significant reduction in the public finance imbalance, beyond those taken under the *2011 Budget Act* and the *Draft 2012 Act*. This is because, firstly, the level of structural public finance deficit in 2012 will continue to deviate significantly from the medium-term objective of 1% of the GDP. Secondly, some of the actions taken to date in order to limit the general government deficit are of a temporary and ad-hoc nature. The effect of some measures – such as VAT rate rises and the reduced amount of social security contributions transferred to the Open Pension Funds (Otwarte Fundusze Emerytalne, OFE) will be phased out, thus contributing to a deterioration, equal to 0.6 GDP percentage points, in the general government balance in 2013-2014. Freezing government sector wages is again a move of an ad-hoc character, while the high dividend income planned for 2012 will be a one-off phenomenon.

Once the necessary fiscal adjustments are implemented, in order to maintain lasting discipline in public finances it would be desirable to enhance the institutional framework for fiscal policy, i.e. fiscal rules and procedures. During the last economic boom, the rules and procedures in place were not sufficient to prevent a pro-cyclical relaxation of fiscal policy, which was one of the reasons behind the public finance problems observed in the recent years. Notwithstanding the amendments introduced by the new Public Finance Act, in force since 2010, Poland is still lacking institutional arrangements which would improve discipline in fiscal policy throughout the entire business cycle. The permanent expenditure rule, whose introduction was announced by the government as early as January 2010, could have been such a solution; yet so far, the rule has not been presented in more detail. Even if the rule were to come into effect only in a few years' time, upon the completion of the process of reducing the general government deficit – a timing mentioned in the *Justification to the Draft Budget Act* – its early adoption could be an important sign of the government's determination to keep the public finances in rein and gradually decrease the debt-to-GDP ratio.

In sum, the Monetary Policy Council believes that there exist two principal sources of risk to the implementation of the presented *Draft Act*. The former relates to the envisaged macroeconomic developments in Poland and worldwide, which, at the moment, are particularly uncertain. The other risk results from the assumed reduction of the 2012 general government deficit. The extent of the reduction is large, yet to a significant degree dependent on discretionary spending cuts in units not covered by the *Draft*.

[2] According to the table on p. 207 of the *Justification to the Draft Act*, general government revenue is to increase from 40.3% of the GDP in 2011 to 42.0% in 2012, while expenditure is to rise from 44.5% of the GDP to 44.9% of the GDP.

I. Macroeconomic assumptions

1. The scenario for economic developments in Poland in 2012 presented in the draft *Act*, relies on the assumption of a marked economic slowdown in countries being Poland's main trading partners, with consolidating measures being concurrently launched by the Polish government with a view to reducing the general government deficit in 2012. This scenario is broadly consistent with the NBP's assessment of the economic developments over the coming year.
2. A material fiscal tightening involving both measures which increase tax burden and expenditure cuts will constitute a factor with an adverse effect on economic activity in Poland in the short and medium term. As follows from the draft *Act*, public consumption is expected to level off and public investment to fall.
3. According to the *Justification to the Draft Act*, economic growth in 2012 will be supported by rising consumer demand of households and persistently rising – although at a slightly weaker pace than in 2011 – corporate investment demand. In a slight contrast to this, the NBP assesses that weaker growth in countries being Poland's main trading partners and the anticipated fiscal tightening at home, combined with a lower utilisation of EU funds will dampen corporate and household demand versus their 2011 trends. The NBP believes, on the other hand, that GDP growth will be supported by improving price competitiveness of domestically manufactured goods due to the zloty depreciation which has continued since September 2011. The scale of the improvement and the ensuing positive contribution of net exports to the GDP may prove higher than assumed in the draft.
4. The assumed scenario of developments in the domestic labour market appears to be another realistic element of the *Draft*, which envisages slower employment growth and subdued growth in the wage bill in the economy in 2012, both dragged by weaker GDP growth in Poland and abroad.
5. A slower pace of economic growth and moderate cost pressure of the labour market will bring down inflation in 2012. On the other hand, inflation will be fuelled by higher import prices, which have been rising as a result of the depreciating zloty. As a consequence, the 2012 inflation will be down on its 2011 level, but may remain – in line with the *Draft* assumptions – above the NBP's inflation target of 2.5%.

II. State budget and general government revenue

6. According to the presented *Draft Act*, the total 2012 revenue of the state budget will amount to PLN 293.8 billion, thus exceeding the out-turn anticipated for 2011 by approx. 5.2%, while its ratio to the GDP will be maintained at the level of approx. 18.5%.
7. The tax revenue of the state budget will increase on the anticipated 2011 out-turn by approx. 7.3%, while its ratio to the GDP is expected to rise from 16.3% to 16.7%. The anticipated increase in the tax revenue-to-GDP ratio will result primarily from

legislation changes, including the rise of excise tax on diesel and tobacco products as well as the introduction of a new tax on copper and silver mining. Both the out-turn of tax revenue as anticipated by the *Draft Act* for this year and the forecast of this revenue for 2012 may be considered realistic.

8. According to the *Draft Act*, the 2012 dividend revenue will reach PLN 8.2 billion and will exceed its anticipated 2011 out-turn by PLN 2.2 billion (i.e. by 37%). High receipts under this heading will be related to good business performance of state-owned enterprises in 2011 and extraordinary revenues generated by some of them as a result of the sale of shares in the Polkomtel company. It should be noted at this juncture that part of the dividend income is therefore of one-off character.

9. General government revenue in cash terms is expected to grow from 40.3% of the GDP in 2011 to 42.0% of the GDP; this will be driven, apart from increased tax revenue, by higher income deriving from EU funds and other non-refundable sources as well as social security contributions (due to the redirection of part of the pension contribution from the Open Pension Funds [OFE] to the Social Insurance Fund [FUS] as well as an increase of the disability contribution by 2 percentage points of the salary).

III. State budget and general government expenditure

10. The *Draft 2012 Budget Act* provides for total state budget expenditure at PLN 328.8 billion, i.e. a level exceeding by 4.9%, in nominal terms, the limit set for 2011. In relation to GDP, it will remain at an unchanged level of 20.7%. Starting with the present *Draft Act*[3], the provisions of the Public Finance Act require that the so-called temporary[4] expenditure rule be applied in the construction of the Budget Act. The rule stipulates that the increase in any expenditure other than legally mandated may not exceed, in nominal terms, the forecast increase in the consumer goods and services index enhanced by 1 percentage point. According to the NBP estimates, the temporary expenditure rule applies to as little as approx. ¼ of the state budget expenditure.

11. The manner in which the impact of the temporary expenditure rule is addressed in the *Draft Act* is not transparent. The document does not present any data on aggregate spending to be covered by the rule as compared with other spending or their respective growth rates. It is impossible to conduct this kind of analysis independently, as the *Draft Act* does not contain the necessary data.[5] The submitted *Draft Act* even fails to provide information on the share of mandatory expenditure in the state budget, similar to that presented in the *Justification to the 2011 Draft Act*, which included a presentation of the structure of mandatory expenditure, albeit without addressing their total level or growth rate.

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[3] According to the *Justification to the 2011 Draft Budget Act* (September 2010), the Act was prepared on the basis of the temporary expenditure rule, in spite of the fact that no statutory provisions imposing the obligation to adhere to it were in place at that juncture. The temporary expenditure rule was introduced by the *Act Amending the Public Finance Act of 16 December 2010* (Journal of Laws 2010, no. 257, item. 1726).

[4] The temporary expenditure rule will apply until the Excessive Deficit Procedure for Poland is abrogated.

[5] Among other items, with respect to funds earmarked for expenditure on land transport infrastructure and transfers to international institutions.

12. According to the *Justification to the Draft Act*, in 2012 current spending other than social and debt service expenditure[6] is expected to rise relatively slowly. Current spending is anticipated to rise by 4.9% in 2012, against a growth of 6.2% recorded in 2011. This decline may be largely attributed to the local government sub-sector, whose expenditure is expected to reach PLN 226.9 billion in 2012 against PLN 225.1 billion (a rise of 0.8%) budgeted for 2011, according to the *Justification to the Draft 2011 Budget Act*.

IV. State budget and general government deficit

13. The 2012 budget deficit ceiling of PLN 35.0 billion adopted in the *Draft Act* is lower than the *2011 Budget Act* figure (of PLN 40.2 billion), yet higher than the anticipated actual deficit in 2011 (PLN 30.2 billion). In relation to the GDP, the 2012 state budget deficit (2.2% of the GDP) is to decrease as compared to the statutory plan for 2011 (2.7% of the GDP) while rising on its anticipated out-turn (2.0% of the GDP).

14. The *Draft Act* provides for a significant reduction in the general government deficit as defined in cash terms – from 4.2% of the GDP in 2011 down to 2.9% of the GDP in 2012. According to the *Convergence Programme 2011 Update*, the extent of fiscal adjustment as expressed in ESA95 terms is to be even larger – the deficit is expected to decline from 5.6% of the GDP to 2.9% of the GDP. The achievement of deficit reduction on this scale is subject to serious risk.

15. It follows from the *Draft Act* that virtually all fiscal adjustment is to take place in the general government sector units other than those covered by the state budget. The balance of special-purpose funds and other entities whose financial plans have been attached with the *Draft Act* is envisaged to improve by 0.4% of the GDP[7]. Information contained in the *Draft Act* and other government documents[8] implies that the general government deficit should also improve to a significant extent through reduced deficits of local government units.

16. The *Justification to the Draft Act* mentions the expected decrease in the deficit of local government units, resulting from, among other things, adoption of the rule requiring that their current budgets be balanced, in force as of 2011. However, a vast majority of local government units generate current surpluses, thus not offering much room for the rule to bring about any significant changes in their budget policies.[9] According to the NBP's analyses, the ceiling on local government debt at 60% of their revenue will have

[6] Social spending is to rise by 5.2%, while interest payments will grow by 13.3%.

[7] The balance of state special-purpose funds, adjusted for privatisation proceeds booked as revenue, is to improve from the expected deficit of PLN 6.0 billion in 2011 to a surplus of PLN 0.4 billion in 2012. The surplus from the executive agencies, state legal entities and budget institutions is to be reduced from PLN 1.1 billion in 2011 to PLN 0.6 billion in 2012.

[8] *Multi-year Financial Plan 2011-2014*, April 2011 and *Convergence Programme 2011 Update,* April 2011.

[9] According to the Ministry of Finance, the aggregate current deficit of all the units not generating a surplus amounted to PLN 0.6 billion. Thus, the requirement to balance the current budget resulted in an adjustment of approx. 0.04% of the GDP. This adjustment must take place in 2011.

a greater disciplinary impact[10]. Even considering the slight improvement observed this year[11] in the balance of the local government units and the application of the rules in effect, the envisaged scale of reduction in the deficit of the local government sub-sector from GDP 1.2% in 2010 to GDP 0.3% in 2012 seems too large.

17. The ESA95-terms public finance imbalance is to be further reduced owing to a decline in the deficit of the National Road Fund (KFD). This is a major factor explaining the larger scale of fiscal adjustment as expressed in ESA95 terms than the one defined in cash terms[12]. Based on the information on KFD's planned spending contained in the National Road Construction Programme 2011-2015, the forecasts of public sector debt calculated on the basis of the national methodology and debt defined in ESA95 terms as presented in the *Public Finance Sector Debt Management Strategy 2012-2015*[13], the 2012 KFD deficit may be expected to diminish on its 2011 level. However, since the KFD financial plans are not enclosed with the *Draft Act*, and its financial reports are not attached with the Reports on State Budget Execution, it is impossible to assess the contribution of the unit's deficit reduction to the overall fiscal tightening.

18. The presented *Draft Act* provides for a change in the strategy for public finance consolidation in 2012 as compared with 2011. The reduction in the ESA95-terms general government deficit implemented in 2011 was primarily based on legislation changes, whose combined scale, in the NBP's assessment , was to have reached 2.0% of the GDP. The estimated impact of the legislation changes in 2012 is weaker and amounts to approx. 1.7% of the GDP[14], in spite of the planned deeper reduction in the general government sector deficit and the fact that the macroeconomic environment will be less favourable. This means that the envisaged deficit reduction will largely rely on discretionary measures, including spending restraint on the part of KFD and the local government units.

V. The borrowing requirement and the public debt

19. The *Draft 2012 Budget Act* envisages an increase in the borrowing requirement both in net (from PLN 32.6 billion in 2011 to PLN 46.2 billion) and gross (from PLN 141.8 billion to PLN 176.1 billion) terms. The increase will primarily result from the one-time

[10] Over the past two years, many local government units have come close to this limit – at the end of 2008, the percentage of local government units posting a debt-to-revenue ratio in excess of 40% was merely 4.8%, while by the end of 2010 it had risen to 18.2%. The rise in debt concerns in particular to larger units – the percentage of city counties with the ratio exceeding 40% rose from 6.2% in 2008 to 36.9% in 2010.

[11] The financial surplus of local government units after three quarters of 2011 amounted to PLN 3.2 billion, as compared to PLN 0.9 billion in the corresponding period of the previous year.

[12] According to the Public Finance Act, the National Road Fund (KFD) is not part of the general government sector, while the ESA95 principles, which apply economic criteria of unit classification into institutional sectors, include KFD in the general government sector.

[13] KFD's spending on the Programme financing is supposed decrease from PLN 30.0 billion in 2011 to PLN 21.6 billion in 2012. The difference between the state public debt and debt in ESA95 terms, which results mainly from the difference in KFD classification, is to increase by PLN 16.0 billion in 2011 and by PLN 12.6 billion in 2012.

[14] The total impact of the 2011 and 2012 legislation changes on the general government sector deficit can be estimated as a decrease of approx. 3.7 % of the GDP, out of which approx. 1.1% of the GDP derives from the redirection of part of the contribution from Open Pension Funds to the Social Security Fund.

decrease of approx. PLN 23.0 billion in 2011 in the borrowing requirement in 2011 as a result of consolidation of public finance sector liquidity management. In 2012, this mechanism will spur a slight increase in the borrowing requirement of the state budget (of PLN 0.2 billion). On the other hand, the reduction in the EU fund deficit from PLN 12.4 billion in 2011 to PLN 4.5 billion in 2012 will work towards lower borrowing requirement. Apart from rising net borrowing requirement, growth in the gross borrowing requirement in 2012 will be driven by higher amounts of debt to be redeemed.

20. Similarly to the period 2009-2011, the designated budget subsidy planned for 2012 will fail to close the gap between the income of the Social Insurance Fund combined with reimbursed transfers to the OFE and the Fund's expenditure. The shortage of funds will continue be offset with transfers from the Demographic Reserve Fund (Fundusz Rezerwy Demograficznej, FRD). As a result, the total amount of FRD funds spent on current pension benefit payments in the years 2010-2012 will reach PLN 14.4 billion, as compared to savings deposited in the FRD, which are to stand at PLN 17.7 billion[15] at the end of 2012. The funds deposited in the FRD derive mostly from privatisation proceeds and were to have been appropriated, in line with the initial assumptions, to mitigate the fiscal impact of population aging in the coming decades. Hence, the fact that they are being spent is not conducive to long-term fiscal sustainability.

21. In spite of the planned transfer from the FRD and a rise in the disability contribution, in 2012 the Social Insurance Fund (Fundusz Ubezpieczeń Społecznych, FUS) will continue to incur debt both with the state budget and commercial banks. At the end of 2012, the cumulative FUS debt to the state budget is expected to stand at PLN 16.2 billion, and to commercial banks – at PLN 0.9 billion. Maintaining the budget subsidy at a level falling short of the Fund deficit for four years while at the same time extending state budget loans to the Fund is designed to improve the cash-terms budget balance and diminishes its information value as a yardstick of fiscal imbalance.

22. The *Draft 2012 Budget Act* envisages a reduction in the public debt-to-GDP ratio to the level of 52.4% by the end of 2012, i.e. 1.3 percentage point below the value anticipated at the end of 2011, which is to be partly driven by the expected appreciation of the zloty[16]. In 2012, the primary balance of the public finance sector will remain slightly negative, both in cash terms (-0.04% of the GDP) and in ESA95 terms (-0.2% of the GDP)[17], which shows that in order to contain public debt growth in a sustainable manner it would be appropriate to further curb the deficit.

[15] According to information provided by the Undersecretary of State at the Ministry of Finance, Ludwik Kotecki, during an interpellation session at the Parliament on 28 September 2011.
[16] The PLN/EUR exchange rates assumed in the *Strategy for Public Finance Sector Management 2012-2015* amounted to 4.35 as at the end of 2011 and 4.00 at the end of 2012
[17] The source for the primary deficit figure in ESA95 terms: *Convergence Programme 2011Update*, April 2011