Warsaw, November 19, 2013

# Opinion of the Monetary Policy Council on the 2014 Draft Budget Act

Fiscal policy is of prime importance to the Monetary Policy Council in terms of ensuring an appropriate coordination of monetary and fiscal policies (the so-called policy mix).

In this Opinion, the MPC takes account of the consequences of adopting fiscal measures presented in the *Draft Budget Act* for the entire economy. Since, similarly to the previous years, the *Draft Act* does not cover all the units of the general government sector, this Opinion also takes into account other official government documents, statements by government officials, as well as estimates and forecasts developed by NBP.

## I. Macroeconomic assumptions of the *Draft Budget Act*[1]

In accordance with the *Justification to the 2014 Draft Budget Act*, economic growth will accelerate to 2.5% in 2014, from the 1.5% expected in 2013. Economic conditions at home will be supported by a revival in economic activity abroad: the *Justification to the 2014 Draft Budget Act* assumes that external GDP growth will rise next year, while remaining below its long-term average. In the light of currently available data, these assumptions should be deemed as realistic.

Stronger GDP growth in 2014 will be supported by, according to the *Justification*, better performance of all – except for public consumption – components of domestic demand, with a neutral contribution of net exports to growth. Public consumption growth is expected to be slower than in 2013 as a result of the process of public finance consolidation envisaged in the *Draft Act*, although in NBP's view, the level of budget expenditure budgeted in the draft implies stronger growth of public consumption than assumed.[2] Narodowy Bank Polski raises no major objections as to the projected development of other components of demand.

Based on the *Justification*, it can be concluded that stronger investment growth in 2014 in comparison to 2013 will result from both the slowing of the downward trend in public investment and stronger private sector investment growth. In the assessment of Narodowy Bank Polski, the assumption that the pace of gross capital formation will rise above that of GDP growth, adopted in the *Justification*, is realistic. This scenario will be

[1] The assessment of the macroeconomic assumptions of the *Draft Budget Act* is based on the November projection of inflation and GDP derived from the NECMOD model.

[2] The most important category of budget expenditure, which contributes to public consumption, is the current expenditure of budgetary units. According to the Draft Act, this category of spending is set to rise by 8.5% nominally in 2014. Meanwhile, public consumption is assumed to remain constant in real terms.



Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 28 faks +48 22 185 10 10

supported by the fact that current capacity utilisation is relatively high – close to its multi-annual average – and by the launch, in 2014, of public investment projects under the new EU financial framework 2014-2020.[3]

NBP shares the opinion expressed in the *Justification to the Draft Act* that the revival in economic activity, anticipated in 2014, as measured with GDP growth, will translate into higher demand for labour and the general situation in the labour market with a lag. For this reason, the *Justification* assumes a stabilisation of the unemployment rate and a relatively weak growth in wages in the economy. These developments in the labour market will drag on households' real disposable income growth. As a consequence, only a moderate increase in private consumption growth is envisaged next year, which is concurrent with NBP forecasts.

Also the scenario for external trade presented in the *Justification* is in line with NBP predictions. Stronger exports growth in 2014 follows from the assumptions of improved economic activity of Poland's main trading partners and about the share of Polish exports in the global trade exchange trending persistently upwards – adopted in the *Justification*. The restoration of domestic demand, in particular with respect to investment, will probably cause a marked acceleration in imports growth. As a result, the contribution of net exports to GDP growth may be expected to narrow down to near-zero levels in 2014, and the current account deficit to GDP ratio may rise slightly in 2014.

According to the *Justification*, given the persisting negative output gap in the economy, inflationary pressure will remain weak next year. One can therefore expect that amidst modest improvement in the labour market situation, entailing slow unit labour cost growth and limited demand pressure, inflation will probably remain below the NBP target in 2014. Considering the above, NBP holds that despite rising economic activity and the resultant higher labour productivity, inflation may run below the 2.4% level assumed in the *Justification*, yet with the caveat that, in similarity to the previous years, a serious risk factor to this scenario is posed by growth in global agricultural and energy prices.

## II. Fiscal Policy in 2014

As in the case of the *2013 Budget Act*, the *2014 Draft Budget Act* does not contain a full set of data concerning the key units generating the demand of the general government sector. The *Draft* does not include information on the planned revenue, expenditure and balance of such entities as the National Road Fund (KFD), National Health Fund (NFZ) and local government units[4]. Also, the draft does not present data on the planned 2013 and 2014 revenue, expenditure and balance of the general government sector, even

[3] According to the amendments to the 2011-2015 National Road Construction Programme adopted by the Council of Ministers.

[4] The *Justification to the Draft Act* does quote the amount of expenditure of the entire local government subsector earmarked for 2014, however without informing about the expected outturn of this expenditure in 2013.

though these figures are presented in the *Convergence Programme Update*, and the main objective of the new expenditure rule is to stabilise exactly the general government balance.

The process of fiscal consolidation initiated in 2011 resulted in a general government deficit reduction from 7.8% GDP 2010 to 3.9% GDP in 2012, despite the fact that deficit reduction in 2012 was hampered by a substantial weakening of tax revenue. In 2013, measures to increase government revenue and curb the growth of public expenditure are being continued, particularly outside the state budget. However, the magnitude of these measures is significantly smaller than in the previous two years. Due to the economic slowdown and the effect of automatic stabilisers, the nominal deficit of the sector will rise to the level envisaged in the autumn fiscal notification (4.8% of GDP) or slightly lower. Traditional methods of computing the structural balance – used by the Ministry of Finance, NBP and international institutions – show the size of fiscal tightening in 2013 to be close to zero or even that fiscal policy is being loosened. For example, according to the government estimates presented in the *Convergence Programme 2013 Update*, the cyclical component of the 2013 budget balance will deteriorate by 0.6 percentage points of GDP[5]. Considering that according to the results of the fiscal notification, the primary balance of the sector is to worsen by 1.1 percentage point of GDP, this means that the change in the primary structural balance, used as the measure of fiscal tightening, will amount to -0.5 percentage points of GDP.

There are, however, indications that under current economic conditions, the structural balance measure does not provide an accurate reflection of the changes in fiscal policy stance. The extent of decline in tax revenue observed in the second half of 2012 and in 2013 is larger than what would result from the development of macroeconomic variables and the elasticities adopted in the estimation of the cyclical component of the budget balance. At the same time, according to NBP estimates, the growth rate of general government primary expenditure this year will be markedly lower than potential GDP growth, which is a sign of continued fiscal tightening on the expenditure side.

The problem of measuring and evaluating discretionary fiscal policy measures taken during an economic slowdown is also observed in other countries. Due to the shortcomings of the structural balance as the tool for assessing these measures, the European Commission proposed an additional measure – the *discretionary fiscal effort – DFE* index[6]. Within this framework, the assessment of the revenue-side monetary policy stance is not based on estimates of revenue adjusted for the impact of the economic cycle, but by the anticipated impact of legislation changes affecting the level of revenue. NBP

[5] The estimates of the output gap that the above cyclical component estimates are based on may be assumed to be current, as the forecasts for real GDP growth in 2013-2016 as presented in the *Draft Act* are identical with those presented in the *Convergence Programme*.

[6] The concept and method to compute DFE were described in detail in the EC report *Public Finances in EMU 2013*.

estimates the fiscal tightening as gauged with this measure to amount to 0.5 percentage point of GDP in 2013.

In 2014, a reduction of the general government sector deficit is expected. According to the Ministry of Finance forecasts, the general government sector will post a surplus, in ESA 95 terms, of 4.5% of GDP.[7] A major role in generating this surplus will be played by the one-off effect of transferring a part of assets from Open Pension Funds (OFE) to the government sector. In ESA 95 terms[8], such an operation is treated as revenue of the general government sector. The planned changes to the pension system will also reduce expenditure on interest payments, while the opting out of some of the participants from the second pillar of the pension system will limit the shortfall in the contributions to the Social Insurance Fund (FUS).

Apart from changes in the pension system, conventional fiscal consolidation measures consisting of revenue increases and constraints on expenditure growth are to be continued. On the revenue side, the measures will include maintenance of frozen personal income tax thresholds and rises in excise tax. Although the *Draft Act* does not comply with the so-called temporary expenditure rule, which had been suspended, other factors will limit the growth of public spending. They include the continuation of the wage bill freeze in the state budget, as well as a relatively slow growth in spending on pension benefits as a result of the increase in retirement age, and a low pension indexation rate (as a result of exceptionally low inflation in 2013). One may also expect continued consolidation of local government expenditure, due to the operation of local government fiscal rules and the ending of the 2007-2013 EU financial framework. Local governments are only expected to begin absorbing EU funds from the next financial framework on a large scale in the subsequent years.

The effect of the measures taken to reduce the fiscal imbalance in 2014 will be partially offset by the introduction of new deficit-increasing legislation changes. These include, among others, changed principles for deducting VAT on passenger cars equipped with a cargo partition, on the fuel for those and the extension of maternity leave as well as increased access to kindergarten education.

NBP estimates the total size of fiscal tightening in 2014, as measured with the use of primary structural balance[9], to reach approx. 0.5-0.8 percentage point of GDP in 2014. In

---

[7] *Information on measures undertaken by Poland to implement Council recommendation under Art. 126.7 of the Treaty on the Functioning of the European Union of 21 June 2013*, published on 21 October 2013

[8] According to the ESA 2010 system of national accounts which will enter into force in autumn 2014, the transfer of OFE assets will be recorded as a financial transaction and will not impact the general government balance. This means, that according to this methodology, the general government will record a deficit in 2014.

[9] The primary structural balance is a general government balance excluding interest payments and corrected for the influence of the economic cycle and one-off effects. Thus, the above mentioned improvement in the primary structural balance does not comprise the revenue resulting from transfer of OFE assets, nor savings in interest payments. The improvement does, however, benefit from the increased revenue of the Social



Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 28 faks +48 22 185 10 10

terms of the DFE index, the scale of the tightening is similar and amounts to 0.7 percentage point of GDP. The anticipated reduction of the structural deficit will partially (approx. 0.2 percentage point of GDP) result from changes in the Open Pension Funds (OFE).[10] This factor, unlike the conventional adjustments in revenue and expenditure, will not have an impact on aggregate demand. Hence, the influence of the fiscal tightening on demand will be smaller. In DFE terms, the scale of tightening having an impact on demand will amount to 0.5 percentage point, as against 0.7 percentage point in 2013[11]; which means that it will decrease despite a marked improvement expected in the cyclical conditions.

## III. Assessment of macroeconomic impact of fiscal policy

The medium-term impact of the steps taken to reduce the deficit of the general government sector described in section II will be determined by their effect on the demand side of the economy. Simulations conducted by NBP indicate that the fiscal adjustments presented in the *Draft Act*, which reduce the growth of expenditure and increase the revenue of the general government sector, will dampen private and public consumption as well as gross capital formation in the years 2014-2015. As a result, GDP growth will decrease on this account by an average of 0.2 percentage points, as compared with the scenario of no change to fiscal policy.[12]

The category to come under the strongest influence of the changes reducing the growth of expenditure of the general government sector – described in section II – will be, in the opinion of the NBP, gross capital formation. Cutbacks in infrastructural expenditure financed by the central subsector and the local government units, while less extensive than in the previous years, will translate into a further drop in public investment in relation to GDP in 2014. The measures designed to stem the general government sector deficit will also affect corporate investment and housing investment through the channel of aggregate demand and households' disposable income.

The freeze on government sector wages announced in the *Draft Act* and the reduction in other current expenditure items will directly translate into the size of private consumption. By reducing income from hired work, it will also have an indirect effect on private consumption. Moreover, income will be weighed down by the rise in the effective PIT rate stemming from, inter alia, the extension of tax thresholds freeze.

The changes in the funded pillar of the pension system, while leading to a substantial reduction of the general government sector debt and deficit, have little impact on

---

Insurance Fund (FUS) as a result of withdrawal of some of the participants from OFE. This is because this measure will have a permanent effect and therefore improves the structural balance.

[10] This refers to the increase in FUS revenue from social contributions as a result of withdrawal of some of the participants from OFE.

[11] The size of the fiscal tightening in 2013 is also affected by changes in the pension system related to the rise in the part of the contribution transferred to OFE from 2.3% to 2.8% of the salary.

[12] Holding the assumption of no adjustment on the monetary policy side.



Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 28 faks +48 22 185 10 10

inflation and GDP within the horizon of monetary policy transmission. As they involve a transfer of savings between the general government and the household sectors, they do not affect the total saving in the economy directly. Thus, the impact of those changes on domestic demand growth in the next two years is relatively limited.

NBP is of the opinion that the effect of the fiscal measures taken in 2014 on the potential output of the Polish economy will be close to neutral. On the one hand, lower investment outlays will translate, albeit with a lag, into a lower capital stock. On the other hand, rising labour participation ratio – following extension of the retirement age – will contribute positively to potential output. In the longer run, the impact of changes in the pension system on the level of savings will depend on whether the improvement in public finances arising from these changes will prove durable. If this improvement turns out to be only temporary, this would imply a reduction in the domestic savings rate, negatively impacting potential output growth.

## IV Fiscal imbalance in 2014 and compliance with fiscal rules

Since the end of the 1990s, fiscal policy in Poland has been subject to the rules set out for public debt in the *Constitution of the Republic of Poland* and the *Public Finance Act*. Pursuant to these, the ratio of the public debt to GDP should not exceed 60%, while exceeding 50% and 55% thresholds triggers the imposition of certain restrictions as regards the drafting of budget acts for the subsequent years. In 2013 an important change is taking place in the institutions of fiscal policy in Poland. The first of the above mentioned prudential thresholds of the debt-to-GDP ratio has been suspended and is to be abolished. In the future, the stabilising expenditure rule is to become the main mechanism of ensuring fiscal discipline.

Despite the application of the debt rule, a loose fiscal policy had been pursued during the economic boom. As a result, fulfilling the rule during the economic slowdown would have required a strong reduction of the budget deficit. As the state public debt-to-GDP ratio persisted above 50%, the relation of the state budget deficit to revenue had to be brought down in the *2013 Draft Budget Act* to a level no higher than that budgeted for 2012. To meet this requirement in the context of the currently forecast level of state budget revenue in 2013 (i.e. the level adopted in the *amended Budget Act*) the budget deficit would have to be reduced to PLN 32.9 billion, which would in turn imply expenditure of PLN 308.6 billion. This would mean a decrease of 1.8 percentage point in the ratio of budget expenditure to GDP relative to its level set in the 2012 budget law (PLN 328.8 billion) in the course of a single year. In an environment of a substantial economic slowdown, such a strong fiscal tightening would have an adverse effect on the real economy.

Under these circumstances, the government decided to suspend the disciplining provisions of the *Public Finance Act* relating to the situations where the public debt exceeds 50% of GDP, and to shift part of the assets of the Open Pension Funds to the government sector. The transfer of OFE assets to the Social Insurance Fund will cause a



Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 28 faks +48 22 185 10 10

substantial public debt reduction, mitigating the risk of the debt-to-GDP relation exceeding 55% in 2014. The situation of having to choose between strongly procyclical fiscal tightening and far-reaching institutional changes highlights the importance of conducting a disciplined fiscal policy during the economic upturn. Such a fiscal policy would create adequate space for the functioning of automatic stabilisers and the resultant deficit and debt expansion in times of slump, without a threat of statutory debt limits being breached. The stabilising expenditure rule proposed by the government might secure the conditions for the conduct of such fiscal policy. However, its effective application may encounter some threats.

Firstly, government documents do not determine the structure of a future fiscal adjustment necessary to comply with the proposed rule. The rule aims at, inter alia, stabilising the balance of the general government sector at the level of medium-term budget target, which is an element of the European fiscal rules and amounts to -1% of GDP in the case of Poland. At the same time, the structural deficit of the public finance currently exceeds 3% of GDP, which entails the need to continue the fiscal adjustment. Given the current large share of legally determined expenditure of the public sector, the application of the expenditure rule may put heavy pressure to cut flexible expenditure, which comprises potentially growth-enhancing expenditure. NBP had pointed this out in its comments on the draft assumptions for the act introducing the expenditure rule.

Secondly, some key parameters of the rule may be set freely by the government, which could facilitate attempts to circumvent the rule. In this case, the entire complex mechanism of its operation, which was to be governed by objective macroeconomic indicators, would be impaired. The problem of discretion relates in particular to two parameters – the inflation forecast and the assumed level of local government unit expenditure.

Thirdly, the complicated mechanism of rule operation, combined with low transparency of public finances, does not permit monitoring the effect of the rule. Despite the fact that according to the *Justification to the Draft Act*, the stabilising expenditure rule was employed to help in the creation of the draft, the latter does not include information on the planned growth in the expenditure covered by the rule, or on the envisaged level of 2013 and 2014 spending by units covered by the rule, such as local government units, the National Health Fund, the National Road Fund and the remaining funds managed from Bank Gospodarstwa Krajowego (BGK).

Fourthly, regardless of the procyclical nature of existing fiscal rules, their partial abolishing at the time when they induced a fiscal adjustment and their replacement with a new rule, reduces the credibility of the latter one.

Finally, the draft of the law introducing the stabilising expenditure rule is designed in such a way, that planned changes in the pension system will make it considerably easier to comply with the rule in 2015. According to NBP estimates, these changes will increase the allowed rate of growth of public expenditure in that year by 2 percentage points. In subsequent years, compliance with the rule will become significantly more



Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 28 faks +48 22 185 10 10

challenging, also in view of the need to ensure co-financing of EU funds from the 2014-2020 financial framework and the possible emergence of wage pressure in the public sector as the economy embarks on a recovery.

## V. Public debt and financing of borrowing needs

The second round of the global economic crisis has had serious consequences for the levels of the state debt-to-GDP ratio in Poland. The decrease in this relation in 2012 proved to be temporary, as 2013 is set to see a new increase, up to a level approximating 55% of GDP, which would probably be continued into 2014. However, the outlook for the public debt-to-GDP ratio is substantially different in the light of the changes in the pension system proposed by the government. These will involve the write-off of the Treasury bonds and bonds of other units of the general government sector held by the Open Pension Funds. In line with the adopted *Strategy for the public finance sector debt management 2014-2017*, this will result in a one-off slump in the state public debt of approx. 7 percentage points of GDP, to 47.1% of GDP at the end of 2014 (and in public debt – in ESA 95 terms – of approx. 8 percentage points of GDP, to 49.9%).

Changes in the pension system will also help to reduce the current borrowing needs. Net borrowing needs will be lower as the financial shortfall in the Social Insurance Fund decreases due to the withdrawal of a part of the insured from the Open Pension Funds and to the transfer to FUS the assets of persons nearing the retirement age (the so-called security zip). Moreover, gross borrowing needs will also decline in 2014 and the subsequent years, since the write-off of OFE-held government bonds will mean a smaller amount of maturing bonds.

As a consequence, the net borrowing requirement of the Treasury is expected to drop to PLN 55.4 billion (3.2% of GDP) while the gross borrowing requirement will amount to PLN 132.6 (7.7% of GDP). The level of gross borrowing requirement will be exceptionally low in comparison to the previous years, and also relative to other countries. According to IMF data[13], the gross public sector borrowing requirement of Poland will amount to 9.3% of GDP, thus running lower than in other countries of the region (the Czech Republic – 11.8% of GDP, Slovakia – 10.0% of GDP, Hungary – 20.1% of GDP) and substantially below the average for developed countries, i.e. 22.5% of GDP. This creates favourable conditions for financing the borrowing requirement over the next year. This may prove important, as in this period the Fed may phase out its quantitative easing programme.

In the mid- and long-run, the impact of the changes in the pension system on the financing of the borrowing requirement will depend, above all, on how the fiscal space, created by the scaling-back of the funded pension pillar, is utilised. If this margin is used to expand public expenditure or to finance tax cuts, the improvement in the general government balance will be temporary. Considering that OFE will be excluded from the

[13] International Monetary Fund (2013), Fiscal Monitor. Taxing Times, October.

Treasury securities market, this will increase the dependence of the borrowing requirement financing on foreign investors, which involves a risk of higher volatility in this market. Moreover, under this scenario there exists a risk that the public debt-to-GDP ratio will return to the vicinity of the prudential thresholds this time with no possibility to take over Treasury securities from OFE in order to stave off this risk. The alternative use of the fiscal space is to decrease the budget deficit and to keep it low through the application of the stabilising expenditure rule. In that case, the public debt would be reduced to approx. 40% of GDP, and the financing of the borrowing needs would happen under secure circumstances. Such a level of public debt could be financed, to a great extent, by domestic entities other than OFE, and the risk of a sudden outflow of foreign investors from a country with sound fiscal fundamentals would be minor.