January 14, 2016

Opinion of the Monetary Policy Council on the *2016 Draft Budget Act*

The assessment of the government's plans concerning fiscal policy is of paramount importance, as fiscal policy needs to be coordinated with monetary policy in a way which will help, to the extent possible, to keep the economy on a sustainable growth path and stabilise inflation around the adopted target in the medium term.

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

I. Macroeconomic assumptions of the *Draft Budget Act*

In accordance with the *Justification* to the *Draft Act*, economic growth in Poland is expected to pick up from 3.4% in 2015 to 3.8% in 2016. In contrast, the November NBP Projection indicated a slower GDP growth in 2016, amounting to 3.3%. The Projection does not take into account changes in fiscal policy introduced in the *Draft Act*, which will impact the developments of key macroeconomic aggregates in 2016. Analyses show that these changes may generate a slightly higher GDP growth in 2016, changing its structure in favour of private consumption growth, amidst slower investment growth.

The *Draft Act* assumes a drop in investment growth from 8.6% in 2015 to 7.0% in 2016. The NBP forecast expects capital expenditure to rise more slowly in 2016, mainly due to a decline in investment co-financed from EU funds, as the 2007-2013 EU financial framework is being phased out.

According to the *Justification*, in 2016 private consumption growth is anticipated to pick up from the 3.4% observed in 2015 to 3.7%, with public consumption growth declining in this period from 3.1% to 1.4%. Higher private consumption growth in 2016 is to be supported by the robust labour market and increased public assistance to families with children. In NBP's assessment, the growth path of wages and private consumption in

2016, as anticipated by the *Draft Act*, may be deemed realistic. With regard to public consumption, the level of current spending of local government units as planned in the *Draft Act* gives rise to expectations of slower real growth in this category in 2016; yet, NBP assesses that this growth will be stronger than the 1.4% assumed in the *Draft Act*.[1]

The *Draft Act* assumes that the deflation observed in 2015 will give way to a CPI inflation of 1.7%. The *Justification to the Draft Act* states that this price growth will be underpinned by a gradual waning of supply shocks observed in the energy commodity markets, combined with accelerated food price growth spurred by adverse weather conditions in 2015. According to the *Justification*, factors conducive to higher 2016 CPI inflation in Poland will also include the emergence of demand pressure resulting from further step-up in domestic demand growth and the expected rise in inflation in the external environment of the Polish economy. In the opinion of NBP, CPI inflation rate may run below the level assumed in the *Draft Act*, even when considering the introduction of the tax on large retail outlets, which would temporarily drive inflation up in 2016 and 2017. Uncertainty surrounding the final shape of the tax and the timing of its introduction poses a risk to the inflation path. The main source of persistence of low inflation, forecasted by NBP, are plummeting prices of energy commodities, in particular oil, in the global markets in the second half of 2015. Those declines will have a lagged downward effect on energy prices,[2] bringing the 2016 CPI inflation below the level assumed in the *Draft Act*.

The macroeconomic scenario underpinning the *Draft Act* is surrounded by rising uncertainty in the external environment of the Polish economy. This uncertainty stems to a significant degree from the possibility of a more pronounced slowdown in the emerging economies, in particular, China. External uncertainty is also related to the persistently slow growth in the economies of the European Union and the European Central Bank's monetary policy.

[1] In 2010-2014, real public consumption growth was on average 1.1 percentage point higher than assumed in the Budget Act.

[2] Declines in energy commodity prices in the global markets result not only in lower fuel prices, but also - albeit with greater lag - in lower electrical energy and natural gas prices charged to households.

II. Fiscal policy in 2016

When assessing fiscal policy as presented in the *Draft Act*, it should be noted that the amounts of actually realized revenue, expenditure and deficit may deviate from the figures assumed in the *Budget Act*. The year 2015 saw a considerable shortage in tax revenue as compared with that assumed in the *Act*. In 2016, a particular source of uncertainty for the level of budget revenue and expenditure is the inclusion of legislative measures which have not yet been adopted. This means that in the course of legislative works, legislative provisions may be changed, which would impact the expected budget effect.

On the other hand, the amount of revenue envisaged by the *Draft Act* under the already existing categories of tax income is in line with NBP estimates. Besides new sectoral taxes, no other major legislative changes are expected in 2016 that would affect the level of tax revenue.[3]

The planned 2016 state budget expenditure is to rise by 7.4% on the level adopted in the 2015 Budget Act. This growth will be partially curbed by a one-off factor which materialised in 2015, related to the payment for jet fighters[4] and a decline in interest payments. Primary expenditure - which more accurately reflects the impact of fiscal policy on the economy - adjusted for the one-off factor mentioned above, is expected to rise by 10.2%.

The 2016 state budget spending on fixed assets is planned at a lower level than in the *2015 Budget Act*, but the decline results chiefly from the above-mentioned one-off factor, namely the payment for fighter jets. After being adjusted for this factor, fixed asset expenditure rises substantially, in particular, under the "National Defence" heading. The rise in the capital expenditure of the state budget will probably be offset by a decline in local government spending in this category, related to the end of the funding under the 2007-2013 EU financial framework. According to NBP's assessment, it can be expected that in 2016 gross capital formation across the general government sector will run at a

[3] The income of the sector will be affected by a number of legislative changes, concerning, among others, VAT deduction on fuel used company cars, a change in the payment of social contributions in the case of persons holding several contracts of mandate and the abolishment of exemption from inheritance and gift tax, as well as the tax on civil law transactions in the case of acquisition of a farm. Yet, the effect of individual changes will be small, with their sum total close to zero.
[4] These payments do not constitute the expenditure of the general government sector in ESA2010 terms.

level close to that observed in 2015, with a decline in the share of EU funds in their financing, and an increase of domestic funds.

The *Draft Act* provides for a considerable rise in social spending of the general government sector. This will be related to the introduction of the new child benefit for every second and subsequent child. Social spending will also increase due to the extension of child benefits to cover persons not eligible for maternity benefits, the upward revision of the amounts of and thresholds for family allowances and care allowance, as well as the thresholds for social assistance allowances, and one-off supplement to the lowest retirement and disability pensions. On the other hand, the deflation observed throughout 2015 will have a lowering impact on the growth of social spending, as it translates into a low indexation rate for most of the benefits in 2016.[5] In NBP's estimates, the effect of the above factors will render a total growth of 10.8% in the general government sector's expenditure on social transfers in ESA 2010 terms.[6]

Based on the *Draft Act*, NBP estimates that the 2016 growth in current spending, which constitutes public consumption, will amount - in regard to the state budget and entities whose financial plans are enclosed with it[7] - to 3.4%, i.e. less than in 2015. Despite earmarking PLN 2 billion for government sector pay rises, the sector may be expected to see a relatively slow wage bill growth, due to, among others, the absence of pay rises to school and university teachers. Public consumption growth will also be dampened by the decline in spending on co-financing of EU funds envisaged in the *Draft Act* to the extent that this co-financing is designated to the sector's current spending.

According to NBP estimates, the balance of the above factors causes a nominal rise of 5.8% in the general government sector spending in ESA2010 terms in 2016, after deducting the expenditure financed from EU finds and adjusting the 2016 expenditure for a one-factor, i.e. fees for reservation of mobile telecom spectrum.[8] The expenditure to GDP ratio will rise by 0.4 percentage point, to 42.1% of GDP. Primary expenditure

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[5] According to NBP estimates , more than 90% of spending on social benefits is subject to indexation by the inflation index from the previous year (or the previous year's inflation index augmented by 20% of real wage growth).
[6] The ESA2010 D.62 category - social benefits other than social transfers in kind.
[7] These are state-run special purpose funds, executive agencies, budgetary management institutions and selected state-owned legal persons.
[8] In ESA 2010 terms, 2015 receipts under this heading will be recorded as a negative expenditure under category K2.

adjusted for the above-mentioned one-off factor will rise by 6.2%, i.e. 0.6 percentage point of GDP.

NBP estimates that the components of fiscal policy described above will render the general government deficit to GDP ratio in 2016 at a level close to that assumed in the *Draft Act*, i.e. 2.8% of GDP. However, this will be largely driven by the one-off factor in the form of payments for reservation of telecom spectrum. Excluding the impact of this factor, the general government sector deficit would have exceeded 3% of GDP in 2016. This means that although the presented *Draft Budget Act* does not increase the public finance imbalance in 2016, the planned changes to fiscal policy will make it more difficult to maintain the deficit at a safe level in 2017, unless new, stable sources of budget revenue are identified.

According to NBP estimates, the primary deficit adjusted for the impact of the business cycle and one-off factors, as well as the DFE[9] indicator used by the European Commission to assess the restrictiveness of fiscal policy, will both deteriorate by approx. 0.7 percentage points of GDP in 2016. This is indicative of rising risks to public finance sustainability in the medium term. Unless other substantial arguments indicate otherwise, such a shape of fiscal policy would seem to warrant a more restrictive monetary policy.

III. Assessment of macroeconomic impact of fiscal policy

NBP simulations show that the changes in fiscal policy described in Part II of the Opinion may, when compared with the neutral fiscal policy scenario,[10] generate accelerated economic growth and higher inflation in Poland in 2016, as well as adversely affect potential output growth. GDP expansion may be mainly fuelled by sharper growth in private consumption and, to a lesser degree, in state budget investment. On the other

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[9] The DFE indicator is constructed in such a way, that the assessment of the fiscal stance on the revenue side is based on the expected effects of legislative changes on the level of revenue, and on the expenditure side - on the deviation of the pace of growth in primary expenditure from potential GDP growth. The concept and the method of DFE computation have been described in detail in: Carnot, N. i F. de Castro (2015) "The Discretionary Fiscal Effort: an Assessment of Fiscal Policy and its Output Effect", European Economy, Economic Papers 543

[10] The simulation was carried out under the assumption of the absence of monetary policy adjustments. The neutral fiscal policy scenario is defined as the absence of changes in the tax rates, and growth in discretionary spending of the general government sector at the level of nominal potential output growth.

hand, GDP growth may be curbed by slower private investment growth due to the new tax imposed on some financial institutions.

The expected higher consumption growth in 2016 is driven by increased expenditure on social benefits resulting from the introduction of new child benefits. These will boost disposable income of households, which will pass through to their consumer spending, giving the economy a demand stimulus. The extent to which private consumption will expand may, however, be hampered by the introduction of the tax on large retail outlets. This will add to price growth, causing a decline in consumers' purchasing power.

NBP's simulations suggest that fiscal policy as envisaged by the *Draft Act* will have a stimulating effect on economic growth through higher state budget spending on gross fixed capital formation.[11] This category manifests relatively low import intensity, which is why the planned increase in the government's capital spending will add considerably – in comparison with other expenditure categories – to GDP growth.

The positive impact of changes in fiscal policy on the aggregate growth in gross capital formation in 2016 will be lowered by the introduction of the tax on some financial institutions. Faced with increased costs, banks will take measures to raise their revenue by, among others, raising the cost of banking services. This may in particular materialise in the form of higher cost of loan service, combined with lower availability of loans. A slowdown in lending may have a dampening effect on corporate and housing investment.

NBP simulations show that the planned changes in fiscal policy, while having a favourable effect on GDP growth, may adversely impact the production potential of the Polish economy. Slower potential GDP growth will result, in particular, from rising family benefits, which will deteriorate the relationship between the income of employees and the income of non-working persons. Thus, higher child benefits provide a disincentive to seeking employment, in particular in the case of persons whose disposable income is low. This may translate into lower labour force participation rate

[11] The planned increase in public investment financed from the state budget will be accompanied by a decline in investment financed from EU funds, as the EU 2007-2013 financial framework is being phased out. However, it has been assumed that developments in this category of expenditure are not part of the current fiscal policy, so the changes in the path of EU fund utilisation have not been included in the simulation of the economic impact of the budget policy depicted in the submitted *Draft Act*.

and higher equilibrium unemployment rate, both constituting a negative stimulus to the potential of the Polish economy.

In addition, the adverse influence of fiscal policy on potential output growth results from the imposition of tax on some financial institutions. Cuts on private investment which may arise as a result of higher tax burden on the banking sector will cause the stock of fixed assets in the country to shrink, rendering a decrease in potential output growth. This effect will be partially offset by the above-mentioned increase in public investment financed from the state budget.

Taking into account the channels described above, the planned changes in fiscal policy may generate a rise in the inflation index in 2016. The inflationary impulse of fiscal policy will primarily stem from the imposition of tax on large retail outlets. It can be expected that, given the low price elasticity of demand in the food market, a large portion of the tax burden will be passed through to consumers. As stated above, the remaining changes in fiscal policy may have an overall favourable effect on the demand side of the economy while adversely impacting its supply side. The latter entail an increase in capacity utilisation in the economy, additionally driving up price growth in 2016.

IV. Fiscal imbalance in 2016 and compliance with fiscal rules

In line with the Stability and Growth Pact, Poland has adopted a medium-term budgetary objective (MTO) of a 1% of GDP structural deficit. The MTO is consistent with the stabilising expenditure rule, which aims to contain the public finance deficit at 1% of GDP in the medium term. In 2011-2014, the public finance structural imbalance had been declining, but in 2014 it remained at 2.6% of GDP, a level remote from the medium-term objective. NBP estimates that the decline in the structural deficit was halted in 2015, while in 2016 the deficit is expected to grow substantially – to 3.4% of GDP. This not only implies that the prospect of reaching the MTO has become more distant, but also the risk of Poland being put again under the Excessive Deficit Procedure in the future.

The most important fiscal rule to discipline Poland's public finances is the constitutional cap on public debt to GDP ratio at 60%, and the prudential debt threshold of 55% of GDP adopted in the Act on Public Finance, aimed to prevent debt from exceeding the constitutional limit. These constraints are supplemented with debt ceilings of 43% and 48% of GDP, regulating the operation of the stabilising expenditure rule. The rule is designed to impose fiscal tightening whenever the public finance deficit or debt deviates from the adopted benchmarks: 3% of GDP in the case of the deficit, 43% of GDP in the case of public debt.[12] The operation of these safety mechanisms should help keep the public debt at a safe level throughout the business cycle, enabling automatic stabilisers to operate in slowdown periods without the threat of the constitutional debt ceiling being exceeded.

In accordance with the *Justification*, the *Draft Act* meets the requirements of the stabilising expenditure rule.[13] The *Draft 2016 Budget Act* is the second budget developed under the stabilising expenditure rule. NBP estimates it will be the second time that, despite the deficit and/or debt exceeding the reference values adopted for the rule, no fiscal policy tightening will take place. In 2015 the compliance with the rule was facilitated by changes in the pension system. In 2016, in turn, factors allowing for a less restrictive fiscal policy than required by the rule included: (1) a decline in interest payments, which makes room for a sharper increase in primary spending, (2) the waning of the one-off factor, i.e. payments relating to the purchase of fighter jets made in 2015, (3) extension of the operation of the rule to include the Bank Guarantee Fund and a permanent raising of the ceiling on the sector's spending by including the 2014 disbursements from the Fund to clients of the SKOK credit unions,[14] (4) assumption of an excessive, in comparison with the projections of other forecasters, inflation index for 2015 and 2016, (5) raising of the 2016 expenditure ceiling by the amount of the planned one-off income resulting from the sale of mobile telecom spectrum and (6) replacement of the planned 2016 inflation rate with the NBP inflation target in setting the expenditure ceiling. The latter change causes the expenditure rule to act less restrictively when inflation is low than what would follow from the original assumptions, while with inflation above the target, its operation would be more restrictive. NBP estimates that due to the combined effect of all those factors, the increase in the expenditure covered by the stabilising expenditure rule may be PLN 36.2bn higher than it would have been on

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[12] The rule additionally provides for the mechanism of the so-called control account which registers all the past deviations of the public finance deficit from the level of -1% of GDP. A drop in the control account balance to less than -6% of GDP constitutes yet another trigger of correction in spending growth.

[13] The *Draft Act* does not contain detailed information on the expenditure of all the entities covered by the rule, in particular, local government units, the National Health Fund and the National Road Fund or the remaining funds deposited with the BGK Bank.

[14] The ceiling on the 2015 spending was set without taking into account the expenditure of BFG; thus the inclusion of this expenditure into the 2016 ceiling is tantamount to raising the allowed spending growth rate versus the 2015 cap.

the basis of the NBP macroeconomic projection, and in the absence of other favourable factors.

V. Public debt and financing of borrowing needs

Following the drop in the public debt to GDP ratio to 47.8% in 2014 as a result of changes to the pension system, the ratio can be expected to rebound in 2015 and 2016. In 2016, it may reach 50% of GDP, i.e. a level which until 2013 marked the first prudential threshold under the Public Finance Act. Under current legislation, the materialisation of such a scenario does not entail any direct implications. Yet, it would provide a warning that the mechanisms described above, designed to secure the sustainability of public finances, are not working effectively, and that the room for fiscal policy manoeuvre in case of a negative external shock, is shrinking.

The increase in the debt to GDP ratio in 2015 and 2016 partially stems from slow nominal GDP growth due to low inflation. This factor adversely affected the relationship between the economic growth rate and average interest on the debt, which besides the primary balance of public finance – is a key component of the equation describing the public debt to GDP ratio. Although the decline in inflation was accompanied by falling yields on newly issued debt, the average interest on public debt has been decreasing with a lag,[15] given the considerable share of past issues of long-term fixed-coupon bonds in the debt.

In the case of an economy growing at a rate close to potential output growth, whose debt is not perceived as risky, the most important determinant of public debt growth is the size of the primary balance of public finance. To prevent the debt to GDP ratio from rising, this balance should in principle be zero or positive, unless GDP growth exceeds the average interest on debt. During the past 20 years, the balance has been largely negative in Poland. There are two key reasons why this has not led to a substantial increase in the debt to GDP ratio. Firstly, the borrowing requirement has been diminished by financial transactions (the so-called "below the line" operations) - proceeds from privatisation deals and transfer of assets between the tiers of the pension system. Secondly, in the last decade, GDP growth has exceeded the growth in mean interest rate on public debt by an average of 1 percentage point. However, both these

[15] In can be expected that by 2016, the adjustment of the average interest to lower inflation will have largely been completed. Thus, in the following years the factor under discussion should no longer influence the debt-to-GDP ratio.

factors are temporary and cannot be relied on to occur in the future. Consequently, in order to ensure a safe path for the public debt, Poland should strive to achieve a primary surplus of public finance. The *Draft Act* is heading in the opposite direction - according to NBP estimates, the primary structural deficit of public finance[16] will rise considerably in 2016, approaching 2% of GDP. Should the primary deficit persist at this level in the long run, it will inevitably lead to a rise in the debt to GDP ratio. According to the equation describing public debt growth, with the initial debt level at 50% of GDP and primary deficit at 2% of GDP, the ratio would only stop rising if GDP growth exceeded the growth in average interest rate on debt by 4 percentage points or more.

The *Draft Act* provides for the net borrowing requirement of the state budget at PLN 74.7 billion (4.0% of GDP) and the gross borrowing requirement at PLN 182.7 billion (9.7% of GDP). Thus, the borrowing requirement will be higher than its anticipated 2015 outcome (PLN 58.8bn and PLN 165.0bn, respectively). The rise in the net borrowing requirement is partly the result of a deficit in EU funds, which is a natural phenomenon in the third year of implementation of the new EU financial framework. However, the main driver of the borrowing requirement in the medium-term is the above-mentioned primary structural deficit.

[16] Primary structural deficit is the deficit of the public finance net of interest payments and adjusted for the impact of the business cycle and one-off factors.