7 November 2017

Opinion of the Monetary Policy Council on the *2018 Draft Budget Act*

At its meeting on 26 September 2017, the Council of Ministers adopted the *2018 Draft Budget Act*. Article 23 of the Act on Narodowy Bank Polski (Journal of Laws 2017, item 1373) obliges the Monetary Policy Council to issue its opinion on the draft budget act. The Council meets this obligation in presenting this *Opinion*.

An assessment of the envisaged shape of fiscal policy is of major significance owing to the need to coordinate the State's macroeconomic policy, including fiscal and monetary policy. While drawing up the *Opinion*, the MPC pays particular attention to the macroeconomic assumptions of the *Draft Act*, the expected impact of fiscal policy on the economy and the outlook for fiscal sustainability.

I. Macroeconomic assumptions of the *Draft Budget Act*

The *Justification* to the *2018 Draft Budget Act* assumes real GDP growth in Poland to run at 3.8% in 2017, with annual consumer price inflation at 2.3%. These forecasts are in line with the NBP November projection.

According to the macroeconomic assumptions of the *Justification*, domestic demand will continue to be the primary driving force of economic growth in 2018. This will, in turn, be largely fuelled by private consumption. Private consumption growth will be supported by a steady rise in households' disposable income, resulting from the consistently strong labour market conditions and the increase in social transfers. The *Justification* also indicates accelerating gross fixed capital formation as a source of 2018 GDP growth. The increase will be driven, to a material extent, by a significant rise in the investment of the general government sector, financed partly by the increasing EU funds. The *Draft Act* also assumes a pick-up in private sector investment next year. The rebound will be underpinned by: strong financial performance of the Polish enterprises, a high degree of capacity utilisation and the fact that the cost of capital remains fairly low. The outlook for growth in private consumption and investment as presented in the *Justification* is consistent with NBP's assessment.

The rate of the 2018 annual CPI inflation as assumed in the *Justification* is in line with NBP's expectations presented in the November projection. The expectations of a slight increase in the inflation rate relative to the level observed in 2017 are related to the rise in demand and cost pressures in the Polish economy assumed in both scenarios. The *Justification* assumes employment to continue to grow next year, although at a somewhat slower rate than this year. At the same time, unemployment will decrease further, rendering a higher nominal wage growth. The above mentioned factors will also, in NBP's expectations, add to wage and consumer price momentum. At the same time, NBP judges that inflation will be dampened by weak price growth abroad and a stabilisation of commodity prices in the global markets.

As in previous years, the macroeconomic scenario assumed in the *Draft Act* is subject to a range of risk factors. Among those, the *Justification* points to a considerable risk to the economic growth forecast posed by the potential impact of changes in the statutory retirement age on the decisions of Poles eligible for retirement as to whether or not to stay on in the labour market. NBP shares the opinion that the impact of the lower retirement age on trends in labour supply in 2018 is a factor of uncertainty. Should a significant proportion of the entitled persons leave the job market, it would affect adversely the productive capacity of the economy. However, it can be expected that high demand for labour and the accelerated wage growth will encourage many retirement-age employees to stay in the labour market. At the same time, labour supply will continue to be supported by the rising activity rates of persons who have not yet reached the retirement age. Strains in the labour market will continue to be mitigated by the significant number of foreign workers in Poland. NBP assesses that the above factors will also determine trends in wage growth in 2018. With regard to inflation, NBP is of the opinion that a risk may be posed by levels of global prices of commodities and food turning out different than assumed in the *Justification*.

II. Situation of public finances in 2017

The point of departure for the assessment of fiscal policy outlined in the *Draft Budget Act* is the performance of public finances in the current year.[1] It is of particular significance at

[1] The assessment of fiscal policy presented in the *MPC Opinion* is not only based on an analysis of the State Budget, along with the appended financial plans of other entities, but also derives from NBP forecasts of the financial situation of the entire general government sector in ESA 2010 terms. This is so because macroeconomic conditions, and hence the conditions for monetary policy, are affected by all the entities of the sector.

the current juncture, as the 2017 general government sector deficit will probably prove much lower than assumed in the justification to this year's draft budget act and earlier forecasts by NBP and other think-tanks. A possibility of a much smaller deficit of this sector in 2017 is indicated by a surplus in the entire general government sector (in ESA terms) in the first half of 2017,[2] as well as the cash-based surplus of the State Budget observed in the first three quarters of 2017.

This marked improvement in the performance of the public finances in 2017 results primarily from two factors – a favourable macroeconomic situation and better tax enforcement, particularly with regard to VAT.

The favourable economic conditions are having a beneficial effect on public finances through a marked increase in tax revenue, additionally supported by the improved tax collection (tax income of the budget increased by 15.2% between January and September 2017). At the same time, the favourable labour market situation is resulting in a significant increase in the contribution receipts of the Social Insurance Fund (a rise of 8.1% y/y in the first half of 2017[3]) and a decline in expenditure on unemployment benefits (a fall of 13.7% y/y between January and September 2017) as well as pre-retirement benefits and allowances (a decline of 4.6% y/y between January and September 2017). Expenditure growth is additionally curbed by the low rate of pension indexation due to negative price growth in 2016. At the same time, the full-year costs of the Family 500 plus programme, the reduction of the statutory retirement age from October 2017 and the disbursement of compensations for the loss of entitlement to free coal are acting in the opposite direction. Despite the costs arising from the introduction of these statutory changes, social expenditure as related to GDP will rise only slightly on 2016, according to current NBP estimates.

The other key source of improvement in the situation of the public finances in 2017 is the enhancement of tax enforcement, especially with regard to VAT. In the period January-September, VAT receipts rose by 23.4%. In 2017 Q1, this revenue grew by 40.6%, being elevated by shifts in VAT refunds between 2016 and 2017. In the following six consecutive months the annual growth in VAT revenue stood at 15.5%, i.e. it continued to considerably

---

[2] In the first two quarters of 2017, the balance of the general government sector in ESA terms stood at PLN 1.8bn, while in previous years it was always negative in the first half of the year.

[3] Information about the monetary benefits from the Social Insurance Fund and some benefits from social assistance system, 2017 Q2.

exceed the growth of the tax base. In the absence of changes in the tax rate, this indicates an improved VAT collection rate, i.e. the narrowing of the so-called VAT gap, which is the difference between the total amount of revenue collectible at a given level of VAT rates and the realised VAT revenue (expressed in relation to potential VAT collection). In accordance with estimates published by the European Commission,[4] in the period following the global financial crisis, i.e. 2010-2015, in Poland this gap stood at an average of 24.0%, while the EU average was 17.0%. According to approximate NBP estimates, in 2016-2017, the VAT gap in Poland decreased by a total of over 9 percentage points.

Apart from the impact of the above factors, the remaining key components of fiscal policy in 2017 are in line with the expectations expressed a year ago in the *Opinion of the MPC on the 2017 Draft Budget Act*. An important element of fiscal policy in 2017 will be public investment growth, following its sharp decline in 2016, related to the gap in absorption of EU funds between two financial frameworks. A significant part of public gross fixed capital formation is realised in the last quarter of the year, which is why its rate of growth in the entire 2017 is still uncertain. Data for the first half of the year suggest, however, that a recovery in investment is materialising. At the same time, across the entire general government sector, increased investment spending is – in line with the expectations – largely compensated for by the slowly rising spending on current running costs of the government sector, i.e. public consumption. In the first half of 2017, public consumption rose by a mere 3.6% in nominal terms and 1.7% in real terms, which renders a decline in this category's share in GDP.

Taking all the above factors into account, NBP estimates that in 2017 the general government sector deficit in relation to GDP will drop from the 2.5% observed in 2016 to less than 2%. As mentioned above, the improvement in the balance of the sector is partly the effect of the positive impact of the economic cycle. However, the magnitude of this improvement is such, that according to NBP estimates the general government balance adjusted for the impact of the business cycle, i.e. the structural deficit, will also improve.

[4] European Commission (2017), Study and Reports on the VAT Gap in the EU-28 Member States: 2017 Final Report, Brussels: European Commission.

III. Fiscal policy in 2018

In the assessment of the MPC, the shape of fiscal policy in 2018 resulting from the *Draft Act* is largely similar to that observed in 2017. General government revenue will continue to benefit from the favourable macroeconomic conditions, in the absence of significant changes in the taxation level[5] and further arrangements to be implemented to improve the efficiency of the tax collection system. On the expenditure side, in turn, gross fixed capital formation is expected to rise further, including projects co-financed from EU funds under the 2014-2020 framework. There will also be a rise in social expenditure, related to the lowering of the statutory retirement age. The increased spending in these categories will, however, be compensated for by the continued decline in public consumption growth.

In 2018, the public finance sector will continue to enjoy favourable macroeconomic conditions, including an excellent situation in the labour market. The persistently robust growth in the wage bill in the economy will generate higher revenue resulting from social insurance contributions and personal income tax, and indirectly – also higher revenue from consumption taxes. On the other hand, growth in spending on social benefits in relation to GDP in 2018 will be contained by nominal GDP growth, which is bound to be markedly higher than the rate of benefit indexation forecast for next year.

The *Draft Act* does not provide for material changes to the total level of tax and social contribution charges, which constitute the income of the general government sector.[6] On the other hand, it does take into account the effects of the continued efforts to improve tax compliance with regard to all the key tax categories. Reducing the VAT gap is bound to remain a priority task, involving, among others, expansion of the system handling the Standard Audit File for Tax (SAF-T), and extension of the obligation to provide data online

[5] On 30 October, the Council of Ministers adopted a draft act submitted by the Ministry of Family, Labour and Social Policy, amending the act on the social insurance system and some other acts, which stipulates the abolition, from 2018, of the cap for retirement and disability insurance contributions. The implementation of this act, whose impact on public finances was estimated at PLN 5.2bn per annum, would mean a significant change of the tax and social contribution burden. However, this change was not taken into account in the *2018 Draft Budget Act*, and hence it is addressed in this *Opinion*.

[6] The legislative changes, which, according to the *Draft Act*, will determine the level of the general government income in 2018 include, among others: diversification of the tax-free allowance in the personal income tax, taking effect with respect to tax returns for 2017, maintenance of thresholds of personal income tax at the last year's level, extension of the scope of innovation activity eligible for tax breaks, extension of the excise tax to include e-cigarette liquid and innovative products. Yet the impact of the individual changes on the revenue of the sector in small, and its total balance close to nil.

to include all the VAT taxpayers. The *Draft Act* also assumes that the split payment mechanism for VAT will come into effect in 2018, along with regulations preventing the use of the financial sector to facilitate tax fraud (the IT system of the clearing house - STIR). The process of implementing online electronic fiscal tills will also commence. Lastly, the *Draft Act* provides for a range of changes to CIT and PIT regulations in 2018, hindering the use of the so-called aggressive tax optimisation.[7]

NBP analyses suggest that in light of a substantial improvement in VAT collection observed in 2016-2017, there is limited room for further increase in revenue under this heading. At the same time, the revenue forecast of PLN 166.0bn cited in the *Draft Act* is conservative enough to warrant a possibility of realisation even if the collection of this tax does not improve markedly. This owes to the favourable macroeconomic conditions and the conservative assumption about the expected realization of VAT revenue in 2017 adopted in the *Justification to the Draft Act*.[8]

According to NBP forecasts, the growth in spending of the entire general government sector, net of expenditure financed from EU funds, will run at 6.1% in 2018, i.e. will be close to nominal GDP growth. This pace of growth of the sector's expenditure will be the product of the relatively slow growth in the cap on state budget spending assumed in the *Draft Act* (3.2% compared to the 2017 cap) and a sharper rise in spending of other government units.

Like in 2017, one of the factors contributing to a higher growth rate of total spending will be the rising public investment funded from sources other than the state budget, partially related to higher absorption of EU funds dispensed under the 2014-2020 framework. Based on data published by the Ministry of Development concerning agreements signed with beneficiaries and providing for the use of these funds, as well as government plans for road and railway investment, it can be expected that public spending on gross fixed capital formation in 2018 will continue rising at a similar pace as in 2017.

Another factor boosting spending growth in the general government sector in 2018 will be the lowered retirement age, effective from 1 October 2017. NBP analyses show that the rise

[7] The package of changes in income taxes aiming to limit aggressive tax optimisation covers, among others, regulations concerning the establishment of foreign subsidiaries and the so-called "undercapitalisation", principles for itemising sources of income in the CIT Act and provisions regulating the operation of corporate tax groups.

[8] Data on budget outturn between January and September 2017 suggest that revenue will probably exceed the assumed level of PLN 153.5bn in the entire year.

in the number of beneficiaries following this change will translate into an increase of 0.4% of GDP in the expenditure of the Social Insurance Fund in 2018.

Low growth in the sector's current spending on operations, i.e. public consumption, will once again be a factor contributing to lowering of the general government imbalance. Based on the comparison of the expenditure planned in the *Draft Act* and the corresponding amounts in the *2017 Budget Act*, NBP estimates that the 2018 current expenditure constituting public consumption will rise by 3.4% in relation to the state budget and the entities whose financial plans have been appended with it.[9] Public consumption growth in 2018 will be dampened, among others, by the continued freeze on government sector wages and the planned slow growth in current spending of budgetary units.

According to NBP forecasts, such a fiscal stance in 2018 will result in a general government sector deficit at a level similar to that projected for 2017. Given the favourable impact of the economic cycle on public finances this implies a possibility of stabilising the structural deficit, or increasing it only slightly, thus rendering fiscal policy close to neutral. NBP forecasts do not take into account any further improvement in the tax collection rate, which – if it materialises – will work towards an improvement of the structural deficit.

IV. Assessment of macroeconomic impact of fiscal policy

The findings of the simulation conducted by NBP indicate that the fiscal policy described in part III of the *Opinion*, compared to a scenario of no changes to fiscal policy[10], will have a close-to-neutral impact on the 2018 economic growth and inflation in Poland. Factors conducive to a pick-up in GDP growth will include primarily, faster growth in capital spending, and – to a lesser extent – private consumption. At the same time, the slowly rising public consumption will dampen growth of investment and overall consumption.

The simulation suggests that fiscal policy as envisaged in the *Draft Act* will have a stimulating effect on the public sector's spending on gross fixed capital formation. This is

[9] The expenditure of entities in charge of water management has not been included in the analysis, as data from 2017 and 2018 could not be compared following the creation of PGW Polskie Wody (Polish Waters), a new institution to be launched at the beginning of 2018. The competences conferred on PGW Polskie Wody include tasks previously performed by local government entities.

[10] The simulation was carried out under the assumption of the absence of adjustments on the monetary policy side. The no-change fiscal policy scenario is defined as 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.

related to higher – compared to the no-change fiscal policy scenario – general government sector spending on road and railway infrastructure in 2018, as well as the increased expenditure of local government units on own contribution to projects cofinanced from EU funds. At the same time, accelerated public capital spending and higher economic growth should also entail a rise in private investment.

The changes to fiscal policy planned for 2018 will also support private consumption growth, although the impact of this category on the level of activity will be smaller than that of public investment. Faster private consumption growth will be supported by the government's activities aimed at boosting households' disposable income. These involve higher expenditure on social benefits as a consequence of the reduction of the statutory retirement age as of 1 October 2017, as well as the increased amount of tax-free allowance for individuals on the lowest incomes. Factors with a downward effect on private consumption growth will include the freezing of wages of part of government sector workers and the freezing of tax thresholds. At the same time, slower wage growth in the public sector will drag on public consumption growth.

The above mentioned effects of the changes in fiscal policy will also work towards higher inflation in 2018, yet the scale of this impact will be insignificant.

V. Fiscal imbalance in 2018 and compliance with fiscal rules

According to the information presented in the *Justification to the Draft Act*, the objective of fiscal policy is to support inclusive economic growth while respecting the constraints arising from the national and EU law, in particular, the stabilising expenditure rule and the 3% of GDP cap on the general government sector deficit. The operating mechanism of the rule should at the same time enable the balance of the general government sector to meet the medium-term budgetary objective (MTO), laid down in the National Long-Term Financial Plan at -1% of GDP.

In accordance with the *Justification to the Draft Act*, the 2018 general government sector deficit may run at 2.7% of GDP, under the assumption of the expenditure level remaining in line with the spending caps resulting from the stabilising expenditure rule. This means that the cited magnitude is neither a forecast nor a target, but rather a kind of an upper limit of the deficit.

NBP forecasts, allowing for realisation of expenditure below the spending limit, show that the deficit of the sector in 2018 may run at a level close to that of 2017, i.e. lower than quoted in the *Justification*. This would mean that the deficit in relation to GDP would be significantly lower than the 3% limit laid down by the European fiscal rules. It should be noted at this point that the Polish economy, in tandem with its external environment, will probably enjoy good economic conditions having a positive impact on the state of the public finances. In accordance with NBP estimates, the structural deficit will amount to around 2% of GDP in 2018, i.e. higher than the above mentioned medium-term budget objective. If this target is met in the medium term, it would provide adequate room for manoeuvre to conduct countercyclical fiscal policy in case of an economic slowdown, without the risk of an excessive increase in the public debt.

VI. Public debt and financing of borrowing requirement

The public finance debt management strategy 2018-2021, contained in the attachment to the *Draft Act*, provides for a reduction of the state public debt-to-GDP ratio from 52.1%[11] observed at the end of 2016 to 51.7% at the end of 2017, and the maintenance of this ratio at the same level at the end of 2018. In turn, the deficit of the general government sector is expected to decline from 54.4% of GDP in 2016 to 53.8% of GDP in 2017, and in the following year, to rise to 54.2% of GDP.

NBP forecasts point to a likely decrease in the public debt-to-GDP ratio, both in 2017 and in 2018. This will be supported by the exceptionally favourable, compared with previous years, difference between the pace of economic growth and the average interest on public debt. In the entire horizon of the NBP projection. i.e. in the years 2017-2019, this difference is in excess of 2.5 percentage points, which means that for the public debt-to-GDP ratio to stabilise, it would be sufficient to achieve a negative primary balance of public finances[12] of 1.3% of GDP. Yet already in 2015-2016 the primary deficit had decreased to 0.7-0.8% of GDP, with a further decline to be expected in 2017.

The *Draft Act* provides for the net borrowing requirement of the state budget of PLN 63.3bn (3.1% of GDP) in 2018, and the gross borrowing requirement of PLN 181.7bn (8.8% of GDP). While the planned amount of the net borrowing requirement is at its lowest of many years, it should be noted that the plan is based on budget deficit outturn at the level of the statutory cap, thus constituting the upper limit of the borrowing needs rather than

[11] On 23 October 2017 the Central Statistical Office (GUS) published the revised estimate of the 2016 gross domestic product for 2016. Based on these data, the ratio of the state public debt to GDP stood at 51.9% at the end of 2016, and that of the general government sector deficit at 54.1% of GDP.

[12] The primary balance is the public finance balance reduced by the cost of service of the public debt.

a forecast of their actual amount. The predicted amount of the 2017 net borrowing needs stands at PLN 53.8bn, as compared with the PLN 79.0bn quoted in the justification to the *2017 Draft Budget Act*.

The extent of the 2018 increase in the debt of the general government sector will depend on the financing of the redemption of infrastructural bonds[13] held in the Demographic Reserve Fund (FRD) portfolio, and the subsequent allocation of those funds. The *Justification* stipulates that the funds released through bond redemption (approx. PLN 9.5bn[14]) be left in the Demographic Reserve Fund. If this is the case, the impact on the stock of public debt will depend on whether FRD invests these funds in debt instruments issued by general government sector entities – which would mean a consolidation of the debt – or in another category of assets.

A factor with a downward effect on the borrowing needs in 2018 will be the transfer of funds accumulated in the OFE (Open Pension Funds) by persons close to the retirement age to the Social Insurance Fund (FUS) under the so-called "security slider " mechanism. The restoration of the statutory retirement age of 65 for men and 60 for women from October 2017 will boost the Fund's revenue under this heading.[15] This revenue is expected at approx. PLN 5.1bn in 2017 and PLN 7.7bn in 2018, compared with roughly PLN 3.5bn in 2016. These funds do not improve the balance of the general government sector[16], but they render a smaller scale of increase in the sector's debt than what is implied by the size of the deficit.

[13] Bonds issued by BGK bank on behalf of the National Road Fund. Debt resulting from this held by the private sector does not constitute part of the state public debt, but is part of the general government debt in ESA terms. In turn, bonds in the FRD portfolio are subject to consolidation, and thus do not add to the debt of the sector.
[14] Principal amount (approx. PLN 8.8bn) and interest (approx. PLN 0.7bn)
[15] The increase in FUS receipts due to the operation of the security slider will result from: i) the inclusion of successive groups of the insured, in connection with the lowering of the statutory retirement age, ii) the accelerated transfer of receipts in the case of persons already covered by the security slider mechanism due to the shortening of the period left to the retirement age, iii) transfer of the total funds accumulated in the OFE in the case of persons who have applied for retirement pension.
[16] In ESA2010 terms, these funds are considered a financial transaction and do not constitute income of the general government sector at the time of the transfer from OFE. In order to ensure the neutrality of the fund transfer from OFE under the so-called security slider mechanism, retirement benefit expenditure financed from the OFE-originating funds is matched with commensurate notional income under the social insurance contribution heading. See: *Ex-ante consultation on registration in GFS and in national accounts of the transactions connected with the pension reform (according to ESA95 and ESA2010 methodologies)*, Eurostat, note of 20 June 2014. http://ec.europa.eu/eurostat/documents/1015035/2990403/PL-Ex-ante-advice-Transac-conn-w-pension-reform_2013.pdf/85fb911c-4a79-4eeb-b6ac-ec9542b2d688