15 October 2019

Opinion of the Monetary Policy Council on the *2020 Draft Budget Act*

At its meeting on 24 September 2019, the Council of Ministers adopted the *2020 Draft Budget Act*. The Act on Narodowy Bank Polski (Article 23, Journal of Laws 2019, item 1810, consolidated text) obliges the Monetary Policy Council to submit its opinion concerning the draft budget act.

The Opinion of the Council on the *2020 Draft Budget Act* contains an assessment of the envisaged shape of fiscal policy, which is of major significance owing to the need for fiscal and monetary policy coordination in a manner which will facilitate, to the extent possible, keeping the economy on a sustainable growth path and stabilising inflation around the NBP medium-term target. 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 *2020 Draft Budget Act* assumes real GDP growth in Poland to slow down in 2019 and run at 3.7%. At the same time, average annual consumer price inflation is expected to rise to 2.5%. In NBP's assessment, the trends outlined above are broadly in line with expectations concerning macroeconomic developments in 2020, even though in the first half of 2020 inflation may be temporarily slightly higher than assumed in the *Draft Act*.

According to the macroeconomic assumptions adopted in the *Justification*, economic growth in 2020 will continue to be driven mainly by domestic demand, in particular by private consumption. Consumption growth will be supported by rising household disposable income, which is related to the assumed continuation of favourable labour market conditions and implemented policy measures. In the opinion of NBP, the above factors may contribute to slightly higher growth in household consumption than assumed in the *Justification*. Another factor the *Justification* indicates as a driver of domestic demand growth in 2020 will be gross fixed capital formation, despite the anticipated slight decrease of its growth rate. The July NBP projection also points to a slowing in investment growth in 2020, with a higher growth rate of investment in 2019 and a lower one in 2020, relative to assumptions included in the *Draft Act*. According to the *Justification,* the contribution of net exports to GDP is expected to be close to zero in 2020. In the opinion of NBP, due to the higher domestic demand growth assumed in the projection, the contribution of net exports next year may be negative.

The average annual rate of consumer inflation assumed in the *Draft Act* for 2020 is higher than forecast for 2019. The *Justification* also points to the continuation of the favourable situation of employees in the labour market, manifested in the decreasing unemployment rate and relatively high nominal wage growth. Developments in global energy commodity and food prices, as well as regulatory changes in the domestic energy market, are considered as risk factors for inflation.

In NBP's opinion, the assumptions adopted in the *Draft Act* concerning the developments in the main macroeconomic categories are realistic.

II. Situation of public finances in 2019

The starting point for the assessment of fiscal policy outlined in the *Draft Budget Act* is the performance of public finances in the current year. Following the decline in the general government sector deficit (ESA2010) in 2018 to an exceptionally low level of 0.4% of GDP, the deficit will probably increase in 2019. According to the *Convergence Programme. 2019 Update*, adopted by the Council of Ministers in April 2019, the government envisaged the deficit to stand at 1.7% of GDP this year. However, in NBP's assessment, current data on the performance of the state budget and other general government units indicate a lower level of deficit than foreseen in the *Convergence Programme Update*. This is also indicated by the *Justification* to the *Draft Act*, where state budget revenue is expected to be PLN 16.5bn higher than planned in the *2019 Budget Act*. The overperformance of budget revenue concerns in particular direct taxes – in the first half of 2019 CIT revenue increased by 18.8% y/y and PIT revenue by 11.4% y/y. Also the Social Insurance Fund recorded robust growth of contribution income in the first half of 2019 (the amount of contributions due increased by 9.0% y/y).

The expected rise in the general government deficit in 2019 is related primarily to the package of legislative changes announced by the government in March 2019, comprising increased social expenditure and a lowering of the income tax for individuals. Moreover, subsidies to energy prices introduced for the duration of 2019 will also contribute to a higher deficit. Altogether, these changes imply that following several years of a fiscal tightening, in 2019 the domestic fiscal policy will have a positive effect on aggregate demand.

It is worth noting, that the current position of the state budget in 2019 is so favourable, that had the legislative changes mentioned above not been introduced, the state budget would have achieved a surplus in 2019. As indicated above, the expected outturn of budget revenue exceeds the plan by PLN 16.5bn. If savings on the expenditure side of the budget had been realised on a scale corresponding to previous years, they might have reached PLN 19bn. As a result, the state budget would have reached a surplus, against the PLN 28.5bn deficit limit foreseen in the *2019 Budget Act*.

III. Fiscal policy in 2020

In line with the *Draft Act*, a significant improvement of the balance of the state budget and the entire general government sector in 2020 is expected, as manifested, in particular by the absence of a state budget deficit in the *Draft*. The deficit of the general government sector in ESA2010 terms is in turn projected to decrease to 0.3% of GDP. The anticipated decline in the deficit will be the result of a range of factors – macroeconomic conditions, the impact of one-off measures, legislative changes and development of expenditures other than those determined by the aforementioned legislative changes.

In spite of the slower GDP growth in 2020, macroeconomic conditions may be expected to remain favourable to public finances. This will result, in particular, from the relatively fast pace of nominal growth of the key tax bases – the wage bill in the economy and household consumption. Against this background, the increase of 5.7% y/y in the tax revenue of the state budget in 2020, assumed in the *Draft Act*, may be considered realistic, even taking into account negative impact of total balance of legislative changes on revenue in 2020. When adjusted for these changes, the growth of tax revenue assumed in the *Draft* would run at 6.8% y/y.

The improved position of the state budget and the general government sector in 2020 to a significant extent results from one-off factors. The most important of them is the anticipated revenue from the so-called transformation charge paid into the Social Insurance Fund, related to the announced transformation of open pension funds into specialised open investment funds (SOIF). On a cash basis, the payment is to amount to PLN 13.5bn in 2020 and PLN 5.8bn in 2021, while in ESA2010 terms the entire revenue from this source will be recorded in 2020. Moreover, in 2020 and 2021 the state budget and the general government sector will gain revenue from additional sales of greenhouse gas emission allowances which had not been allocated in 2013-2019. In the *Convergence Programme*, the amount of one-off income of the sector from this source (ESA2010) was estimated at PLN 5.7bn and PLN 4.7bn., respectively.

In line with the submitted *Draft Act*, general government revenue and expenditure on social benefits in 2020 will be affected by a range of legislative changes. The eligibility criteria for the benefits under the Family 500+ Programme were expanded as of mid-2019, which means that the full-year impact of this change will be visible next year. In addition, in 2020 a considerable rise of expenditure (to PLN 4.5bn annually) is expected due to the payment of supplementary benefits for persons unable to function on their own, disbursed out of the Solidarity Support Fund for Disabled People. At the same time, the *Draft Act* does not envisage the payment of the additional benefit for old-age and disability pensioners (the so-called 13th pension) in 2020, which would have a downward effect on the growth of spending on benefits. A reduction in the lower bracket of income tax for individuals from 18% to 17% was legislated in 2019, as well as a full exemption from this tax for persons under 26 years of age, and an increase of the employee tax-free allowance. According to the assessment of the impact of the regulations introducing these changes, they will contribute to PLN 3.6bn decrease in general government revenue in 2019 and another PLN 8.4bn in 2020.

The *Draft Act* also assumes the adoption of legislative measures increasing the revenue of the Social Insurance Fund in 2020, but these measures have not been adopted so far. The first of these relates to the planned liquidation of Open Pension Funds, following which the pension contributions previously transferred to Open Pension Funds will constitute the revenue of the Social Insurance Fund. This is expected to raise the income of the Fund by approximately PLN 3.5bn in full-year terms. The other change concerns the abolishment of the ceiling on the income constituting the basis for the calculation of old age and disability pension contributions (the so-called 30-fold limit). In line with the *Justification*, this change is expected to increase the revenue of the sector by PLN 5.1bn in net terms. In NBP's opinion, there exists a risk of additional revenue proving lower than assumed, due to taxpayers' potential efforts to avoid the increase in the tax burden resulting from this measure.

The overall effect of aforementioned changes on the position of the general government sector in 2020 will be positive. The *Draft Act* also envisages a moderate increase in expenditure other than that affected by the above-mentioned legislative changes. The state budget spending limit laid down in the *Draft Act* is merely 3.2% higher than the limit in 2019. Meanwhile, state budget expenditure net of subsidies and grants (including among others the subsidy to the Social Insurance Fund and subsidies to local governments, rising due to the expanded financing of the Family 500+ Programme) is expected to grow by 5.4%, compared to the spending limit in 2019.

Given the above factors, in the opinion of NBP, fiscal policy in 2020 implemented in accordance with the submitted *Draft Act* would be neutral.

IV. Fiscal imbalance in 2020 and compliance with fiscal rules

According to the *Justification*, the priority of the government's economic policy is to ensure sustainability of public finances while supporting inclusive economic growth. Budgetary policy is to be implemented with consideration to fiscal rules resulting from the national and EU law.

Based on the submitted *Draft Act*, it is expected that Poland will comply with the key principles of the European Stability and Growth Pact in 2020. The general government balance will be close to zero, against the 3% of GDP deficit limit, while public debt in ESA2010 terms is expected to decline to 46.3% of GDP and continue to follow a declining path. The decline in the debt-to-GDP ratio also diminishes the risk of this ratio exceeding the debt limits determined by the national regulations – Article 86 of the Public Finance Act (55% of GDP) and the Constitution of the Republic of Poland (60% of GDP).

According to the recommendations of the Stability and Growth Pact, the general government structural balance should tend towards the medium-term objective (MTO), which in the case of Poland is -1% of GDP. In 2018 r. – for the first time since 2005, when the concept of MTO was introduced to the Pact – the structural deficit in Poland declined below 1% of GDP. In the opinion of NBP, based on current forecasts and the Draft Act under discussion, it may be expected, that in 2019-2020 the structural deficit will exceed the MTO. Hence, in the medium term, it would be desirable to undertake measures bringing the structural deficit closer to the medium-term objective as long as this does not result in an excessive slowing of economic growth.

V. Public debt and borrowing requirement financing

According to the forecasts presented in the *Public Finance Debt Management Strategy 2020-2023*, contained in attachment to the *Draft Act*, the public debt (as defined in the Public Finance Act) in relation to GDP is to decrease from 46.5% at the end of 2018 to 44.9% at the end of 2019, and further to 43.5% at the end of 2020. The general government gross debt (ESA2010) in relation to GDP is expected to diminish at a similar pace - from 49.2% at the end of 2018 to 47.7% at the end of 2019 and 46.3% at the end of 2020.

A steady decline in the general government debt as a share of GDP is also indicated by NBP forecasts. This is supported by the expected maintenance of the favourable interest-growth differential.

In line with the *Draft Act* assumptions, the net borrowing requirement of the state budget in 2020 will amount to PLN 19.4bn (0.8% of GDP), while the gross borrowing requirement will be PLN 137.4bn (5.8% of GDP). The amount of the net borrowing needs in 2020 reflects in particular the absence of a state budget deficit. In 2018 the net borrowing requirement of the state budget stood at PLN 1.3bn, while in 2019 this amount is anticipated at the level of PLN 15.1bn (against PLN 46.0bn envisaged in the *2019 Draft Budget Act*).