9 November 2022

Opinion of the Monetary Policy Council on the *2023 Draft Budget Act*

At its meeting held on 28 September 2022, the Council of Ministers adopted the *2023 Draft Budget Act*. The Act on Narodowy Bank Polski (Article 23, Journal of Laws of 2022, item 2025, consolidated text) obliges the Monetary Policy Council (MPC) to submit its opinion concerning the draft budget act.

The Opinion of the Council on the *2023 Draft Budget Act* contains an assessment of the envisaged shape of fiscal policy, which is of major significance due to mutual interaction of fiscal and monetary policy in a manner which will facilitate, to the extent possible, keeping the economy on a sustainable growth path and stabilising inflation at a level compatible with 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, including, in particular, demand growth and the outlook for fiscal sustainability.

As in previous years, the *Draft Act* covers only some of the revenue and expenditure of the general government in ESA 2010 terms. From the laws already passed by the Parliament, or adopted by the government and submitted to the Parliament, it follows that some of the government measures implemented in 2022 or planned for 2023 will be financed from extrabudgetary funds. Therefore, in addition to the *Draft Act*, this Opinion is based on other government documents, including, in particular, regulatory impact assessments of draft laws, statements by government officials as well as NBP estimates and projections.[1]

[1]The NBP projections were prepared taking into account data available by 21 October 2022 and information on planned regulatory changes announced by 7 November 2022.

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I. Macroeconomic assumptions of the *Draft Budget Act*

In the *Justification* to the *Draft*, Poland's real GDP growth in 2023 is assumed to decline to 1.7%, from 4.6% in 2022. According to the macroeconomic assumptions adopted in the *Draft Act*, economic growth in 2023 will continue to be mainly driven by domestic demand, although its contribution to GDP growth will decrease significantly in comparison to 2022. The *Justification* states that the real growth of private consumption will decrease relative to its 2022 rate as the economic climate and the situation in the Polish labour market deteriorate, and there is a possibility of a fall in average employment in the economy and a rise in the unemployment rate. According to the Ministry of Finance, consumer demand will be further dampened by the tightening of monetary policy by NBP. On the other hand, it is assumed that taxation changes under the Low Taxes programme – having come into force on 1 July 2022 (and involving, among others, a reduction in the base PIT rate from 17 to 12%) – will act to boost the real growth of household disposable income in 2023. The *Draft Act* assumes that real growth in gross fixed capital formation will pick up compared to 2022, spurred by the planned increase in defence spending and the launch of the projects under the National Recovery Plan. By contrast, according to the Ministry of Finance forecast, private investment growth will be constrained by the markedly higher – due to the monetary policy tightening – cost of capital. Moreover, the *Draft* assumes that inventory change in will have a negative impact on GDP growth in 2023, while the contribution of net exports will be positive.

In the opinion of NBP, GDP growth in 2023 may decline more heavily than assumed in the *Draft Act.* An important source of this momentum loss will be slower growth in Poland's external economic environment, driven by the expected severe deterioration in economic activity in the euro area on the back of high gas and electricity prices and the tightening of monetary policy by major central banks. At the same time, NBP believes that gross fixed capital formation growth may be significantly slower than assumed in the *Draft Act*. In particular, private sector investment demand may be expected to decline in 2023, due to – in addition to the above mentioned slowdown in economic growth in the external environment – the adverse impact of high global commodity prices and energy consumption costs, as well as depressed business sentiment: assessments of uncertainty in company surveys in 2022 Q3 rose to their highest level on record.[2] The remaining

[2] NBP Quick Monitoring Survey. Economic climate in the enterprise sector, NBP, October 2022.

determinants of GDP growth in 2023 assumed in the *Draft* are largely compatible with the assumptions and findings of the November NBP projection.

The *Draft Act* assumes that the average annual consumer price inflation in 2023 will decline on its 2022 level to reach 9.8%. The macroeconomic scenario presented in the *Justification* assumes that the government will not introduce any further sanitary restrictions related to COVID-19 in 2023 and that there will be no new supply shocks that would affect the prices of food and energy commodities in the global markets. Energy price growth will continue at an elevated level, albeit lower than in 2022. It was also the assumption that core inflation will gradually decline in 2023 due to the economic slowdown and the lagged effect of already implemented NBP interest rate hikes. The *Draft Act* and the *Justification* do not mention what assumptions were adopted in the 2023 inflation projection concerning the extension of the Anti-Inflation Shield.

The CPI inflation assumed in the *Justification* for 2023 is lower than envisaged in the NBP projection, according to which inflation will decline only slightly, despite the expected weaker growth in global energy and agricultural commodity prices and a slowdown in domestic economic activity. Indeed, the inflation rate forecast for 2023 will be boosted by the expiry of some of the tax changes introduced under the so-called Anti-Inflation Shield, which is assumed in the projection. By contrast, in the following year inflation may be expected to decline markedly, in line with the assumptions of the *Justification* to the *Draft Act*.

As indicated in the *Justification*, the adopted macroeconomic scenario is subject to a risk posed, primarily, by the further course of Russia's military aggression against Ukraine and its impact on the domestic and global economy, including on agricultural and energy commodity prices. NBP agrees with the assessment of this uncertainty factor. At the same time, the extent and duration of the anticipated economic downturn in Poland’s environment will be an important factor of uncertainty.

II. Situation of public finances in 2022

The starting point for the assessment of the *Draft Budget Act* is the fiscal policy pursued in 2022. Its shape deviates substantially from the assumptions made in the *Draft Budget Act* in the autumn of 2021. The main cause of this development is Russia’s armed aggression against Ukraine and its implications for the prices of energy and food commodities. Amid the unprecedented turmoil in the markets for these commodities and in the European electricity market – translating into a sharp rise in inflation – the government has taken a number of fiscal measures aimed at curbing the negative impact of price increases on households and other entities. Measures implemented in 2022 include cuts in some indirect taxes[3], gas prices subsidies,[4] subsidies to district heating,[5] support for energy-intensive companies,[6] fertiliser subsidies[7] and payment of a range of benefits to households – protective allowances,[8] coal allowances[9] and allowances for users of other sources of energy.[10] NBP estimates the total cost of these measures at 2.3% of GDP in 2022.

Another change in fiscal policy introduced as a consequence of the war is public spending on refugees from Ukraine, more than a million of whom are still staying in Poland. This assistance covers, among other things, expenses relating to transport and accommodation, benefits for families with children as well as education and health care.[11] According to the estimates presented in the *Convergence Programme. 2022 Update*, public expenditure on refugees from Ukraine will amount to approx. PLN 11 billion, i.e. 0.4% of GDP, while, according to the information of the Ministry of the Interior and Administration dated 19 October 2022, Poland has to date received almost PLN 0.7 billion from the EU budget for this purpose.

Public expenditure growth in 2022 will also be boosted by increased interest payments on public debt, which are growing substantially on the back of the rising NBP interest rates and short- and long-term market rates. According to the Ministry of Finance estimates

[3] Act of 9 December 2021 amending the Excise Tax Act and some other acts (Journal of Laws item 2349, as amended), Ordinance of the Minister of Finance of 17 December 2021 amending the Ordinance on goods and services subject to reduced goods and services tax, and conditions for applying the reduced rates (Journal of Laws, item 2350), Act of 13 January 2022 amending the goods and services tax Journal of Laws item 1137, as amended)

[4] Act of 26 January 2022 on special solutions for the protection of gas fuel consumers in connection with the situation in the gas market (Journal of Laws item 202, as amended), the Act of 5 August 2022 amending certain acts in order to strengthen the state's gas security in connection with the situation in the gas market (Journal of Laws, item 1723).

[5] Act of 15 September 2022 on special solutions for certain heat sources in connection with the situation in the fuel market (Journal of Laws, item 1967).

[6] Act of 29 September 2022 on the principles for implementation of programmes of support for entrepreneurs in connection with the situation in the energy market in 2022-2024 (Journal of Laws, item 2088).

[7] Ordinance of the Council of Ministers of 17 March 2022 amending the Ordinance on the detailed scope and implementation of certain tasks of the Agency for the Restructuring and Modernisation of Agriculture (Journal of Laws, item 642).

[8] Act of 17 December 2021 on the protective allowance (Journal of Laws of 2022, item 1).

[9] Act of 5 August 2022 on the coal allowance (Journal of Laws, item 1692).

[10] See also footnote 5.

[11] Act of 12 March 2022 on assistance to citizens of Ukraine in connection with the armed conflict on the territory of that country (Journal of Laws, item, 583, as amended).

contained in the autumn fiscal notification, the cost of interest payments in ESA terms will rise from 1.1% of GDP in 2021 to 1.7% of GDP in 2022.

Factors acting to increase headline deficit in 2022 also include the regulatory changes under in the "Polish Deal" programme, which have been taken into account in the *2022 Budget Act*. These comprise, among others, a reduction in the PIT tax rate for most taxpayers (with a concurrent change in principles for deducting the health contribution)[12], and the new benefit for families with young children (Family Care Capital[13]). In March 2022, in turn, the government announced it would launch the "Low Taxes" programme, introducing an additional reduction in taxes, among others, through a reduction in the lower tax rate to 12%, coming into effect as of mid-2022.[14] According to the estimates presented in the regulatory impact assessments of the laws introducing the changes under the above-mentioned programmes, their total effect on the balance of the general government in 2022 will be negative and will amount to 1.0% of GDP, which is consistent with the estimates of the NBP.

The negative impact of the factors listed above on the fiscal outturn in 2022 is partly offset by the impact of higher-than-assumed inflation, through the revenue side of the general government. This effect is reflected in the tax revenue growth observed in 2022. Between January and September 2022, the tax revenue of the state budget rose by 12.4% y/y, as compared to the growth of 5.1% assumed in the *2022 Draft Budget Act*,[15] despite the fact that the *Draft* did not take into consideration the reductions in the VAT and excise tax rates under the Anti-Inflation Shield and the reduction in the PIT rate under the Low Taxes programme. This provided grounds for the assumption adopted in the *2023 Draft Budget Act* that the state budget revenue in 2022 will be realized at a higher level than assumed in the *2022 Draft Budget Act*.

Despite the above mentioned factors working towards a higher general government deficit in 2022, according to Statistics Poland (GUS) data in the first half of 2022 the deficit in ESA terms remained moderately low – in seasonally adjusted terms, it amounted to 1.0% of GDP, as opposed to a deficit of 2.1% of GDP in the first half of 2021. However, in

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[12] Act of 29 October 2021 amending the Personal Income Tax Act, the Corporate Income Tax Act and certain other acts (Journal of Laws item 2105, as amended)

[13] Act of 17 November 2021 on Family Care Capital (Journal of Laws, item 2270).

[14] Act of 9 June 2022 amending the Excise Tax Act and some other acts (Journal of Laws, item 1265).

[15]The rate of growth of tax revenue planned in the *Justification* to the *2022 Draft Budget Act* adopted by the Council of Ministers on 30 September 2021 (revenue planned for 2022 relative to the anticipated execution in 2021).

the second half of 2022 the deficit can be expected to rise substantially – a range of energy price subsidies will be disbursed in this period, along with the so-called "14th pension". Furthermore, the previously mentioned Low Taxes programme launched in July 2022 will hamper the pace of growth of tax revenue.

The overall balance of the factors listed above provides for a significant widening of the general government deficit in 2022. According to the estimates of the Ministry of Finance presented in the autumn fiscal notification, the headline deficit will rise from 1.8% of GDP in 2021 to 4.7% of GDP in 2022. In the assessment of NBP, the notification, in similarity to its past issues, has adopted conservative assumptions, and the deficit will probably be in the range of 3%-4% of GDP.

III. Fiscal policy in 2023

Given the anticipated persistence of high prices in energy commodity markets, also in 2023 the shape of fiscal policy will continue to be predominantly determined – like in many other EU countries – by government measures aimed at limiting energy costs to energy consumers, including households and businesses.

Considering the measures announced so far, including, in particular, subsidies aiming to reduce electricity prices for households, small and medium-sized enterprises and vulnerable consumers,[16] support for energy-intensive enterprises,[17] the announced expiry of some of the indirect tax reductions in 2023,[18] and the one-off nature of the coal and protective allowances disbursed in 2022, the total cost of the measures can be expected to decrease by 0.3 percentage point of GDP on its 2022 level. This estimate is subject to considerable uncertainty, considering, in particular, levels of commodity prices in international markets and the planned shape of assistance to natural gas providers in 2023.

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[16] Act of 7 October 2022 on emergency measures to protect electricity consumers in 2023 in connection with the situation on the electricity market (Journal of Laws, item 2127), Act of 27 October 2022 on emergency measures to limit the level of electricity prices and support certain electricity consumers in 2023 (Journal of Laws, item 2243).

[17] See also footnote 6.

[18] As the law currently stands, these reduced rates will remain in force until the end of 2022, while the November projection assumes an extension of the reduced VAT rates on food (in line with the Prime Minister's statement of 7 November 2022) and of the reduced excise tax rate.

The increased defence spending provided for in the Homeland Defence Act will have a significant impact on the general government balance in 2023.[19] The State's planned defence expenditure will rise from 2.2% of GDP in 2022 to 3.0% of GDP in 2023. Moreover, in line with the forecast of the public debt presented in the *Public finance sector debt management strategy 2023-2026* attached to the *Draft Act*, Armed Forces Support Fund is planned to incur obligations of PLN 39.6 billion in 2023. These funds may be used to increase the total spending on national defence on a cash basis to a level exceeding the statutory minimum of 3% of GDP. Yet, on the other hand, since expenditure in ESA terms is recorded on an accrual basis, spending on arms purchases is recorded upon delivery, so an increase in cash spending translates into spending in ESA terms with a delay.

Rising interest payments will again contribute to a higher deficit in 2023. In line with the assumptions of the *Draft Act*, the average annual level of the NBP reference rate in 2023 will be higher than in 2022, which will translate into higher interest rate on variable rate coupon bonds. At the same time, fixed coupon bonds issued while long-term interest rates at home and abroad were low will mature, and new debt will be issued at significantly higher yields. According to NBP forecasts, the cost of service of the public debt in 2023 will reach 2.4% of GDP.

Public expenditure growth in 2023 will also result from high inflation observed in 2022 and forecast for 2023. This can be seen, among other things, in the assumed high nominal growth of expenditure on day-to-day running of public institutions compared to previous years. The cap on current expenditure of budgetary units assumed in the *Draft Act* is 24.6% higher than provided for in the 2022 *Budget Act*, and excluding the "National Defence" section of the budget (posting a faster growth due to the changes indicated above) this increase is 16.5%, representing an increase of 0.1 percentage points in this spending as related to GDP. The high 2022 inflation will also translate into higher spending on old age and disability pensions in 2023 – according to the draft law adopted by the Council of Ministers, these benefits are to be indexed by 13.8%, with the lowest benefits rising more (the minimum pension by 16.4%). According to NBP estimates, expenditure on old age and disability pensions – including the so-called 13th and 14th pensions – expressed as percentage of GDP will rise by 0.6 percentage points in 2023.

Taking into account the above factors, further widening of the general government deficit can be expected. Meanwhile, the structural deficit, i.e. the deficit adjusted for the impact

[19] Act of 11 March 2022 on Homeland Defence (Journal of Laws item 655, as amended)

of the business cycle and one-off factors, will remain at the 2022 level, which implies a neutral fiscal policy stance. At the same time, in line with the November NBP projection, despite the increase in the fiscal deficit described above, household real disposable income will decline in 2023, while the output gap will turn negative and hence will not add to inflationary pressure. The increase in the general government deficit in 2023 will thus be conducive to supporting economic growth, limiting the risk of recession.

In line with the *Justification* to the *Draft Act*, the general government deficit in ESA 2010 terms will stand at 4.5% of GDP in 2023. In light of current NBP forecasts – taking into account the recently announced anti-inflation measures, in particular the draft laws adopted by the Council of ministers on prices of electricity and the expiry of some reductions in indirect taxes – the outlined deficit forecast is realistic.

IV. Public debt and financing of the borrowing requirement

Along with the robust rebound in the Polish economy after the COVID-19 pandemic, and the accompanying improvement in the general government balance, in 2021 the public debt-to-GDP ratio in ESA terms declined from 57.2% to 53.8%. In 2022, despite a marked rise in the fiscal deficit, this ratio may be expected to fall further, supported by the fast pace of nominal GDP growth. According to the *Public finance sector debt management strategy in the years 2023-2026*, the public debt in ESA terms will reach 51.7% at the end of 2022, and public debt according to the domestic definition - 40.5% of GDP. In contrast, for 2023 the *Strategy* envisages an increase in the above ratios to 53.3% and 40.6% of GDP, respectively – despite the elevated inflation – and consequently, a further rapid nominal GDP growth (according to the *Justification* to the *Draft Act*, its pace will be 9.9%). Under these circumstances, the increase in the public debt-to-GDP ratio will stem from the higher borrowing requirement of the public finance sector in comparison to the previous years.

According to the *Justification*, in 2023 the net borrowing requirement of the State Treasury will amount to PLN 110.5 billion (3.3% of GDP), with net market funding raised in the form of bond issue and loans amounting to PLN 82.6 billion (2.5% of GDP). The remaining borrowing requirement is to be primarily financed with EU funds (PLN 13.5 billion) and flows related to the foreign currency account (PLN 14.5 billion). In addition to State Treasury debt, substantial borrowing requirement of other entities of the public finance sector is planned for 2023. In accordance with the *Strategy*, the increase in the State Treasury debt is to amount to PLN 117.4 billion (3.5% of GDP), while the increase in the general government debt in ESA terms to PLN 207.3 billion (6.2% of GDP). The increase in the debt of the remaining units of the sector will comprise, above all, a rise in the liabilities of funds managed by Bank Gospodarstwa Krajowego, i.e. the COVID-19 Counteracting Fund, the Armed Forces Support Fund, the Assistance Fund and the National Road Fund, which are expected to increase by PLN 81.4 billion (2.5% of GDP).

Also in the following years covered by the *Strategy*, public debt in ESA terms as a percentage of GDP is expected to increase. At the end of 2026, this ratio is to amount to 55.7%. At the same time, the net borrowing requirement (calculated as the nominal increase in ESA public debt) is expected to gradually decrease over this period, to 5.6% of GDP in 2024, 4.0% of GDP in 2025 and 3.1% of GDP in 2026, thus remaining much higher than observed in recent years (except for 2020).

With the currently observed monetary tightening by central banks, short- and long-term interest rates can be expected to remain at elevated levels in the years ahead. In this situation, the conditions of financing the sector's borrowing requirements will probably be significantly less favourable than in the previous decade, which will not be conducive to maintaining heightened borrowing needs.

The rise in the public finance sector borrowing requirement planned for the coming years is partly due to an increase in spending on national defence, which, given the current geopolitical situation, is a strategic priority for Poland. However, in view of the above conditions of financing these needs, in the long term it seems desirable to undertake measures to limit other public spending or to raise public finance revenue, which, together with a return of the economy to a growth path close to its potential, will enable of the return of the downward trend in the debt-to-GDP ratio.