Warsaw, October 3, 2002

Opinion of the Monetary Policy Council
on the project of the *Act on the State Budget for the Year 2003*

I. General comments

According to the Monetary Policy Council, the project of the *Act on the State Budget for the Year 2003* does not support the accomplishment of objectives declared by the Government: taking actions that would bring a sustained improvement of the public finance condition, providing conditions for a sustained economic growth and fighting unemployment.

- The project does not contain systemic solutions that would improve the structure of budget expenses, reduce their dynamics and the size of the deficit. As a result, the public debt is to increase over 50% as related to the GDP. In such circumstances, the Government abandons the adopted principle of reducing the increase of budget expenses to 1% in real terms, which was to lead gradually to the decrease of the budget deficit. Additionally, it is assumed to maintain the freeze of tax brackets for natural persons and to withdraw from the announced reduction of the tax rate for legal persons. These are the actions that do not support the reduction of the budget deficit on a longer run.
- The public finance improvement and other structural reforms are necessary for a sustained economic growth achievement. In the Council's opinion, the project of the *Act on the State Budget for the Year 2003* is not based on such guidelines.

II. Macroeconomic guidelines of the budget

1. The construction of the budget for 2003 is based on two fundamental guidelines:

- the annual average growth of prices for consumer goods and services will amount to 2.3%,
- the gross domestic product will grow by 3.5%.

The Monetary Policy Council positively evaluates the guideline about the inflation level. However, the presently shaped conditions of the economic growth in 2003 justify the evaluation of the guideline about the GDP growth by 3.5% as very optimistic. In the context of the present forecasts for the economic situation development worldwide, more probable is the growth at 2-3%.

In the forecast of the GDP growth in 2003 that has been adopted in the project of the *Act on the State Budget*, the basic importance is given to the assumption of the acceleration of the domestic demand growth pace to 3.4%, including the growth pace of the investment in fixed assets to 5.6%, and the growth pace of individual consumption to 3.2%. These forecasts, especially in the part related to consumption, seem very optimistic. Additionally, the attention should be paid to the fact that with such a strong domestic demand growth there would have to be a change in the tendency of a faster growth of exports than imports that has been maintained for two years. It is connected with a high import intensity of investments and consumption.

The project of the budget assumes a slight negative impact of net exports on the GDP growth (minus 0.1 percentage point) as a result of a slower improvement of the turnover balance. With a faster growth of imports than exports, the negative contribution of net exports to the GDP growth pace, however, would have to be considerably bigger (minus 0.4 – 0.7 percentage point). It would mean that with the domestic demand growth by 3.4%, the GDP growth pace would have to be lower.

2. According to the macroeconomic projection adopted in the project of the budget, the individual consumption growth by 3.2% will take place when the real growth of the gross income at disposal of households amounts to 2.8%. It would mean a further drop of the tendency to save and not – as it is said in the justification to the project of the act – maintaining it at a level comparable to the one of 2002. The forecast of the income growth is, inter alia, based on the assumption that the lowering tendency of income from the hired labor is overcome – it is forecasted that after several years of

the decrease the employment in the national economy will increase and, at the same time, the real wages growth will be bigger. Without expressing an opinion on the reality of these assumptions (whether the GDP growth by 3.5% is really enough not only to overcome the lowering tendency in employment, but also result in its growth by 0.8%), it should be emphasized that they mean a material decrease of the growth pace of labor efficiency as compared to the one observed in previous years. In such situation it is difficult to expect a faster wage growth in the enterprise sector.

3. The projected increase of expenses is funded with revenues assessed on the basis of not prudent enough assumptions. In part, these revenues are of a single nature. As a result, the fiscal policy next year can appear looser than it is forecasted by the budget guidelines for 2003.

III. Public finances in 2003

Revenues

4. The project of the *Act on the State Budget*, based on an optimistic assumption related to the economic growth pace in 2003, also provides solutions the effect of which will be single revenues of the state budget. It constitutes a basis for the decrease of the state budget deficit from PLN 40 billion in 2002 to PLN 38.7 billion in 2003. The tax revenue forecast resulting from the assumed GDP growth and the improvement of tax collection (PLN 1.85 billion) and the single revenues forecast (PLN 1.92 billion) are connected with a high risk. It creates the threat of overestimation of the revenue side of the state budget that may lead to a bigger deficit of the state budget or the remaining segments of public finances, or to the necessity to limit expenses during a budget year.

5. The increase of revenues provided in the project of the *Act on the State Budget* has been achieved, inter alia, by the increase of the tax burdens. Abandoning the cut of the income tax rate for legal persons to the level of 24% - that was adopted in the act

in 1999 – and maintaining frozen PIT tax brackets and excise tax on electric energy will weaken the tendency to save and invest, adversely affecting the economic growth. Moreover, such actions impair the confidence to the tax system.

Expenses

6. The increase of the state budget expenses in 2003 by 4.5% in nominal terms, i.e. by 2.2% in real terms as compared to 2002, will adversely affect the decrease of imbalance in public finances and maintaining control over the current and future size of the public debt. Abandoning the strategy of controlling the budget deficit through the reduction of the expense dynamics that was announced by the Government will weaken the credibility of fiscal policy in medium- and long-term. In this connection, decisions in the area of monetary policy will be made on the basis of the real course of fiscal policy and not the government forecasts of the economic deficit.

7. The biggest reductions of expenses (by over PLN 1.5 billion) took place through the decrease of allocations to local self-government units. Moreover, the deficit of earmarked funds (approximately PLN 4.3 billion) and of agencies (approximately PLN 2.3 billion) is forecasted. It indicates that the reductions in the state budget expenses will be considerably based on the shifting of budget deficit to other units of the public finance sector and on the repeated postponing of some expenses for the years to come.

8. The state budget expense structure has not been materially changed as compared to the year 2002. The reduction of social expenses share in the total structure of expenses is only formal. In reality, the planned low level of allocations to earmarked funds as compared to their needs (especially in case of the Labor Fund) may mean the increase of their deficits. According to the Government declarations, expenses for the basic functions of the state (public safety, national defense, jurisdiction) increase.

9. The lack of systemic reforms in 2003 results in the situation where the share of legally determined expenses in total expenses increases to 67.8%, while in 2001 they constituted 65.2% and in 1999 58.2%. It reduces the field to perform the development supportive tasks of the budget.

Deficit and its financing

10. The budget deficit amount and big borrowing needs of the state in 2003 create a threat that long-term interest rates will be maintained at a high level. It would limit the dynamics of investments and be a factor that contributes to the appreciation of the zloty exchange rate.

11. The Ministry of Finance introduces a change into the way of calculating the economic deficit of the public finance sector. However, the Monetary Policy Council, as last year, evaluates the public finance impact on the macroeconomic situation on the basis of the deficit of the public finance sector adjusted for only two categories: compensations for not increasing wages, pensions and disability allowances, as well as transfers of social insurance contributions to open pension funds. The maintaining of the above definition is justified by the fact that it is the closest one to the commonly applied by the International Monetary Fund definition of the consolidated deficit of the public finance sector that is understandable to financial markets. According to the forecasts of the NBP, the deficit in such approach will amount to at least 5.4% of GDP in 2003 as compared to 5.8% of GDP in 2002. As compared to the forecasts contained in the act on the state budget, the NBP provides a bigger deficit of self-governments and other units of this sector. The forecasted economic deficit in 2003 can be subject to increase for expenses resulting from the accomplishment of the government programs, e.g. construction of roads and highways or the modernization of the army. In conditions of the assumed acceleration of the economic growth pace, it would mean the maintaining of a loose fiscal policy or even its further loosening.

12. The Monetary Policy Council wishes to emphasize the problem of the extent of the public finance sector in question. In the analysis of the impact of the financial policy of the state on the economy, there should be taken into consideration the following institutions: the Industrial Development Agency, the Public Roads Administration, and the Military Property Agency. The mentioned entities that are controlled by the state and which receive transfers of public resources from the state transform the received assets into expenses. Moreover, these institutions, performing tasks resulting from the adopted economic policy of the government, will draw loans guaranteed by the State Treasury. The scale of expenses of these institutions can reach many billions of zlotys and the increase of their indebtedness will create the deficit of public finances outside the state budget. Not taking these entities into consideration in the deficit of the public finance sector makes it more difficult to evaluate correctly the public finance situation and, at the same time, the level of the restrictive character of fiscal policy next year. It also decreases the public finance transparency. In its evaluation of fiscal policy, the Monetary Policy Council will also take into account the financial situation of these entities.

13. The project of the act on the state budget for the year 2003 does not fully consider the fiscal results of all intended actions of the Government, e.g. the introduction of a new tax – vignette, the modernization of the army and the announced change of the medication refund system. It means the increase of uncertainty about the final shape of fiscal policy next year.

14. In the project of the *Act on the State Budget for the Year 2003* it is provided that in 2002 the revenues from privatization are to be accomplished at the level of approximately PLN 3.7 billion (approximately 55.8% of the planned amount). In 2003, it is planned that the increase of revenues from privatization reinforcing the budget will amount up to PLN 7.4 billion, mainly as a result of the shifting of revenues initially planned for the year 2002. Privatization is the basic structural reform that supports the economic growth. Further delay in ownership structure transformation in the economy would threaten with the accruing problems in state-

owned enterprises that will not be covered by this process, as a result weakening the state finances. Additionally, revenues from privatization enable the reduction of the treasury securities issuing, and as a result the public debt and costs of its servicing.

Public debt

15. According to the presented project of the act, the state public debt will be at the level of approximately 50.4% of GDP at the end of 2003, while in 2001 this relation was 41.9%. In this situation, changes in fiscal policy should be expected, which would counteract the increase of expenses and commitments of the state budget and the remaining entities of the public finance sector. However, the Government assumes in 2003 the stepwise rise of the scale of granted guarantees and pledges of the State Treasury that will increase the potential commitments due to this reason by 44%. It will contribute to a further growth of the state public debt (by 2.1% of GDP to the level of 52.5% of GDP). It is a particularly distressing process if it is considered that the disciplining program that is a result of exceeding by the public debt of the level of 50% of GDP in 2003 will be in force only in 2005.

16. The presented project of the budget does not mention the problem of the state budget arrears in relation to Open Pension Funds. An essential issue is also the Demographic Reserve Fund. According to the guidelines of the pension system reform, this Fund was to receive the resources at the amount of 1% of the pension contribution rate. However, the project of the budget for 2003, similarly to the act on the state budget for this year, provides that the Demographic Reserve Fund will get only 0.1% of the basic pension contribution rate next year. It will cause the cumulating of problems related to the social security reform and will be connected with an additional burden to the state budget in the following years when Poland will have to meet the fiscal criteria of the EU.