Warsaw, April 9, 2003

Opinion of the Monetary Policy Council
on the *Programme for Restructuring Poland's Public Finances*

This opinion refers to the draft document submitted to the Monetary Policy Council on March 25, 2003.

I. General comments

1. According to the Monetary Policy Council, the current state of Poland's finances is in need of in-depth reform. A substantial imbalance within the public finance sector, the resulting growing deficit and public debt stem from the long-time absence of necessary adjustments in this area. The major problems of this sector include high level and dynamic of public/budget expenditure, the large proportion of the so-called fixed expenditure (comprising social spending) and small share of outlays encouraging growth. All this in the context of high, given the current stage of development of the economy (per capita GDP), share of the revenues of the public finance sector in the GDP and major fiscal burdens. Due to the public finance crisis, investment outlays made by businesses and infrastructure-related spending are decreasing, while the basic functions of the state chronically lack adequate financing. Consequently, economic growth is stalled and high unemployment is on the rise.

2. The approach adopted in the *Programme*, which seeks to increase the flexibility of state budget expenditure (abolition of indexation and valorisation mechanisms, rendering defence spending less 'rigid'), enforce institutional consolidation (liquidation and merging of 'budget-supporting' funds and agencies) and decentralise (higher proportion of internally generated income of local governments in financing their statutory responsibilities), is correct. These measures constitute an attempt to meet the formal

criteria of Poland's accession to the European Union and to establish mechanisms for absorbing structural funds.

The forecasted abolition of tax breaks and exemptions should also be welcome provided that these measures are accompanied by the lowering of effective tax rates.

3. The *Programme* does not present any arguments that would justify the optimistic assumptions behind the GDP dynamic. There are no undertakings on the supply side of the economy that would account for the forecasted acceleration of economic growth. The contributing factors listed in the *Programme* ('further reductions in interest rates and gradual release of the NBP reserve against foreign exchange risk', 'controlled level of budget deficit') point to a focus on stimulating internal demand for short-term economic recovery at the expense of the establishment of lasting supply-driven foundations for sustainable economic growth.

4. Proposed amendments to the tax system are intended to simplify it. This objective, however, will not be furthered by the introduction of new rates of personal income tax. The planned scale of the reduction in nominal rates of corporate and personal income tax will be disproportionate to the lost revenues, assuming that tax breaks and exemptions are abolished and tax rates frozen. Presented proposals with regard to changes in personal income tax rates are likely to contribute to an increase in the effective PIT rate, especially in the case of taxpayers from the higher-income tax group, and to the preservation of the effective CIT rate at the 2002 level, at most.

   New solutions adopted with regard to personal income tax fail to remove severe tax progression. On the contrary, instead of being narrowed, as desired, the tax scale is widened. Combined with the growth of indirect taxes, and the imposition of tax on share proceeds, the tax reform may be said to increase fiscal burden. In consequence, higher fiscal burden is likely to adversely affect the private sector's propensity to save.

5. The *Programme* does not foresee systemic changes limiting budget expenditure on a permanent basis. Proposed measures to cut expenditure are very limited in scope and temporary in nature (e.g. freezing social benefits, the so-called other expenditure, at a nominal level, reducing the percentage of excise duty imposed on petrol and earmarked for road construction and maintenance, from 35% to 30%). Given the above, the envisaged scale of fiscal consolidation seems very inadequate.

6. The ‘open deficit’ concept presented in the *Programme* raises substantial doubts. The document assumes that a high budget deficit of approximately PLN 40 billion can be financed. At the same time, it shows a budget gap, i.e. expenditure not balanced by revenues, of some PLN 10 billion. Although the document features declarations that further work will be conducted on eliminating the gap, the fact that the generation of additional income and reduction in expenditure have both been adopted as equivalent solutions is disturbing, as it overlooks the differing macroeconomic effects caused by these basically different adjustments. Solving this problem will be the basic condition for a positive assessment of fiscal policy in the coming years. A severe threat of an increasingly restrictive fiscal policy is manifest and/or that of the imbalance within the public finance sector, with its adverse consequences for the economy. The expanding budget deficit, expected to reach approx. PLN 50 billion p.a. in the years 2004 – 2006, would point to a loosening of the fiscal policy in circumstances of an anticipated acceleration of economic growth and the overrun of subsequent statutory prudential limits on public debt in relation to GDP.

7. In fact, the level of budget deficit projected in the *Programme* may prove even bigger as the estimates of budget revenues have been based on the assumed strong acceleration of economic growth and a significant improvement in tax collection.

8. The *Programme for Restructuring Poland’s Public Finances* developed by the Ministry of Finance cannot be considered a comprehensive action plan leading to in-depth and lasting restructuring. On the contrary, in its current shape the *Programme* gives rise to serious reservations as to the anticipated scale of public finance consolidation, procedures for its implementation and its sustainability. Therefore, the government paper cannot be treated as an ultimate set of solutions in the area of public finance.

II. Release of revaluation reserve

1. The National Bank of Poland releases the revaluation reserve when generating transactional profits. This mechanism reflects widely recognised international accounting standards applicable to central banks, whereas the proposal of the Ministry of Finance laid down in the *Programme* provides for the transfer of the revaluation reserve established against unrealised profits to finance current budget expenditure, thus violating the above standards.

2. The transfer of the revaluation reserve to the budget would constitute a monetary expansion equivalent in volume requiring an adequate increase in open market operations. This would result in the increase of interest rates and/or reduction in foreign currency reserves and/or increase in the rate of reserve requirement.

3. In line with the ESA 95 standards, the transfer of the revaluation reserve may not constitute a state budget revenue, only a source of financing the deficit. Furthermore, in the following year this would contribute to higher public finance deficit. Given the level of short-term interest rates that exceed the rates adopted for longer periods, the costs of open market operations at the NBP would be higher than the savings generated by the budget in public debt servicing.

4. The transfer of the revaluation reserve in contravention of previously adopted principles for its establishment compatible with international standards would negatively affect the credibility of the central bank.

5. Therefore, the Monetary Policy Council sees no grounds for the proposed transfer of the revaluation reserve presented in the *Programme*, as its execution, while offering no benefits in terms of fiscal policy, would give rise to numerous negative effects in monetary policy.