Warsaw, 30 September 2003

Opinion

of the Monetary Policy Council

concerning

The 2004 State Budget Act

I. General Comments

1. *The 2004 State Budget Act* contains a forecast of a highly significant increase in the state budget deficit from PLN 38.7 billion (4.8% of GDP) to PLN 45.5 billion (5.3% of GDP). An amendment introduced to the act concerning budget expenditure, i.e. not accounting for subsidies directed to the Social Insurances Fund compensating for the insurance premiums transferred to open old-age pension funds, makes the data featuring in the document hardly compatible with this year's budget. This creates a vague image of the state of public finances and makes the fiscal policy less transparent. The deficit, as compared with that of 2003, will amount to approximately PLN 56.9 billion (6.6% of GDP) in 2004. This means its steep increase by approximately 1.8 percentage points of GDP.

2. Under the middle-term strategy for public finances, the public debt/GDP ratio will stand at 51.5% in 2003. This means exceeding the first security threshold and necessitates the application of corrective measures in order to ensure that the deficit/income ratio in the state budget for 2005 does not exceed the level reached in 2003. The draft budget for 2004 fails to provide for any action to be taken in order to contain the public debt/GDP ratio in the future. Moreover, the projected scale of fiscal expansion creates a serious risk of exceeding the next security threshold of 55% already in 2004. This bleak scenario could only be averted next year should a highly optimistic series of coincidences occur, namely if: the economic growth reached 5%, the rate of the Polish zloty against the euro and the American dollar strengthened to the levels of 4.25 and 3.78, respectively, net revenues from privatisation amounted to

PLN 7 billion, while deficits outside the central budget (e.g. in the Social Insurances Fund or in the Labour Fund) did not exceed the optimistically projected values.

In turn, the occurrence of even a single development from the list below would bring the public debt/GDP ratio to over 55%, thus beyond the second security threshold indicated in the Public Finance Law:

- the GDP growth is lower than 4.5%,
- privatisation revenues are by at least PLN 2 billion lower than those projected for 2003 or 2004 ,
- the rate of the Polish zloty against the euro and the American dollar is by at least 3% less than the figure given in *The 2004 State Budget Act*,
- the total debt increase in earmarked funds exceeds the projected level by over PLN 2 billion.

Should the public debt exceed 55% of GDP in 2004, the budget for 2006 would have to guarantee that the public debt/GDP ratio could reduced to a level lower than that of 2004. Meeting that requirement may necessitate effecting a budget surplus in 2006. If so, the required scope of a forced fiscal consolidation would include both a drastic restriction of expenditure and a steep increase in taxation. The pace of the implementation and the scale of the required budgetary adjustments would both bring very serious negative economic and social consequences.

Therefore, the Council has concluded that a minimal scope of a public finance reform should result in a 2004 budget designed so as to eliminate the risk of exceeding the second security threshold.

A considerable deepening of the public finance imbalance is taking place while the economy is enjoying fast growth. Thus, the structural deficit, by definition free from the impact of cyclic factors, is growing at an even faster pace.

3. *The 2004 State Budget Act* provides for a rapid increase in state budget expenditure while failing to offer any systemic solutions which could contain it. Yet again, taking necessary measures aimed at curbing public expenses has been postponed until some future time.

4. The Monetary Policy Council expresses its concern that such a significant increase in budget deficit, as well as an increase in long-term interest rates which it will bring,

may result in crowding out private sector investment by budget expenditure, thus stifling economic growth. Those phenomena are going to be accompanied by a heightened uncertainty regarding exchange rates, which may be different from the government's forecasts. Additionally, the uncertainty as to the fiscal stability leads the Council to suggest that the forecasts regarding the balance of payments are too optimistic.

5. In the light of *The 2004 State Budget Act* and *The Medium-Term Strategy for Public Finance*, it is going to be essential for the government to present and implement a programme of public finance recovery. Such a programme, unknown at the time when the Council was drafting this opinion, must include solutions which would curb expenditure in the public finance sector in a sustained manner. The above pertains to systemic reforms of public finance sector expenditures and a profound restructuring of loss-making sectors, in particular coal mining, The Polish State Railways and health-care. A long-term recovery of public finances also requires action to be taken to boost the registered labour supply and labour demand. A credible programme, leading to a radical curbing of the public finance deficit, would make it possible to avoid the serious financial problems of the country and, in consequence, disorders in its economic development. A programme of rationalising public expenditure would be of key importance for decisions taken by financial markets, foreign investors and domestic business entities.

II. Macroeconomic Provisions Contained in the Act

6. The budget act for 2004 has been based on two basic assumptions:
   - the average annual increase in prices of consumer goods and services will be 2%,
   - the GDP will grow by 5%.

   The inflation forecast does not raise the Council's concern. The forecast concerning economic growth represents the upper ceiling of the prognoses currently available.

7. Faster economic growth in 2004 is to be a consequence of domestic demand becoming much stronger than in 2003, including, in particular, an increase in gross outlay for fixed assets by 12.2% and individual consumption by 3.8%. Both an improvement in the financial standing of companies and Poland's accession to the EU

may not be enough to stimulate investment to such high levels. Additionally, the state of public finance is going to have a negative impact on companies' willingness to make much investment, by limiting the availability of outside resources for investment financing and breeding uncertainty as to economic prospects. The state of public finance may also restrict the flow of foreign direct investment into Poland.

8. The forecast concerning the macroeconomic situation in 2004 has been developed on the basis of non-coherent assumptions.

   - The projected increase in available income seems to be justified by a higher level of economic activity and changes in the labour market related to it, as well as by higher incomes of households engaged in individual economic activity. With more income available, a stronger propensity to save is to be expected while the act assumes such a trend to be weaker.
   - According to the government's assumptions, the pace of domestic demand growth in 2004 is going to be 5.0%. If so, net exports should fall by much more than is projected in the act. An investment improvement related to upgrading needs results in significantly stronger imports, even if exports could be retained at a relatively high level. The negative contribution of net exports to GDP growth may be higher than projected in the act.

III. Public Finance in 2004

Income

9. The act provides for a radical drop in the rate of income tax for entities engaged in economic activity, which in the long term should bring positive economic effects. However, the necessity to significantly curb the budget deficit in the years to come may mean that the projected solutions are not sustainable, thus considerably increasing the prospect of higher tax rates in the future. Also, the diversification of income tax rates for various taxpayer groups introduces uncertainty in 2004 as to the accuracy of the estimated amount to be collected from direct taxation. This is particularly disadvantageous in the face of a rapidly growing budget deficit and state indebtedness.

Expenditure

10. The execution of the budget act in the form in which it has been presented entails an expenditure increase of 9.9% in nominal terms and a one of 7.7% in real terms. A half of the projected increase in state budget expenditure is attributable to Poland's EU accession costs. However, a sharp increase in other budget expenses is also considerable, as a result of a failure to introduce comprehensive systemic changes to the state budget expenditure structure.

11. In 2004, fixed expenditures will continue to be a significant part of total expenditures. The data presented in the budget act distort the actual picture of these expenses. This is caused by changes in expenditure classification, subsidies for open old-age pension funds not being included as expenses, as well as not accounting for the EU membership fee as an expense determined by law. If revised by the above, the expenditure side shows that in 2004 the share of legally determined expenditure remains very high and amounts to 66.6% of total budget expenditure. This represents only 1.5 percentage points less than in 2003, while the budget act features a decrease of its share in total expenditure by 6.4 percentage points.

12. The task-related expenditure structure has not improved, either[1], which limits manoeuvres aimed at executing pro-development budget tasks. It may be projected that the share of expenses related to the state's basic functions will go up (from 30.3% in 2003 to 30.8% in 2004), but according to the act economy- and infrastructure-related expenditure is to be reduced (from 9.4% in 2003 to 8.3% in 2004). Most resources are still going to be absorbed by social tasks (36.3%). As compared with 2003, this figure marks a decrease in the share of social expenditure in total expenses by 0.7 percentage points, yet this is partly related to a low level of subsidies for the Labour Fund.

The Deficit and Deficit Financing

13. The growing state budget deficit is accompanied by a radical deterioration of the original balance, one of the basic yardsticks of fiscal stability. Next year, the original

[1] The total expenditures include the subsidy for the Social Insurances Fund while the EU's own resources have not been included in the figure.

deficit will amount to approximately PLN 30 billion – i.e. a twofold growth over the 2003 figure. The original deficit was present only at the early stage of the post-1989 transformation process and then in the last three years, yet lower than that projected for 2004. The 2004 figure for the original deficit of 3.5% of GDP (1.7% of GDP in 2003), implies a serious risk of a future crisis in public finances.

14. According to the act presented, net borrowing needs of the state budget will amount to approx. PLN 56 billion as compared with PLN 37.4 billion in 2003, which represents a significant increase (of approx. 50%). This will have a negative impact on domestic savings and create a serious risk of an increase in long-term market interest rates, regardless of decisions made by the National Bank of Poland. An intensified issue of treasury bills on domestic market would mean restricted access of businesses and households to bank loans, thus stifling the economy's developmental potential.

15. As regards an issue which is of key importance to the account of transfers from the EU, i.e. the forecast for using resources transferred from the EU budget to Poland, the presented estimates are extraordinarily optimistic. It is namely projected that in 2004 those resources will amount to as much as EUR 865 m (PLN 3,677 m). This means that the account of resources received has been credited not only with the advance payment (which is 10% of the total payment expected in the period of 2004-2006), but also with another 10% (EUR 433 m). Given the experiences thus far, receiving any payment exceeding the advance is unlikely.

    Similarly unrealistic seems the estimate of payments from pre-accession funds projected for 2004 (PLN 6,338 m, or EUR 1.491 m). If this were to materialise, it would mean that the fund absorption is 100% more than that projected by the European Commission for 2003, and it is still unsure whether this year's absorption is going to be that high. In particular, the act includes a forecast of a dramatic increase in using resources from ISPA and SAPARD. It seems that, even if a considerable progress in contracting were actually recorded, these estimates are overstated by 20-30%.

    In summary, transfers to Poland in 2004 may have been overestimated by PLN 3 - 3.5 billion (approx. EUR 705 - 820 m). If so, transfers from the European Union less the Polish membership fee in 2004 may amount to EUR 1.1 – 1.3 billion at the most, and not to EUR 1.9 billion.

16. The budget act provides that in 2003 revenues from privatisation transferred to the state budget are going to be PLN 4.5 billion (61% of the figure projected originally). Under the act, revenues from privatisation transferred to the state budget in 2004 are going to be up to PLN 7 billion, mainly as a consequence of moving the revenues originally planned for 2003. If property restructuring is delayed any further, the economy may be jeopardised by problems developing in companies not yet privatised, thus having an adverse impact on the state budget. Furthermore, revenues from privatisation help restrain the issuing of treasury bills, and, consequently, public debt and the costs of its servicing. In the light of the experiences from recent years, the attainment of the projected PLN 7 billion is uncertain while any considerably lower amount obtained from privatisation increases the risk that public debt will exceed the threshold of 55% of GDP.

Public debt

17. In 2004, only an extraordinary coincidence may keep the figure for public debt below 55% of GDP. Should necessary reforms of the public finance sector be postponed any further and the pessimistic scenario regarding economic growth come true, then in 2005 public debt might exceed 60% of GDP.

18. The 2004 financial plans for funds and agencies project a deficit of such units of the public sector of PLN 6.6 billion, i.e. 0.8% of GDP. That projected level of deficit seems questionable given that the forecasts concerning incomes of funds and agencies are optimistic. The likely increase in their deficit, financed by bank loans, might constitute an extra contribution to public debt. Another possible danger is the expansion of hidden state debt which would be a result of growing health-care related liabilities due and a lower transfer of old-age pension premiums to open old-age pension funds.