Overview: This week, our fiscal policy expert examines the most recent data on the general government deficit and public debt in Poland. Is the condition of public finance in Poland really as good as it looks at first glance?

Poland’s budget deficit and public debt: Is the situation really as good as it looks at first glance?

By: Łukasz Janikowski, Fiscal Economist

According to the preliminary estimates published by the Polish Central Statistical Office on 4th of April, the general government deficit in Poland in 2017 amounted to 1.5% of GDP, which was the best result since 2007, while the public debt to GDP ratio decreased to 50.6% (compared to, respectively, 2.3% and 54.2% in 2016). The very low deficit to GDP ratio resulted mainly from a significant improvement in the balance of the central budget. Ministry of Finance noted on their webpage that this improvement “was primarily a result of a number of measures aimed at rebuilding the tax revenue and tightening the tax system.” But is the situation really so bright?

In 2017, the deficit of the central government amounted to PLN 25.4 billion (EUR 6 billion) and was lower by PLN 20.8 billion (EUR 4.9 billion) than in the previous year. The central government revenues increased by 11.4%, and spending increased by 4.2%. Together with a solid GDP growth rate (4.6% in real terms), it brought down the general government deficit to 1.5% of GDP.

However, when assessing sustainability of public debt, one should not look at the headline budget balance, but at the so-called “structural balance”, which is adjusted for one-off operations and business cycle fluctuations. One-off operations are extraordinary events that are not stable sources of income or regular, repetitive expenditures. For example, in 2017, a record high profit of the National Bank of Poland resulted in a contribution of PLN 8.7 billion (EUR 2 billion) to the central budget. Profits of the central bank are primarily a result of exchange rate fluctuations and therefore are not a stable source of income. They should be excluded from the picture for the purposes of analyzing fiscal sustainability.

In order to properly assess the condition of public finance, one needs also to adjust the budget balance for business cycle fluctuations. When the economy is booming (or, more precisely, the output gap is positive), tax revenues increase faster than on average, and spending on welfare decreases due to growth of wages and reduction of unemployment.
Polish economy is currently above its potential, the natural result of which is an improvement of the fiscal balance. In other words, the deficit would have declined even if there had been no tightening of the tax system at all.

The most important source of revenue increase in 2017 was VAT, which grew by PLN 30.2 billion (or by 23.9%). This impressive result was possible thanks to the tightening of the tax system but also thanks to the composition of the economic growth, which was to a large extent driven by consumption (+4.2% in real terms). Another factor behind the growth of nominal VAT revenues, which accounted for approx. PLN 2.5-3 billion, was inflation. Even after taking these factors into consideration, the results of the tightening of VAT collections are impressive, but much lower than the increase of the revenues. According to the data published by the Ministry of Finance on April 5th, the VAT gap in 2017 was reduced by 6 pp. (from 20% to 14%), which accounts for approx. PLN 11 billion (EUR 2.6 billion), rather than PLN 30.2 billion (EUR 7.1 billion).

When we compare the data on the deficit in Poland and other EU countries, the headline numbers lose even more of their appeal. The economy of the entire EU is on the rise, and budget balances are improving in nearly all the member states. Complete data for 2017 are not yet available, but in 2016, when Poland had a deficit of 2.3%, 10 EU countries had budget surpluses. This number almost certainly grew in 2017, and it will not be a surprise if it turns out that over half of the member states had a budget surplus. In this context, the deficit of 1.5% does not look good any more.

When it comes to the public debt to GDP ratio, beside the deficit and the GDP growth, it is influenced also by exchange rate fluctuations, which affect the value of public debt denominated in foreign currencies. Since over 30% of Polish public debt is denominated in foreign currencies, appreciation of the Polish zloty in 2017 also contributed to the decrease of the debt to GDP ratio. Moreover, the improvement in the debt to GDP ratio in Poland is relatively small compared to the rest of the EU countries. Data for the entire year 2017 is not yet available, but according to Eurostat, over the period from 2016 Q3 to 2017 Q3, the debt to GDP ratio decreased in 24 member states, in 19 of which the scale of improvement was higher than in Poland (including countries from the CEE region: Bulgaria, Czech Republic, Hungary, and Lithuania).

Fiscal policy is sustainable if it does not allow the public debt to GDP ratio to increase in the long run. Since the accession of Poland to the EU in 2004, public debt increased from 45% to 54.2% in 2016 (ESA 2010 methodology). What is more, a significant part of it was hidden in the Social Insurance Institution (ZUS), when the government bonds worth PLN 153.2 billion (EUR 35.7 billion) were redeemed after being transferred from open pension funds to ZUS in 2014. If this operation had not been performed, public debt to GDP ratio could have breached the constitutional limit of 60% as early as in 2016. Despite its drop to 50.2% in 2017, public debt to GDP ratio has a clear upward long term trend, the source of which is excessive structural deficit. According to the calculations of the European Commission (AMECO), the structural deficit in Poland was equal to 2.2% of GDP in 2016 and was the fourth highest in the EU, after France, Spain, and the UK, and was the same as in Romania. The tightening of the tax system could have reduced the structural deficit, but additional expenditure on child benefits (500+), the lowering of the retirement age, and planned increases of the public spending on healthcare from 4.7 to 6% of GDP by 2025 by far offset these additional incomes, especially in the long run.

Summing up, the improvement of the fiscal balance can only partially be explained by the tightening of the tax system. Other important factors behind the low deficit are the high profit of the central bank, business cycle in the expansion phase, and the composition of the economic growth. Additional revenues from the tightening of the tax system are too small to compensate higher government spending in the long run, and, in the view of the recently announced generous social spending, long-term sustainability of public debt in Poland is questionable. In times of economic prosperity, the general public and politicians tend to forget that the expansion phase of the business cycle is the time to build up fiscal resilience against future economic downturns instead of using temporary fiscal leeway for increased government spending. One of the steps aimed at improving the quality of the public debate regarding the fiscal policy may be the establishment of a fiscal policy council, something that the European Commission has repeatedly urged Poland to do. Poland is the only country in the entire EU that does not have such a council.
**This week:** On April 13, S&P Global Ratings revised its outlook for Poland from stable to positive and upheld the BBB+ and A- long-term sovereign credit ratings for debt denominated in foreign and local currency, respectively. The positive outlook indicates increased probability that S&P would upgrade Poland’s rating within the next 24 months. S&P justifies their decision with “solid economic and fiscal outcomes in Poland”. We do not share S&P’s optimistic outlook on public debt sustainability in Poland, especially in the long-run (see the article above).

**GDP (Q4 2017)**
- 4.3% y/y (est.)
  Down from 5.2% in Q3 2017

**Inflation (Feb 2018)**
- 1.3% y/y
  Down from 1.4% in Feb 2018

**Real GDP forecast (%)**
- CASE: 3.9
- IMF WEO: 3.5
- OECD: 3.3

**Unemployment (Feb 2018)**
- 6.3%
  Down from 6.5% in Jan 2018

**NBP Base rate**
- 1.5%
  From 2% in Mar 2015

---

**This week:** Russia’s rouble fell on Wednesday to its lowest levels since November 2016 as the United States imposed new sanctions on April 6 against government officials, oligarchs, and companies they control to punish Moscow for its purported meddling in the 2016 US election. Tensions escalated on Wednesday over the conflict in Syria and rouble hit 65.06 versus the US dollar on the Moscow Exchange, losing more than 11% of its value since the sanctions were introduced. Finance Minister Anton Siluanov said Russia had put purchases of foreign currency on hold to avoid additional pressure on the currency.

**GDP (Q4 2017)**
- 0.9% y/y
  Down from 2.2% in Q3 2017

**Inflation (March 2018)**
- 2.4% y/y
  Up from 2.2% in Feb 2018

**Real GDP forecast (%)**
- IMF WEO: 1.6
- OECD: 1.5

**Unemployment (Feb 2018)**
- 5.0%
  Down from 5.2% in Jan 2018

**CBR Base rate**
- 7.25%
  From 7.5% in Feb 2018

---

**This week:** Europe’s largest economy released its trade figures last week, reporting its weakest start to a new year since 2009. Germany raked in EUR 104.7 billion in exports in February, a fall by 3.2% on January, although up by 2.4% on the same month in 2017. The figures come amid an escalating tit-for-tat tariff battle between the US and China, of which Germany is likely to be a major casualty. China has announced tariffs of 25% on car imports from the US — with some of the largest auto plants and exporters in the US owned by German manufacturers.

**GDP (Q4 2017)**
- 2.9% y/y
  Up from 2.8% in Q3 2017

**Inflation (March 2018)**
- 1.5% y/y (est.)
  Up from 1.2% in Feb 2018

**Real GDP forecast (%)**
- IMF WEO: 1.8
- OECD: 2.3

**Unemployment (Feb 2018)**
- 3.8%
  Up from 3.6% in Jan 2018

**ECB Deposit rate**
- -0.4%
  From -0.3% in Dec 2015

---

**showCASE No. 72 | 16.04.2018**
This week: According to the State Fiscal Service of Ukraine, the number of imported electric cars in Ukraine in the first quarter of 2018 increased three times compared to the same period in 2017 – up to 1744 vehicles. As of 2018, electric vehicles and other vehicles equipped exclusively with an electric motor are exempted from the excise tax and the value-added tax (VAT) upon their importation into the customs territory of Ukraine.

**GDP (Q1 2018)**
- **2.2% y/y**
- Down from 2.4% in Q4 2017

**Unemployment (Q1 2018)**
- **9.9%**
- Up from 8.9% in Q4 2017

**Inflation (Mar 2018)**
- **13.2% y/y**
- Down from 14.0% in Feb 2018

**NBU Base rate**
- **17.0%**
- From 16.0% in Jan 2018

This week: The Ministry of Finance released its growth forecast for Czech economy, which features a 3.6% expansion this year and a 3.3% expansion in 2019. Last year, the economy grew by 4.6%, according to updated data published by the Czech Statistical Office. According to the Ministry, the growth will be supported by solid public finance, which last year recorded a surplus of 1.6% of GDP, and this year is expected to record a surplus of 1.5% of GDP. In 2018, public debt is expected to fall to 32.9% of GDP from last year’s 34.6%. The average inflation rate in 2018 is expected to reach 2.1%, compared to 2.5% in 2017.

**GDP (Q4 2017)**
- **5.5% y/y**
- Up from 5.1% in Q3 2017

**Unemployment (Q4 2017)**
- **2.4%**
- Down from 2.8% in Q3

**Inflation (Feb 2018)**
- **1.8% y/y**
- Down from 2.2% in Jan 2017

**CNB Base rate**
- **0.75%**
- From 0.5% (2nd Jan 2018)

This Week: According to the latest data published by the Hungarian Statistical Office (KSH), in March 2018, consumer prices increased by 2% compared to March 2017 and by 0.1% compared to February 2018. In March 2018, Hungarian consumers paid more for food (growth by 4.1% y/y) and for alcoholic beverages as well as tobacco (growth by 6.8% y/y). The prices of certain goods, including households and pharmaceutical products, decreased by 0.4% y/y.

**GDP (Q4 2017)**
- **4.4% y/y (est.)**
- Up from 3.9% in Q3 2017

**Unemployment (Q1 2018)**
- **3.8%**
- Unchanged since Q4 2017

**Inflation (March 2018)**
- **2% y/y**
- Up from 1.9% in Feb 2018

**MNB Base rate**
- **0.9%**
- From 1.05% in May 2016
The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

Our weekly online CASE CPI

![Online CASE CPI (---) vs GUS CPI (─) vs GUS CPI (─)]

Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, and the CPI.

<table>
<thead>
<tr>
<th>CASE economic forecasts for the Polish economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>(average % change on previous calendar year, unless otherwise indicated)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>2018</td>
</tr>
<tr>
<td>2019</td>
</tr>
<tr>
<td>Nominal monthly wages</td>
</tr>
<tr>
<td>2018</td>
</tr>
<tr>
<td>2019</td>
</tr>
</tbody>
</table>

For more information on our weekly online CASE CPI, please visit: http://case-research.eu/en/online-case-cpi
To subscribe to our weekly showCASE newsletter, please click here. To see previous issues of showCASE, please visit: http://case-research.eu/en/showcase

Contributions: Stanislav Bieliei, Krzysztof Głowacki, Łukasz Janikowski, Katarzyna Sidło, Sara Skejo, Klaudia Wolniewicz-Słomka
Editor: Krzysztof Głowacki

***Any opinions expressed in showCASE are those of the author(s) and do not necessarily reflect the views of CASE.