Special Report

Poland –Fiscal risks are low at present but public finance improvement since 2016 is set to reverse

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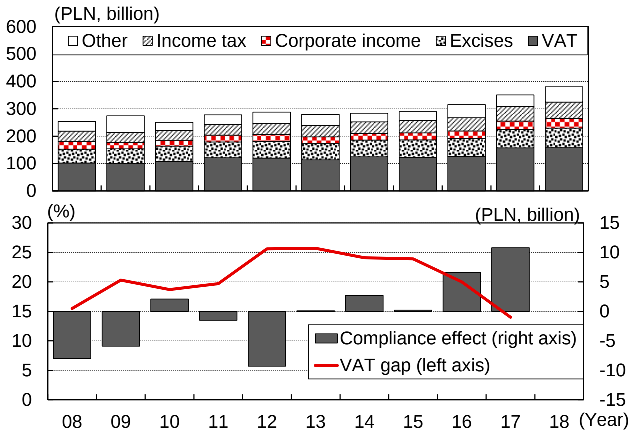
1. Introduction

The fiscal deficit improvement since 2016 is set to reverse, although, at present, there has been no major indication of higher fiscal risks. The improvement has been down to the marked increase in government fiscal revenues since 2016 which has offset increased expenditures. In fact, the fiscal deficit has narrowed to 0.5% of GDP in 2018 from 2.5% of GDP in 2016 as corporate income tax receipts have surged by 34.7%, personal income tax receipts by 33.1%, VAT revenues by 27.8% and excises by 14.8%, from 2016 to 2018. The main drivers of the increase in fiscal revenues have been first, strong economic growth which has underpinned improved tax receipts across the board including VAT, and second, the decline of the VAT gap (the gap between expected and actual VAT revenues).

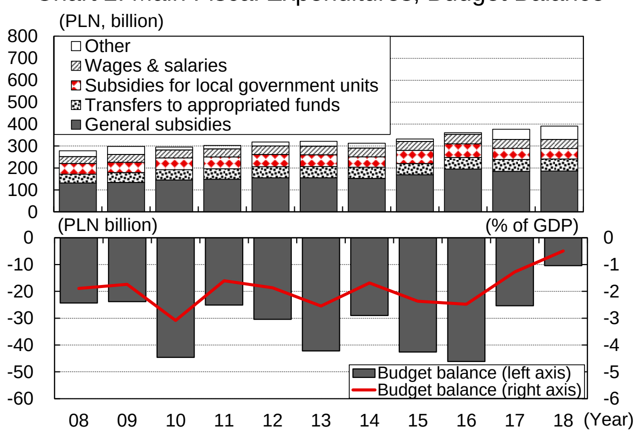
VAT is the largest source of tax revenue for the Polish government and this shift has contributed to the clear improvement in overall revenues (Chart 1). The decline of the VAT gap has been sustained by increased compliance (shown below), and the reduction of fraud. Indeed, the VAT gap has narrowed much more sharply than in other EU member states. However, the recent improvement in public finances is not expected to continue. Government expenditures have increased (Chart 2), and expenditure pressures are expected to rise.

Chart 1: Main Fiscal Revenues, VAT Gap



Source: Polish Ministry of Finance,
MUFG Bank Economic Research Office

Chart 2: Main Fiscal Expenditures, Budget Balance



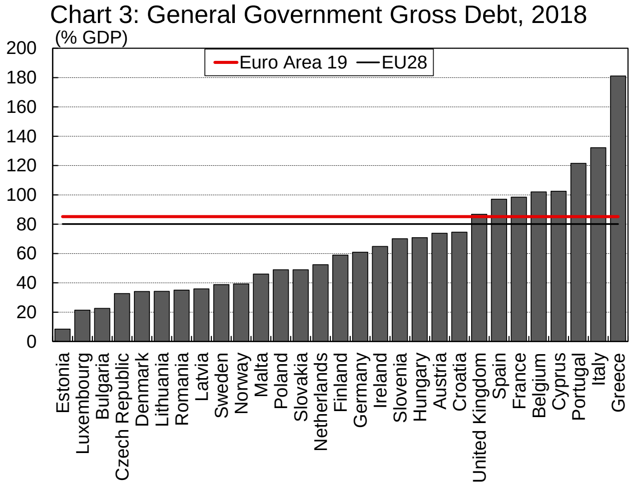
Source: Polish Ministry of Finance,
MUFG Bank Economic Research Office

2. Fiscal Risks are Low at Present

The most recent IMF Article IV undertook a series of stress tests on Polish general government debt, and found persistent downward pressure on Polish government debt, even when shocks to the primary balance, real GDP growth rate and the exchange rate were applied. Poland benefits from 70% of its public debt being denominated in local currency, with effective interest rates on a long downward trend. This is helped by most existing debt being long-term with fixed rates. Maturity and rollover risks are also 'well managed' according to the IMF.

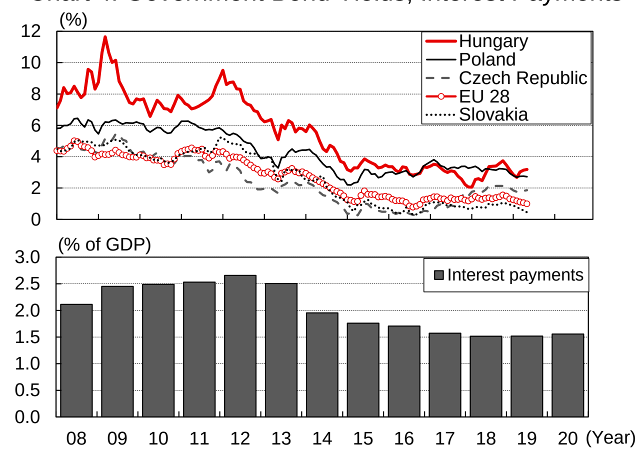
The overall level of government debt stock at 48.4% of GDP in 2018 is also moderate, and firmly below the Euro area and EU28 averages, as well as that of Hungary in 2018 (Chart 3). In addition, there are few fears about debt sustainability. The IMF expects gross general government debt to decline to 47.8% of GDP in 2019 from 48.4% of GDP in 2018, before increasing back slightly up again to 48.2% of GDP in 2020. Government bond yields have been fairly stable, indicating no major stresses, and government interest costs are fairly low at just 1.5% of GDP (or 3.7% of total government expenditure) in 2018 (Chart 4). The recent more dovish tone from both the ECB and US Fed will also help global financial borrowing conditions which in turn will be beneficial for Poland.

Chart 3: General Government Gross Debt, 2018



Source: Eurostat, MUFG Bank Economic Research Office

Chart 4: Government Bond Yields, Interest Payments



Source: Polish Ministry of Finance,
MUFG Bank Economic Research Office

3. Public Finances Set to Deteriorate

(1) Pre-election fiscal package announced

The program, currently worth cumulatively around 2.5% of GDP from 2019 (0.9% of GDP) to 2020 (1.6% of GDP), was announced just before the government faced European elections in May (with general elections set to take place by November this year). The measures include an extra PLN 1,100 (USD 289) pay-out for each pensioner in May, new monthly benefits for families with children and lower personal income taxes for people under 26, due to be rolled out before the general election in late 2019. Further benefits for families are set to kick-in from July this year, with pensioners to get an additional PLN 1,100 again in 2020 and 2021, although this is subject to parliamentary approval. The governing PiS party also wants to improve public transport in rural areas by increased infrastructure investment.

The fiscal package is expected to be partly funded by increased tax revenue through better tax collection as well as the introduction of new taxes from 2019 to 2022. On tax collection, the tax authorities continue to expect the VAT gap to decline, which is estimated to bring in PLN 27 billion a year. The government hopes to increase government efficiencies in tax collection as well, which will raise additional revenues. On new taxes, the introduction of digital taxes on online digital purchases such as video and music streaming, and online adverts, is expected to increase tax revenues by PLN 1 billion. The fiscal package could also be funded through expenditure reallocation, as well as potentially from the Social Insurance Fund. It is hoped that 'automation in public administration, health care and social security' will reduce spending.

(2) Fiscal Deficit to Widen, Poland to Stay Within '3% of GDP' limit

The efforts by the government mentioned above, though, are not expected to fully fund the fiscal package. The IMF forecasts the government fiscal deficit to widen to a deficit of 2.2% of GDP in 2019 and 3.1% of GDP in 2020, due to increased expenditures, including from the new 'fiscal package' as well as increased spending pressures. First, further implementation of fiscal package measures, subject to parliamentary approval, are likely to increase pressures on the fiscal budget. Second, the fiscal consolidation has been helped by the compression of wages and social benefits relative to GDP, which is unlikely to endure.

Key boundaries for Poland's fiscal deficit are the 3% of GDP limit required by the medium-term budgetary objective (MTO) as well as its expenditure ceiling, both of which we think will not be breached. The IMF forecasts put Poland just above the EU's 3% of GDP nominal fiscal deficit limit in 2020. The 3% of GDP limit is required by the medium-term budgetary objective (MTO), as part of the preventive arm of the 'Stability and Growth Pact' which is designed to ensure fiscal discipline in EU member states. We think that Poland will get closer to the 3% limit in 2020 but that authorities will take necessary measures to remain within the bounds of the fiscal limit considering the strength of the recent increase in taxation revenues and strong real GDP growth momentum. We note that the most recent consensus forecast still has a mean estimate of the fiscal deficit at 1.7% of GDP in both 2019 and 2020.

Poland also has to adhere to its expenditure rule, as part of its MTO. The MTO aims for a minus 1% of GDP structural fiscal balance. In order to reach this balance, nominal spending limits are set. In 2019, the expenditure rule limits nominal spending growth to 5.5%. Adherence to the expenditure rule, though, could prove more challenging as authorities may have to need to juggle existing expenditures.

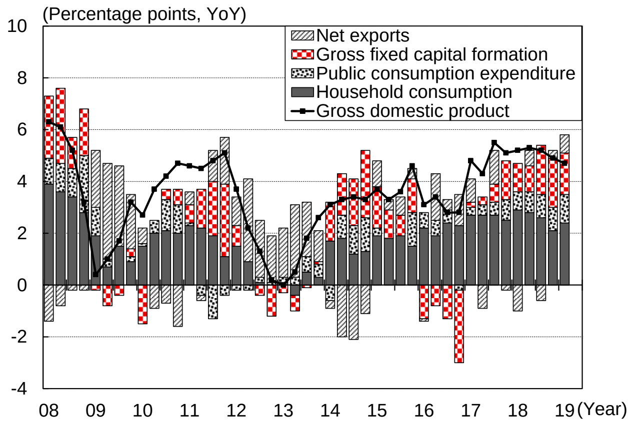
4. Strong Growth Momentum

The IMF forecasts real GDP growth of 3.8% in 2019, and 3.1% in 2020 (after 5.1% in 2018). Over a ten-year period, the real GDP growth rate has averaged 3.7% YoY. Strong domestic consumption, as stated in our latest Visegrad report (link below[1]), has been the main driver of real GDP growth and will remain so. Gross fixed capital formation has also been a strong contributor to GDP growth, together with a small contribution from public consumption expenditure (Chart 5). Consumption has benefitted from a strengthening labour market with strong growth in employment and real wages in recent years. The fiscal package will support real GDP growth through consumption, at a time of increased external risks from US-EU trade tensions, and a weaker Eurozone growth environment.

[1]See here: https://www.bk.mufg.jp/report/ecoeu2019e/specialreport_20190405.pdf

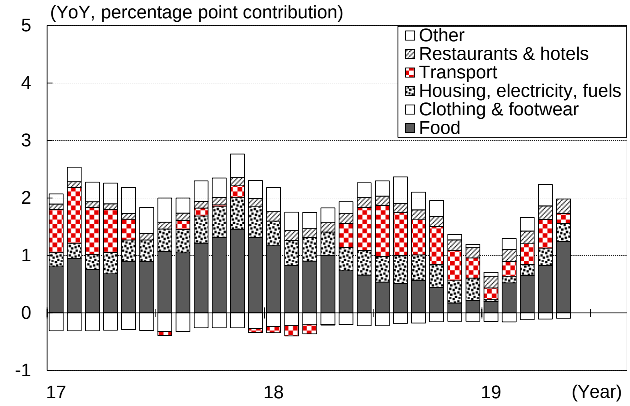
Monetary policy has remained accommodative due to lower than expected inflation that has resulted from the weak pass-through of the increase of wages to CPI, despite strong economic growth. Core inflation is also currently low, averaging 0.5% YoY in the first quarter of 2019 (Chart 6). But as can be seen below, headline inflation has recently seen a sharp increase as energy and food prices have increased. Additionally, there may be pressures from higher food prices in the next few months due to higher pork prices as a result of the ASF disease, and vegetable prices due to dry weather in April 2019. Monetary policy remains accommodative, but if the pass-through of higher wages to CPI increases or the fiscal package boosts domestic pressures, this could lead to sustainably higher inflation and to tighter monetary policy consequently.

Chart 5: Contributions to Real GDP Growth



Source: Polish Central Statistical Office, MUFG Bank Economic Research Office

Chart 6: CPI Contributions



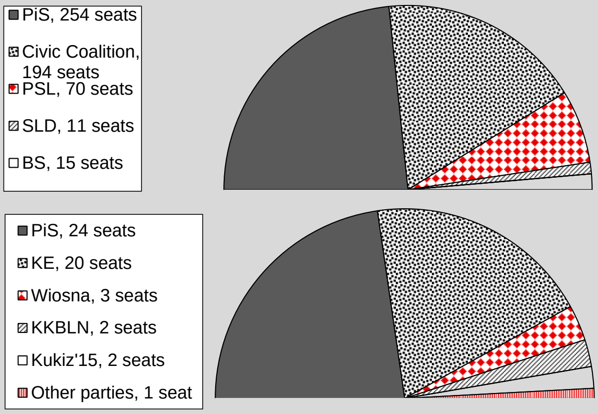
Note: Data uses moving base, CPPY=100
Source: Polish Central Statistical Office, MUFG Bank Economic Research Office

Box 1: Local Election Results 2018, European Election Result 2019 & Election Polls

The next general elections, set to take place by November this year, come after the recent European elections, which were held in May 2019, and after local elections for the regional assemblies held in October 2018, (results shown in Chart A). The European elections saw the ruling Law and Justice (PiS) party winning the elections with 43.1% of the votes, with the European coalition (KE), which includes the Civic Platform (PO) and the Polish People's Party (PSL), coming in second, with 38.4% of the vote. The PiS victory compared to a vote of 31.8% in 2014 European elections, with record high voter turnout of 45.6% in Poland in this year's European election. This looks like a solid platform for PiS ahead of the general elections. As shown below in Chart B, opinion polls show the PiS party continues to have fairly stable support. The recent announcement of the fiscal package is likely to be one of the factors that have helped this and, with the continued roll-out of measures, this support may continue.

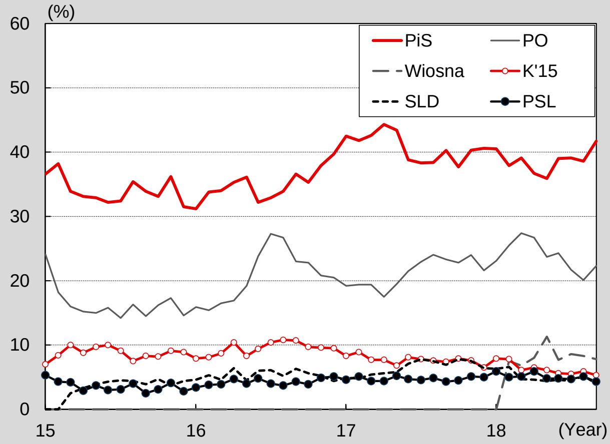
Box 1 continued: Local Election Results 2018, European Election Result 2019 & Election Polls

Chart A: Local Election Results 2018 (top) & EU Election Result 2019, Poland (bottom)



Source: Reuters, MUFG Bank Economic Research Office

Chart B: Election Polls



Source: Ewybory, MUFG Bank Economic Research Office

5. Conclusion

The Polish government's fiscal revenues have improved as the VAT gap has narrowed and personal income tax receipts have risen amid strong GDP growth. At the same time, though, expenditure has increased as the government has introduced social measures such as benefits for families. With expenditure pressures likely to increase further, the IMF suspects that the recent improvement in the fiscal balance might be "difficult to sustain". The announcement of a fiscal package by the government makes this task more difficult.

Fiscal risks are expected to remain low under the current baseline. The IMF forecasts the government fiscal deficit will widen to a deficit of 2.2% of GDP in 2019 and 3.1% of GDP in 2020. We think that Poland will get closer to the 3% of GDP limit in 2020 but that authorities will take necessary measures to remain within its bounds, considering the strength of the recent increase in taxation revenues and strong real GDP growth momentum.

Public finances have been supported by strong real GDP growth which is expected to moderate in 2019 but will remain firm. The IMF forecasts real GDP growth of 3.8% in 2019, and 3.1% in 2020 (after 5.1% in 2018). Real GDP growth in 2018 and in the first quarter of 2019 has been driven by strong domestic consumption and solid investment, which are expected to continue over 2019 and 2020. At present, Poland remains well placed, although risks to the real GDP outlook will stem from increased external risks from US-EU trade tensions, and a weaker Eurozone growth environment, which will have to be monitored.