showCASE
No. 82 | 30.07.2018

CASE – Centrum Analiz Społeczno-Ekonomicznych
CASE – Center for Social and Economic Research

From the Editor: In this issue of showCASE, our fiscal policy expert argues that Poland is repeating the mistakes made in the past by developed economies, which currently suffer from excessive levels of public debt.

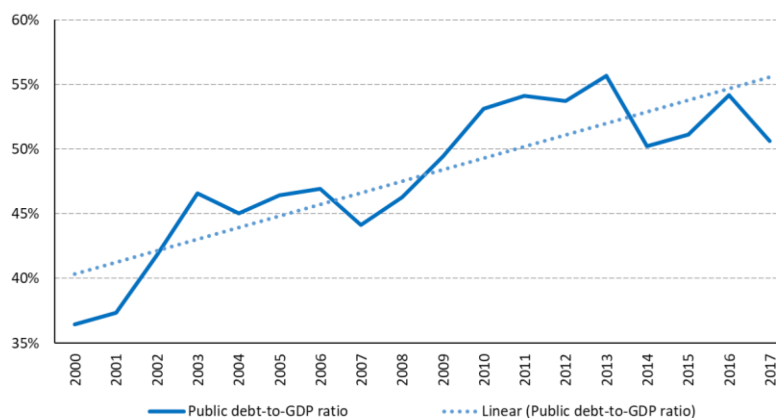
What Is the Quality of the Fiscal Policy in Poland?

By: Łukasz Janikowski, Fiscal Economist at CASE

Mainstream economic theory indicates that the optimal fiscal policy must fulfill at least two basic conditions: it must be sustainable and counter-cyclical. According to the commonly used definition formulated by Evsey Domar in 1944, the first condition is met if the public debt to Gross Domestic Product (GDP) ratio converges toward a constant value in the long run. In other words, the government is bound by an intertemporal budget constraint, so it cannot finance its spending by increasing the debt-to-GDP ratio indefinitely. Countercyclical policy, in turn, is one that reduces the amplitude of the business cycle fluctuations, meaning it is expansionary during economic slowdowns and contractionary during economic expansions. According to the "Tax Smoothing Paradigm" formulated by Robert Barro in 1979, optimal fiscal policy should also smooth out the level of tax rates over time. All these elements combined constitute the mainstream economic consensus according to which public debt-to-GDP ratio should oscillate around a constant value (increasing in times of economic slowdown and decreasing in times of economic prosperity).

The practice of political and economic life shows, however, that actual fiscal policies deviate from this model – notoriously so. Beginning in the 1970s, the debt-to-GDP ratio has been growing in many countries, particularly strongly in developed economies, where it reached levels heretofore unknown in times of peace. According to the IMF data, in 2017 it reached 86.6% in the euro area, 112.9% in the G20 advanced countries, and 118.6% in the G7 countries. Those numbers indicate unambiguously that in the last half-century fiscal policy in the abovementioned countries has been conducted in an unsustainable manner. Among them is a number of EU Member States that have been recently teetering on the verge of bankruptcy and had to turn for assistance to institutions such as the International Monetary Fund, the European Financial Stability Fund, and the European Stability Mechanism.

Figure 1. General government debt in Poland, 2000-2017 (% of GDP)



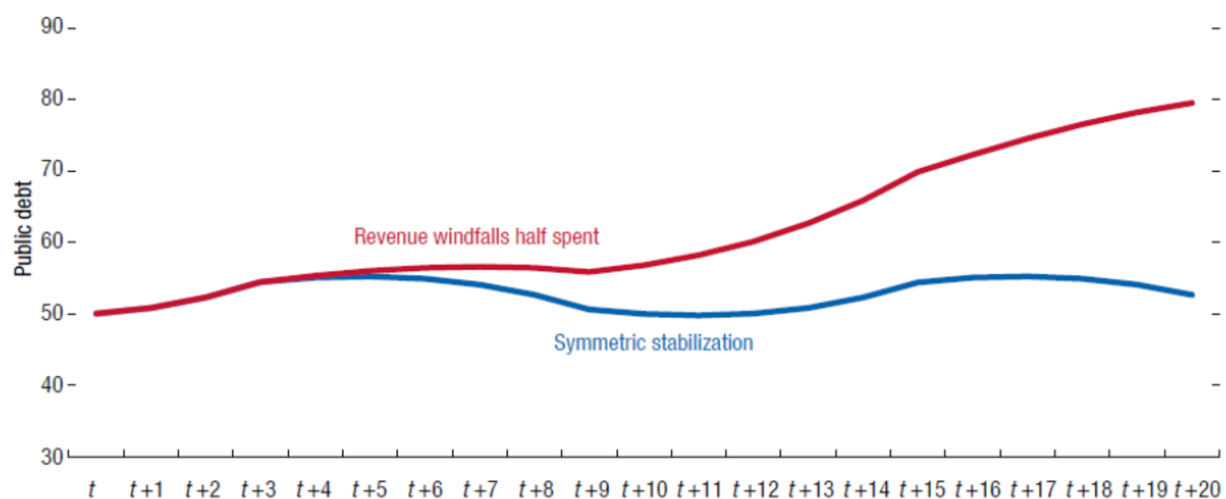
Source: Own elaboration based on the Central Statistics Office (GUS) data

Does Poland perform better than these countries or does it repeat the same mistakes? Judging from Figure 1, which displays an upward-trend in the public debt-to-GDP ratio in Poland between 2000 and 2017 (the dotted line), it is safe to say that unfortunately the latter is true, and fiscal policy in Poland during this period was unsustainable according to Domar's definition. While admittedly the public debt-to-GDP ratio is still much lower in Poland than in the majority of advanced economies, its dynamics are worrying and call for policy correction, especially in the context of the constitutional limit of public debt (60% of GDP). If the government does not undertake necessary corrections immediately, then during the next economic slowdown Poland will be at risk of breaching this threshold. When this happens, the result will be one of the following: a sharp pro-cyclical fiscal tightening, abolition of this fiscal rule, attempts to circumvent it by changing the definition of the public debt, or a combination of those. In any case, the results will be highly detrimental to public finance and the economy.

Optimal fiscal policy should play a stabilizing role, i.e. reduce the amplitude of economic fluctuations. The most basic tool used to achieve counter-cyclicality are automatic stabilizers, e.g. progressive income taxes, unemployment benefits and social benefits. Such automatic stabilizers naturally improve the budget balance during economic expansions and loosen fiscal policy during economic slowdowns. In the expansion phase, they limit the growth in aggregate demand, and during declines, they stimulate it.

Alas, international experience shows that very often discretional decisions of politicians limit or even completely eliminate the positive effect of automatic stabilizers. Particularly problematic is the loosening of fiscal policy during good times. During the expansion phase, the government's tax revenues grow rapidly, while spending on unemployment benefits and social transfers shrinks. As a result, additional funds appear in the budget, which can be named "revenue windfall". In an ideal world, the government would eliminate it by reducing the budget deficit by the full amount of this windfall, taking full advantage of the automatic stabilizers. IMF indicates, however, that governments frequently do the opposite, using it (in full or in part) to increase spending or to lower taxes. This type of asymmetrical reaction of governments to the expansion and contraction phases of the business cycle not only increases the amplitude of cyclical fluctuations, but can also lead to uncontrolled growth of public debt, which is shown in Figure 2. The blue line shows the public debt to GDP ratio with a symmetrical reaction to the business cycle, while the red line shows what happens if the automatic stabilizers work with full force during downturns, but only half of the "revenue windfall" during expansions is designated for reducing the budget deficit.

Figure 2. IMF's simulation of the effect of an asymmetrical reaction to the business cycle on the public debt-to-GDP ratio

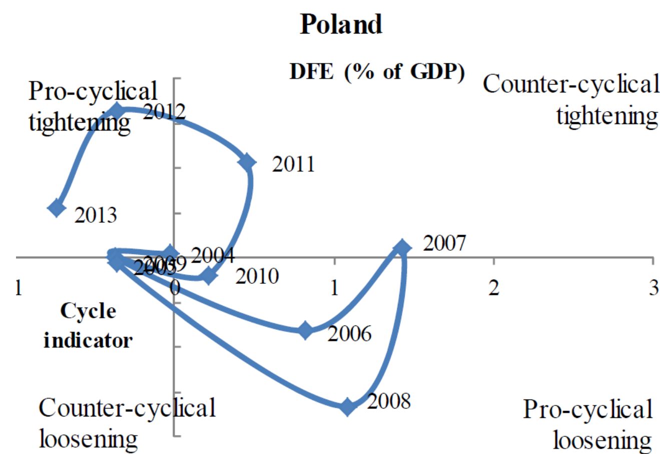


Source: IMF (p. 32)

The problem of the discretional pro-cyclicality of fiscal policy has manifested itself clearly during the global financial crisis (GFC), which in Europe has transformed into a public debt crisis. Many EU Member States have pro-cyclically loosened the fiscal policy before the GFC, to later pro-cyclically tighten it. First, in 2005-2008, when the economy was booming, we observed a discretionary loosening of fiscal policy, after which governments conducted a clear pro-cyclical tightening in 2012-2013. The only year in which it was clearly counter-cyclical was 2009, when governments decided to respond to the outbreak of the GFC with budgetary expansion. But it quickly turned out that they did not have sufficient fiscal buffers, which forced them into fiscal tightening despite the continuing crisis; the problem of pro-cyclicality of the fiscal policy in the EU was described very well in a paper published by the European Commission.

Coming back to Poland, the shape of the solid line in Figure 1 strongly recalls the chart with the results of the IMF simulation presented in Figure 2, which suggests that the country may be dealing with a discretionary loosening of fiscal policy during periods of economic expansion as well. A careful analysis of the level of budget spending and taxes confirms this hypothesis. Additionally, it is also true that profligacy during periods of expansion results in insufficient fiscal buffers when the economy weakens, which forces fiscal tightening. As a result, discretionary budget policy in Poland is strongly pro-cyclical.

Figure 3. Cyclical stance of fiscal policy in Poland, 2004-2013.



Source: European Commission (p. 28)

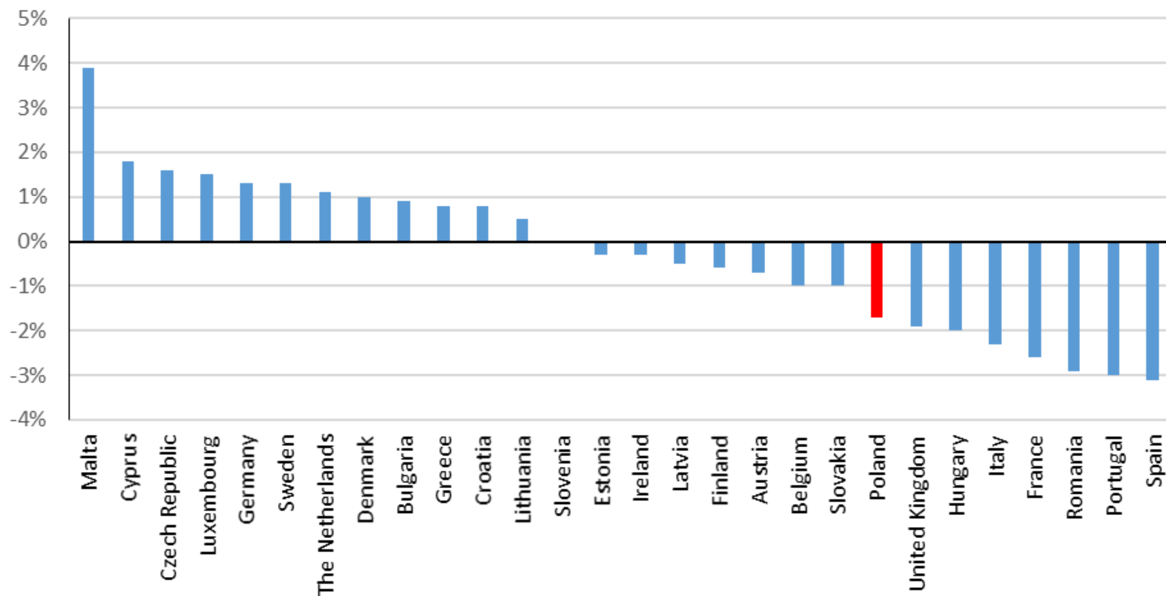
Evidence supporting the thesis that fiscal policy in Poland is pro-cyclical is presented in Figure 3, which shows the cyclical stance of fiscal policy, measured by the discretionary fiscal effort.[1] The only year in which fiscal policy in Poland was clearly counter-cyclical was 2011, when there was a fiscal tightening coupled with a temporarily higher GDP growth. In 2006 and 2008, fiscal policy was strongly pro-cyclically loosened, which reduced the fiscal buffer for bad times. As a result, fiscal policy in 2009 and 2010 (the GFC), as far as the discretionary part is concerned, was acyclical (there was no space for fiscal stimulus), and in 2012 and 2013 we observed a pro-cyclical tightening. Because the impact of automatic stabilizers is weaker in Poland than in developed economies,[2] we must suppose that the discretionary decisions of politicians are of key importance for the cyclical stance of fiscal policy. The data presented here indicate that fiscal policy in Poland not only fails to fulfill its stabilizing role, but may in fact destabilize the economy.

After 2013, things did not get better. As I argued in showCASE no. 72, Poland does not use the current favorable economic situation to accumulate sufficient fiscal buffers for the future economic slowdown. I would now like to strengthen the arguments presented there with data from Eurostat on the public finance balance in EU countries in

[1] The discretionary fiscal effort is a measure designed by the European Commission for the purpose of assessing the impact of discretionary decisions by fiscal authorities on budget revenues and spending. See European Commission (2015) for details.
[2] This results from the lower generosity of the welfare system and the lower progressivity of the personal income tax (about 97% of Polish taxpayers are in the first tax bracket, making personal income tax approximately flat).

2017. The data is presented in Figure 4, which shows that the majority of the EU countries are taking advantage of good economic conditions to build a fiscal buffer for a future slowdown. As many as 12 EU countries showed a budget surplus in 2017, and Slovenia's budget was balanced. Against the backdrop of the rest of the EU, Poland's performance is weak, with as many as 20 countries showing a better budget balance. Additionally, among countries that had worse results, there are the most indebted ones: France (public debt of 97% of GDP), Spain (98.3%), Portugal (126%), and Italy (132%). It must also be pointed out that the improvement in the budget balance in 2017 was strongly influenced by the record-high payment of profit from the National Bank of Poland (PLN 8.7 billion), which created an excessively optimistic picture of reality. This causes serious fears of whether Poland is building up an appropriately sized fiscal buffer for a period of economic slowdown. In the future, it may turn out that the government will be forced, again, to pro-cyclically tighten fiscal policy during a slowdown.

Figure 4. The public finance balance in EU countries, 2017 (% of GDP)



Source: Own elaboration based on the Eurostat data

Available data clearly shows that fiscal policy in Poland is unsustainable and pro-cyclical, which is the opposite of the optimal fiscal policy. It is so despite the existence of several fiscal rules in the Polish law – the constitutional debt ceiling of 60% of GDP, the "safety threshold" of 55% of GDP, and the expenditure rule putting a limit on the growth of public expenditure. The set of fiscal rules adopted in Poland is far from perfect and, in my opinion, should be modified. Most importantly, fiscal rules should force the government to meet the medium-term objective of structural deficit, which is 1% of GDP. The general government deficit has never been this low in Poland, even in the times of the highest economic growth. Fiscal rules should also have a stronger legal foundation – all of them except the constitutional limit of public debt can be changed or removed by the parliament practically overnight. A very negative precedence was a removal of the "safety threshold" of 50% of GDP by the previous government. Moreover, the constitutional limit of the public debt can also be easily circumvented, as the methodology of calculating public debt is defined by the law that can also be changed overnight with simple parliamentary majority. If we want the fiscal rules to be binding, these flaws need to be corrected. Additionally, the quality of the fiscal policy in Poland could be also increased by the establishment of the fiscal council. These topics are complicated and therefore deserve entire separate analyses, so I will refrain from discussing them in this article. In the future issues of showCASE I will write how, in my opinion, fiscal rules should be modified and what should be the tasks and responsibilities of the fiscal council in Poland.

This week: The synthetic business climate indicator published by the Central Statistics Office (GUS) increased from 109 in June to 109.6 in July. The retail sales in June increased by 10.3% y/y in current prices and by 8.2% in constant prices. On the other hand, current consumer confidence indicator published by GUS fell by 0.9 pp. to 5.2 in July. On a different note, GUS confirmed that the unemployment rate decreased in May to a record-low level of 5.9%.

GDP (Q1 2018)

5.2% y/y

Up from 4.9% in Q4 2017

Inflation (Jun 2018)

2.0% y/y

Up from 1.7% in May 2018

Unemployment (Jun 2018)

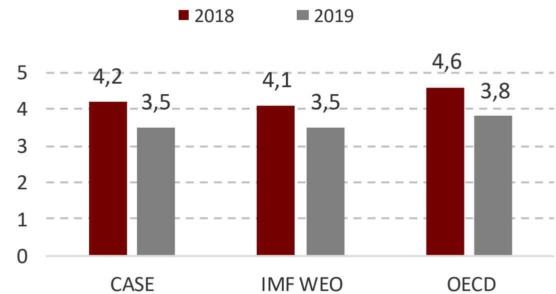
5.9%

Down from 6.1% in May 2018

NBP Base rate

1.5%

From 2% in Mar 2015



This week: Russia's central bank is steadily tightening the conditions of banks' FOREX operations in an attempt to limit FOREX exposure of the economy. The bank decided to increase the mandatory reserve ratios on credit institutions' foreign exchange liabilities by 1 pp. starting from August 1, 2018. The required reserve ratio on liabilities to individuals will be raised to 7%, while the ratio on liabilities to non-resident legal entities and on other liabilities will be elevated to 8%. Requirements on ruble deposits will remain unchanged.

GDP (Q1 2018)

1.3% y/y

Up from 0.9% in Q4 2017

Inflation (June 2018)

2.3% y/y

Down from 2.4% in May 2018

Unemployment (May 2018)

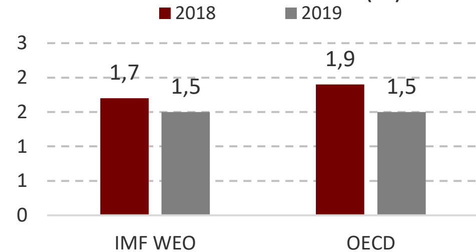
4.7% (est.)

Down from 4.9 % in Apr 2018

CBR Base rate

7.25 %

From 7.5% in Feb 2018



This week: In response to Turkey's decision on ending the 24-month-long state of emergency, the German government announced that it would not prolong its EUR 1.5 billion cap on export guarantees. Berlin also eased travel recommendations by removing a warning memo from the Ministry of Foreign Affairs website about German citizens facing a high risk of arrest when traveling to Turkey.

GDP (Q1 2018)

2.3% y/y

Down from 2.9% in Q4 2018

Inflation (June 2018)

2.1% y/y

Down from 2.2% in May 2018

Unemployment (May 2018)

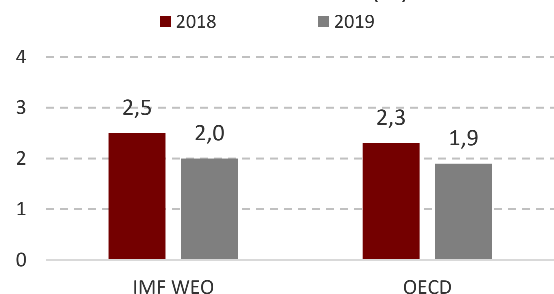
3.4%

Down from 3.6% in April 2018

ECB Deposit rate

-0.4%

From -0.3% in Dec 2015



This week: The Slovenian company Riko d.o.o. won a tender for the construction of a 10.79/9.35 MW (DC/AC) solar power station in Zhytomyr. This is the second project to be implemented by the company in Zhytomyr. Previously, the Slovenian company won the World Bank open tender and signed an agreement with Communal Enterprise "ZhytomyrVodokanal" on the implementation of a project for drinking water preparation and reconstruction of the pumping station of drinking water in the city of Zhytomyr.

GDP (Q1 2018)

3.1% y/y

Up from 2.2% in Q4 2017

Inflation (June 2018)

9.9% y/y

Down from 11.7% in May 2018

Unemployment (Q2 2018)

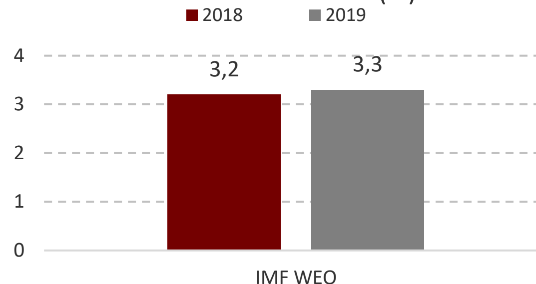
9.7%

Down from 9.9% in Q1 2018

NBU Base rate

17.0%

From 16.0% in Jan 2018



This week: The Ministry of Finance released new Debt Portfolio Management Quarterly Report, according to which, in H1, the Ministry profited from positive conditions on the money market and sold state treasury bills in total nominal value of EUR 6.81 billion. The proceeds were re-invested in repo and depo operations, resulting in an additional net income of EUR 4.27 million in accruals. The Ministry also redeemed in advance the majority of the August installment of the Czech treasury Bonds in the total nominal value of EUR 2.90 billion.

GDP (Q1 2018)

4.2% y/y (est.)

Down from 5.5% in Q4 2017

Inflation (June 2018)

2.6% y/y

Up from 2.2% in May 2018

Unemployment (Q1 2018)

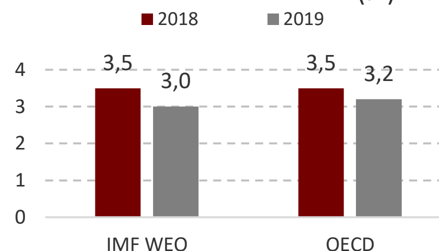
2.4% (est.)

Unchanged since Q4 2017

CNB Base rate

1%

From 0.75% in Feb 2018



This week: As confirmed by Minister of Foreign Affairs of Hungary, Peter Szijjarto, the country has officially launched a process of pulling out of a United Nations global agreement on migration. Szijjarto stated that the incompatibility of the Hungarian and UN positions on migration was unresolvable, and that Budapest would retain its current migration policy, which "no global package can change". Szijjarto expressed the belief that the Pact formulated "beautiful goals" such as the fight against smuggling people, but the effects of the UN liberal approach to migration are oftentimes ambiguous.

GDP (Q1 2018)

4.7% y/y (est.)

Up from 4.4% in Q4 2017

Inflation (June 2018)

3.1% y/y

Up from 2.8% in May 2018

Unemployment (Q2 2018)

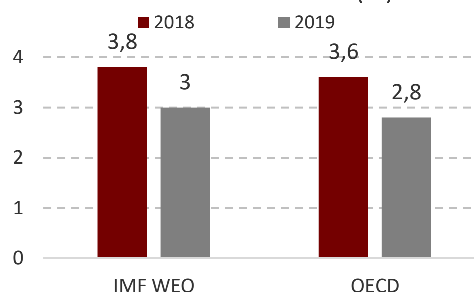
3.6%

Down from 3.7% in Q1 2018

MNB Base rate

0.9%

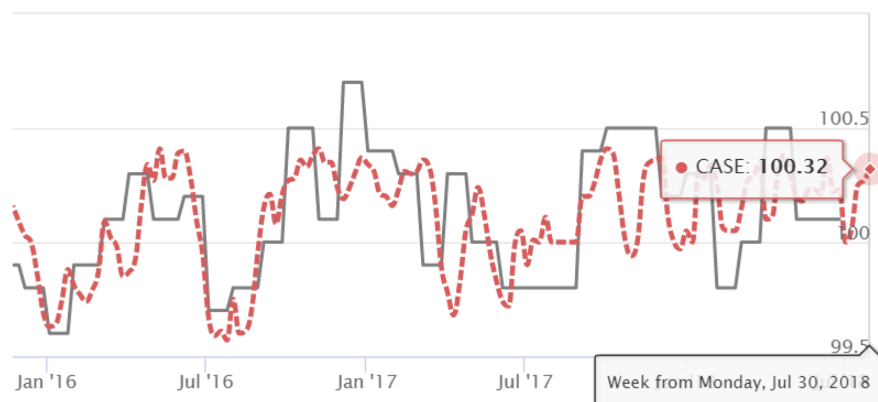
From 1.05% in May 2016



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 (——)

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.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2018	4.2	4.1	4.9	3.7	2.5
2019	3.5	3.6	3.3	3.8	2.3
	Nominal monthly wages	**Merchandise exports (USD, bn)**	**Merchandise imports (USD, bn)**	**Merchandise trade balance (USD, bn)**	**CA balance (USD, bn)**
2018	4.5	233.4	235.2	-1.8	-3.9
2019	3.7	242.7	244.6	-1.9	-4.1

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, Karolina Zubel
Editor in Chief: Przemysław Kowalski **Editors:** Krzysztof Głowacki, Katarzyna Sidło
***Any opinions expressed in showCASE are those of the author(s) and do not necessarily reflect the views of CASE.