Appendix 1 – stabilizing expenditure rule

The process of introducing the stabilizing expenditure rule comes to an end. On 16 July this year, the Council of Ministers approved *the draft guidelines for the act amending the Public Finance Act* that introduces the stabilizing expenditure rule (SER). Currently works are conducted on the draft act drawn up on the basis of the above guidelines. In August, the draft was subject to public consultation and was discussed by the Joint Commission of Government and Local Governments. **On 1 October of this year the draft act was adopted by the Council of Ministers. However, the rule was already used supplementary in the planning of expenditure for 2014, and according to the draft act SER will be binding in the budget process for 2015.**

The rule is an element of implementation of the Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States and the Council recommendation under the excessive deficit procedure of 21 June 2013. In addition to this legal requirements, it is expected that the rule will ensure sustainability of public finances in Poland and will correct their possible excessive imbalances. At the same time, SER should not cause excessive tightening of fiscal policy, especially under conditions of severe economic downturn.

The main goal of the rule is to reduce and stabilize the general government deficit, and consequently – the public debt. For this purpose, the expenditure resulting from the rule will cover the general government expenditure with two exceptions. First, the calculation of the limit will exclude budget spending of EU funds and that part of the expenditure which is financed by means of a non-refundable grant from the EU and EFTA countries. Secondly, the costs of units which do not have the ability to generate high deficits will be also excluded. The rule will therefore cover about 90% of the expenditure of the general government.

From the amount of spending determined this way we subtract the expected level of consolidated expenditures of local government units (LGUs) and their associations; units referred to in Article 139 of *the Public Finance Act* and units of the National Health Fund (NFZ). The rest of the amount will be a limit distributed within the rest of the sector. The limit will be legally binding and aggregated. This means that the expenditure of some units covered by the limit (about 2/3 of government spending) will be able to grow faster at the expense of slower growth or decrease in expenditures of other entities subjected to the limit. Decisions on directions of fiscal policy, and thus the distribution of the limit amount will be taken by the Government and the Parliament in compliance with applicable laws and programmes.

Formula of the stabilizing expenditure rule is defined as follows:

$$\mathrm{EXPEN}_n = \mathrm{EXPEN}^*_{n-1} \cdot \mathrm{E}_n(\mathrm{CPI}_n) \cdot \left[\mathrm{GDP}^*_n + \mathrm{C}_n\right] + \mathrm{E}_n(\Delta \mathrm{DM}_n)$$

where:

EXPEN_n – the expenditure level specified in the draft budgetary act for year n;

$EXPEN^{*}_{n-1}$ – the expenditure level specified in the draft budgetary act for year n-1 adjusted by the updated CPI forecasts;

$E_m(x_n)$ – forecast in the draft budgetary act for year m variable x in year n;

CPI_n – consumer price index in year n;

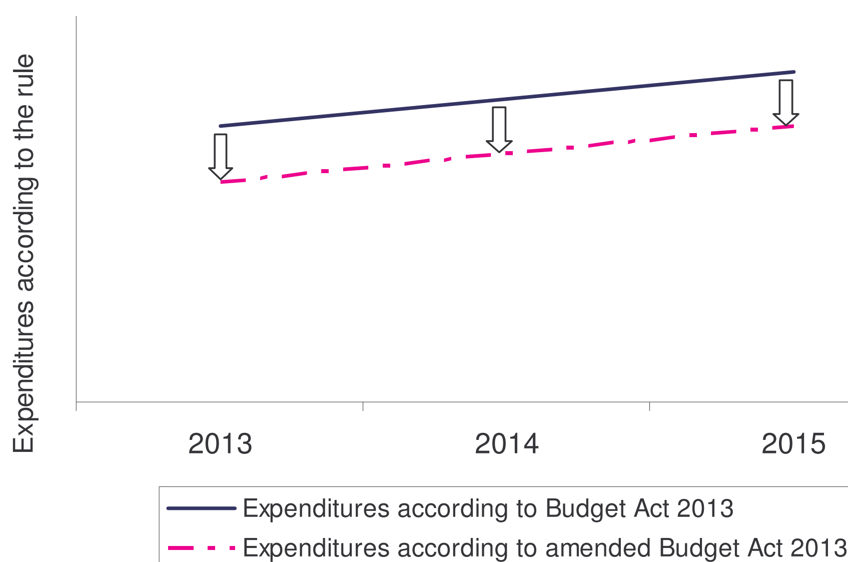
GDP^{*}_{n} – medium-term real GDP dynamics for last 8 years starting from n;

C_n – size of the correction implied by the correction mechanism, expressed in percentage points;

ΔDM_n – forecast level of discretionary measures in taxes and social security contributions planned for year n;

n – year for which the expenditure level is calculated.

Figure 1. Expenditure of the sector covered by the rule



The chart above illustrates the fact that, according to the draft law introducing the SER, the expenditure of 2013 (after amendment of the Budget Act) **will provide a permanent basis for calculating the expenditure limits.** Measures taken in the amendment act lower the limit of spending in future years in a sustainable manner, because even if any of the categories of expenses increase in the coming years, within the overall permanently reduced ceiling, they will have to be offset by a decrease in other expenses.

In line with the formula, the expenditure grows substantially in the medium-term real GDP growth rate multiplied by the projected CPI. In addition, the model includes an adjustment resulting from erroneous forecasts of inflation and projected discretionary measures on the revenue side. In case of imbalance in public finances, the growth in expenditure will be further revised. If public debt (calculated using the average annual exchange rate and reduced by free cash to fund next year's borrowing requirements) exceeds 55% of GDP or the deficit (including pension reform costs) exceeds 3% of GDP, the stronger

correction is applied (2 percentage points subtracted from the medium real GDP growth). This adjustment takes place regardless of the economic forecast. Otherwise, if the debt exceeds 50% of GDP, a normal correction is applied (1.5 percentage points), unless strong economic slowdown is projected (next year's projected real GDP growth lower by over 2 percentage points than mid-term – the so-called "bad times").

Where none of the above conditions is met, the correction depends on the sum of the differences between the general government nominal balance and the medium-term budgetary objective – MTO (currently 1% of GDP). The purpose of this corrective mechanism is a temporary reduction (increase) in the amount of expenditure growth below (above) the real medium-term GDP growth, as long as there are excessive deviations from the target. This mechanism will ensure long-term sustainability of public finances. It is worth noting that the mechanism is automatic and precisely determines the type of correction. If the sum of the differences exceeds -6% (+6%) of GDP, a simple negative (positive) correction is applied. The exception is "bad times", when the negative correction is suspended and the "good times" (projected next year's real GDP increase by over 2 percentage points than the mid-term) when the positive correction is suspended symmetrically.

The impact of the proposed rule on deficit and debt was analyzed using model simulation. The basis of the simulation were the European Commission forecasts for 2013-2014, for 2015 to 2040 – the projected path of potential real GDP growth was assumed from the guidelines on macroeconomic assumptions for the long-term financial forecasts of LGUs developed by the Ministry of Finance. For the period 2041-2050 it is assumed that the potential real GDP growth in the amount similar as in 2040. Then, the path of potential GDP was connected with output gap and inflation modelled with autoregressive stochastic processes (estimated on historical data for Poland). At the same time, the revenue–to-GDP ratio and forecast errors of GDP and inflation were simulated, also stochastically. The obtained simulations show that, by application of the rule, the average nominal general government balance in 2014-2050 is (automatically) at a level close to MTO (-1% of GDP), and stabilization of expenditure at the level of operational objective ensures that the public debt to GDP ratio stabilize at a safe level (below 40% of GDP).

Exceeding the limit will be possible in the event of war, state of emergency or natural disaster throughout the territory of the Republic of Poland. In these situations, the amount of expenditure will continue to be calculated according to the formula, to allow for specifying another amount of expenditure by multiplying the adjusted amount of the previous year ($EXPEN_{n-1}$), after ending the exit clause. Calculation, according to the model, of the sum of the differences between the general government nominal balance and the operating goal (MTO) will also continue.

Recommendation arising from the directive to monitor compliance with the rules by the independent budgetary authorities does not require changes in the Polish legal system. Under the Act, the Supreme Audit Office shall examine "in particular the implementation of the state budget and the implementation of laws and other legal acts in the field

of financing, economic, organizational and administrative activities" and controls the execution of the budget.

Due to a much wider range, the new rule at the time of entry into force will replace the temporary expenditure rule, which limited the growth of certain budget expenditure to forecast CPI inflation rate increased by 1 percentage point. Temporary expenditure rule concerned only about 10-12% of the general government, i.e. the planned budget discretionary spending and so-called new legally mandated expenditure, which also included the existing legally mandated expenditure, when the act determining them was modified.

Entry into force of SER will also change the sanctions applicable beyond prudential limits of public debt. The draft act provides that the sanctions after exceeding 55% and 60% of GDP will remain unchanged. Previous sanctions invoked after exceeding the threshold of 50% of GDP will be replaced by sanctions resulting from the correction mechanism of the SER. Current sanctions amount only to the imposition of restrictions on the state budget, without taking the whole public sector into accout, which would not prevent the increase in public debt in the coming years. The additional disadvantage is their strong pro-cyclical nature due to the need to tighten fiscal policy in the bad economic times. The stabilizing expenditure rule provides for a different type of sanction that primarily will affect a much wider range of public sector, thus ensuring more effective correction, which will also depend on the forecast of the economic situation for the next year. According to the draft act, the sanctions relating to the higher (55%) threshold will be supplemented by the SER correction mechanism. After the entry into force of the amendments to the pension system, in relation to the estimated reduction in the public debt-to-GDP ratio, it is planned to adequately (by 7 percentage points) lower the thresholds of the public debt, on which the SER correction mechanism is based.