Economic analysis from the European Commission's Directorate-General for Economic and Financial Affairs

Volume 4, Issue 4

09.03.2007

ECFIN COUNTRY FOCUS

Highlights in this issue:

- **High public expenditure contributes to large government deficits which are subject to electoral cycles**
- **Current fiscal rules in Poland are not sufficient to ensure low deficits**
- **An expenditure rule can complement the deficit "anchor"**

Ceilings and anchors: fiscal rules for Poland

*By Aleksander Rutkowski**

Summary

National fiscal frameworks can complement the EU budgetary surveillance procedure. Poland has traditionally had a debt rule, but it did not discourage governments from running high deficits. High expenditure (mainly on social benefits) has been identified as one of the main sources of large deficits. Hence, the introduction of an expenditure rule may be beneficial for Poland. Such a rule was proposed in recent years in Poland but not adopted: the so called "Belka rule" set a ceiling of 1% on real expenditure growth. It has, however, not been implemented, but recently a nominal ceiling ("anchor") has been introduced on the deficit of the central government. This Country Focus argues that the implementation of an expenditure rule is a complementary safeguard and does not entail abandoning the existing control mechanisms or giving up ongoing expenditure reforms. The effectiveness of the expenditure rule depends on the degree of enforceability and comprehensiveness.

Intertwined political and budget cycles

The literature on electoral budget cycles is one of the strands of research on politically-motivated policies. As in many other countries, the reasons for persistent deficits in Poland seem to be rooted in politico-economic factors, i.e. in the system of incentives that shape the behaviour of fiscal authorities. In this respect, governments which are unsure of being re-elected, have an incentive to attempt to affect electoral outcomes via fiscal policy and not to fully take account of the negative longer term implications of deficits. (for a related survey see: Buti and Van den Noord, 2004).

Like other countries, Poland has experienced electoral cycles…

In recent years, this type of analysis has also been extended to the new EU member states. Poland belongs to the group of 'new democracies' which have experienced strong political budget cycles. This phenomenon is attributable to lack of experience or information that voters in more mature democracies have (Brender and Drazen, 2003). Empirical research has suggested that the Polish state budget is 'expenditure-led', i.e. tax revenues are adjusted to the planned levels of government expenditures (Green et al., 2001).

The cyclically-adjusted deficit, that reveals the impact from structural factors and discretionary policy decisions, appears to be strongly influenced by the 4-year election cycles in Poland (Chart 1).

*** Directorate for the Economies of the Member States.**

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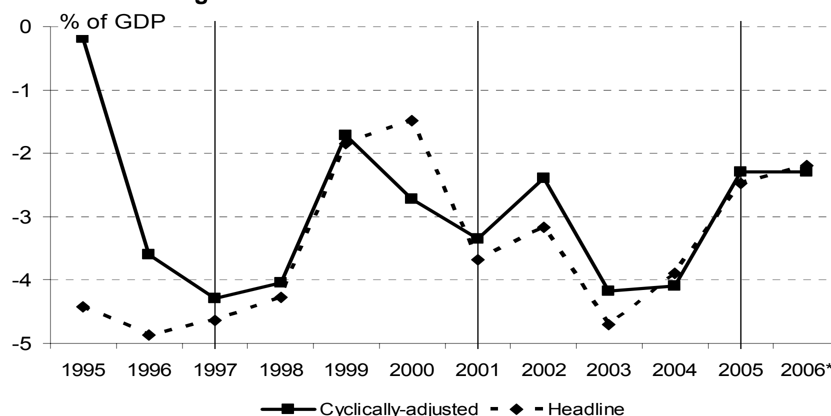
…contributing to high deficits.

Chart 1. General government balances in Poland



* Commission services autumn 2006 forecast.
Vertical lines mark the years with parliamentary elections. Pension reform costs not included.
Source: Ameco

The headline deficits are very close to the cyclically-adjusted ones, proving that the deficit levels depend almost entirely on policy decisions. The highest deficits occur in parliamentary election years independent of the 'colour' of the incumbent government. In the latest cycle, the deterioration of the cyclically-adjusted balance occurred in 2003-2004 ahead of the election year 2005. This can be attributed to strong expectations of early elections and, indeed, the government formed after the 2001 elections stopped functioning by mid-2004. The subsequent 'technocratic' government partly implemented the so called "Hausner plan"[1] and introduced some statistical revisions, which explains the budgetary improvement in 2005.

Fiscal rules are meant to respond to these institutional problems.

A standard response in many countries to limit the implementation of short-sighted policies is the introduction of numerical fiscal rules. They can introduce limits on the deficit or debt, as in the case for the Stability and Growth Pact, or impose constraints on some categories of government expenditure or tax revenues.

The existence of a positive link between numerical rules and budgetary outcomes has been empirically tested. It has been demonstrated that an increase in the share of government finances covered by numerical fiscal rules leads, ceteris paribus, to an improvement in the structural position of government finances (European Commission, 2006b). In the case of expenditure rules, it appears that an increase in the coverage of government finances by expenditure rules leads to a reduction in the primary expenditure-to-GDP ratio. The analysis also suggests that the characteristics of fiscal rules are important in influencing budgetary outcomes; strong rules, enshrined in law or a constitution, including automatic enforcement mechanisms, seem to have a greater impact.

Both national fiscal rules and the EU fiscal framework aim at ensuring the attainment of sound fiscal positions. However, compliance with national fiscal rules does not necessarily secure the respect of EU fiscal rules. For instance, respect of expenditure rules does not guarantee convergence of the deficit towards levels consistent with the SGP, since this also depends on developments on the revenue side.

Poland has national fiscal rules concerning the "public finance sector", which in the Polish definition roughly corresponds to the general government. There are fiscal rules in the Polish Constitution based on the debt ratio. In addition, there have been political attempts to strengthen control over central government expenditure growth ("Belka rule") and the central government deficit level ("anchor").

The Polish Constitution has a debt rule

There are fiscal rules in the Polish Constitution and Public Finance Act but…

The Polish Constitution (Art. 216.5) stipulates that public debt (national definition) shall not exceed 60% of GDP. In addition, Art. 220 of the Constitution states that only the government is allowed to increase the level of the deficit, while the Parliament may only modify the composition of revenue and expenditure. The Polish

Public Finance Act (Art. 79) sets three additional safety thresholds and adjustment requirements. If public debt is higher than 50% of GDP, but below 55%, the draft budget for the following year must not propose a higher deficit-to-revenue ratio than in the current year. This constraint applies also to local government. If the debt is between 55% and 60% of GDP, the draft central budget must not increase the ratio of central government debt to GDP in the following year and for local draft budgets a formula based on the restriction of the deficit-to-revenue ratio is applied.[2] If the debt exceeds 60% of GDP, despite the previous safeguards, any government borrowing is forbidden in the subsequent year, which means that public accounts should be in balance or surplus. Currently, the debt ratio is still below 50% of GDP so the aforementioned rules are not at work.

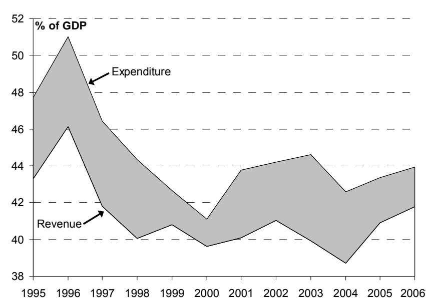
Deficit bias: expenditure-generated

The aforementioned constraints on the annual budgets associated with breaching the second and, especially, the third threshold provided for by the Polish Constitution and the Public Finance Act are so harsh that they might be unfeasible in reality, leading to possible amendments softening the rules. Some observers have concluded that this undermines the credibility of these fiscal rules (Krajewski and Mackiewicz, 2005).

…they have not been able to eliminate persistent large government deficits…

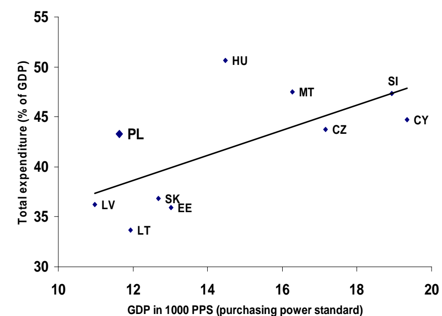
The debt-ratio thresholds (rules contained in the Constitution and in the Public Finance Act) have not been able to prevent Polish governments from running high deficits. Until 2004, the government balances reflected expenditure behaviour. In 1995–2000, the improving general government balance relative to GDP coincided with a declining general government expenditure ratio. Nevertheless, the clear downward trend in the expenditure ratio observed in the 1995-2000 period came to an end in 2000 and seems even to have reversed since then (Chart 2). The general government balance has been deteriorating in Poland since early 2000. The gradual increase of expenditure lead to a worsening government balance until 2003. In 2004–2006, the expenditure ratio was on a rising track, but the fiscal balance improved thanks to tax-rich growth related to EU accession, the implementation of a part of the Hausner plan, methodological revisions and lagged effects of personal and corporate income tax reforms.

Chart 2. General government balance and expenditure in Poland



* Commission services autumn 2006 forecast. Pension reform costs not included. Shaded area signifies government deficits.
Source: Ameco

Chart 3. New Member States: government expenditure and GDP per capita in 2005



Pension reform costs not included.
Source: Ameco.

…which result from very high public expenditure.

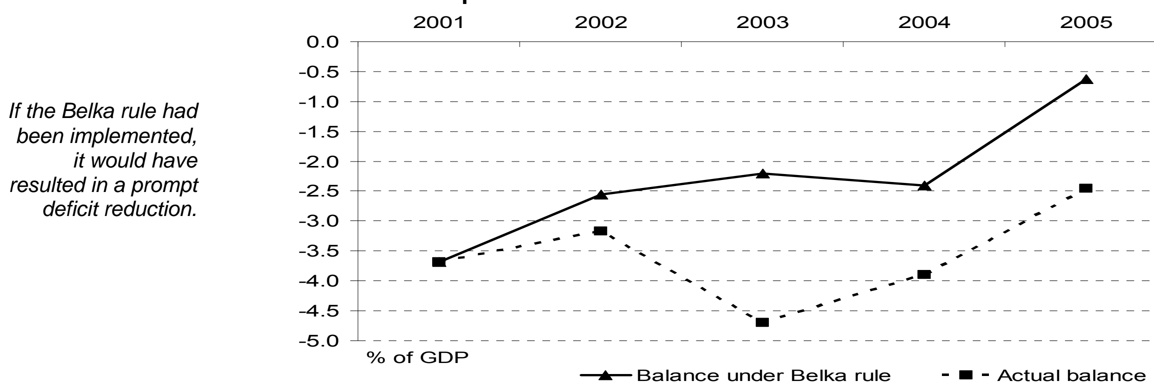
Social expenditure is particularly sensitive in this context because entitlements remain “mandatory” (legally-binding) for the government for many years. In Poland, the high share of social expenditure is an important source of persistent government deficits (European Commission, 2006a). A restoration of the annual indexation of pensions and disability benefits (which had been abandoned as part of the Hausner plan) planned in the 2007 budget is an example of a measure which will boost social expenditure. The restoration in 2007 has been rejected by the Parliament but is still promised for 2008. Generous social spending has led to a relatively higher expenditure-to-GDP ratio in Poland than in other new member states at a similar level of economic development (Chart 3). Hence, controlling expenditure is key to reducing deficits in Poland.

Keeping spending in check: the "Belka rule"

A promising expenditure rule has already been proposed in Poland but never implemented.

The design of a fiscal rule includes the definition of a target (in real or nominal terms, as a ceiling or a rate of growth), exceptions from the rule (cyclically sensitive items and/or productive expenditure categories), the legal base of the rule (political agreement or legislation) and the enforcement procedures (European Commission, 2005). Empirical analysis on the design and implementation of expenditure rules in EU member states suggests that only rules that are both ambitious yet still realistic have been successful in the EU (European Commission, 2003).

Chart 4. Simulated impact of the "Belka rule" on the general government balance and expenditure in Poland



Pension reform cost not included.
Source: Ameco, Eurostat, own calculations.

If the Belka rule had been implemented, it would have resulted in a prompt deficit reduction.

Two fiscal rules have attracted much attention in Poland: the *Belka rule* and the *deficit "anchor"*. According to the *Belka rule,*[3] proposed in 2001, real growth of public expenditure should not exceed 1%, applying to central government only. If the rule of limiting expenditure growth to 1% in real terms had been in effect since 2002, it would have restored the government balance relatively quickly (Chart 4). In the stylised simulation, it is assumed that the implementation of the rule is neutral with respect to growth and tax revenue meaning that contractionary implications, due to lower government spending, and 'non-Keynesian' expansionary effects, thanks to lower government deficits, are not considered. As a result of this assumption, the simulated effects of the Belka rule are likely to be conservative as 'non-Keynesian' effects are quite probable in Poland (European Commission, 2006a). Based on data for 2001–2005, one can see that the general government balance would have improved to −0.6% of GDP already by 2005 (i.e. by ¾% of GDP annually on average). Because of insufficient political support, the "Belka rule" has not been implemented.

From expenditure to deficit control: is the "anchor" insufficient?

The recently introduced "deficit anchor" is a good step but has limitations.

To gradually reduce the deficit-to-GDP ratio, the January 2006 convergence programme presented the *four-year nominal "anchor" (ceiling)* of PLN 30bn (slightly above 3% of GDP in 2005) for the central state budget deficit. The "anchor" aims at tackling the challenge of the excessive deficit during the current term of Parliament (2006-2009). The anchor is a move in the right direction but it has a number of shortcomings (Krajewski and Mickiewicz, 2005). As it is a political declaration, it has not been implemented as a law which reduces its strength. It only covers the state budget and thus allows for shifting deficits to other parts of the general government sector. It is also not very ambitious: just sticking to the nominal anchor for the state budget leads to a deficit reduction of merely 0.2% of GDP per year (Table 1). In addition, the anchor does not target the causes of high deficits in Poland, i.e. too rapid growth of public expenditure. Consequently, addressing the shortcomings of the anchor, or implementing some additional fiscal rule to control directly the increase in government expenditure, would be beneficial.

Table 1. Simulation of the effects of the state budget "anchor"

Year	"Anchor" (PLN bn)	Real GDP growth (%)	Inflation (%)	"Anchor"/GDP (%)	Change in "Anchor"/GDP (%-points)
p.m. 2005	*30*	*3.5*	*2.6*	*3.1*	
2006	30	5.2	1.0	2.9	−0.2
2007	30	4.7	1.9	2.7	−0.2
2008	30	4.8	2.5	2.5	−0.2
2009	30	4.8	2.5	2.3	−0.2

Source: Commission services' autumn 2006 forecast and own calculations

Conclusions: paying more attention to expenditure

An effective fiscal rule satisfies a number of conditions.

Poland is struggling to keep its government deficit under control and it appears that public expenditure (mainly "mandatory", in the social domain) is the principal source of budgetary imbalances. An expenditure rule could be a useful device to contain the budget deficit, as it directly targets the main cause of the government deficit. Against this background, the 2006 Commission's progress report on the Polish national reform programme recommends an expenditure rule in order to limit overall expenditure growth (European Commission, 2006b).

Some lessons can be drawn from the literature on fiscal rules and the experience with the *Belka rule* and the *"anchor"* for the design of an effective fiscal arrangement in Poland (see also European Commission, 2003 and 2005).

Firstly, *incorporation into law* may increase the binding character of any fiscal rule. If a constitutional amendment is unfeasible, the fiscal rule could be established in a parliamentary bill. This will also make the government accountable before the Constitutional Court and State Tribunal. Secondly, in order to prevent shifting deficits to agencies and funds or local municipalities whose fiscal accounts are outside the central state budget, the rule should *encompass the general government sector*. Thirdly, the rule must *cover a sufficiently long period* to reduce the opportunities of 'creative accounting' in some shorter period by shifting expenditure and revenue to other periods. Fourthly, by *targeting the source of the imbalances*, namely high expenditure, one can eliminate deficits without an increase in the tax burden, eventually weighing on GDP growth. Moreover, restrictions on expenditure commit the government in those parts of public finances that are under its direct control, making the authorities fully accountable for respect of the rule. Finally, in case of an expenditure rule, specifying the expenditure ceiling as a fixed real *rate of growth rather than an absolute value or share of GDP* has the advantage of making the ceiling anti-cyclical. If expenditure growth is set at the "long-run optimal" level, expenditure can increase faster than GDP during temporary slowdowns and is restrained below the rate of GDP growth during good times. With a ceiling for a growth rate in real terms, the expenditure ratio will fluctuate with GDP growth. A cap on real expenditure growth directly targets an outcome in real terms, which may be hard to manage due to uncertainty in the inflation forecast or very different deflators across different expenditure components. Alternatively, a maximum nominal growth rate can be used for the ceiling if there is high uncertainty about the inflation forecast.

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[1] The most comprehensive and specific attempt at expenditure reform so far, proposed in 2003 and aimed at reducing public expenditure on social protection, public administration and state aids. Named after then deputy prime minister Jerzy Hausner.

[2] If the public debt ratio is between 55% and 60% of GDP, the local governments' budgets in the following year (t) face the following constraint: $\left(\frac{\text{Local Deficit}}{\text{Local Revenue}}\right)_t \leq \frac{0.6-\left(\frac{\text{Public Debt}}{\text{GDP}}\right)_{t-1}}{0.05}\left(\frac{\text{Local Deficit}}{\text{Local Revenue}}\right)_{t-1}$.

[3] Named after then deputy prime minister Marek Belka.

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.
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Coordinating Committee: Gerrit Bethuyne, Heinz Jansen, Stephanie Riso
Layout: Vittorio Gargaro, Johannes Kattevilder
E-mail: ECFIN-CountryFocus@ec.europa.eu
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