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Abstract

The study is a description of public finance in Poland made by comparing the most important features of this sector in Poland and Central and Eastern European countries, European Union and OECD in the period 2004-2014. The following topics are discussed: scope of the public sector, sources of public revenue, public spending mix, deficit and debt figures. The focus of this study is on identifying the most important similarities and differences. The main assumptions of the 2016 state budget are also analysed. The study may serve as a starting point for the debate on desired directions of the future evolution of Polish public finance.

Keywords: public finance, fiscal policy, tax system, public spending

JEL: H20, H50, H60

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[♣] I would like to thank Jan Baran for his excellent research assistance. I am also grateful to Piotr Lewandowski for his helpful comments.

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Introduction

As consequence of the 2008 global economic crisis, public finance have been at the centre of the socio-political debate of a number of countries. In particular this concerns the European Union countries, as some of them have experienced significant problems with the sustainability of public finance and the capacity to inhibit a dynamic growth of public debt. This issue was relatively frequently discussed in Poland – in connection with the possibility to exceed the constitutional debt limit and with respect to changes in the national pension scheme. Such a debate also took place in relation to the feasibility of promises made by political parties during the 2015 election campaign. In this context, the fact that only a small segment of the Government's "Responsible Development Plan" (the so-called Morawiecki Plan presented at the beginning of 2016) is dedicated to the issue of public finance poses a serious concern. It is noteworthy that the soundness of public finance may turn out to be one of the underlying determinants of the new Government's strategy implementation.

First of all, a discussion on the outlook for the public finance requires an in-depth and factual diagnosis. The research project "How are my taxes spent" held by Institute for Structural Research in 2015 and 2016 aimed at providing such a diagnosis. The present study is the synthesis of papers published in the Polish language as part of that project. It may constitute a reference work on the Polish public finances for the foreign reader. The study may also serve as a starting point for the debate on desired directions of the future evolution of Polish public finance.

The paper is divided into 6 chapters. Chapter 1 compares the size of the public sector in Poland and the EU and OECD countries. Chapter 2 describes the distinctive features of the Polish tax and social insurance system compared to other countries. Areas where public spending in Poland is significantly higher or lower in comparison to other EU Member States are presented in Chapter 3, which also presents the evolution of the spending mix in the period 2004-2014. Chapter 4 describes the level and the composition of the public deficit and debt, with a special regard to the shaping of fiscal policy in Poland and other countries during the global financial crisis. Chapter 5 provides the outlook for the Polish public finance, i.e. an analysis of the key elements of the 2016 state budget and an outline of the essential determinants of fiscal policy in the coming years.

1. The scope of public sector in the EU and OECD countries

In 2014, the average share of public spending in GDP (the level of fiscalism) reached 46.3% in the EU and 45.3% in the OECD countries.[1] The range varies from 32.3% in South Korea to 58.3% in Finland (Chart 1). In Scandinavian countries – Finland, Sweden, Denmark and, to a lesser extent, Norway, the importance of public sector measured as the share of public spending in GDP was the highest. France, Belgium, Austria and three out of four PIGS counties[2]: Portugal, Italy and Greece are also characterised by a high share of public spending in GDP. Although Germany, the biggest EU economy, is considered the country where the state plays an important role in the economy and has an extensive social welfare system, its level of fiscalism reached 44.3% of GDP in 2014, i.e. below the average of this indicator in the EU and OECD. Some of the countries which have a relatively low share of public spending in GDP (below 40%) are the following: the United States, the Baltic states (Lithuania, Latvia, Estonia), Romania, Switzerland and Korea. Generally, the non-European OECD countries are characterised by a lower public share in the economy measured by the level of fiscalism in comparison to the EU countries.

In 2014, the share of public spending in GDP in Poland reached 42.1%. The level of this indicator was lower than the EU and OECD average and lower than the median for all the analysed countries (43.5%). The moderate level of fiscalism in Poland is particularly visible if compared to other EU countries. In 2014, the share of public spending in GDP in Poland was 4.2 pp lower than the EU average. This indicator was lower only in six out of the 28 EU countries. However, Poland does not significantly deviate from the countries of our region. Most of the CEE[3] countries are characterised by a lower level of fiscalism in comparison to the countries of the so-called old Union. The Central and Eastern European countries can be divided into three groups:

- countries where the level of fiscalism is relatively high (approx. 50% of GDP) and is above the EU average – Hungary, Slovenia and Croatia;
- countries where the level of fiscalism is between 40-45% of GDP – Czech Republic, Bulgaria, Poland and Slovakia (more precisely – in 2014 the fiscalism rate in all these countries was between 41-43% of GDP);
- countries where the level of fiscalism is below 40% of GDP – similar to the non-European OECD countries – the Baltic states and Romania.

In 2014, only seven out of 38 analysed countries achieved a surplus of revenues over public spending (see Chart 1). Most of the developed counties are characterised by a negative balance of public finance. Importantly, there is no distinct correlations between the public finance imbalances and the level of fiscalism. High deficits occur both in countries where the state's share in the economy is relatively low (e.g. Ireland and USA) and in countries where revenues and public spending are relatively high (e.g. Portugal and Slovenia).

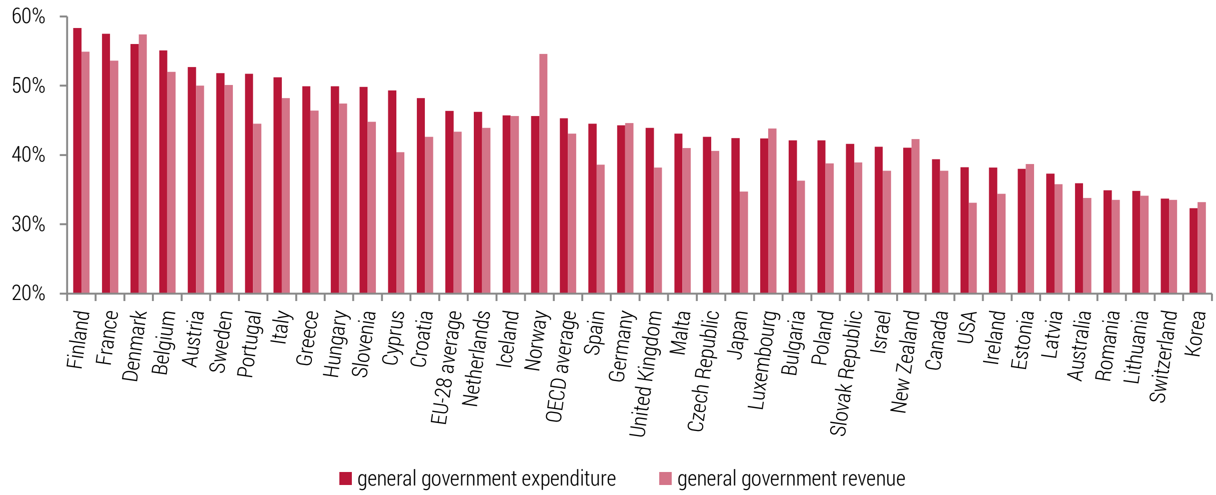
[1] In this study, public sector means the general government sector. Solutions regarding the public finance sector in different countries are considered as separate systems (specific to each country). The public finance in Poland is presented against this backdrop. Therefore, in order to show characteristic features of a group of countries the arithmetic mean instead of weighted mean is applied.

[2] PIGS – Portugal, Italy, Greece and Spain – countries which experienced a public finance crisis after 2009.

[3] *Central and Eastern European Countries* – 11 EU Member States of Central and Eastern Europe. Apart from Poland, the group also includes: Bulgaria, Croatia, Czech Republic, Estonia, Lithuania, Latvia, Romania, Slovakia, Slovenia and Hungary.

The characteristic feature of the public finance evolution in the EU and OECD countries in 2004-2014 was a significant rise of the level of fiscalism as a result of the 2008 financial crisis. In 2009, the average level of fiscalism rose by 5.6 pp in the EU and by 5.5 pp in the OECD in comparison to 2007 (Chart 2). In 2009, the share of public spending in GDP began to fall; however, in 2014 it was still significantly higher than before the financial crisis. This took an unusual course in Poland. First of all, the level of fiscalism rose less than in other countries – in 2009 it was 2.1 pp higher than in 2007. Out of the 38 analysed countries, only Israel (the only country where the level of fiscalism fell in that period), Malta and Hungary recorded a lower increase. Secondly, by 2014 the level of fiscalism receded below the 2007 level. A similar situation occurred only in four other countries – in Israel, Lithuania, Romania and Hungary. Therefore, the global crisis had a much lower impact on the spending side of the Polish public finance in comparison to other EU and OECD countries.

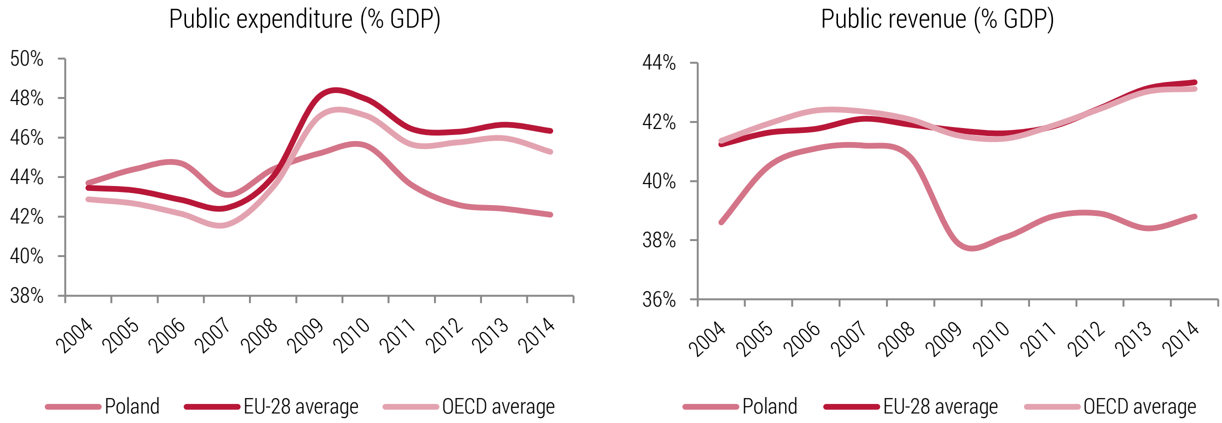
Chart 1. Public expenditure and revenue as percentage of GDP in the EU and OECD* countries in 2014



** no data available for Chile, Mexico and Turkey*

Source: Own elaboration based on Eurostat data and OECD Economic Outlook No. 98.

Chart 2. Public expenditure and revenue as percentage of GDP in the EU and OECD* countries in 2004-2014



** no data available for Chile, Mexico and Turkey*

Source: Own elaboration based on Eurostat data and OECD Economic Outlook No. 98.

The share of public spending in GDP in the EU and OECD countries rose in almost all countries (with the exception of Israel) as a result of the global financial crisis. However, public revenues were less predictable. In 24 out of 38 countries, the share of public revenues in GDP fell, while it rose in the remaining 14 countries. Poland ranked in the first group. In 2009, public revenues fell significantly in comparison to 2007 – by 3.3 pp of GDP. During the same period, the average share of public revenues in GDP fell by 0.4 pp in the EU, and by 0.8 pp in the OECD. Additionally, by 2014 the level of public revenue in relation to GDP in Poland did not come back to the level observed before the crisis. Meanwhile, in 2014 the average share of revenues in GDP in the EU and OECD was higher than in 2007.

2. Public revenue sources in Poland compared to other countries

2.1. Indirect and direct taxes and contributions in the public revenue mix

The main source of public revenue in Poland in 2014 were social insurance contributions (Table 1). They amounted to 34.1% of total public revenue, i.e. 13.2% of GDP. A similar share of revenue (33.2% of total revenue, i.e. 12.9% of GDP) came from indirect taxes. This category consisted mainly of the VAT (in 2014, it accounted for 55.3% of revenue from indirect taxes in Poland) and, to a lesser extent, excise tax as well as other indirect taxes. Direct taxes (including mainly personal income tax and corporate income tax) had the lowest share in public revenue. They amounted to 17.9% of public revenue in Poland in 2014, i.e. 6.9% of GDP.

Table 1. Public revenue structure in the EU Member States in 2014

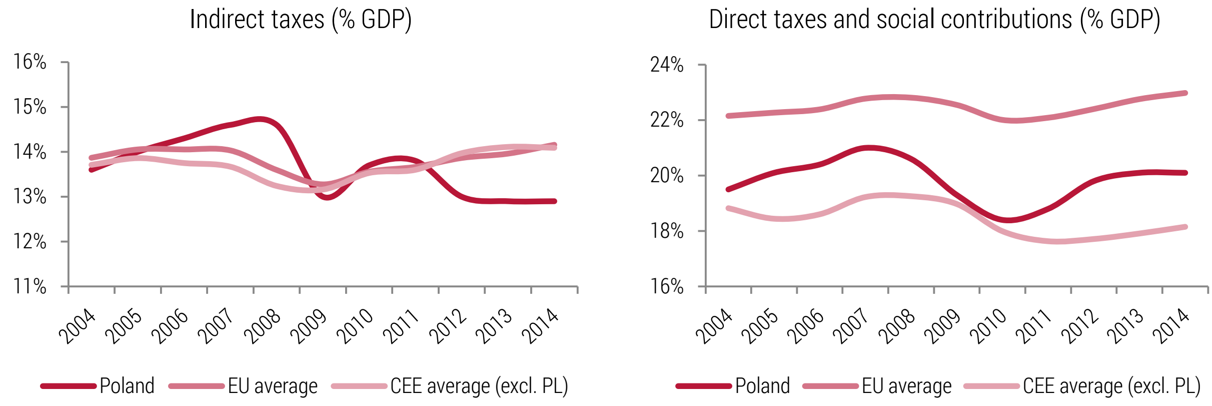
Specification	Poland	EU average	CEE average (excl. Poland)	Poland	EU average	CEE average (excl. Poland)
	as % of GDP			as % of public revenue		
indirect taxes	**12.9**	**14.2**	**14.1**	**33.2**	**32.9**	**35.9**
VAT	7.1	7.8	8.5	18.4	18.4	21.7
excise tax*	3.4	2.7	3.4	8.9	6.4	8.7
other indirect taxes**	2.4	3.6	2.2	6.0	8.1	5.5
direct taxes	**6.9**	**11.5**	**6.6**	**17.9**	**25.8**	**16.9**
PIT	4.6	8.0	4.3	11.8	17.7	10.9
CIT	1.7	2.6	2.0	4.5	6.1	5.2
other direct taxes	0.6	0.9	0.4	1.7	2.0	0.9
social security contributions	**13.2**	**11.5**	**11.6**	**34.1**	**26.8**	**29.3**
other revenue	**5.8**	**6.2**	**7.0**	**15.1**	**14.6**	**17.9**
total	**38.8**	**43.4**	**39.3**	**x**	**x**	**x**

** no data available on revenue from excise tax in Estonia*

*** Eurostat classifies under indirect taxes i.a. property tax (in the table above this tax is included under "other indirect taxes")*

Source: Own elaboration based on Eurostat data.

Chart 3. Revenue from taxes and contributions in the EU Member States in 2004-2014



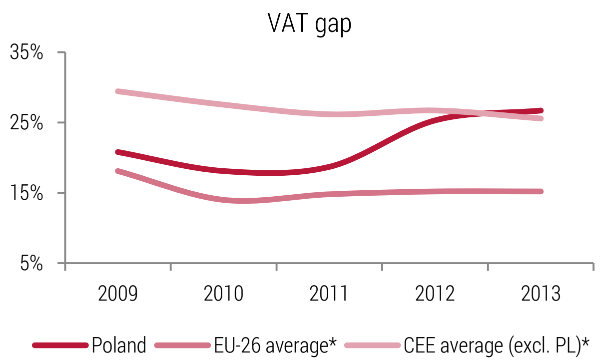
Source: Own elaboration based on Eurostat data.

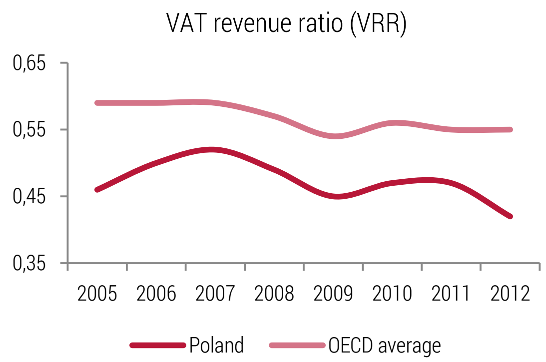
Indirect taxes. In 2014, the indirect tax revenue/GDP ratio in Poland was 1.3 pp lower than the EU average and 2 pp lower than the CEE average. Such tendency, however, had not been visible in Polish public finance in earlier years. As shown in Chart 3, in 2004-2011 the indirect tax revenue/GDP ratio in Poland was similar to or higher than the EU and CEE average. It is only since 2012 that the evolution of this ratio had deviated from the tendencies observed in other EU Member States. Since reaching its lowest level in 2009 (13.2-13.3% of GDP), the average indirect tax revenue/GDP ratio in the EU and CEE countries constantly grew to return to its pre-crisis values (ca. 14% of GDP) in 2012-2014 . Meanwhile, in Poland this ratio fell from 13.8% in 2011 to 13.0% in 2012, and remained at this level in the following years. In 2014, the ratio was 1.7 pp lower than in 2008. VAT revenue decreased by 0.9% of GDP, excise tax revenue fell by 0.8% of GDP, and revenue from other indirect taxes remained the same.

No significant changes in regulations concerning indirect taxes which could justify such a large decrease took place between 2008 and 2014. On the contrary, in 2008-2014 excise tax rates were raised on certain products, and since 2011 the VAT rate has increased by 1 pp. A negative impact on indirect tax revenue was exerted by a declining share of consumption in GDP. According to Eurostat data, that share decreased from 80.6% in 2008 to 78.4% in 2014, including the share of private consumption in GDP, which fell from 61.1% to 59.3%. However, analyses carried out for the European Commission show that one of the main factors of decrease in the indirect tax revenue/GDP ratio in Poland is lower VAT collection, resulting from increasingly popular tax evasion and avoidance. While in 2009-2011 the VAT gap was similar to the EU average (18-20% of theoretical VAT receipts), in 2012 and 2013 it reached one of the highest levels in the EU (Chart 4). In 2013, this tax gap amounted to 27% of theoretical VAT receipts, i.e. 8.8 pp more than the EU average and 12.8 pp more than the EU median. Only in 6 out of 26 analysed EU Member States was the tax gap in 2013 larger (CASE, CPB 2015). Results of the study carried out for the European Commission are similar to an analysis made by the consulting company PWC (2015), which indicates that the VAT gap in Poland in 2013 amounted to 24% of theoretical receipts, and to 29% in 2014. PWC analysts point out that the share of tax gap in Poland increased from 0.6% of GDP in 2007 to 2.9% of GDP in 2013. According to first estimates, the VAT gap in 2015 amounted to 3.0% of GDP. Returning to the 2007 tax gap value would result in a PLN 42.7 billion increase in public revenue in 2015 (i.e. 69% of the public finance sector deficit in 2015).

Another way of measuring VAT collection is the VAT Revenue Ratio (VRR) proposed by OECD. This tax gap indicator is calculated based on the effective tax rate and it focuses on tax evasion and avoidance. The VRR expands the analysis by the impact of state policy consisting in applying reduced VAT rates on certain products and granting tax exemptions to certain types of operators or operations. The VRR shows the ratio of actual VAT revenue vs. "ideal" VAT revenue, calculated basing on the standard VAT rate applied to the whole potential tax base. The VRR for Poland in 2012 equalled 0.42, meaning that almost 60% of the potential VAT revenue is not collected, largely due to the existing reduced rates and exemptions. As the analyses of CASE and CPB (2015, p. 24) show, the VAT revenue in the Polish economy is particularly affected by a wide application of reduced rates. Poland ranks second out of 26 EU Member States in terms of public finance sector losses resulting from this practice. A decrease of the VRR in Poland from 0.52 in 2007 to 0.42 in 2012 (see Chart 4) indicates an increasingly lower VAT collection, which is consistent with our observations above concerning the VAT revenue/GDP ratio and the VAT gap. In 2012, only 5 OECD countries had a lower VRR than Poland.

Chart 1. VAT gap in the EU Member States in 2009-2013 (as % of theoretical VAT revenue) and VRR in OECD countries in 2005-2012





** no data available for Croatia and Cyprus*
Source: Own elaboration based on CASE, CPB 2015; OECD 2014.

As for the excise duty, a decrease in the revenue/GDP ratio between 2008 and 2014 seems to be caused by more diversified reasons. Over that period, consumption of tobacco products was consistently falling, there were changes in alcohol consumption patterns (adverse to public revenue), and fuel prices had been decreasing since 2012. It is noteworthy that in the CEE countries, including Poland, the excise duty revenue/GDP ratio is higher than the EU average (see Table 1). This can be explained, among other things, by a low income flexibility of the demand for alcohol and tobacco products – in countries with lower per capita revenue those goods represent a relatively high proportion of the total consumer spending. As a result, 8 CEE countries rank among the top ten EU Member States with the highest share of revenue from excise duty on alcohol and tobacco products in GDP. Poland is third in this ranking (Eurostat data for 2012).

Direct taxes. The CEE countries (including Poland) make significantly lower revenue from direct taxes than other EU countries. In 2014, 17.9% of public revenue in Poland and 16.9% of public revenue on average in the CEE countries was collected from direct taxes, while the EU average was 25.8%. The revenue from those taxes constituted 6.9% of GDP in Poland and 6.6% in the CEE countries. The EU average was 11.5%, while in the EU-15 countries[4] it amounted to 14.9%, i.e. over two times more than in Poland and in CEE on average. Scandinavian countries are leaders in this respect – the average direct taxes revenue/GDP ratio in Denmark, Finland, Sweden and Norway in 2014 amounted to 21.5%, which represented from 30% of public revenue in Finland to 59% in Denmark. In the following countries, the share of direct taxes revenue in public revenue was also in excess of 30%: Belgium, Ireland, Luxembourg, Malta, Italy and the United Kingdom.

In 2014, the difference between the direct taxes revenue/GDP ratio in Poland and the EU average was 4.6 pp, of which 3.4 pp from the personal income tax, 0.9 pp from corporate income tax and 0.3 pp from other direct taxes. Among direct taxes, the personal income tax is the most significant. In Poland, the share of revenue from this tax in GDP in 2014 amounted to 4.6%. In 2007 and 2008, this share exceeded 5% (5.2% and 5.3% of GDP respectively). The main reason for this decrease was a change of the tax brackets in 2009 – 19%, 30% and 40% rates were replaced by 18% and 32% rates, while the second tax bracket was set at the income level previously used for the third tax bracket. Therefore, that reduction of the personal income tax was addressed above all to well-off persons which are between the second and the third tax bracket (from PLN 44,490 to 85,528 of annual taxable income) or above the third tax bracket. The revenue/GDP ratio also decreased with respect to the corporate income tax – from 2.7% in 2008 to 1.7% in 2014. However, there were no significant changes in regulations in this case. As IMF experts point out, increasingly popular tax evasion and avoidance is a growing problem for the corporate income tax collection in Poland, similarly to the case of VAT (Toro et al. 2015).

Social security contributions. In comparison with the EU and CEE average, the public revenue in Poland is characterised by a large proportion of social insurance contributions. In 2014, they represented 34.1% of public revenue in Poland, while the EU average was 26.8% and the CEE average – 29.3%. This corresponded to 13.2% of the Polish GDP, whereas the EU average amounted to 11.5% of GDP and the CEE average – 11.6%. In 2014, Poland was among 9 countries in which revenue from contributions was the biggest revenue category. Only in 5 EU countries (among others in Germany and in France) was the share of contributions in total public revenue higher than in Poland. As compared to other EU countries, Poland stands out in particular in terms of revenue from social insurance contributions paid by self-employed persons. In 2014, the Polish ratio of such revenue to GDP was the highest in the EU, i.e. 2.6% of GDP (PLN 45.4 billion), while the EU average was 0.6%, and the CEE average – 0.3%.[5]

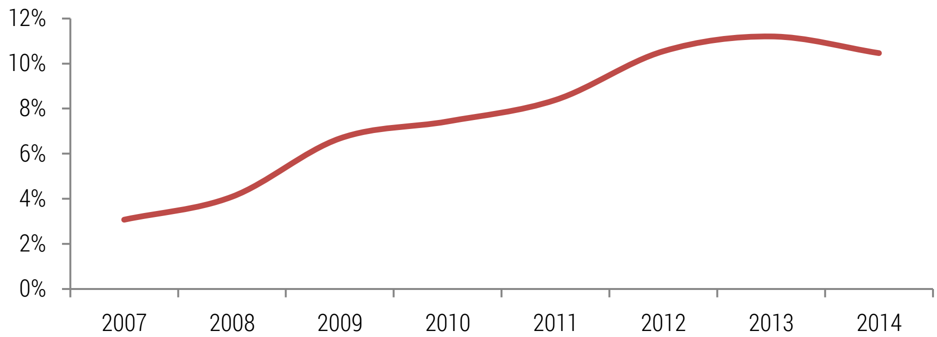
The Polish ratio of revenue from social insurance contributions to GDP in 2004-2014 showed first a gradual decrease (from 13.2% in 2005 to 11.7% in 2010), followed by a gradual increase (reaching again 13.2% in 2014). Those changes were above all a result of changes introduced by public authorities. In 2007 and 2008, the disability contribution rate was reduced – in total by 7 pp (from 13% to 6%). In the following years, the decrease in the revenue from contributions was stopped by a number of changes in the pension system, consisting mainly in limiting the role of the funded pension pillar – by lowering the rate of contribution transferred to Open Pension Funds (OFE) – from 7.3% to 2.3% in 2011 and 2012, 2.8% in 2013 and 2.92% since 2014; and by making OFE

[4] Countries forming the European Union before the accession of new members in 2004.
[5] Calculations for 23 EU countries. No data available for Denmark, Lithuania, Portugal and Slovenia.

contributions non-mandatory and introducing a "safety slider" pension mechanism.[6] Moreover, starting from 2012 the disability contribution rate was raised by 2 pp.

Non-repayable financial aid from the EU. Revenue from European funds is an important part of the public sector finance in Poland. In 2014, it amounted to PLN 71 billion (i.e. 10.5% of the total revenue). Since Poland's accession to the EU, the importance of European funds in the public finance sector revenue in Poland has increased (Chart 5). In 2007, revenue classified as non-repayable financial aid from the European Union amounted to PLN 14.9 billion, while in 2014 it totalled PLN 70.8 billion. This translated into an increase of this source of funding in the revenue mix from 3.1% in 2007 to 10.5% in 2014. EU funds helped to carry out many investment projects during the analysed period, primarily in transport infrastructure (see next chapter). However, it should be kept in mind that there are certain risks related to long-term reliance on foreign aid when it comes to investments and development. First of all, this may lead to the economy's dependence on foreign aid, which is visible when additional funds are starting to become depleted and the economy is not able to create its own incentives for development. Secondly, foreign aid leads to partial ineffectiveness of public spending, as repeatedly pointed out in relation to different projects in Poland co-financed by European funds.[7] Thirdly, carrying out projects funded from external sources requires usually an own contribution, which is most often financed by issuing bonds. This contributes in the long term to the growth of public debt and may cause instability in public finance. Some authors also point out that during the financial perspective 2007-2013 there was too much focus on infrastructure problems, while neglecting other matters prevented better infrastructure conditions from translating into quicker economic growth (Misiąg et al. 2013, p. 50).

Chart 2. Share of non-repayable financial aid from the EU in public sector revenue in Poland in 2007-2014



Source: Own elaboration based on data of the Ministry of Finance.

2.2. Composition of revenue from taxes and contributions by subject of taxation

In comparison with the EU and CEE average, the composition of revenue from taxes and contributions in Poland by subject of taxation is characterised by a slightly lower share of revenue from consumption, significantly lower share of revenue from labour and higher share of revenue from capital (Chart 6). It should be noted, however, that

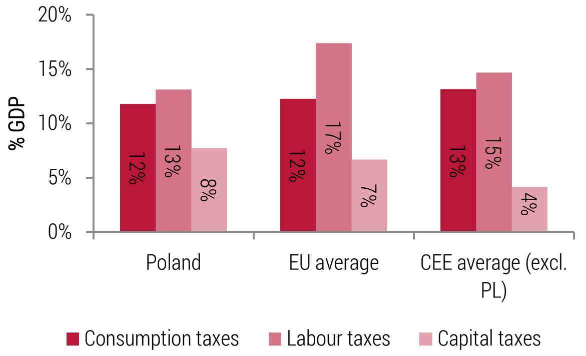
[6] Ten years before retirement, funds of the insured person are gradually transferred from the funded pension pillar to the pay-as-you-go pension pillar.

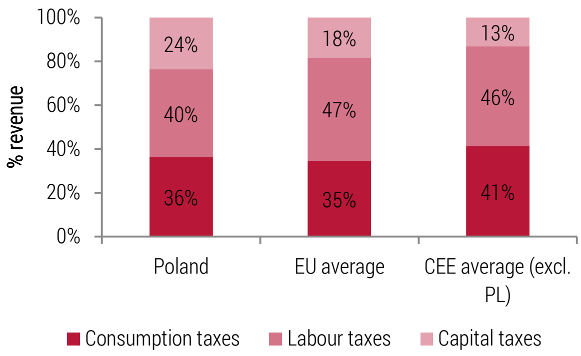
[7] For instance renovations of railway stations where no trains stop, or thermal pools in which water has to be heated. It should be noted that such investment projects later generate maintenance costs.

differences in the revenue mix result not only from the taxation level, but also from the size of the tax base. The relatively low revenue from labour taxation in Poland is in particular a result of a lower share of remunerations in GDP than in most EU countries (Karabarbounis and Neiman 2013). The ITR (Implicit Tax Rate), presented in Chart 7, shows the ratio of revenue from taxes and contributions to the potential tax base.[8]

Observations concerning revenue from the taxation of consumption are consistent with those concerning indirect taxes. In 2012, the ratio of revenue from consumption to GDP and to the total revenue from taxes and contributions was slightly lower in Poland than in other EU countries (in particular CEE countries), even though before the crisis – in 2007 and 2008 – Poland was characterised by a relatively high share of this category of revenue. As far as the revenue from labour taxation is concerned, it is only in 6 EU countries (4 CEE countries, the Netherlands and Ireland) that the share of this revenue in GDP in 2012 was lower than in Poland. As a rule, the countries which joined the EU in 2004 or later are characterised by a significantly lower revenue from labour taxation than the EU-15 countries. In addition to that, this category of revenue in Poland in 2012 was also lower than the CEE average. On the other hand, the revenue from capital in Poland was much higher than in the other CEE countries. The difference in the public revenue mix between Poland and other countries of the region mainly depends on the revenue from the taxation of self-employed persons (due to not only the above-mentioned contributions, but also to the income tax). To a certain extent, it is a consequence of fictitious employment in Poland, as many self-employed individuals in reality work only for one employer and perform duties which are typical for regular employees (Arak, Lewandowski and Żakowiecki 2014). Self-employment allows for paying lower taxes and contributions, and the large amount of public revenue is generated here by a big number of people working in such a way (also in agriculture). Therefore, the revenue from capital in Poland should actually be partly classified as revenue from labour, which means that the actual composition of revenue from taxes and contributions by subject of taxation is more similar to the taxation mix in the CEE countries than it is shown in the statistics.

Chart 3. Composition of revenue from taxes and contributions in the EU countries in 2012 by subject of taxation



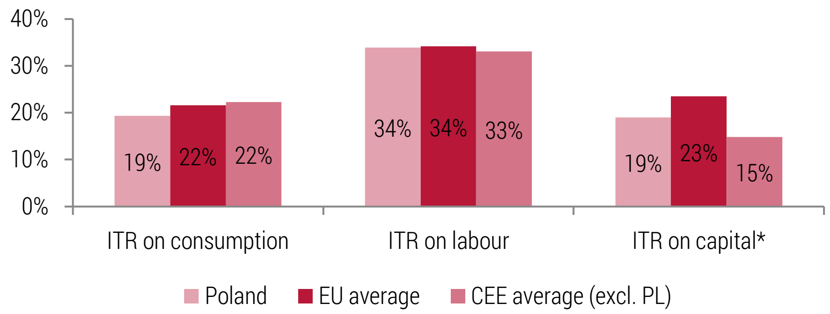


Source: Own elaboration based on Eurostat data.

[8] For methodological details concerning breakdown of revenue from taxes and contributions by subject of taxation and for the Implicit Tax Rate calculation method see: European Commission 2014.

An analysis of the ITR in the EU countries also leads to interesting conclusions. This indicator shows that a higher revenue from labour in the EU-15 countries is a result of a larger tax base, and not a higher taxation level. In fact, the average labour ITR in the EU, CEE and Poland is very similar. Moreover, after analysing the ITR, it turns out that the difference between Poland and other EU countries in terms of taxation of consumption is bigger than it is shown in the revenue from taxation alone. In 2012, the consumption ITR in Poland was 3 pp lower than the EU and the CEE average. The biggest differences between Poland, the EU and the CEE average occur with regard to the capital ITR. The CEE countries are characterised by a much lower average capital ITR than the EU average. Poland has a higher capital ITR than the CEE average, but lower than the EU average. In Poland, as in the case of the EU average, the value of the capital ITR is similar to the consumption ITR. In 6 out of 7 other CEE countries for which data are available, the value of the consumption ITR is significantly higher than the capital ITR.

Chart 4. Implicit Tax Rate for consumption, labour and capital in the EU countries in 2012



** no data available for ITR on capital for Bulgaria, Denmark, Greece, Croatia, Luxembourg, Malta and Romania*
Source: Own elaboration based on Eurostat data.

2.3. Investment and labour taxation levels

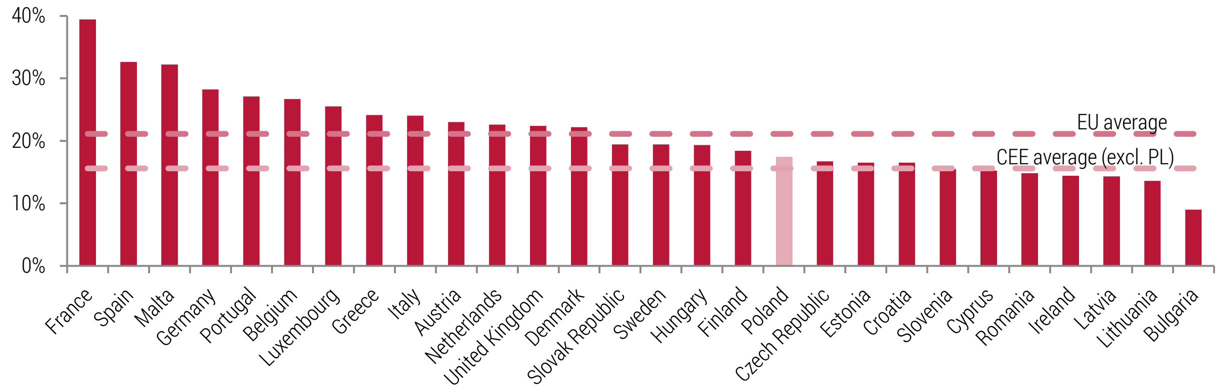
The EATR (Effective Average Tax Rate) indicator presents the capital taxation level in a given country from the microeconomic point of view. Its creators examine 15 hypothetical investment projects (in 5 different assets, with 3 different financing sources) in different countries, assuming a certain return rate. The EATR measures the share of paid tax in generated revenue streams.[9]

The level of the EATR in the EU countries in 2014 is shown in Chart 8. Its rates are clearly lower in the Central and Eastern European countries than in the EU-15. Among the top 10 countries with the lowest EATR, there are 8 CEE countries, Cyprus and Ireland. The relatively low EATR rate is an element of tax competition among the Central and Eastern European countries attempting to attract direct foreign investments and to stimulate investments. In 2014, the EATR rate in Poland was higher than the CEE average, but lower than the EU average. Therefore, Poland, together with Hungary and Slovakia, takes the position between the old Union and the new Member States. The tax competition between EU states leads to the gradual decline of EATR rates. The particularly sharp decline was recorded between 2000 and 2004, when the average EATR value in the 28 Member States fell by 4.4 pp, in the CEE countries (excluding Poland) – by 5.8 pp and in Poland - by as much as 10.0 pp Interestingly, from

[9] Methodological details and EATR for different types of investments in the study: Spengel et al. 2014.

2004 to 2014 the average EATR rate fell by 1.9 pp in the EU and by 1.3 pp in the CEE, while in Poland it rose by 0.4 pp.

Chart 8. Effective Average Tax Rate (EATR) in the EU countries in 2014



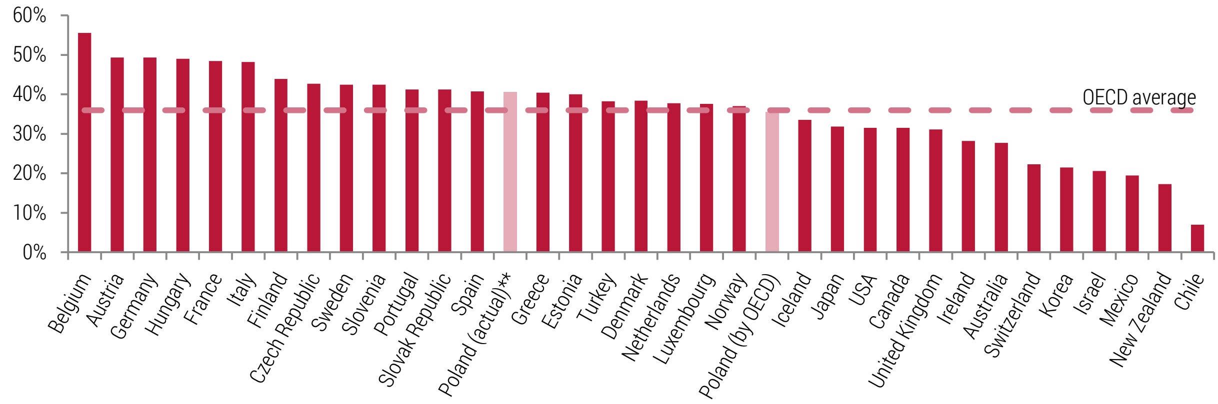
Source: Own elaboration based on European Commission 2015b.

In order to determine the labour taxation levels in a given country, the comparison of the tax wedge levels is helpful. According to the OECD calculation shown in Chart 9, the tax wedge for a single, childless individual who earns the equivalent of the average salary in Poland was 35.6%. Therefore, it was about equal to the average in the OECD countries, which is 36.0%. However, the OECD methodology does not take into account the open pension fund and social insurance sub-account contributions in the tax wedge. The actual tax wedge for the Polish salary consistent with the OECD definition is 40.6%. Regardless of the adopted methodology, the tax wedge level in Poland does not distinguish itself amongst the rest of the OECD countries. However, it is noteworthy that, as a rule, the CEE countries which are OECD members have a higher tax wedge than Poland.

What clearly distinguishes the labour taxation in Poland from other OECD countries is the tax wedge is almost linear. Chart 10 shows the value of the tax wedge in Poland and the OECD average depending on the amount of salary in four different configurations. It is clear that the tax wedge in Poland does not change significantly with the increase of earned income. Meanwhile, in the OECD countries the taxation progression is much stronger and rises when the taxpayer have children. In Poland, the difference in the tax wedge level between an individual earning 67% of the average salary and an individual earning 167% of the average salary for the basic variant (a single, childless individual) is only 1.4 pp. Out of 34 OECD countries, only four do not apply a significant progression linked to the level of earnings (with a difference lower than 4 pp). Apart from Poland, these are: Estonia (1.9 pp difference), Chile (0.9 pp) and Hungary (0.0 pp)[10]. The average difference for the OECD countries is 8.2 pp.

[10] In Hungary, the changes in the tax wedge are determined by the number of children, not the level of earnings.

Chart 9. Tax wedge in OECD countries in 2014*

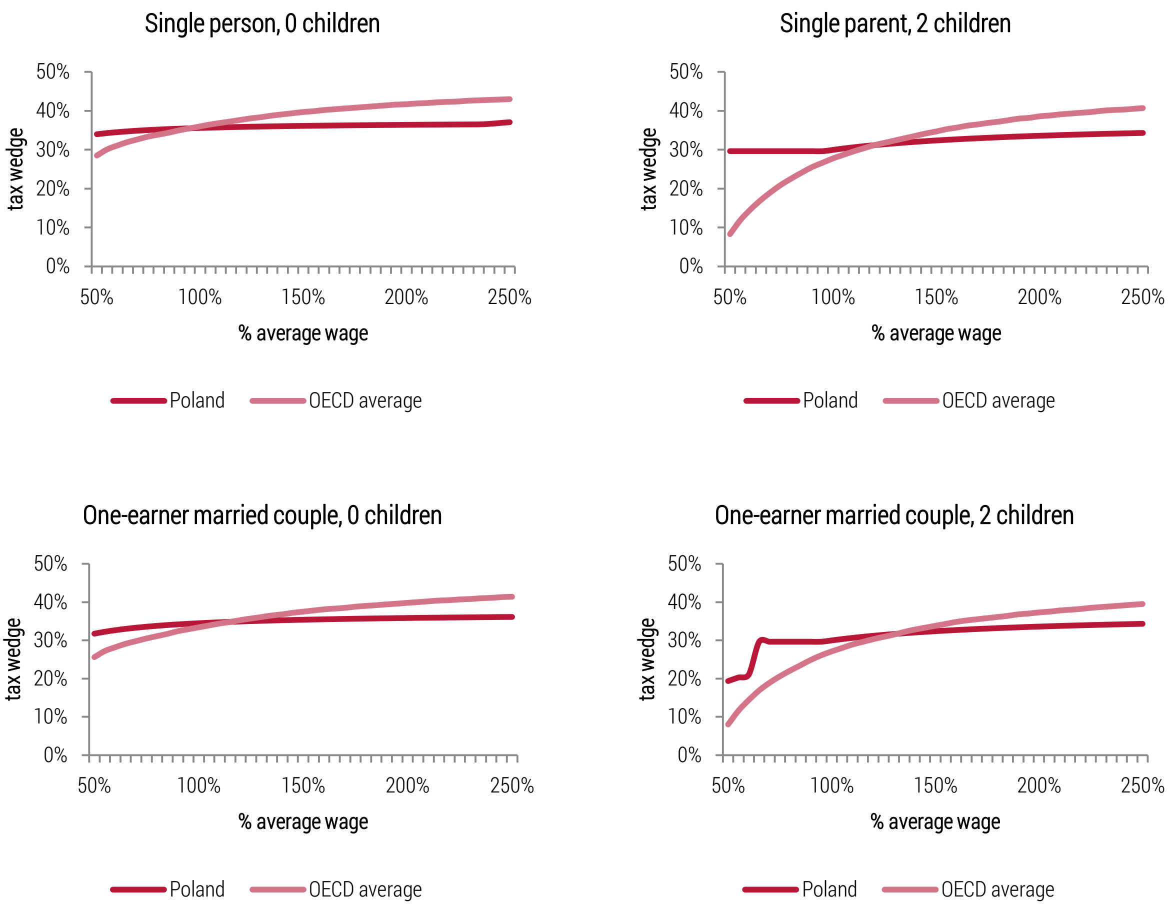


** assumptions: single, childless individual earning 100% of the average salary*

*** including contributions for Open Pension Funds and social security sub-account*

Source: Own elaboration based on OECD data.

Chart 10. Tax wedge as percentage of average earnings in OECD countries in 2014



Source: Own elaboration based on OECD data.

3. Public spending in Poland as compared to other EU states

3.1. Public spending mix according to COFOG

A comparative analysis of the orientation of public spending in the EU states is possible thanks to the so-called COFOG (Classification of the Functions of Government). According to the data for the year 2014 (table 1), Poland spends a relatively large share of public funds on national defence, public order and safety, education and social protection. However, in the case of three categories, namely general public services, economic matters and health, the spending is relatively low as compared to the EU and the CEE average.

The social protection spending is the largest line both in Poland and other EU states. In 2014, it amounted to 38.2% of public spending in Poland, which corresponded to 16.1% of GDP. As compared to the EU average, the share of social protection spending in GDP in Poland was lower by 1.3 pp, whereas its share in total spending was higher by 0.9 pp. Poland stands out among the other CEE states due to the scope of social spending. In 2014, its share in GDP exceeded the CEE average by 1.8 pp. Only three CEE states are ahead of Poland in this respect – Slovakia (20.0%), Slovenia (18.0%) and Hungary (16.6%). The share of social protection spending in total public spending was higher only in Slovakia (48.1%), whereas the CEE average was lower by 4.2 pp. Along with Slovakia and Slovenia, Poland belongs to the CEE states where the share of social spending in the structure of public spending is closer to the EU-15 average than the CEE average.

Table 2. Public spending mix in the EU Member States in 2014* according to COFOG

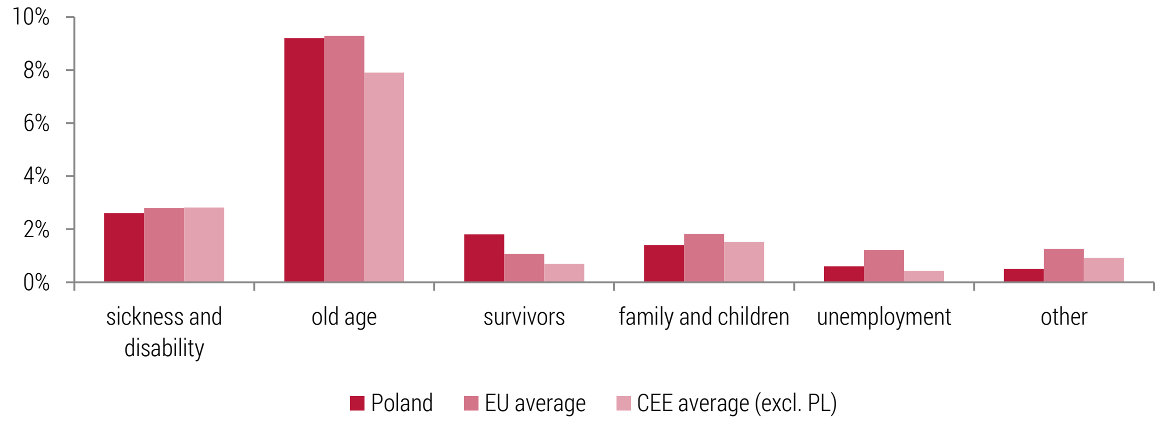
spending lines	Poland	EU average	CEE average (excl. Poland)	Poland	EU average	CEE average (excl. Poland)
	as % of GDP			as % of public spending		
General public services	5.0	6.9	6.3	11.9	14.9	14.6
Defence	1.5	1.2	1.0	3.5	2.5	2.5
Public order and safety	2.2	1.8	2.0	5.3	4.1	4.9
Economic affairs	4.6	4.8	5.3	11.0	10.5	12.8
Environment protection	0.9	0.8	0.7	2.1	1.7	1.7
Housing and community amenities	0.7	0.7	0.8	1.7	1.6	2.1
Health	4.6	6.2	5.2	11.0	13.3	12.4
Recreation, culture and religion	1.2	1.2	1.4	2.8	2.6	3.3
Education	5.3	5.3	4.9	12.5	11.5	11.8
Social protection	16.1	17.4	14.3	38.2	37.3	34.0
Total	**42.1**	**46.3**	**42.0**	x	x	x

** 2013 in the case of Cyprus, Ireland, Lithuania, Luxembourg, Malta, Hungary and UK*

Source: Own elaboration based on Eurostat data.

The difference in social spending between Poland and the average of the remaining CEE states results mainly from spending on benefits related to ageing (mainly retirement pensions) and benefits granted to relatives of a deceased person (see chart 11). In 2014, Poland spent on these two categories 2.4% of GDP more than the CEE average. High spending on benefits related to ageing cannot be explained by the demographic structure of Polish society. According to Eurostat data, as of 2014 the share of people over 65 years in the total population of Poland reached 14.9%, with the EU and the CEE average reaching 17.7% and 17.6%, respectively. The median age was 39.2 years, while the EU and the CEE average median age was 41.3 and 41.6 years, respectively. Taking into account these two indicators, in 2014 only 4 EU states had as young demographic structure as Poland (the first indicator – under 16%, the second one – under 40 years): Cyprus, Ireland, Luxembourg and Slovakia. The reasons for high spending on benefits related to ageing in Poland are both – relatively fast exit from labour force by elderly people and relatively high retirement benefits. In 2014, 65.7% of the population over 50 years of age were inactive in Poland. On average, this indicator was 63.2% in EU, whereas in the case of the CEE states – 63.6%. At the same time, in 2014 the aggregate replacement rate[11] reached 0.63, while the EU and the CEE average was 0.54 and 0.51, respectively (Source: Own elaboration based on Eurostat). The relative financial standing of elderly people in Poland is very good. In 2014, the ratio between the median of equivalent disposable income of people over 65 years and the median of equivalent disposable income of people under 65 years reached 0.99. This indicator was higher only in 6 EU states, whereas the EU and the CEE average stood at 0.89 and 0.86, respectively (Source: Own elaboration based on Eurostat).

Chart 11. Spending on social protection in the EU Member States in 2014* (as a percentage of GDP)



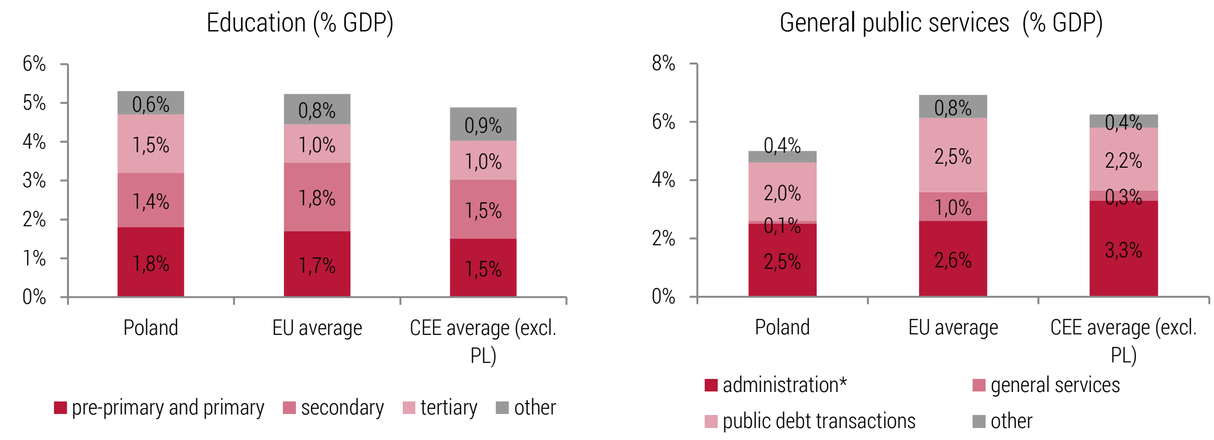
** 2013 in the case of Cyprus, Ireland, Lithuania, Luxembourg, Malta, Hungary and UK*
Source: Own elaboration based on Eurostat data.

High retirement benefits also have an impact on the amount of spending on benefits granted to relatives of a deceased person. The amount of survivors' pension depends on the amount of retirement or disability benefit to which a deceased person was entitled. Relatives of a deceased person are entitled to a death benefit. Such benefits are either not granted in other EU Member States or much lower than in Poland. High survivors' pensions and death benefits contribute to the fact that in 2014 the share of spending on benefits granted to relatives of a deceased person in the Polish GDP was twice as high than the average for other states from the region. Only four EU states (Belgium, Spain, Germany and Italy) spent more on this.

[11] The ratio between the median of gross pension of people aged 65-74 and the median of gross earnings of people aged 50-59.

The second highest category of public spending in Poland was spending on education. In 2014, this category constituted 12.5% of public spending in Poland. The EU and the CEE average was lower by 1.0 and 0.7 pp, respectively. Poland stood out mainly due to the amount of spending on higher education (chart 12). In 2014, 1.5% of GDP was spent on this purpose. Only two Scandinavian states (Denmark and Finland) spent more on higher education in relation to their GDP. High spending on higher education results mainly from the high number of people enrolled at this level of education while full-time studies are guaranteed to be free of charge by the constitution. In 2012, the number of university graduates per 1,000 people between 20-29 years of age in Poland was the highest in the EU (GUS 2014, p. 99). In 2014, spending of educational institutions per student amounted to 43% of GDP per capita, with the average for the OECD countries reaching 40% (OECD 2015, p. 221).

Chart 12. Decomposition of public spending on education and general public services in the EU Member States in 2014**



** executive and legislative organs, financial and fiscal affairs, external affairs*
*** 2013 in the case of Cyprus, Ireland, Lithuania, Luxembourg, Malta, Hungary and UK*
Source: Own elaboration based on Eurostat data.

Poland is one of the leading EU Member States in terms of public spending on national defence. In 2014, 1.5% of GDP[12] was spent on defence, whereas the EU and the CEE average amounted to 1.2% and 1.0%, respectively. In 5 EU states, the spending on national defence in relation to GDP was higher than in Poland. These were: Cyprus, Estonia, Greece, France and the UK. In the entire EU, a downward trend can be observed in relation to the share of spending on national defence in GDP. Between 2004 and 2014, this indicator grew in 4 states only. In the EU, the average dropped by 0.1 pp, whereas in the CEE – by 0.5 pp. In Poland, the spending on national defence remained on a similar level (1.6 % of GDP in 2004, 0.1 pp more than in 2014). Public order and safety also have a relatively high share in public spending in Poland. This category includes spending on justice, police and fire services. However, the difference is not as significant as in the case of the other sections discussed above, while Poland stands out mainly due to the amount of spending on the police force. In 2004-2014, Poland spent on the police 0.2-0.3 pp of its GDP more than the EU average.

[12] Pursuant to Polish legislation, public authorities are obliged to allocate to national defence at least 1.95% of GDP, and even as much as 2% of GDP since 2016. This requirement is met since spending on pensions paid to former soldiers are, among other things, considered spending on national defence for the purpose of compliance with the statutory minimum. In the COFOG classification, spending on pensions for soldiers is recognised in spending on social protection.

On the other hand, health care is one of the categories of public spending where Poland spends relatively little. As far as this category is concerned, similarly to social protection a difference can be observed in the scale of financial involvement between Central and Eastern Europe and the remaining EU states. In most CEE states, the public spending on health is below the EU average, which stood at 6.2% of GDP in 2014. However, Poland even falls behind the other states of CEE region. In 2014, the share of public spending on health in Poland reached 4.6% of GDP, with the average of the remaining CEE states amounting to 5.2%. Only 4 EU states spent less public resources on health (Cyprus, Latvia, Romania and Slovakia).

General public services are the second category of public spending where Poland spends relatively little. The spending on this category is basically divided into 3 subcategories: maintenance of public administration (executive and legislative organs, financial and fiscal affairs, external affairs), general services of the state (e.g. collecting statistical data) and public debt service. In 2014, the spending on general public services in Poland amounted to 5.0% of GDP and was 1.9 pp lower than the EU average and 1.3 pp lower than the CEE average. The difference between Poland and the EU and the CEE average can be explained by lower spending on almost all the subcategories of general public services (chart 12). Much lower spending on maintenance of public administration in Poland as compared with other CEE states can be observed. In 2014, Estonia and Romania were the only CEE states which spent less on this subcategory. What can also be observed is the difference in public debt servicing between the EU-15 states, which are characterised by a relatively higher level of public debt, and Central and Eastern Europe. The spending on public debt interests is particularly high in PIGS states (2014 average – 4.4% of GDP), Ireland (4.4% of GDP) and Hungary (4.8% of GDP). In 2014, Poland spent less on public debt servicing than the EU and the CEE on average. However, it largely resulted from the take-over and redemption of bonds owned by the Open Pension Funds. In 2013, public spending on public debt servicing amounted to 2.6% of GDP, whereas in 2014 it dropped to 2.0% of GDP.

The last significant category where public spending in Poland is lower than the EU average is spending on economic affairs. Low spending in this category is determined by low spending on trade support and employment promotion. In 2014, Poland spent 0.4% of its GDP on the subcategory “general economic, commercial and labour affairs”, whereas the EU and the CEE average reached 1.1% and 0.9%, respectively. In the remaining subcategories of economic affairs, in particular agriculture and transport, the spending in Poland in 2014 was comparable (agriculture) or higher (transport) than the EU and the CEE average.

(Non)transparency of public finance in Poland

The public finance sector in Poland is largely diversified in terms of organisation of its units, their financial independence and financial interaction with the central budget. This heterogeneity hinders the analysis of the division of tasks between different units of the public sector, financial relations between them, methods of financing and directions of spending resources. In this situation, public authorities should be tasked to establish homogeneous, accurate, clear and reliable communication on the condition of state finances, which would empower any citizen to scrutinise fiscal policy activities.

However, the reporting in public finance does not meet these requirements. Its basic deficiency lies in very limited information on the situation of the entire public finance sector. The Ministry of Finance publishes detailed information on the execution of financial plans only for some entities belonging to the sector. A summary of revenue, spending and the bottom line of the entire public finance sector consists of 4-5 pages of information and a single table in the report on state budget execution. This information is not sufficient to learn the detailed directions of public spending.

Among other things, the lack of information on the condition of the entire public finance sector is the reason why the public debate in Poland is focused entirely on the state budget. In 2014, the state budget expenditure constituted 43.6% of the spending of the public finance sector. After deducing funds allocated from the budget to other entities of the sector, this share drops to only 21.3%. The public space basically lacks information on the financial plan of the Social Insurance Fund, whose net expenditure (outside the public finance sector) exceeds the net expenditure of the state budget.

The IMF Fiscal Transparency Code postulates that public finance reports should cover all entities conducting public operations (IMF 2014). As indicated above, Polish reporting does not meet these requirements, whereas a complete self-analysis of state finances is hindered due to the lack of access to data and multiple financial flows between the entities of the sector. The key contribution towards increasing the transparency of the Polish fiscal policy would consist in making the Ministry of Finance responsible for drawing up a comprehensive report on the situation of the entire public finance sector.

The drawbacks related to the transparency of Polish public finance refer not only to a too narrow scope of published data, but also to their method of presentation. Public institutions in Poland make practically no use of available IT tools in order to publish data (databases, applications, data visualisations). Too general and unclear classifications of spending which carry little informative value are a problem as well.

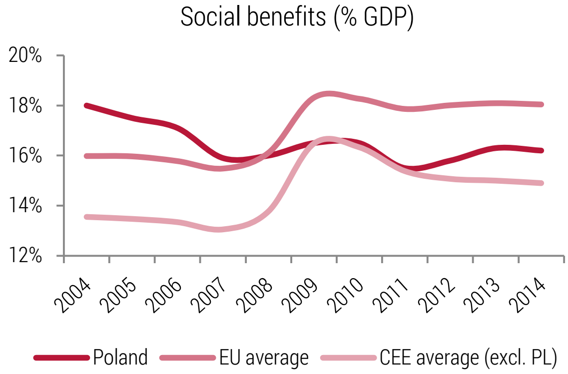
The transparency of fiscal policy in Poland is also disrupted by public authorities which allow for artificial underestimation of the state budget deficit, the deficit of the public finance sector and the public debt in the Polish methodology for assessment of the condition of public finance. The first such practice is improper recognition of refunds for premiums transferred to the Open Pension Fund, which results in overestimation of public revenue by the amount of compensation for earnings from premiums transferred to the Open Pension Fund; such compensation corresponds to the loss of earnings by the Social Security Fund. The second type of practice consists in granting the Social Security Fund loans from the state budget, whose economic meaning is equivalent to grants from the state budget to the Fund. However, thanks to such loans it is possible not to show this transaction as an expenditure of the state budget. The third piece of practice is the non-inclusion of the National Road Infrastructure Fund in the public finance sector and, therefore, the non-inclusion of the debt of the Fund in the public debt.

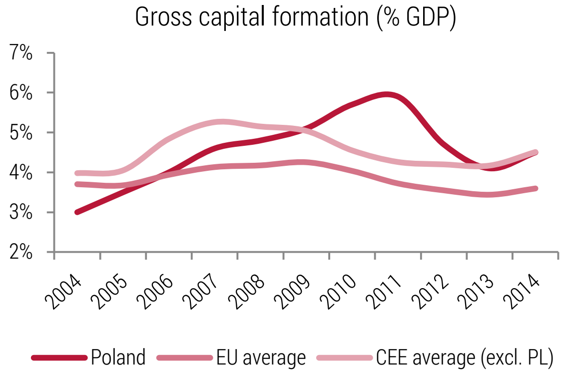
3.2. Public spending in the EU Member States during the global financial crisis

As indicated in the first subchapter, public finance in the EU and OECD states during the global financial crisis was characterised by a growth in public spending. The culmination of that growth came in 2009, with social protection being the main category of spending in which the financial involvement of the state was increased. In 2009, the average share of spending on social transfers in proportion to GDP in the EU was larger by 2.2 pp than in 2008, and by 2.8 pp larger than in 2007 (chart 13). In the case of the CEE states, these differences amounted to 2.7 and 3.4 pp, respectively. The main increase was noted in spending on benefits related to ageing. Pension spending is one of the types of public spending which is not very flexible in response to changes in the business outlook. As a result, the reduction in GDP in the EU Member States caused a growth in the share of transfers to elderly people in GDP. What also grew was the spending related to the functioning of automatic macroeconomic stabilisers, including, above all, spending on unemployment benefits. It is noteworthy that in 2010-2014 the average ratio between spending on social protection and GDP in the EU Member States remained at a higher level than before the crisis (2004-2007).

Interestingly, that phenomenon of a significant growth in spending on social protection in the EU states basically did not occur in Poland. In 2009, the share of spending on social transfers in GDP was larger by 0.6 pp than in 2007. In that period, it was the smallest growth among all the EU Member States, while changes below 1 pp were also observed only in Malta and Hungary. In the entire analysed period (2004-2014), the ratio between spending on social protection and GDP in Poland was characterised by a downward trend. The difference between the amount of spending on this purpose in 2014 and 2004 was -1.8 pp. A negative trend was observed only in four other EU states; however, in none of them was it lower than in Poland. This results from the fast-paced GDP growth in Poland in that period (also in the years of the deepest financial crisis), reduced spending on unemployment benefits (which is associated mainly with a better situation on the labour market) as well as reforms aiming at delaying the moment when elderly people exit from the labour force, and reduction in the amount of retirement benefits: removal of early retirement pensions, increasing the retirement age, more restrictive policy of granting disability pensions and changes in the rules of indexation of pensions.

Chart 5. Public spending on social transfers* and investments in the EU Member States in 2004-2014





** according to the System of National Accounts, hence some minor differences between spending on social protection under the COFOG classification (table 2) and the data shown in the chart.*
Source: Own elaboration based on Eurostat data.

The evolution of public finance in Poland in 2004-2014 is characterised by a significant growth in public spending on investments, especially in 2009-2011 (chart 13). On the year of Poland's accession to the EU, the share of public investments in GDP amounted to 3.0% and was lower than the EU and the CEE average. However, this share doubled by 2011. In 2010 and 2011, the ratio between public spending on investments and GDP was 5.7% and 5.9%, respectively, i.e. the highest ratio in the EU (*ex aequo* with Romania in 2010). In the subsequent years, the share of public investments in GDP dropped to 4.5% in 2014. However, Poland still remains one of the top EU states in that category. In 2014, the share of public spending on investments in GDP was higher only in four countries (Bulgaria, Estonia, Hungary and Slovenia).

The main part of the public investment spending is the expenditure on transport infrastructure. In 2009-2011, the spending on the transport subcategory was 4.0%, 4.3% and 4.2% of GDP, respectively, which gave Poland the fourth, third and first place in the EU. The number of kilometres of expressways and highways in Poland increased between 2007 and 2012 by almost 2.5 times. In that period, large public spending on investments was related, among other things, to EURO 2012 tournament, while the development of infrastructure was co-financed from EU funds. The willingness to fully use the available funds was the reason why those investments were not slowed down during the global financial crisis, even at the cost of increasing the deficit of the public finance sector.

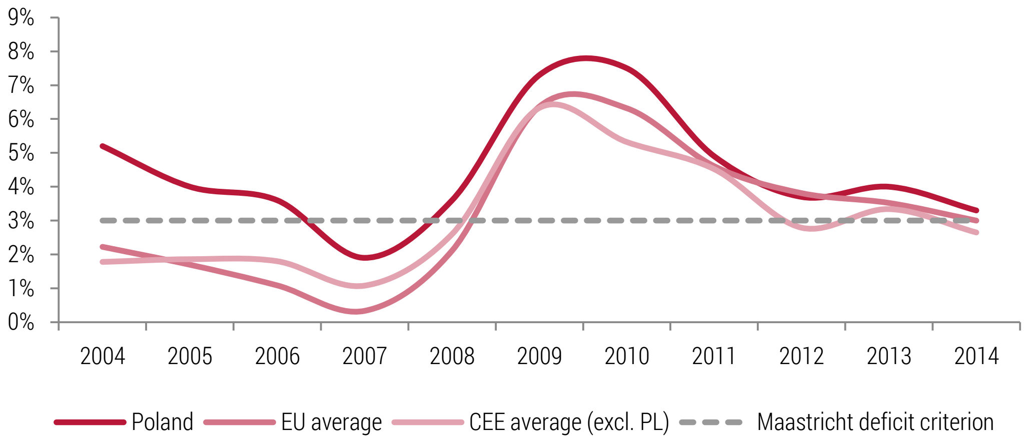
4. Public deficit and debt

4.1. Determinants of the deficit of the general government sector

In 2004-2014, Polish public finance was characterised by a relatively high deficit of the general government sector. In almost entire analysed period, that deficit was higher than the EU and the CEE average (chart 14). The largest difference between Poland and other EU states could be observed in 2004-2006, when the average deficit in the EU states was lower than in Poland by 2.3-3.0 pp. In subsequent years, that difference was reduced. In 2007-2010, it amounted to 0.9-1.6 pp, whereas in 2011-2014 – it ranged from -0.1 to 0.5 pp. The reduction of that difference was largely influenced by the changes in the funded pillar of the Polish pension system, implemented in 2011 and 2014. It is estimated that they allowed for a reduction in the deficit of the general government sector by 0.6 pp of GDP in 2011, 1.1 pp of GDP in 2012 and 2013 as well as by 1.2 pp of GDP in 2014. If such changes had not taken place, the difference between the deficit of general government in Poland and the EU average would have probably remained at the level of 2007-2010. Poland is one of two EU states (the other being Portugal), where the deficit of public finance in 2004-2014 only once dropped below 3% of GDP (in 2007). The only country where it did not happen even once was Greece. The failure to fulfil the deficit convergence criterion was a common phenomenon in the EU in 2009-2012. The number of states involved by the Council of the European Union by the excessive deficit procedure increased from 2 in 2008 to 18 in 2009, and to 22 in 2010. That procedure was applied in the case of Poland in 2009 and lifted in 2015 (European Commission 2015a, p. 29-31).

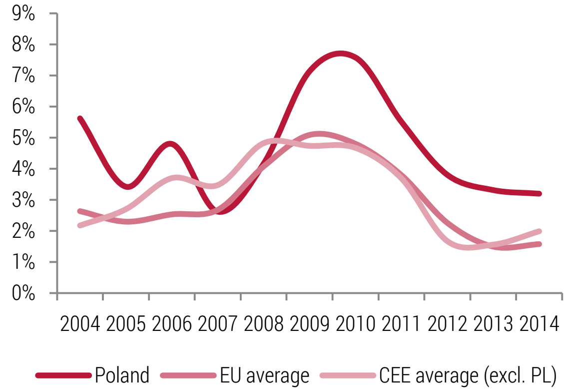
What clearly distinguishes Poland from the other EU Member States is the fact that the main reason for the growth in the deficit of the general government sector during the global financial crisis was not the economic downturn and, subsequently, the automatic reduction in revenue and increase in spending. The increase in the imbalance of the public sector in Poland was caused by discretionary measures of public authorities, taken both before and during the crisis. In 2009 and 2010, the deficit of the public finance sector related to the business cycle accounted for only 0.1% of GDP. The remaining part of the deficit consisted of structural deficit, which is the theoretical value of the deficit under the assumption that GDP is equal to potential output. Very small differences, below 1% of GDP, between the deficit of the general government sector and the structural deficit were a distinct feature of Polish public finance in the entire analysed period (chart 15). It means that the deficit of public finance in Poland is mainly structural, while its cyclical component is small. The changes in the deficit in 2004-2014 (both growths and reductions) should be mainly associated with political decisions. Another cause is a small share of automatic macroeconomic stabilisers in the Polish economy, such as unemployment benefits or progressive income tax. In the EU Member States, the impact of the business cycle on deficit was much greater, reaching even up to several percentage points of GDP. It is noteworthy that since 2009 the amount of structural deficit in Poland has been substantially higher than in the EU and the CEE on average. In 2014, the structural deficit in Poland was 3.2% of GDP. On the other hand, the medium-term objective adopted by Poland in the Stability and Growth Pact related to the level of structural deficit is 1% of GDP, while government documents define high structural deficit as a serious threat for the stability of economic growth since the occurrence of a deficit restrains the possibilities of mitigating the impact of potential economic crises (Council of Ministers 2011, p. 3).

Chart 14. Deficit of the general government sector in the EU in 2004-2014 (as a percentage of GDP)



Source: Own elaboration based on Eurostat data.

Chart 6. Structural deficit (left chart) and cyclic component of the deficit of the general government sector* (right chart) in the EU in 2004-2014 (as a percentage of GDP)



** the difference between the deficit of the general government sector and the structural deficit*
Source: Own elaboration based on Eurostat data and World Economic Outlook Database.

The total impact of discretionary policies in terms of revenue and expenditure of the public finance sector is indicated by the DFE (Discretionary Fiscal Effort) indicator. A positive value of this indicator shows a restrictive fiscal policy of the government, whereas a negative value – an expansionist policy. Chart 16 shows the average values of the DFE indicator in the EU Member States in 2008-2010 and 2011-2013. Most EU Member States are in the upper-left quarter of the chart, which means that expansionist fiscal policy was dominant in the EU in 2008-2010, while in 2011-2013 it was more restrictive. Poland was one of the states where very active fiscal policy was applied in both periods. In the first three analysed years, the average value of the DFE indicator was -1.3% of GDP, while the value of this indicator was lower in only three EU states (Cyprus, Finland, Portugal). In the next three years, the average DFE indicator in Poland was 2.2% of GDP, i.e. it was one of the highest among the EU Member States. The data confirm the importance of discretional policies in Polish public finance in the analysed period.

Chart 7. Discretionary Fiscal Effort (DFE) in the EU* Member States in 2008-2013 and 2011-2013 (as a percentage of GDP)

** no data available for Croatia, Greece, Luxembourg and Hungary.*
Source: Own elaboration based on Carnot and Castro 2015.

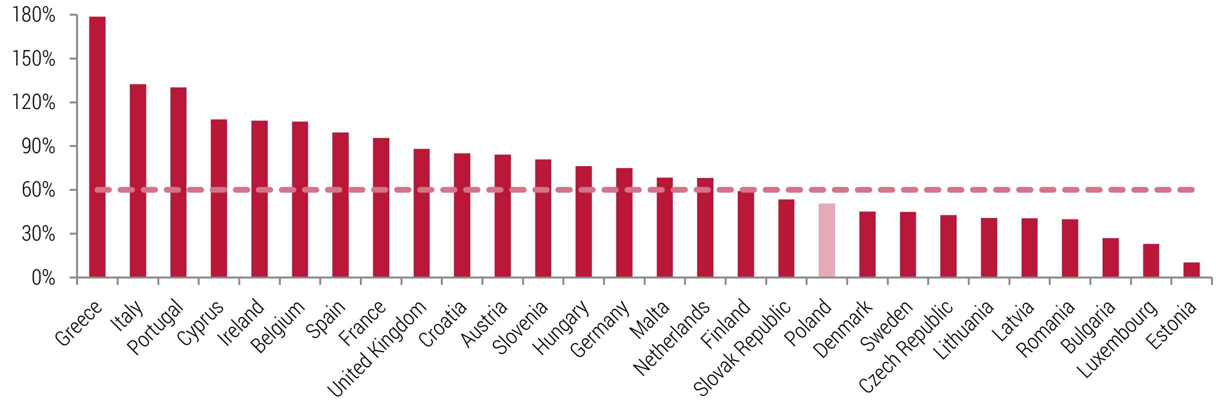
4.2. Evolution and composition of the public debt

As of the end of 2014, Poland was one of the 12 EU Member States whose public debt to GDP ratio was lower than the reference value of 60% of GDP defined in the Maastricht Treaty (chart 17). The states with relatively low public debt include Scandinavian countries, most Central and Eastern Europe countries and Luxembourg. Countries from Western and Southern Europe, especially Greece, Portugal and Italy, are characterised by high public debt (over 130% of GDP in each case). At the end of 2014, the public debt to GDP ratio exceeded 100% in 6 EU states.

In 2004-2014, an interesting phenomenon occurred in Polish economy. As indicated in the previous subchapter, the deficit of the public finance sector was higher than the average deficit in the EU Member States (in relation to GDP) in almost whole analysed period. However, high deficits did not translate into fast growth of the public debt to GDP ratio, as in the case of other EU states (chart 18). In 2014, the share of public debt in the Polish GDP was higher by 5.1 pp than in 2004. Only four EU states are characterised by a lower growth of this indicator. Even if the effects of the redemption of bonds of the Open Pension Fund are ignored, which resulted in a one-time reduction in the relation between general government debt and GDP by 8.6 pp of in 2014, Poland would still be one of the countries with the lowest growth of the debt to GDP ratio. On average, this indicator grew by 26.2 pp across the EU.

The main reason for a significantly smaller impact of the imbalance in the public finance sector on the growth of the public debt was the fast-paced increase in the Polish GDP. Good business outlook contributed to the fact that in some years, despite a deficit, the share of the public debt in GDP decreased (2007 and 2012), while in other years it grew significantly slower than the condition of the public finance sector would suggest (e.g. in 2009 the deficit was 7.3% of GDP, whereas the public debt grew by 3.2% of GDP). This phenomenon is well portrayed by comparing Poland and Italy – one of the states strongly affected by the global financial crisis. In 2007-2014, the deficit of the general government sector as a share of GDP in Italy was lower than in Poland in every single year. Nevertheless, the public debt in Poland increased in that period by 3.3% of GDP (or by approximately 12% of GDP after excluding transactions related to the bonds of the Open Pension Fund), whereas in Italy – by 29.8% of GDP.[13]

Chart 17. Public debt in the EU Member States in 2014 (as a percentage of GDP)



Source: Own elaboration based on Eurostat data

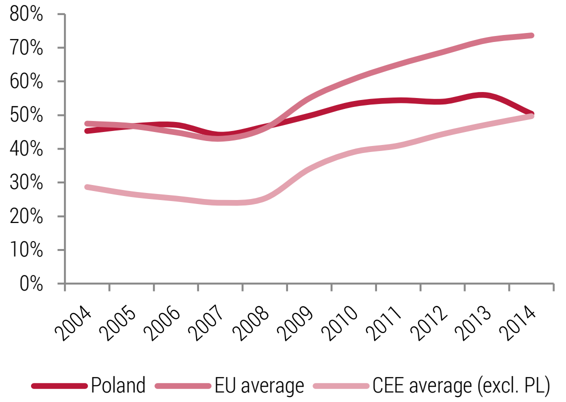
In 2004-2008, the share of the public debt in GDP in Poland was close to the EU average, yet higher than the CEE average by approximately 20 pp. The fast growth of the debt in relation to GDP in most EU states was associated with the financial crisis, in contrast to a much steadier growth of this indicator in Poland and additional effect of redemption of bonds of the Open Pension Fund. As a result, in 2014 the share of the debt in GDP in Poland was basically equal to the CEE average. In comparison to the average of all the EU Member States, the ratio between the public debt and GDP in Poland was 23 pp lower in 2014 (see chart 18).

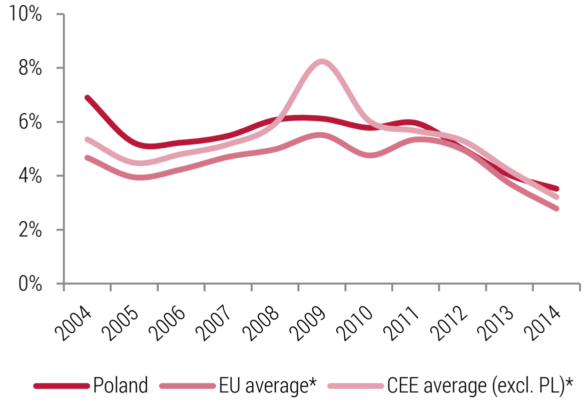
In 2004-2014, the Polish public debt was characterised by a slightly higher interest rate than the EU average. This is a feature of the entire Central and Eastern Europe – although these states are generally less indebted than the EU-15 states, their average interest rate for long-term government bonds is higher. This can be explained by higher interest rates determined by central banks (refers to the CEE states outside the Eurozone) as well as from lower financial market confidence concerning these states. The gap between the debt interest in Poland and the EU average has been decreasing. In 2004-2008, its average value was 1.3 pp, whereas in 2011-2014 it was only

[13] Changes in the amount of public debt in GDP are caused also by factors other than the deficit of the public finance sector and growth in GDP. Foreign exchange differences are the most essential factor. However, in 2004-2014 the impact of foreign exchange differences on the ratio between the public debt and GDP in Poland was both positive – e.g. a reduction of the public debt by 2.2% of GDP in 2004 and by 1.3% in 2012 – and negative – e.g. an increase in the public debt by 2.0% of GDP and 1.8% in 2011 (Ministry of Finance 2015, p. 63).

0.4 pp (1.3 and 0.8, respectively, after excluding Greece from the average). However, the long-term interest rate in Poland is still quite high. In 2014, only 6 EU states showed a higher interest rate (Cyprus, Greece, Croatia, Portugal, Romania and Hungary).

Chart 8. Public debt and its interest rate in the EU Member States in 2004-2014

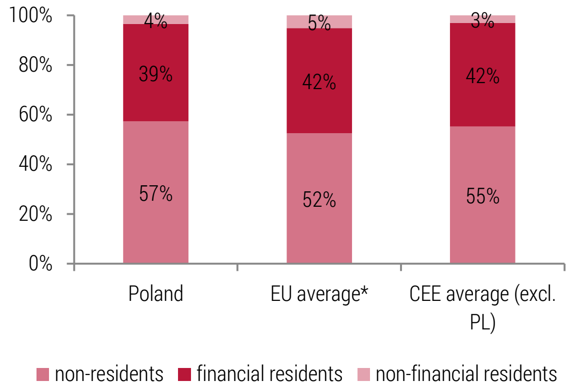


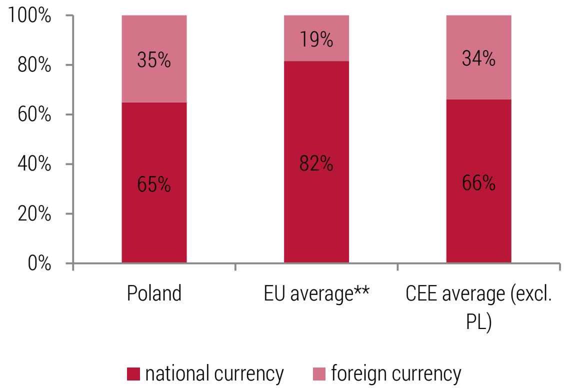


** No data for Estonia*

Source: Own elaboration based on Eurostat data.

Chart 19. Composition of public debt in the EU Member States in 2014 by creditor status (left chart) and currency (right chart)





** no data for Denmark, Greece and UK*

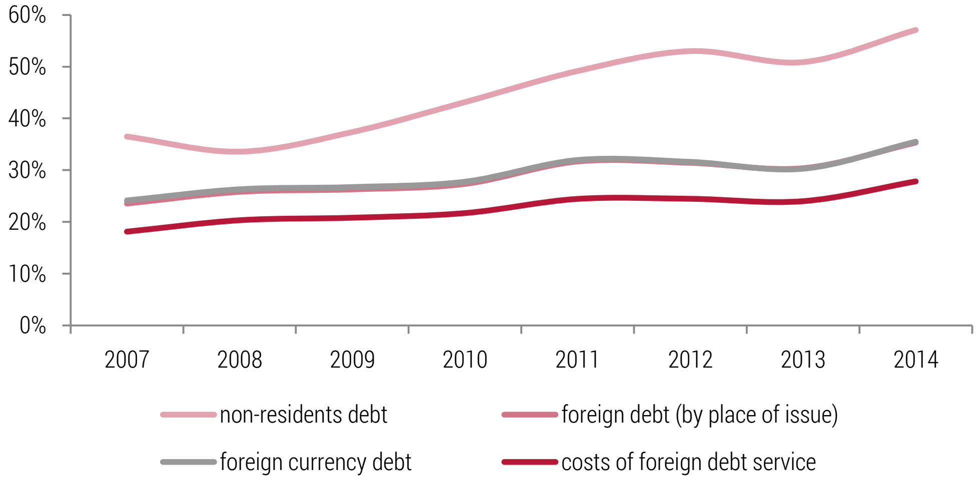
*** no data for Austria, Denmark, Finland, Greece, Sweden and UK*

Source: Own elaboration based on Eurostat data.

Poland and the other CEE states also differ from EU-15 in terms of debt composition by creditor status and currency (chart 19). In Central and Eastern Europe, the majority of public debt is held by non-residents. At the end of 2014, the share of non-residents in the Polish public debt was 57%. On average, this share in CEE reached 55%, whereas in the entire EU – 52%. Even larger differences can be observed in the currency mix. At the end of 2014, 35% of the Polish public debt was denominated in foreign currencies. The CEE average was 34%; however, large differences among the states from this region can be observed, due to the fact that some CEE states belong to the Eurozone. As of the end of 2014, the share of foreign currencies in the debt of the CEE states was 82% in Bulgaria and 79% in Croatia, whereas both in Estonia and Slovenia it stood at 0%. The EU-15 states make little use of the possibility to issue public debt in foreign currencies. In 2014, out of nine EU-15 states for which the Eurostat data was available in only one was the share of foreign currencies in public debt above 10% (Portugal – 14%).

The importance of external financing in public debt in Poland increased significantly as compared with the years preceding the global financial crisis (chart 20). The nominal value of Polish public debt held by foreign investors grew from PLN 200.7 billion (end of 2008) to PLN 445.5 billion (end of 2012), i.e. by almost 2.5 times in just 4 years. The increase in the involvement of foreign investors in this period by PLN 244.8 billion was almost equal to the growth of the entire public debt (growth by PLN 242.7). In the meantime, domestic entities (both banking and non-banking sector) basically did not change their involvement in Polish public debt (in nominal terms). The share of external financing in Polish public debt increased also in 2014, which largely resulted from the redemption of bonds of the Open Pension Fund. The share of domestic non-banking sector (to which the Open Pension Funds belong) in the composition of the state public debt dropped from 29% (end of 2013) to 16% (end of 2014). As a result, we saw the growth of the share of the domestic banking sector (from 20% to 27%) and foreign investors (from 51% to 57%).

Chart 20. Share of external financing in public debt in Poland in 2004-2014



Source: Own elaboration based on data of the Ministry of Finance.

The increase in the share of foreign debt and the role of foreign investors in Polish debt financing resulted in a decrease in the average debt interest rate and extension of the average maturity date. However, it should be noted that apart from the positive effects, there are also certain threats. First of all, it leads to an increase in the share of foreign currencies in public debt, which exposes Polish public finance to foreign exchange risk. The share of foreign currencies in the public debt in Poland increased from 24.1% in 2007 to 35.5% in 2014. Second of all, foreign investors are considered a less stable source of financing than domestic investors. In crisis situations, they withdraw their capital much faster from a given country, worsening its problems (Sawulski 2016). The risk related to external debt financing is broadly described in literature. In Eichengreen et al. (2003, p. 3), the inability of developing states to raise debt on foreign markets in their own currencies is described as the “original sin”. An empirical analysis carried out by Bordo et al. (2009, p. 29 and 30) shows that countries with a high share of foreign currencies in their debt are more prone to financial crises. Panizza (2008, p. 10) and Rajan (2012, p. 128-130) describe the consequences of refusal to refinance debt by foreign markets in crisis situations. Gray and Woo (2000, p. 21) show that a particularly careful approach is required when a debt-issuing government starts to largely rely on foreign markets on the strength of lower financing costs only.

5. Analysis of the state budget for 2016[14]

5.1. Macroeconomic assumptions

When designing the 2016 state budget, a GDP growth rate of 3.8% was assumed (vs. 3.8% forecasted for 2015) and domestic demand was indicated as the main growth factor. The rate of investment increase in real terms is to be 7.0% and the increase in total consumption (private and public) should reach 3.2%. The government assumes a 6.0% growth in export, while, after consideration of the import increase rate, the net export contribution to GDP will be -0.3 percent. 2016 should be the year when Polish economy moves out of deflation. The budget assumptions estimate the price growth rate at 1.7%. It was also assumed that NBP interest rates would remain at an unchanged level and that the zloty would strengthen against the two major currencies – the dollar and the euro. The 2015 situation on the labour market should also prevail in 2016. The unemployment rate is expected to remain at a level slightly below 10%, while employment and wages will continue to rise at a relatively good pace.

The outlook for the Polish economy in 2016 is moderately good. If no unforeseen scenarios occur the economy will develop at a similar pace as in 2015; inflation will return after two years of deflation and a continuation of positive trends on the labour market may be anticipated. In this situation, one would expect a moderate fiscal policy, with a tendency to decrease the public finance sector deficit. Meanwhile, a significant increase in budget spending and budget deficit is planned for 2016.

5.2. Budget revenue

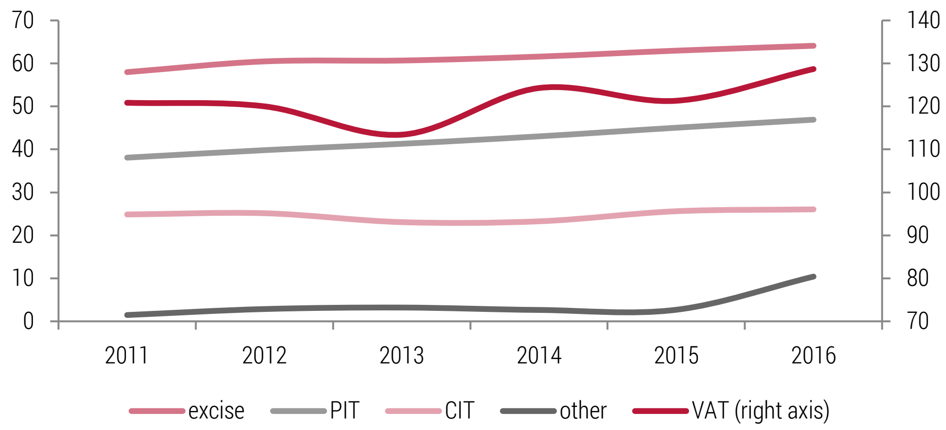
The state budget revenue has not fluctuated significantly since 2011, remaining within the bracket of PLN 275-290 bn. According to the draft budget for 2016, the revenue is to rise significantly. The government assumes a revenue of PLN 313.8 bn, i.e. an increase of PLN 27.1 bn (nearly 10%) in comparison to 2015. The tax revenue is to account for PLN 276.1 bn (88.8%) of the total revenue and the remaining PLN 37.7 bn (12.0%) is to be derived from non-tax revenue and EU funds. The planned increase in public revenue in 2016 is primarily a consequence of three new revenue categories that were absent in 2014 and 2015: new sectoral taxes (bank tax and tax from large stores), dividend from the NBP profit and the LTE frequency auction, which are to bring total receipts of PLN 19.9 bn (PLN 7.5 bn, 3.2 bn and 9.2 bn, respectively). After excluding these three categories the forecasted budget

[14] This part of the study concentrates only on the state budget, which constitutes about 40-50% of whole public sector in Poland.

revenue would be equal to PLN 293.9 bn, i.e. 2.5% higher than in 2015. This forecast should be judged as moderate (in 2014 the revenue rose by 1.6%, and in 2015 - by 1.1%), however it carries certain risks.

As indicated in Chart 21, in recent years it has been particularly difficult to forecast VAT receipts, which are subject to rather irregular fluctuations. In 2015, they probably achieved nearly the same level as in 2011 and 2012. However, the government has assumed an increase of these receipts by 6.1% compared to 2015, based on a high rate of private consumer spending growth forecast (nominal increase by 5.5%), hardly realistic inflation projection and, as stated in the draft budget, a forecast indicating "positive impact of actions increasing compliance with tax regulations and improving the effectiveness of tax administration". This quote rightly indicates that the low effectiveness of tax administration in collecting this tax was a significant factor in stagnant levels of VAT revenue in the last years. However, it is difficult to estimate the extent to which it is possible to achieve results in this area as soon as in 2016. One may also have doubts as to whether it is justified to assume that the growth of VAT receipts in 2016 will be higher than the rate of consumption.

Chart 9. Tax revenue of the state budget in 2011-2016* (in PLN bn)



** year 2015 – according to the amended Budget Act; year 2016 –according to the draft State Budget Act of 21 December 2015.*
Source: Own elaboration based on the data of the Ministry of Finance.

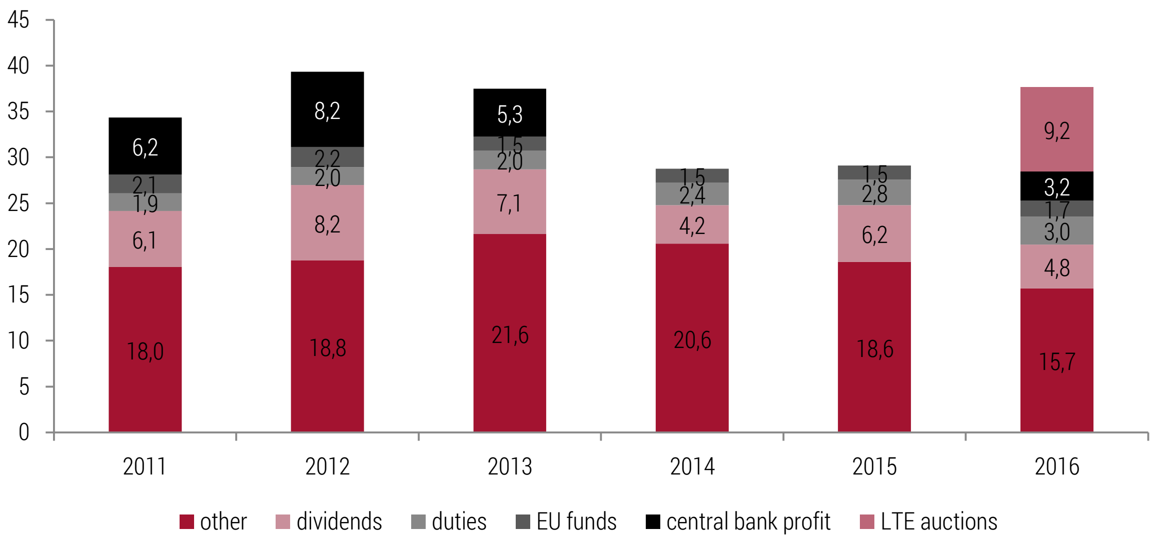
Since 2011, receipts from the excise duty and personal income tax, which are the next two largest taxes in terms of budget revenue generation, have shown stable growth. Considering that nearly no changes were made to regulations concerning these taxes, a continuation of this trend was validly assumed in the state budget for 2016. The revenue from the excise duty is to increase by 1.8% (PLN 1.1 bn) as compared to 2015, against an increase of 2.2% in 2004 and of 1.5% in 2013. The PIT revenue is forecast to be 4.1% (PLN 1.9 bn) higher than in 2015, which can be explained by the increase in receipts from this tax recorded over 2012-2015 (4.3% on average). As the tax threshold levels, tax-free allowance and most regulations on tax reliefs and exemptions will stay unchanged, there should be a visible effect on the effective tax rate as compared to previous years. It is worth remembering that the indicated parameters, apart from certain small issues, have not changed since 2009. An increase in PIT revenue in 2016 will also be fostered by a good situation on the labour market – budget assumptions include a 3.6% nominal average increase in wages and a 0.8% employment increase. For 2016, it is in the corporate income tax that the budget revenue increase in percentage terms as compared to 2015 is forecast to be the smallest. The Council of Ministers assumed that budget revenue from CIT would increase by 1.7%, i.e. by PLN 0.4

bn. This prudent forecast is due to the fact that in the case of the CIT, similarly to the VAT, more and more problems are appearing with tax collection.

A relatively high non-tax revenue is also planned in the 2016 budget. It is to increase by as much as 30.4% with respect to 2015, up to PLN 35.9 bn (Chart 22). However, two new items appear in this category that were absent in 2014 and 2015. These are the revenue from LTE frequency auction (PLN 9.2 bn) and the dividend from the NBP profit (PLN 3.2 bn). Without these items, the non-tax revenue would be lower than in 2014 and 2015. Other forecast items draw attention, such as the lower "other non-tax revenue" (excluding LTE frequency auction), which includes receipts from various fees (e.g. court fees and fees for concessions and licences), fines and financial penalties as well as revenue from the sale of greenhouse gas emission allowances.

The revenue from LTE frequency auctions are one-off receipts from fees that auction participants declare to pay for the reservation of frequencies within the 800 and 2600 MHz range. The corresponding revenue was already included in the draft state budget act in 2015 (in the amount of PLN 1.8 bn). However, the new government moved the whole amount to the year 2016, explaining that this is due to prolonged procedures connected with the auction. The revenue from the LTE frequency auction must be treated as a one-off revenue for the state finance that will not be repeated on such a scale in the future. This may be a significant factor deteriorating the budget situation in 2017 versus 2016.

Chart 10. Non-tax revenue of the state budget in 2011-2016* (in PLN bn)



** year 2015 – according to the amended State Budget Act; year 2016 – according to the draft State Budget Act of 21 December 2015.*
Source: Own elaboration based on the data of the Ministry of Finance.

Including the dividend from the NBP profit in the budget by the Council of Ministers was a surprise. Until now, this item had not been included in the budget; such receipts, if any, were considered as extra revenue. This should however be judged as the right direction – all revenues whose achievement is highly probable should be included in the state budget. It must be underlined that the forecast amount of dividend from the NBP profit was prepared on the basis of the NBP's financial result in the first semester 2015. The actual payment will be over two times higher and will amount to approximately PLN 8 bn. This significantly decreases the risk of non-execution of the total state budget revenue planned for 2016.

5.3. Budget expenditure

The draft state budget for 2016 provides for a clear increase in expenses – up to PLN 368.5 bn. This is 9% (PLN 31.8 bn) more than in 2015 and as much as 18% (PLN 56.0 bn) more than in 2014. The share of state budget expenditure in GDP will be equal to 19.5% in 2016, versus 18.7% in 2015 and 18.8% in 2014. A major part of this increase is due to the fact that social promises made during the Law and Justice party electoral campaign are included in the state budget act. However, it must be underlined that the draft state budget approved by the previous PO-PSL Council of Ministers in September 2015 was not particularly frugal either. It assumed expenses in the amount of PLN 351.5 bn, i.e. exceeding the forecast execution level for 2015 by PLN 14.8 bn (4.4%) and the 2014 actual execution by PLN 39.0 (12.5%). Such a rise in public spending between 2014 and 2016 is not justified since during a significant part of this period the economy has been in deflation and the rate of economic growth does not require additional stimulation through increased public spending.

It is noteworthy that the significant increase in spending has not been halted by the stabilising expenditure rule stated in the Public Finance Act in 2013. Shortly upon taking office, the Law and Justice party voted an amendment to the Act, introducing changes leading to an increased limit of public spending in 2016 (among others by making the rule dependent on the NBP inflation target and not on the current inflation rate). Thanks to this amendment, the public spending limit for 2016 increased from PLN z 715.3 bn to PLN 728.5 bn.[15] This measure shows that introducing any fiscal policy restrictions through legislative acts, without broader guarantees ensuring the durability of such rules (e.g. constitutional guarantees) does not make much sense in Poland. A similar situation occurred in 2013, when the Parliament suspended first of the public debt limits due to the risk of breaking the rules set out in the Public Finance Act.

The new Council of Ministers supplemented the spending lines of the draft budget act prepared by the PO-PSL coalition by adding the "Family 500+" programme, free medicines for people over 75 and increased farming fuel subsidies, without removing any significant items adopted by the previous government. This moved up the expenditure limit by PLN 17.0 bn, the major component being the cost of child benefits in the amount of PLN 500 per child.[16] The "Family 500+" programme will bring a significant increase in the scale of support provided by the Polish state to families with children. Until now, relatively small amounts have been allocated to this purpose (see Chart 11). The problem is that there are no stable sources of financing earmarked in the budget for this increased state expenditure. In 2016, over one half of this programme will be financed through a one-time receipt from the LTE frequency auction. According to the Ministry of Finance, in the coming years additional revenue is to be derived mainly from tightening the tax system. However, the measurable results of these announcements are difficult to estimate. It seems that finding sources of financing through limiting state budget spending in specific areas would be a safer solution.

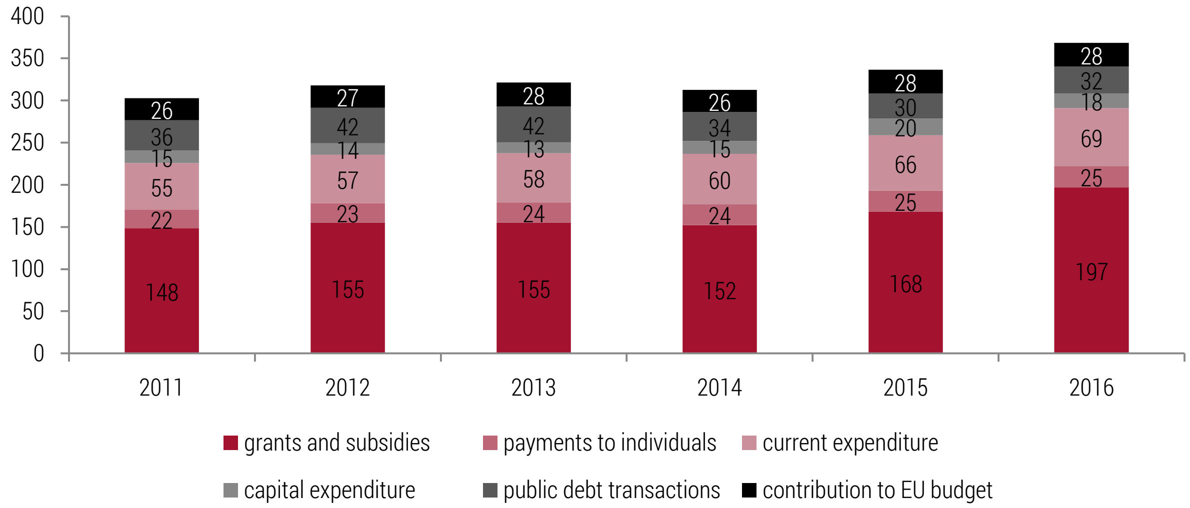
Grants and subsidies represent a dominating share of the state budget expenditure (Chart 23). This is due to the special role played by the budget in the public finance sector, which consists on the one hand in directly financing the state's basic tasks in areas such as national defence, government administration or the judiciary, and, on the

[15] This limit covers a broader scope of public spending than state budget expenditure only.

[16] As a general rule, starting from the second child; starting from the second in families with a disposable income per capita lower than PLN 800 (or PLN 1200 in the case of families with a disabled child).

other hand, in shaping the financial situation of most public sector entities through a system of internal cash flows. In the 2016 Budget Act, the share of grants and subsidies in state expenditure increases significantly from 48-50% in the years 2011-2015 to 53% in 2016. In consequence, the increase in budget expenditure in 2016 compared to 2015 will be almost entirely executed through grants and subsidies, whose value will increase by PLN 28.8 bn. Table 2 presents the details of major state budget grants and subsidies to other public finance sector entities. In 2016, the sum of budget expenditure will increase under all the indicated headings in comparison to previous years, including a particularly clear (nearly twofold) increase in the category of grants to local government units. This growth is the effect of increased grants for financing and co-financing social assistance tasks as in this item the funds for benefits under the "Family 500+" programme are stored (local governments will be in charge of paying out the benefits).

Chart 11. State budget expenditure in 2011-2016* by economic aggregates (in PLN bn)



** year 2015 – according to the amended State Budget Act; year 2016 – according to the draft State Budget Act of 21 December 2015.*
Source: Own elaboration based on the data of the Ministry of Finance.

2016 will also be yet another year of increased grants for the Social Insurance Fund (FUS) and to funds operating within the framework of the Agricultural Social Insurance Fund (KRUS). The growth of the FUS grant year after year arouses concern as since 2009 many measures have been taken to curb it, including granting the FUS interest-free loans from the state budget, using funds from the Demographic Reserve Fund, gradually raising the retirement age and implementing the so-called "safety slider" pension mechanism. These measures caused the budget grant to the FUS to decrease in 2014 to approximately PLN 30 bn, however in 2016 it will be again nearly 50% higher, totalling PLN 44.8 bn. It has not been possible to permanently solve the problem of self-financing deficit in the FUS. According to the plan for 2016, the grant and the loan from the state budget will make up nearly one fourth (24.3%) of the FUS revenue. Due to Poland's deteriorating demographic situation, there are no perspectives for this imbalance to be redressed, particularly as the new government has announced a return to the previous retirement age. The condition of the pension fund (FER) operating within the KRUS is even more difficult. In 2016, as much as 92% of the revenue of this fund is to come from a state budget grant, which will amount to PLN 17.8 bn. When summing up the FUS and FER grants with the expenses incurred for pension benefits of the uniformed services as well as those of judges and prosecutors (financed directly from the state budget), which are to reach PLN 16.7 bn, we will find that the state budget imbalance is in a certain sense the result of the pension system being co-financed by the state budget. This situation requires systemic solutions, consisting at least in the liquidation of retirement pension privileges and perhaps also a more in-depth reorganisation of the social insurance system.

Table 1. Selected state budget grants in 2013-2016* (in PLN millions)

title	2013	2014	2015	2016
subsidy to local government units	51,257	51,204	51,460	53,043
of which: educational subsidy	39,509	39,500	40,377	41,497
grant to local government units	23,539	25,308	17,499	33,693
FUS grant	37,114	30,363	42,066	44,848
FUS loan**	12,000	8,924	5,524	4,917
KRUS grant	15,853	16,096	17,041	17,780
grant to public higher education institutions	12,070	13,229	13,246	14,405

** year 2015 – according to the draft State Budget Act of September 2015; year 2016 – according to the draft State Budget Act of 21 December 2015.*

** Formally, the FUS loan to is classified as a budget outflow and not as an expense, however in practice it should be threaten as an expense.

Source: Own elaboration based on the data of the Ministry of Finance.

Table 2. State budget expenditure in 2013-2016* by function (in PLN millions)

details	2013	2014	2015	2016	2016 (2013=100)	2016 (2014=100)	2016 (2015=100)
Sundry payments	71,165	70,381	89,897	96,259	135%	137%	107%
Social security	74,793	69,149	82,151	86,658	116%	125%	105%
Public debt service	42,460	34,456	29,752	31,800	75%	92%	107%
Social assistance	14,251	14,475	12,409	28,776	202%	199%	232%
Defence	20,137	23,352	30,133	28,358	141%	121%	94%
Higher education	13,203	14,390	14,391	15,401	117%	107%	107%
Other	17,232	19,362	15,160	15,228	88%	79%	100%
Public safety	13,561	13,721	13,454	14,018	103%	102%	104%
Public administration	12,737	12,641	12,601	13,219	104%	105%	105%
Judiciary	10,471	10,841	11,030	11,645	111%	107%	106%
Transport and communications	8,996	8,774	8,464	9,629	107%	110%	114%
Health care	7,534	7,358	6,848	7,189	95%	98%	105%
Science	4,791	5,002	5,236	5,587	117%	112%	107%
Agriculture and hunting	10,014	8,617	5,154	4,762	48%	55%	92%
Total	**321,345**	**312,520**	**336,680**	**368,529**	**115%**	**118%**	**109%**

** year 2015 – according to the amendment to the State Budget Act; year 2016 – according to the amendment to the draft State Budget Act.*

Source: Own elaboration based on the data of the Ministry of Finance.

Mandatory social insurance (grant to FUS, FER and retirement benefits) represents the second largest category of state budget expenditures classified by functions (Table 3). The largest function are sundry payments, composed mainly of the general subsidy to local government units (PLN 53.0 bn) and the contribution to the European Union budget (PLN 19.2 bn). In 2016, the most significant increase in the ranking by function will be recorded in social assistance, where the expenditure will double in comparison to 2013 as a result of the implementation of the "Family 500+" programme. In 2016, the national defence spending will be slightly lower than in 2015. However, this is due to the fact that in 2015 PLN 5.4 bn were allocated to deferred payments for F-16 planes. When comparing the year 2016 to 2013 or 2014, a significant increase is visible in expenditure for that purpose, mainly due to increased outlays for the purchase of weapons and military equipment (according to the plan for 2016, capital expenditure in the "National Defence" chapter of the budget will amount to PLN 10.2 bn whereas in 2013 and 2014 they equalled PLN 6.1 bn and PLN 8.2 bn, respectively).

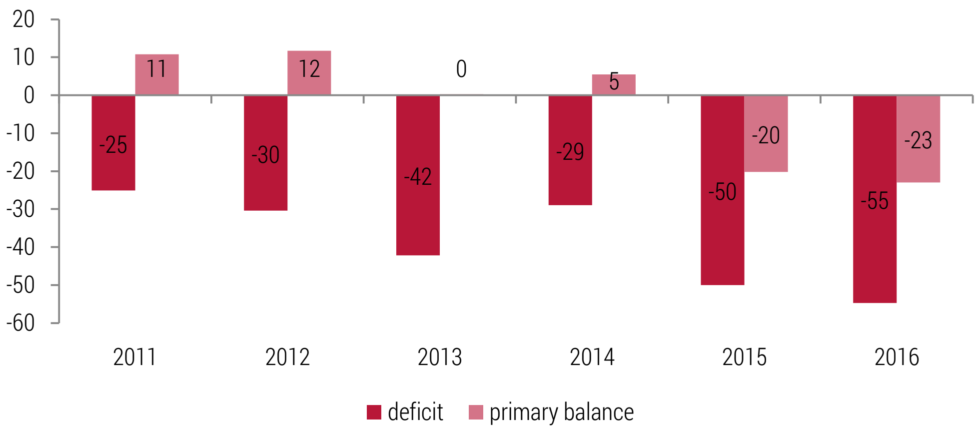
It is also worth indicating the categories of expenditure where savings have been made in recent years. In comparison to 2013 and 2014, budget spending in 2016 will be visibly lower in agriculture and servicing of the public debt. A decrease in the first category is mainly due to lower budget spending on co-financing programmes involving EU funds, implemented by the Agency for Restructuring and Modernisation of Agriculture (mainly the Rural Development Programme and the Common Agricultural Policy – pillar I). In 2013, the budget spending for that purpose attained PLN 5.0 bn, whereas in 2016 it is to reach only PLN 1.2 bn. Lower costs of debt servicing come as a consequence of decreasing yields of Polish bonds on the financial markets and the redemption of OFE bonds in 2014. In total, the decrease of expenditure in agriculture and public debt servicing will lead to budget savings of PLN 15.9 bn (in comparison to 2013). These funds would therefore be sufficient to cover the expenditure connected with the "Family 500+" programme. However, in 2015 and 2016 savings from those two categories were used for increasing expenditure in almost all other budget lines, and not for new social programmes or for decreasing the budget deficit.

5.4. State budget deficit and public debt projection

The state budget deficit planned for 2016 is relatively high. According to the draft Budget Act, it will amount to PLN 54.7 bn, i.e. 9.5% more than in 2015 and nearly twice as much as in 2014. An almost identical deficit (PLN 54.6 bn) was already planned in the draft budget of September 2015. The amendments made by the Law and Justice government to the previous draft symmetrically increased both the budget revenues and expenses, without significantly changing the forecast balance. Chart 24 shows the evolution of the state budget deficit and its primary balance in the years 2011-2016. The primary balance is the difference between the state budget revenue and the state budget expenditure decreased by debt servicing costs. Therefore, it helps to visualise how the budget balance would evolve if the state had no public debt. As shown in the chart, a positive budget primary balance was maintained in the years 2011-2014, whereas 2015 and 2016 marked a sharp increase in the primary deficit – up to the level of PLN 20.2 bn and PLN 22.9 bn, respectively. Interestingly, the budget lexicon published on the website of the Parliament of the Republic of Poland suggests that: "the occurrence of a primary deficit signals that the safety limit has been overstepped as far as public debt is concerned and points to a threat of public finance crisis" (Budget Lexicon 2015).

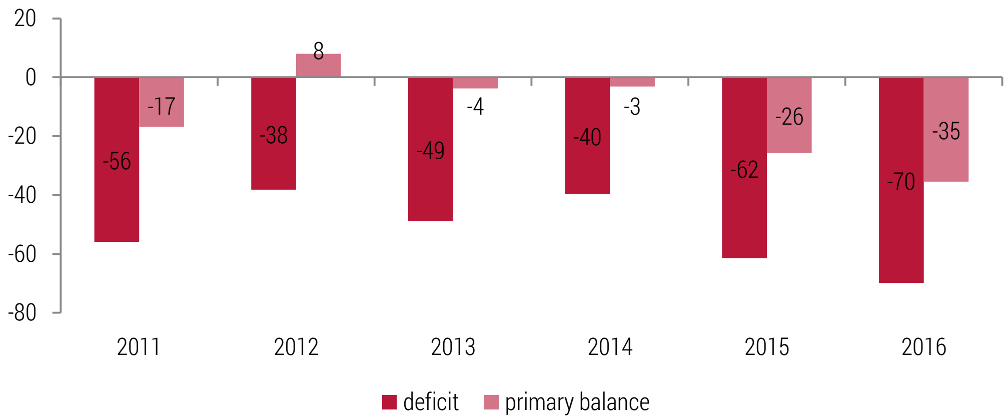
Such a high budget deficit for 2016 should be judged critically, particularly in view of the changes, that have taken place in Polish public finance over the last few years (as described in the previous subchapters), and which should contribute to an improvement of the budget balance. The reforms of the pension system carried out in the previous years, relatively low costs of servicing the public debt and decreasing spending on co-financing programmes for the modernisation of Polish rural areas should serve the purpose of reduction in public expenses in 2016. Moreover, the 2016 revenues are exceptionally boosted by receipts from the LTE frequency auction and dividends from the NBP profit. However, these changes did not cause the budget deficit to decrease, on the contrary, it has escalated. The budget imbalance in 2016 should not be associated solely with the increase in public assistance benefits linked to the implementation of the "Family 500+" programme. It is more the result of the profligacy of public authorities in spending public funds in almost all the sectors of state activity, combined with weakness of the tax administration in tax collection, mainly with regard to the VAT and the CIT.

Chart 24. The state budget deficit and primary balance in 2011-2016* (in PLN bn)



** year 2015 – according to the amendment to the State Budget Act; year 2016 – according to draft State Budget Act of 21 December 2015.*
Source: Own elaboration based on the data of the Ministry of Finance.

Chart 25. The public finance sector deficit and primary balance in 2011-2016* (in PLN bn)

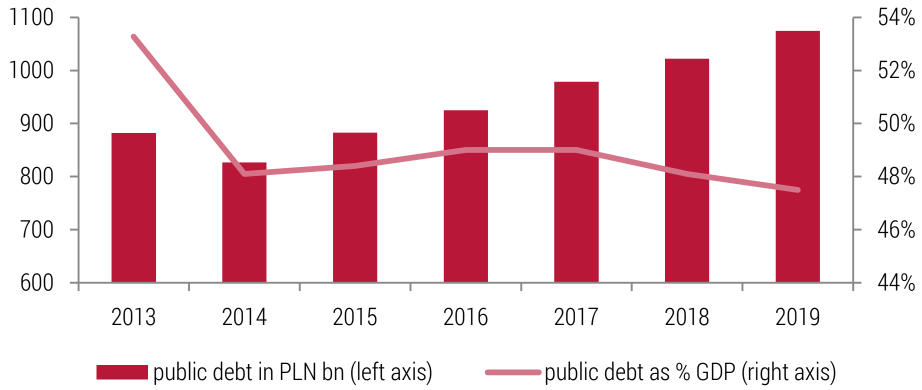


** year 2015 – according to the amendment to the State Budget Act; year 2016 – according to draft State Budget Act of 21 December 2015.*
Source: Own elaboration based on the data of the Ministry of Finance.

When analysing the condition of public finance in Poland, one should not ignore the fact that the state budget represents only a part of the public finance sector. According to the plan included in the explanatory statement to the State Budget Act, the 2016 revenue of the entire public sector will be equal PLN 711.7 bn, the expenditure – PLN 781.6 bn and the deficit will be PLN 69.9 bn. A higher public finance sector deficit in Poland was recorded only once – in 2010 (PLN 85.1 bn). Chart 25 presents the public sector deficit and the public sector primary balance in the years 2011-2016. The primary balance of the sector lies below the state budget balance because a significant part of the sector's deficit is usually formed outside the state budget (this is particularly visible in 2011) whilst the costs of servicing the public debt are predominantly carried by the central budget. However, the conclusions are similar to those concerning the primary state budget deficit: after a few years of a relative equilibrium of the public sector primary balance, there was a significant change to primary deficit growth in 2015 and 2016. Despite this, the Ministry of Finance forecasts that the public finance sector deficit to GDP ratio (according to the EU methodology) will be equal to 2.8% in 2016, below the reference value of 3% set by the European Commission. However, this forecast was established based on the assumption that the expenditure of the sector as laid down in the State Budget Act for 2016 is treated as a maximum limit and its final execution will lie below that level.

The permanent imbalance of Polish public finances drives a growing public debt. Chart 26 shows the public debt forecast for the years 2015-2019. According to the plan adopted by the Council of Ministers, until 2019 the ratio between the public debt and GDP should be stable and keep within the bracket of 47.5% to 49.0% of GDP. However, these forecasts should be approached with some caution as the strategies adopted in previous years have not always been put into practice (for example those strategies did not assume the necessity of using funds collected in OFE in order to avoid overstepping the second public debt limit in 2014). Poland's official public debt is forecast to exceed the amount of PLN 1000 billion as soon as in 2018. Moreover, according to the Ministry of Finance forecast updated in December 2015, the nominal value of the public debt at the end of 2015 achieved the same level as that recorded at the end of 2013. The transaction of redeeming OFE bonds took place in the first quarter of 2014. This means that at the current pace of incurring debt less than two years were enough for Polish public finance to consume the sum of PLN 130.2 bn that had been collected by citizens in the OFE during 14 years. This fact is the best illustration of the scale of imbalance in the Polish public finance. The 2016 budget does not solve this problem in any way and even contributes to its exacerbation.

Chart 26. Public debt in 2013-2015 and forecast for 2016-2019 (in PLN bn and as a percentage of GDP)



Source: Own elaboration based on the data of the Ministry of Finance.

Summary

In the period 2004-2014, Poland's fiscal policy was conducted under specific circumstances. Firstly, Poland was the only EU country that was not hit by the recession in 2009 and GDP growth rate during the whole analysed period was one of the highest in the EU. Secondly, the condition of public finance was determined by significant infrastructural investment projects with inflowing financial aid from the EU and preparations for the EURO 2012. Due to those drivers, Poland on the one hand exhibited a relatively high general government sector deficit over that period (especially in 2010 and 2011), but, on the other hand, a fast GDP growth protected the country from the escalation of problems associated with this imbalance and from the increase of public debt.

Maintaining public finance stability may be one of the main challenges facing the Polish economic policy in the next few years. This topic was addressed many times during the electoral campaign in 2015, when the winning party made many promises that seem to be unfeasible from the public finance perspective. The new government's optimistic approach regarding the possibility of keeping these promises is based on the assumption of high GDP growth in the coming years and a significant improvement in tax collection. However, both of these factors are subject to a high degree of uncertainty.

The analyses carried out in this study have allowed us to formulate the following conclusions:

- The level of fiscalism in Poland is lower than the EU average, but it does not depart significantly from the average rate in the CEE countries. The Polish public finance demonstrated non-standard behaviour during the global financial crisis. The share of public expenditure in GDP increased much less than in other EU and OECD countries, but at the same time there was a significant fall in the public revenue to GDP ratio (by 3.3% pp in 2009 against 2007).
- Public revenue in Poland is characterised by a high share of social insurance contributions, particularly contributions paid by self-employed individuals. Since 2009, a plunge in revenues is visible in the Polish public finance, significantly impacted by the deteriorating levels of VAT and CIT collection. The significance of non-refundable aid from the EU, whose share in public finance revenue in 2012-2014 was approximately 10%, is on the rise. Poland distinguishes itself from other countries by close to linear labour taxation.
- The public spending mix in Poland is characterised by a high share of social protection expenditure, primarily composed of pension expenditure and benefits for families of deceased persons. Relatively high public spending is allocated to education, mainly higher education, and to national defence. Categories on which relatively small amounts are spent include: health care, where a low level of investments is particularly visible, and the general public services (public administration and public debt service).
- Between 2004 and 2014, the share of public expenditure on social transfers in GDP in Poland recorded the greatest decline among all the EU countries – by 1.8 pp. In the same period, the level of public expenditure on investments almost doubled (in relation to GDP), including mainly investments in transport infrastructure.
- During nearly the entire analysed period (2004-2014), the deficit of the general government sector in Poland was higher than both the EU average and the average in the CEE countries. The Polish fiscal policy is characterised by a large significance of discretionary measures taken by public authorities and a relatively small impact of the cyclical component on public sector balance. Since 2009, the structural deficit in Poland is significantly higher than the EU and CEE average.

- After 2008, the relatively high imbalance of the public sector in Poland did not transpose into as rapid increase of the public debt to GDP ratio as it was the case in most EU countries. The main driver helping to keep the public debt in Poland under control was the relatively high GDP growth rate.
- The share of external financing in Polish public debt increased significantly as compared with the years preceding the global financial crisis. The share of foreign investors increased from 34% in 2007 to 57% in 2014, and the share of foreign currencies expanded from 24% to 36%. This evolution was one of the factors driving down the public debt interest rates and extension of debt maturity. However, it also makes public finance more vulnerable to debt crisis due to an increased foreign exchange risk and less stable sources of financing.
- In 2016, a number factors will arise in Polish public finance that could contribute to decreasing the scale of the state budget imbalance: a good economic outlook, non-standard sources of revenue, changes in the pension system implemented in previous years, decrease in expenditure on Polish agriculture modernisation and falling costs of public debt servicing. The 2016 budget does not make use of these opportunities. The adopted Act provides for high deficit, including an extraordinary high primary deficit.

The diagnosis and conclusions presented in this study may be a starting point (or a supplement) of public debate on reforms in several areas, including: limitation or liquidation of reduced VAT rates, increasing progressiveness of the tax wedge, changes in the system of social protection in case of relatives death, increasing economic activity of people aged 50+, limitation of social transfers to elderly people other than those under vested rights, rationalisation of the number of students on certain faculties and sub-participation of young people in the cost of higher education, increasing capital expenditure in health care, changes in the public debt structure in terms of funding sources and currencies. In this context it must be underlined, that measures taken in the coming years in the area of fiscal policy should take into account the necessity of limiting the relatively high structural deficit of the Polish public finance.

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