



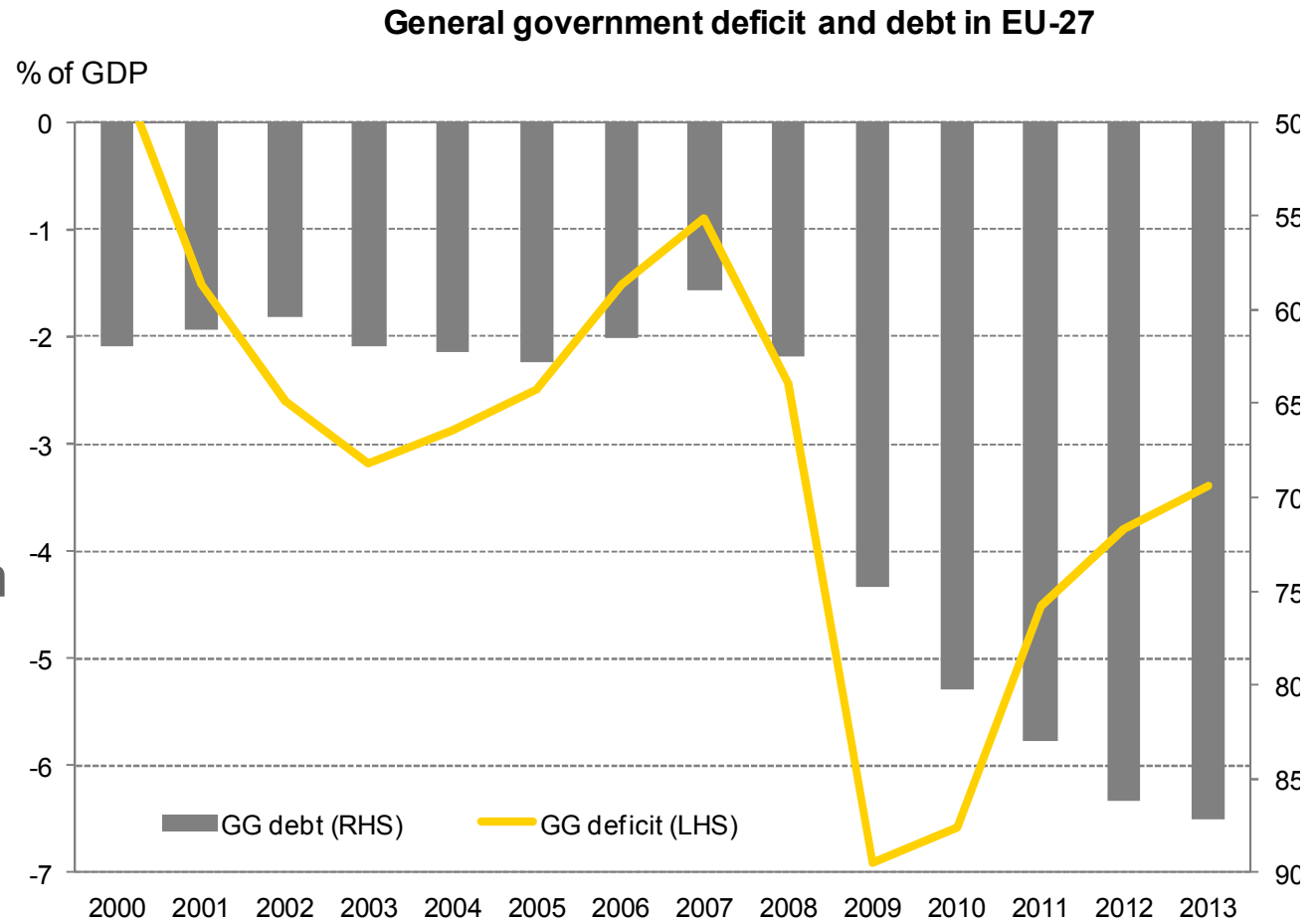
Marek Rozkrut

**Economic governance reform and fiscal rules –
challenges for Poland**

Conference on Economic Governance
in the EU/euro area – What lessons for Poland?
5th July 2012, Warsaw

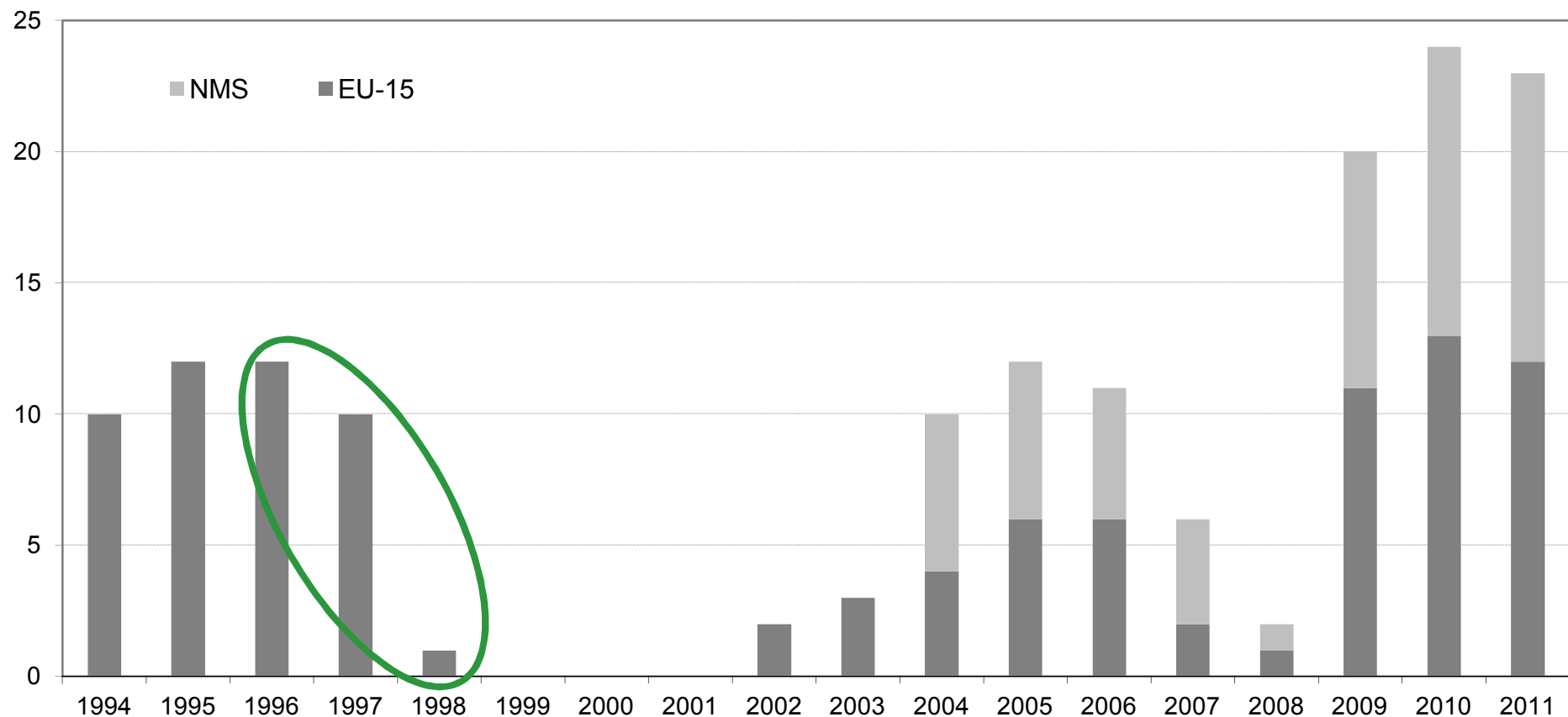
The crisis has revealed, too often overlooked, structural imbalances that led to the ongoing debt crisis

- ▶ MTOs often seem to have been met only due to overestimated structural revenues, stemming from unsustainable macroeconomic imbalances: recall “structural” surpluses in Spain and Ireland, driven, i.a., by housing booms



Fiscal criterion exerting discipline on candidate countries before joining the euro-area (even in economic bad times)

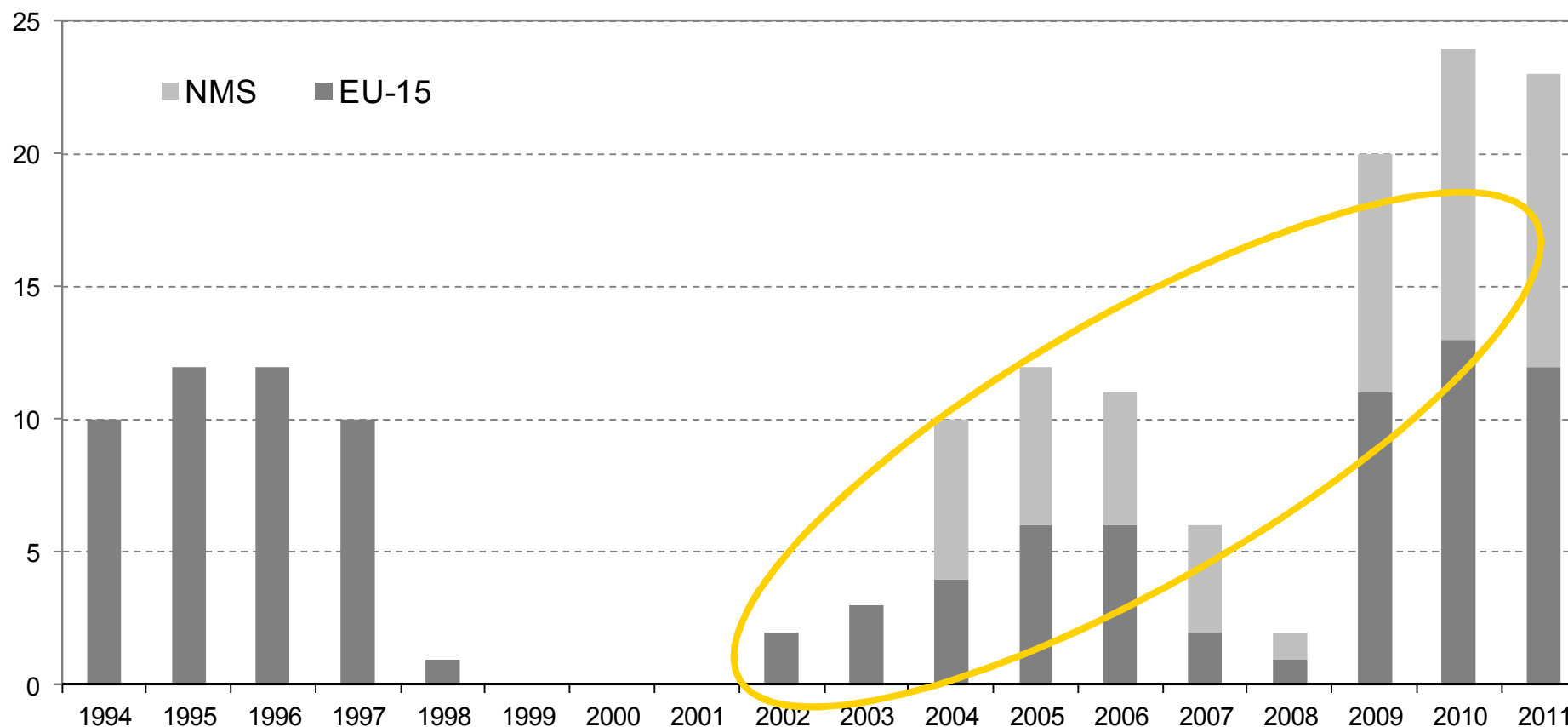
Number of countries subject to Excessive Deficit Procedure



Source: European Commission

But the rules have turned out to be effective in the short-term only ... – no more “carrot” and no real “stick”

Number of countries subject to Excessive Deficit Procedure



Source: European Commission

The crisis has revealed institutional weaknesses in the EU and the need of economic governance reform

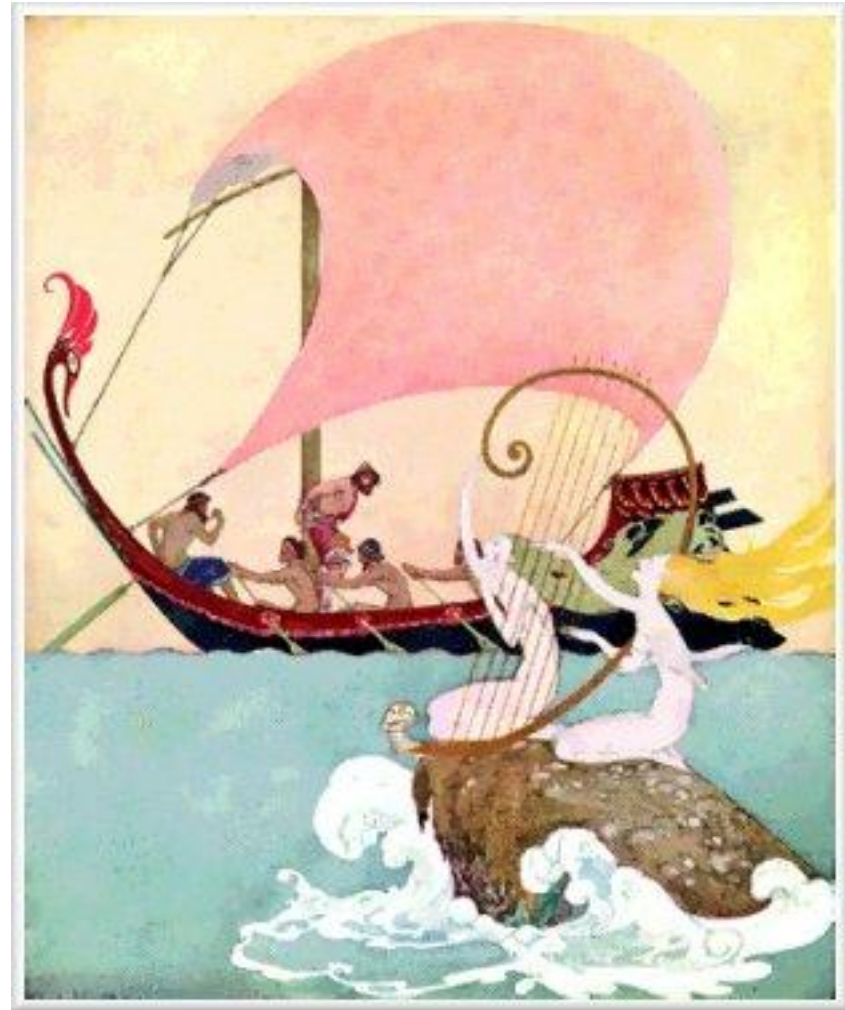
- ▶ Six-Pack, Two-Pack, International Treaty (incl. Fiscal Compact), ... – discussed in the European Commission's presentation
- ▶ Here we focus on fiscal rules – **strong country-specific numerical fiscal rules should be a cornerstone of the strengthened budgetary surveillance framework** (Directive on requirements for budgetary frameworks – part of the Six-Pack)
 - ▶ Decentralization of the Pact and enhancing national ownership of the Union's fiscal rules
 - ▶ Directive requirements reinforced by Fiscal Compact – rules of the Compact **to be enshrined in law**, preferably in Constitution (though not binding for non-euro MS, unless they declare their intention to be bound by the Treaty before joining the euro area)

Fiscal rules

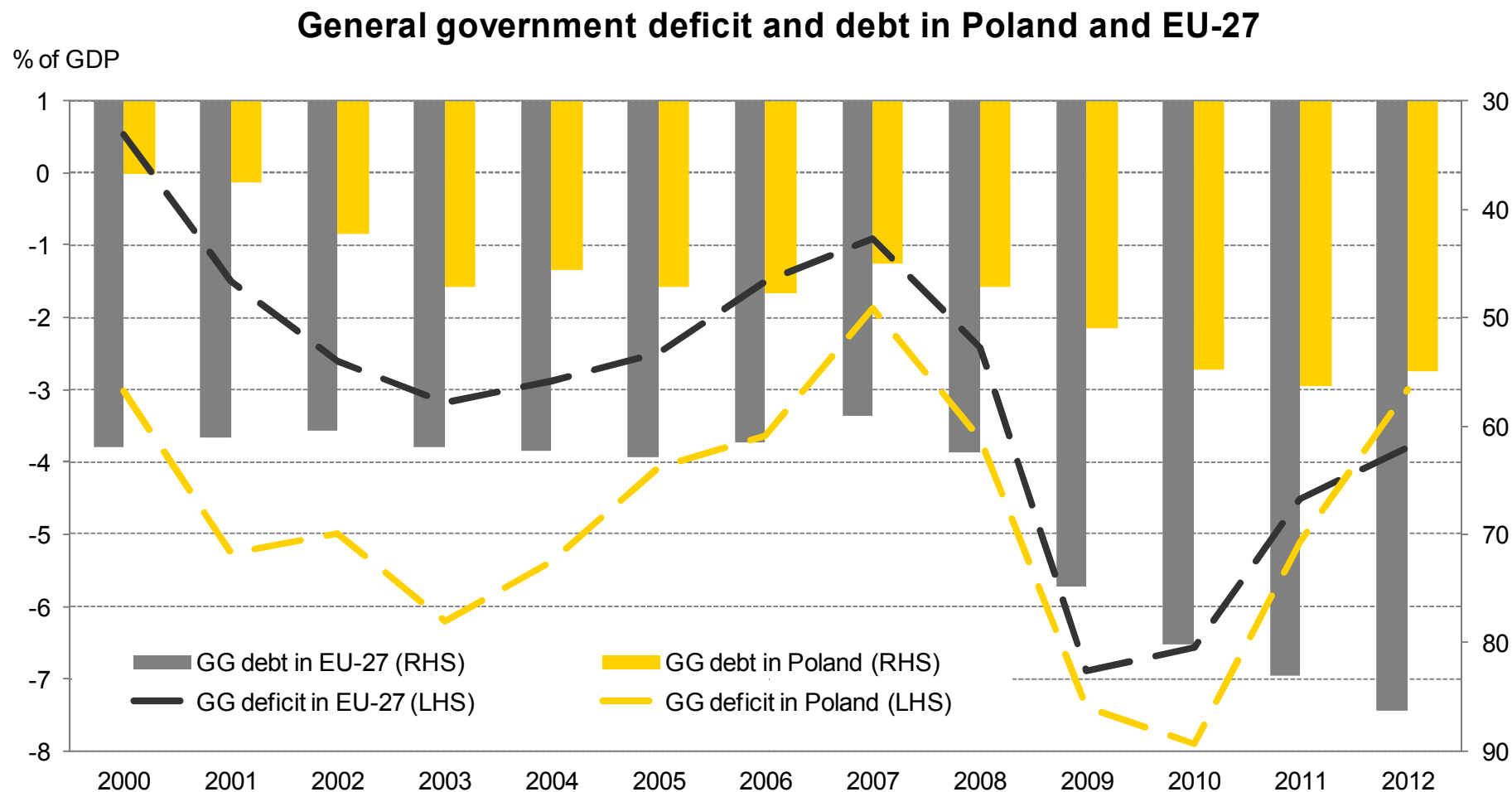
- ▶ Fiscal policy rule – a permanent constraint of fiscal policy, expressed as a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof (Kopits and Symansky 1998)
- ▶ Different rules – different pros and cons
 - ▶ Debt rule
 - ▶ Overall/structural/primary budget balance rule
 - ▶ Expenditure rule
 - ▶ Revenue rule
 - ▶ ...

Adopting fiscal rules and giving up flexibility – cost or benefit?

- ▶ Ulysses and the sirens
 - ▶ Ulysses – saving himself from certain death by making the sailors tie him to the mast
- ▶ Time inconsistency problem: example of monetary policy – following painful disinflation period, politicians granted independence to central banks
- ▶ The recent crisis – an opportunity to persuade politicians to give up some power and introduce fiscal rules?
 - ▶ How important is that opportunity to Poland?



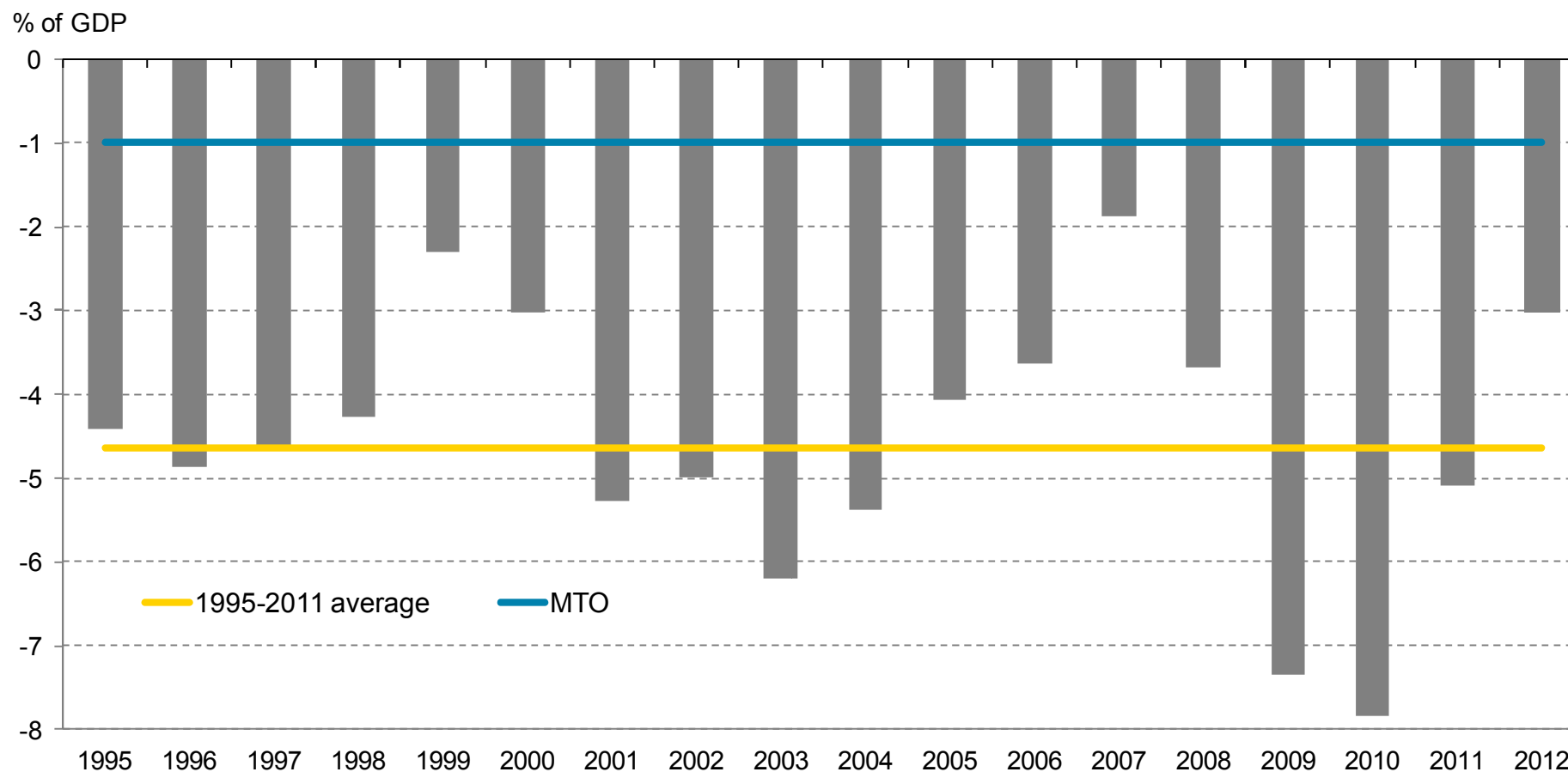
Despite the highest economic growth in the EU, Poland has not avoided deterioration in public finances



Source: AMECO

Public finance imbalances in Poland – persistent rather than transitory

General government balance in Poland (1995-2012)



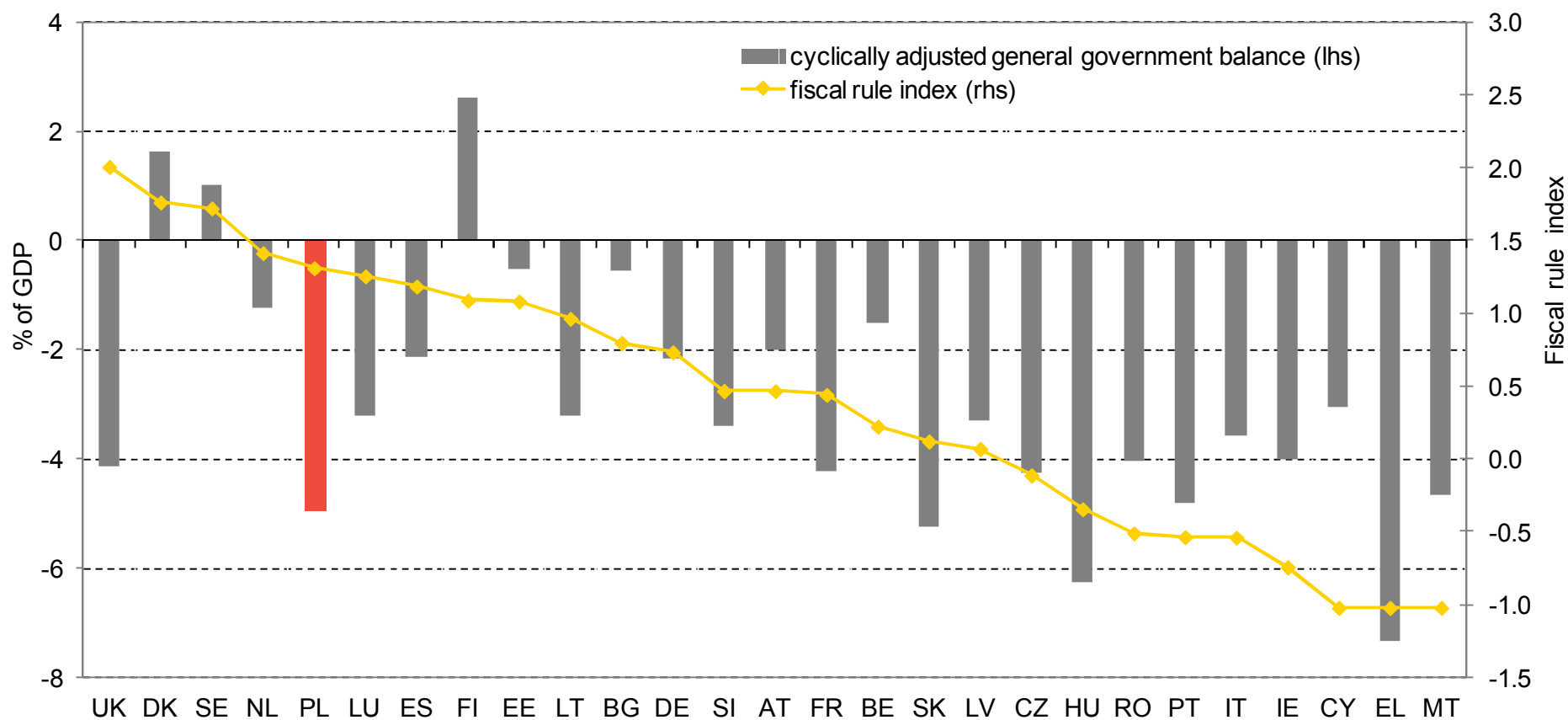
Source: AMECO

Fiscal rules in Poland

- ▶ Public debt limits, enshrined in Public Finance Act (50, 55, 60% of GDP) and Constitution (60% of GDP)
- ▶ Recent “CPI + 1” rule and new disciplining mechanisms
- ▶ Set of rules for local government units, incl.:
 - ▶ Debt-to-revenues ceiling (to be abolished?)
 - ▶ Balanced current budget principle
 - ▶ Interest and principal payments to be covered with current budget surpluses and revenues from property sales (from 2014)
 - ▶ Planned implementation of a legally binding limit on the local government subsector deficit
- ▶ Stability and Growth Pact rules

Fiscal rules in Poland – highly ranked but far from ensuring sound fiscal policy

Fiscal rule index and cyclically adj. GG balance (2000-2010 average)



Fiscal rules in Poland

- ▶ Budgetary framework in Poland has proved insufficient to prevent persistent public finance imbalances – need for improvement
- ▶ Public debt thresholds – no guidance for fiscal policy in economic good times and the risk of pro-cyclicality during the economic downturn
- ▶ New EU requirements – a window of opportunity to overcome internal obstacles and implement new and more comprehensive solutions
- ▶ Designing a new fiscal rule:
 - ▶ Conducive to public finance stability
 - ▶ Consistent with EU requirements

New fiscal rule in Poland in light of EU requirements

- ▶ In order to comply with EU requirements, the rule should:
 - ▶ ensure meeting the MTO (-1% of GDP), and thus minimize the risk of breaching the 3% and 60% of GDP thresholds for GG deficit and debt, respectively
 - ▶ limit the growth rate of expenditure, and thus comply with the expenditure benchmark, imposed by the reformed SGP.

New fiscal rule in Poland in light of EU requirements

- ▶ Preventive arm of the Pact: introducing **expenditure benchmark** in the form of a cap on the annual growth of expenditure not exceeding medium-term growth, net of:
 - ▶ interest expenditure,
 - ▶ expenditure on EU programmes fully matched by EU funds revenue,
 - ▶ non-discretionary changes in unemployment benefit expenditure
- ▶ If MTO not reached – expenditure growth should be lower by ca 1 pp relative to the benchmark level

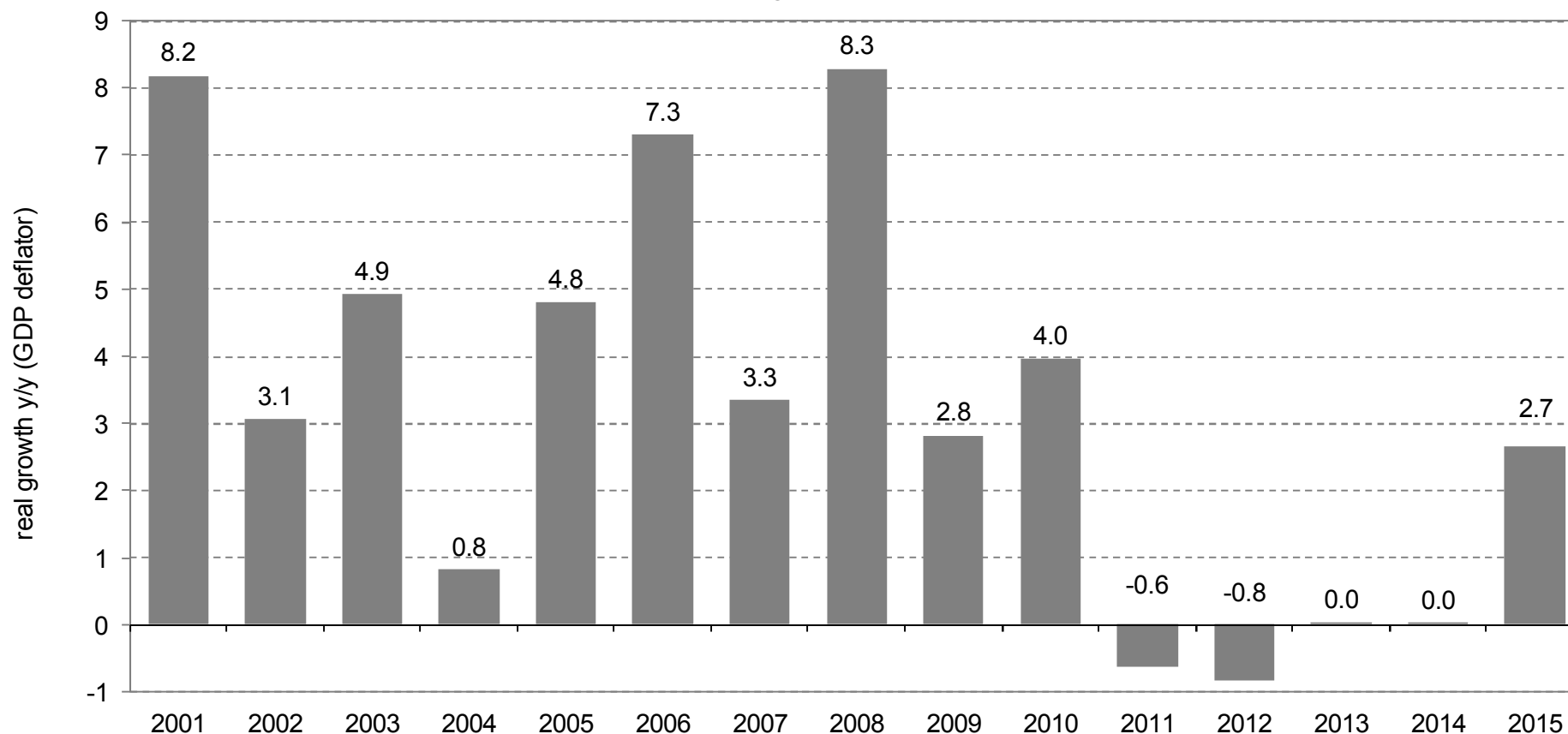
New fiscal rule in Poland – what can we learn from the Convergence Programme 2012 update?

- ▶ Setting a cap on the growth of GG expenditure net of:
 - ▶ expenditure of local government subsector
 - ▶ expenditure financed with non-returnable EU funds (GG neutral)
 - ▶ public debt servicing costs (?)

Growth of such-measured expenditure should not exceed medium-term GDP growth rate

Expenditure restraint in Poland from 2011 onwards

Real growth of GG expenditure net of EU funds, debt-servicing costs and cyclical unemployment expenditure

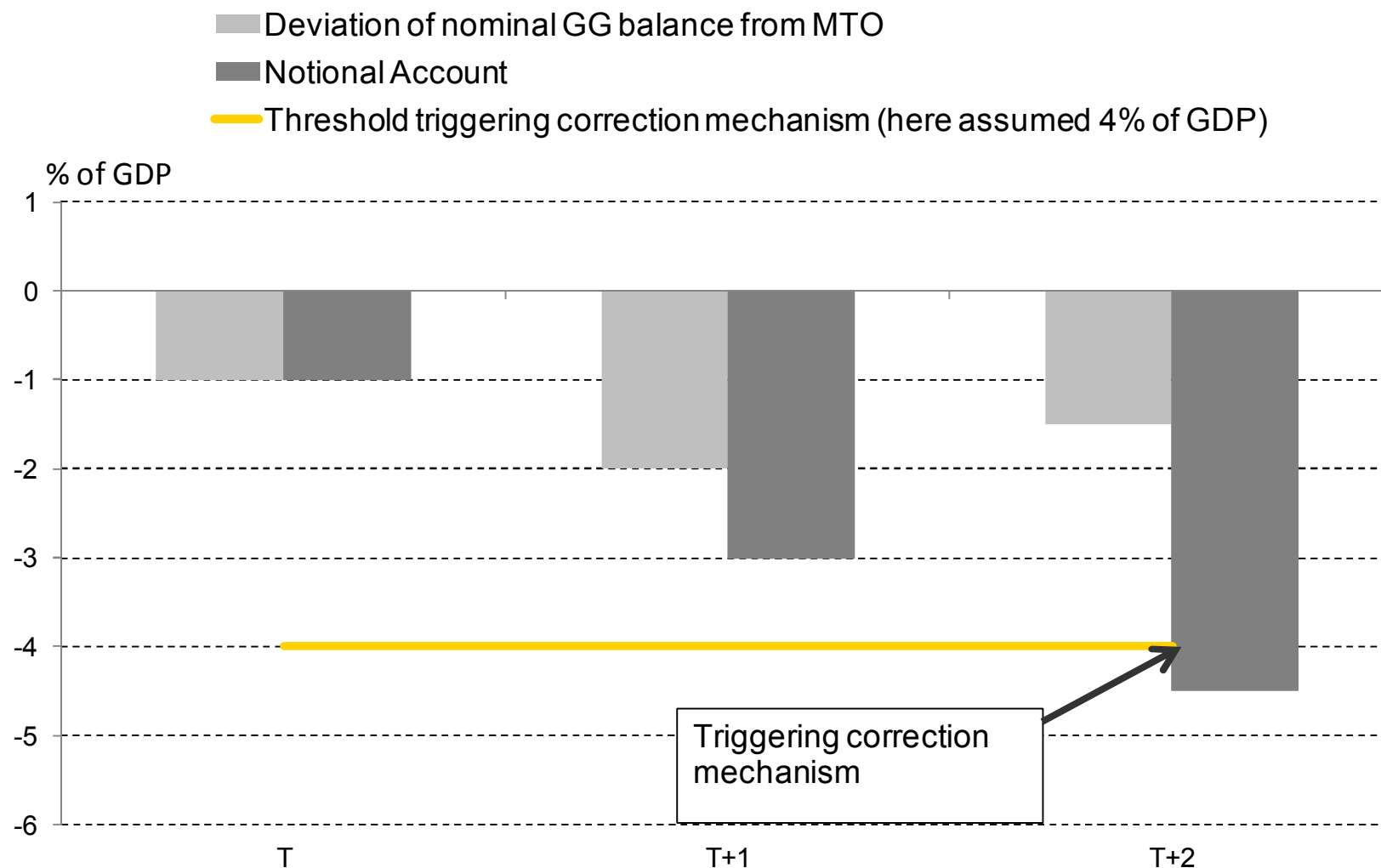


Source: Convergence Programme 2012 update

New fiscal rule in Poland – what can we learn from the Convergence Programme 2012 update?

- ▶ Expenditure limit adjusted for discretionary change in revenues (accounting for tax expenditure, etc.)
- ▶ Expenditure further tightened if deviations of the **nominal** GG balance from the MTO level, accumulated in the Notional Account, exceed a pre-defined threshold

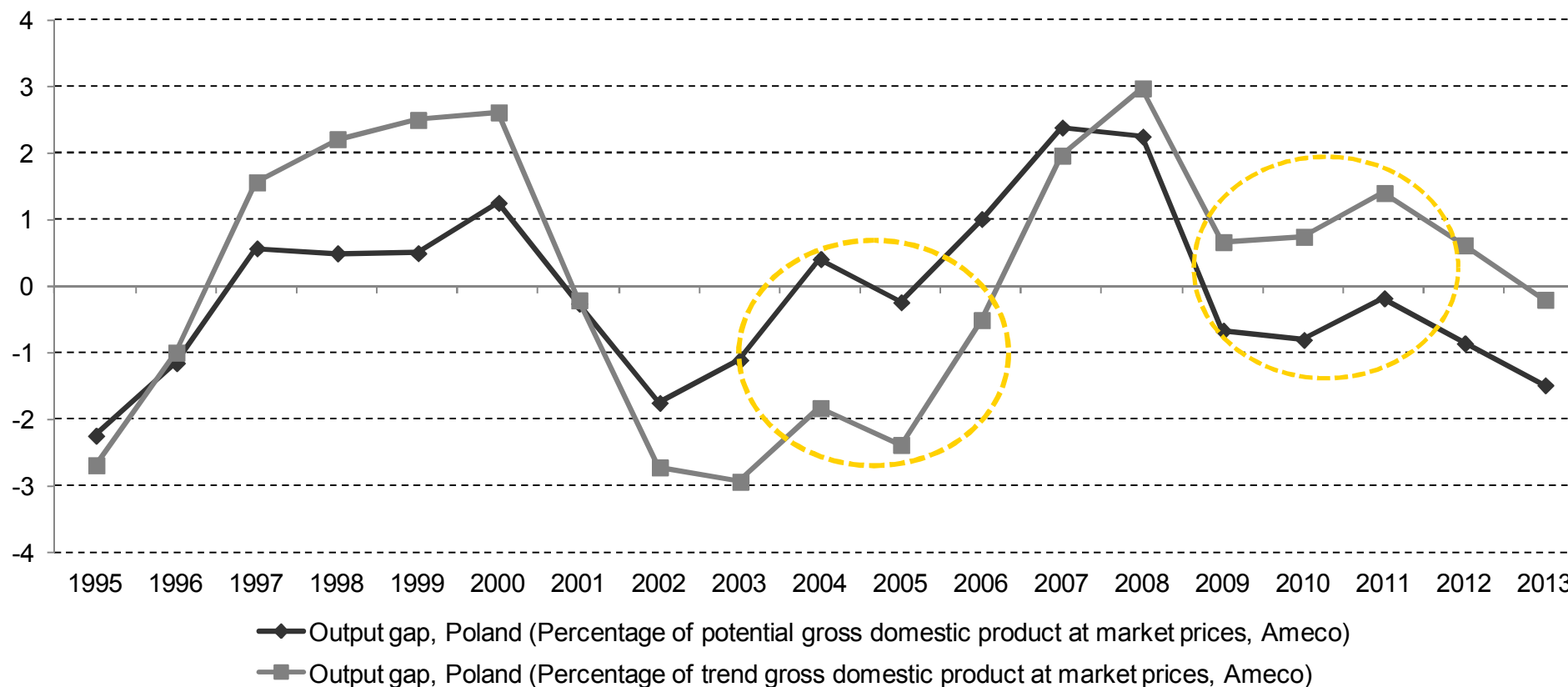
Notional account with a debt-brake safeguard mechanism



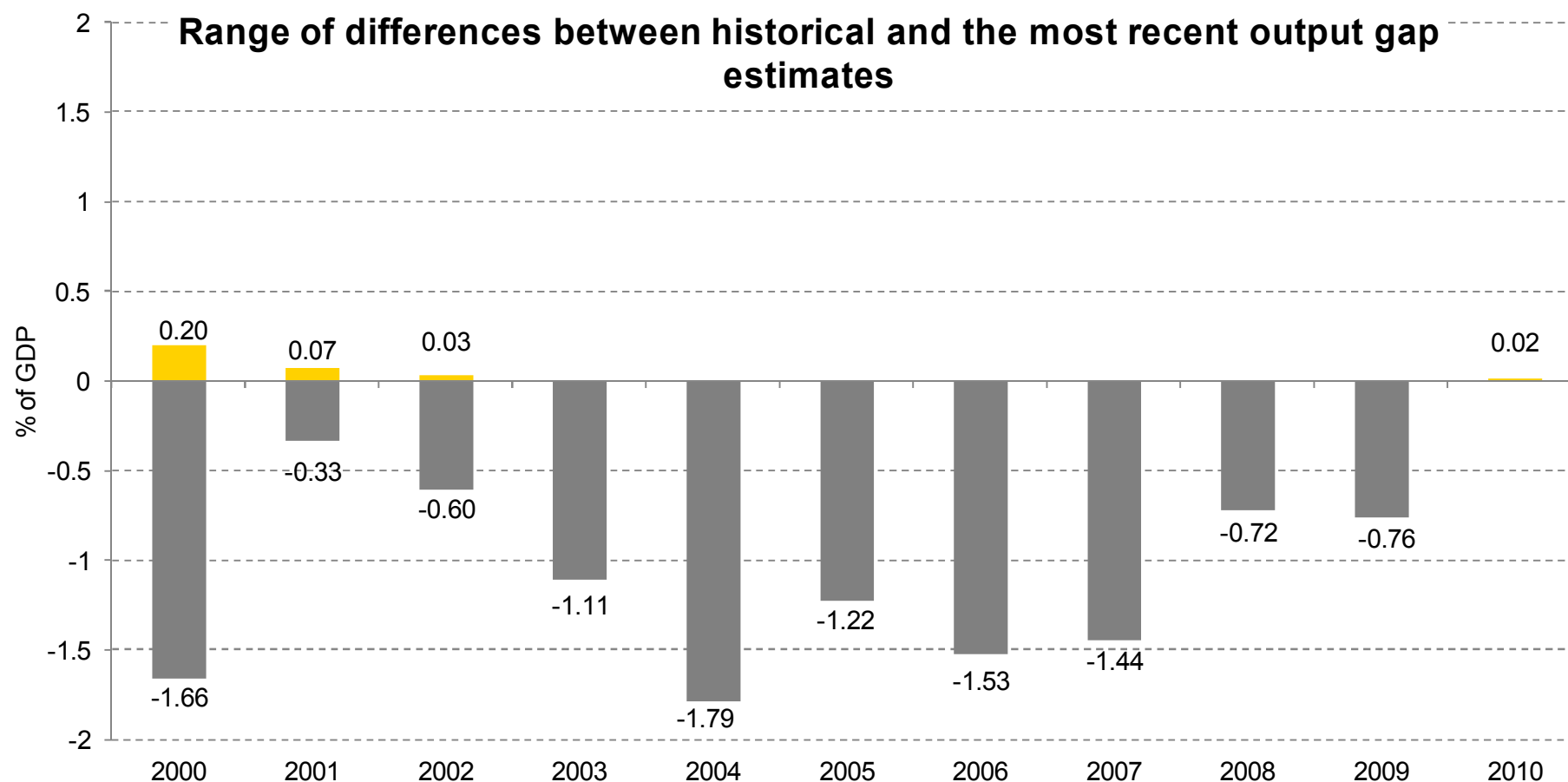
New fiscal rule in Poland – what can we learn from the Convergence Programme 2012 update?

- ▶ Expenditure limit adjusted for discretionary change in revenues (accounting for tax expenditure, etc.)
- ▶ Expenditure further tightened if deviations of the **nominal** GG balance from the MTO level, accumulated in the Notional Account, exceed a pre-defined threshold
 - ▶ Debt-brake mechanism ensuring meeting MTO over medium-term
 - ▶ In the short-term, however, deviations of structural balance from the MTO are allowed
 - ▶ But beware of focusing too much on the structural measure of GG balance
 - ▶ Reacting too soon to uncertain, and likely to be revised, structural balance estimates may lead to increasing rather than reducing volatility in the economy

Output gap – different measures, different estimates, often large differences



Output gap estimates – subject to frequent and often significant revisions



New fiscal rule in Poland – what can we learn from the Convergence Programme 2012 update?

$$Expenditure_{t+1} = Expenditure_t (G_{t+1} - Cr_{t+1}) + E_t(\Delta revenue_{t+1}) + ?$$

G - Medium-term growth indicator

Cr - correction factor, adjusting expenditure downward if cumulated deviations of nominal GG balance from the MTO have exceeded a predefined threshold

$\Delta revenue$ - discretionary change in revenues

New fiscal rule in Poland vs. EU requirements – local government subsector coverage

- ▶ EU requirements as regards the rule's coverage vs. local government units heterogeneity:
 - ▶ ca 2800 local government units:
 - ▶ Imposing aggregate ceiling?
 - ▶ Distribution challenges
 - ▶ Individual expenditure ceilings?
 - ▶ Feasibility of a (one-off) much-needed, but significant capital expenditure in a small local government unit with a debt-servicing capacity

New fiscal rule in Poland vs. EU requirements – local government subsector coverage

- ▶ In practice – separate rules for local government subsector
- ▶ One possible solution – a requirement that:
 - ▶ x-year annual average balance of each local government unit:
 - ▶ is non-negative, or
 - ▶ may not exceed $-y\%$ of the unit's average own revenues over the x-year period
 - ▶ Assuming local government subsector (own) revenues remain (in the medium-term) roughly stable in terms of GDP, the rule would be conducive to maintaining the subsector's balance roughly stable relative to GDP
 - ▶ It would then complement the permanent expenditure rule and help stabilize the whole GG balance at the MTO level

New fiscal rule in Poland – summary

- ▶ Ensuring meeting MTO in the medium term (but not every single year)
- ▶ Fulfilling expenditure benchmark, though growth of local government expenditure may occasionally lead to a temporary breach of the benchmark
- ▶ Avoiding problems related to structural balance estimates/forecasts
- ▶ Fiscal rule to be enshrined in law – much needed, not least in less advanced economies, where the credibility bonus is particularly large
 - ▶ The Polish track-record shows that as long as rules are not enshrined in law, they are meaningless: legally binding “CPI+1” rule vs. previous “empty promises”
- ▶ Implementation of the rule: after approaching the MTO (in 2015?); otherwise it would stabilize a structural deficit at too high a level

Conclusions and challenges ahead (1)

- ▶ Changes in the EU economic governance – supporting implementation of much needed institutional reforms, aimed at strengthening budgetary framework at the national level
 - ▶ A window of opportunity to introduce fiscal rules and “beneficial self-constraint”
- ▶ A new fiscal rule in Poland:
 - ▶ Ensuring meeting the MTO in the medium term, and thus minimizing the risk of breaching the “Maastricht thresholds”
 - ▶ Limiting the growth of GG expenditure
 - ▶ Still, **temporary** deviations of structural balance from the MTO or expenditure growth exceeding the SGP benchmark would be possible

Conclusions and challenges ahead (2)

- ▶ Non-compliance with EU requirements due to:
 - ▶ exclusion of local government subsector from the rule's coverage – based on sound rationale
 - ▶ dealing with shortcomings of structural balance estimates
- ▶ One size does not fit all!
 - ▶ Check whether **objectives** of the rule are met (and they seem to be)
 - ▶ Not least when “non-compliance” does improve the soundness of the budgetary framework

Conclusions and challenges ahead (3)

▶ Challenges ahead:

- ▶ Enforcement mechanisms – effective enforcement of the rules as important as the rules themselves
- ▶ Aggregate nature of the expenditure limit – operational distribution challenges
- ▶ Reforming the budgetary process (towards top-down approach)
- ▶ Enhancing Medium-term budgetary framework
- ▶ Spending review – necessary for expenditure prioritization, introducing “productivity savings” mechanism, etc.

THANK YOU
FOR YOUR ATTENTION