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Economic Comment

New proposals by PiS

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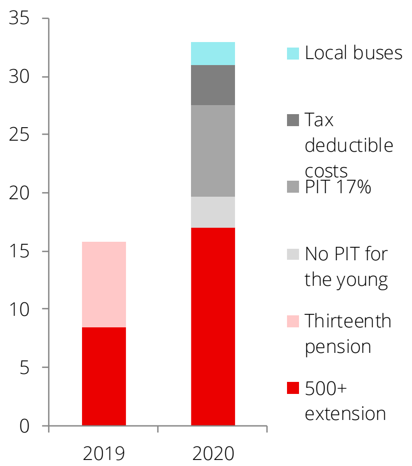
New PiS election proposals are likely to generate net costs for public finances falling in 0.6-1.0% of GDP range in 2019 and 1.2-1.6% of GDP in 2020, depending on the details of the program and the pace of its implementation. These actions will support higher private consumption, mitigating the risk of a more pronounced economic slowdown despite weaker growth outlook globally. So far, the government is not planning to amend this year's budget and is probably hoping to cover the extra spending with savings in other categories or / and the NBP profit. As a result, this year's borrowing needs are unlikely to rise markedly (if at all), while generous transfers to households will boost banks' demand for T-bonds in 2H19. 2020 will be more challenging, as it might prove difficult to deliver all the promises and at the same time keep the GG deficit below 3% of GDP as well as spending below limit resulting from the spending rule amid economic slowdown.

On February 23 the ruling Law and Justice (PiS) held its party congress where it presented its pre-election package. The program includes:

1. Extension of the 500PLN child benefit facility (called 500+) to all first children (currently the benefit is available for some first children meeting a per capita income criterion and to all second and further children),
2. One-off bonus for pensioners worth PLN1100,
3. No personal income tax for employees up to 26 years of age (for incomes falling in the lower 18% tax bracket),
4. Easing the tax burden: lower first PIT tax rate, rise in tax-deductible expenses,
5. Restoring public local bus transport.

What is important (and the most surprising), all above-mentioned elements were said to be implemented already this year. According to PM Morawiecki, the annual total cost of these measures would amount to PLN40bn. At the same time, he underlined that this was not the end of the pre-election proposals, more will be shown in June.

Costs of the new PiS proposals, PLN bn



Source: Santander Bank Polska

Estimates of the program costs

PLN500 benefit starting from the first child: planned introduction in July 2019. Currently the benefit is available for second and further children and for the first one only if monthly net family per capita income is below PLN800 (PLN1200 if the child is disabled). After the proposed change, virtually all children under 18 years old will be eligible for the program. According to our estimates, extension will cost **PLN17bn** per year (half of this in 2019, if introduced still this year). Recall that in 2018 costs related to the ongoing program amounted to PLN23bn.

Bonus payment for pensioners (13^{th} pension) worth PLN1100 to be paid in May 2019. Costs would depend on the final shape of this idea. If only old-age pensioners were included (5.7mn people in main social insurance system and 920k in farmers social insurance system), then the annual cost would amount to **PLN7.3bn.** However, if the bonus covers also widow pensions and disability pensions (which has recently been suggested by Deputy PM Beata Szydlo), 9.3mn people in total, then it translates into **PLN10.2bn** of the annual cost for the budget. What is important, there was hard pledge that this payment will be repeated in the future so for now we consider it as a one-off.

0% PIT for employees under 26 years of age: according to Labour Force Survey data, in Poland there are 1.2mn people working aged 24 or less, we estimate there are 360k workers aged 25, and 380k aged 26. To estimate this, we assumed that the employment rate for 25 and 26 year-old workers is equal to the total in 25-29 group although in reality it could be slightly lower. Our estimates for incomes in these groups were based on the POLNTA project and we conclude that PIT paid by workers aged 26 or less amounts to **cPLN2.5bn** (out of which 60% goes to the state budget, the rest to

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the local government budgets). This figure could be underestimated since the LFS data do not include short-term immigrants. According to PM Mateusz Morawiecki, this program will cost **cPLN3bn**.

Lower PIT for everybody: according to PM Morawiecki, the lower bracket personal income tax rate would be cut to 17% from 18%. We estimate this would cost **PLN8bn** per year (PLN5bn for the central budget, the rest for the local governments).

Higher tax-deductible expenses: assuming that the tax-deductible amount in the fixed job contracts will be doubled (currently it is PLN111.25 per month and PLN139.06 for commuters), PIT revenues would fall by c3% that is **cPLN3.5bn** per year, out of which PLN2bn for the central budget.

Reinstatement of public local bus services: in this case we are not attempting to estimate the costs, too few details are known at this stage. Media cited expenditures of **PLN1.5-2.0bn**.

Total cost, impact on the economy

While the moment of pension bonus payment and of 500+ benefit extension were indicated precisely (May and July respectively), there is less clarity about the time frame for implementation of other ideas, or at least the moment when they will have a fiscal effect. It is possible that the changes decreasing PIT revenues will only weigh on 2020 budget (this is what we assume here as the base case). The worst case would require assigning more or less a half of the annual cost of these items to 2019.

In total, we estimate that the new proposals from PiS will cost public finances some **PLN19bn in 2019 and PLN33bn in 2020** (costs for the central budget are PLN19bn and PLN27.5bn, respectively). Note that these are calculated in gross terms. We need to also take into account that higher social transfers will partly return to the budget in the form of taxes, so the net budget effect will be somewhat lower.

First of all, income tax and health care contribution have to be deducted from the bonus pension, yielding cPLN2.0bn (assuming that the announced PLN1100 value of the individual transfer is a gross amount).

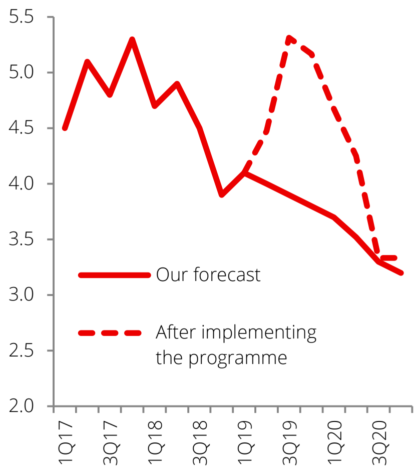
Secondly, additional transfers to households potentially mean higher consumption, so also higher VAT revenues and excise duties. In our view, the propensity to spend the extra money obtained due to the extension of 500+ benefit may be lower than in the first phase of the program: due to the design of the program and the increase of incomes in the recent years the aid will go to slightly wealthier households, which have a higher propensity to save. In case of pensioners, the marginal propensity to spend the extra cash on consumption will be limited by the fact that it will be a one-time payment, not a permanent income. On the other hand, in case of less wealthy pensioners a large part of the payment may immediately be used to cover basic needs. In total, we expect that the new programs will boost private consumption by c0.5 percentage point in 2Q19 and by c1.4 pp in 3Q and 4Q19. In 2020 the effect on growth rates will be diminishing. Based on this we expect indirect taxes to rise by cPLN1.5bn in 2019 and cPLN4bn in 2020.

Total cost of the new proposals by PiS for public finances, PLN bn:

	*Base case**		*Maximum case***	
	2019	*2020*	*2019*	*2020*
Extension of 500+	*8.5*	*17.0*	*8.5*	*17.0*
13th pension	*10.2*	*-*	*10.2*	*10.5*
No PIT for the young	*-*	*2.5*	*1.2*	*2.5*
PIT 17%	*-*	*8.0*	*5.0*	*8.0*
Higher tax-deductible costs	*-*	*3.5*	*1.7*	*3.5*
Local buses	*-*	*2.0*	*1.0*	*2.0*
Gross total	*18.7*	*33.0*	*27.5*	*43.5*
To return in taxes	*3.5*	*4.0*	*4.5*	*6.5*
Net total (PLN bn)	*15.2*	*29.0*	*23.0*	*37.0*
Net total (% GDP)	*0.7%*	*1.2%*	*1.0%*	*1.6%*

** base case is what we consider the most likely implementation*
*** In the maximum case we assume all promises to be delivered by mid-2019, and in 2020 the 13th pension will be paid again.*
Source: Santander Bank Polska

Change in consumption growth, % y/y



Source: GUS, Santander Bank Polska

We estimate that the maximum impact of the new program on GDP would be **0.3pp and 0.2pp to GDP growth in 2019 and 2020, respectively**. However, it does not mean we are going to revise our forecasts now. First, let us wait for more details on implementation (fiscal stimulus will be lower if new measures will be financed by cuts in other spending). Second, we treat it as a factor decreasing the risk of downward revision to our forecast given the deteriorating global macro outlook.

Deficit to go up?

New proposals are costly and this encourages questions about its financing and condition of the public finance. If we assume that the new program was financed entirely by higher deficit and debt that would mean the government would divert from the fiscal consolidation path and general government deficit would swell above 2% of GDP (from 0.7% in 2018) with a major risk of surpassing 3% in 2020.

However, that is not so easy to implement. The stabilising spending rule is one limitation, as it puts a cap on GG spending. In 2019 the limit for the central sector is at cPLN622bn versus PLN597bn in 2018. Thus, in 2019 the government was able to increase spending by PLN25.0bn and has already used all the available room in the budget prepared in autumn 2018.

Interestingly, representatives for the government and the Finance Ministry suggested that **no budget amendment is planned this year.** We guess that the government is hoping to cover the gap by savings in other planned spending, use of some reserves and disbursement of NBP profit, which was not put in the budget (in our view the NBP profit is unlikely to go strongly above PLN5.0bn). Additionally, the pension bonus is likely to go into the Social Security Fund budget, so will cause no change in the central budget or in the supply of government debt if the Fund uses a loan to finance it. If effects of changes in PIT appear in 2020, which is our baseline scenario, then it may be possible to fit the 500+ extension into this year's deficit limit thanks to savings in other sectors and higher revenues. Even if it is not enough, then budget amendment would be an option, but this can be implemented after the autumn election.

How is the government putting the program into 2020 budget? We are unlikely to know the answer soon. In April the government is obliged to present its Convergence Program Update, but we assume it can skip the new ideas as long as they are not officially enacted.

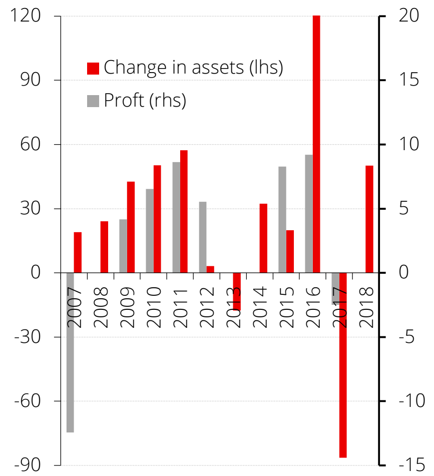
We estimate that the stabilising fiscal rule will allow for a rise of general government spending in 2020 by cPLN40bn (assuming no discretionary measures). It has to be stressed however that the limit has to cover many items, including higher expenditures of local governments and other agencies, as well as expenditures due to other actions and mechanisms (defense spending going up together with GDP, indexation of pensions and disability allowances, plus a potential rise of wages in the budgetary sector – the generosity of the government expressed in the new proposals may strengthen the wage pressure in this area). As a consequence, there will not be much room for additional social spending, anyway not enough to repeat the payment of another 13th pension (this is why we consider this proposal as a one-time payout, only in 2019).

The potential tampering with the fiscal spending rule to generate some more space for the extra expenditures would in our view be risky and would be negatively received by the financial markets and rating agencies. We remind that the current parliament changed the rule already a couple of weeks after the 2015 elections. Two changes were then introduced: first, in the original version expenditures were allowed to rise at the pace linked to inflation forecasts of the government, and there was a correction mechanism for earlier forecast errors (so if the government set its forecast too high in one year, it was punished for it in the following year). The formula was changed to include central bank's inflation target, 2.5%, instead of the forecasts. Second change to the rule was to allow one-off discretionary revenue measures to increase the spending limit. The two changes de facto lowered the restrictiveness of the rule (especially that in 2016-2018 inflation was below the target) and made it possible for the government to go ahead with the introduction of 500+ benefits in 2016.

Market implications

The market reaction to the announcement of the PiS political agenda took the form of higher bond yields, which is understandable, given the risk of higher borrowing needs, the scope for stronger private consumption and the possibly less dovish monetary policy (several MPC members have already stated that the fiscal stimulus can trigger a

Change in NBP assets and NBP profit, PLNbn



Source: GUS, Santander Bank Polska

discussion on the need for rate hikes in the future), and the apparent conflict between the new proposals and the constraints imposed by the fiscal spending rule.

The declaration by the Ministry of Finance that there is no need to amend 2019 budget suggests however that the increase of government bond supply this year may be limited (or none at all), and we should only worry about the next year.

In 2H19, market-positive effects of the proposals may appear: firstly, higher consumption is to generate higher tax revenues; secondly, higher liquid deposits in banks, which in our view should strengthen demand for bonds from domestic financial institutions (and may simultaneously put downside pressure on deposit rates). In the horizon of this year and later on this should offset some of the negative effects linked to the increase of yields in reaction to the announcement of the plans by PiS.

In a longer time frame, the proposals do not bode well for the economic outlook and the stability of public finances. Further significant rise of social expenditures reduces space for investment-oriented spending that are needed in other, often more important areas (education, health care, energy production). Also, the sensitivity of public finances to cyclical slowdown is also going up. The new proposals support an increase in private consumption, but – as was the case with the 'first wave of 500+ child benefits – the effect on the growth rate of consumption may be short-lived. A potential risk is also that the fiscal spending rule will be tampered with, which might undermine the trust of investors.

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