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Economic Comment

Redistribution rather than easing

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The government has found a way to deliver the costly election promises without breaching the expenditure rule or even without halting the fiscal consolidation. This was achieved through (1) indication of new sources of revenues (with the upfront taxation of pension savings playing the key role), (2) trimming the room for expenditures other than those linked to the pre-election promises, except maybe a few areas where increases are obligatory from the legal point of view. If government plans are implemented, it would imply that (our) worries about fiscal easing and increased debt issuances were overblown. It needs to be stressed, however, that the indicated measures on both the revenue and the spending side require a considerable legislative effort – to be made still before the autumn elections. And important part of this legislation is not what the voters would love to see before going to the polls (new/higher taxes, substantial narrowing of room for spending in areas like healthcare, education, salaries in the public sector). We see the risk that at least part of the government's plans presented in the document could be abandoned later this year, especially if PiS does not score well in the European Elections in May and would have to fight harder for voters' support. Still, the Convergence Programme Update, seen as a formal expression of government's fiscal plans (feasible or not), removes some of the uncertainty from the fiscal outlook, and even if achieving the GG surplus in 2020 is not our base-case scenario, the risk of substantial fiscal easing seems to be off the table, as the fiscal deficit in 2020 should not be much higher than 1% of GDP even in the 'risk-case' scenario.

The 2019 Convergence Programme Update (CPU2019) released on April 16th showed a more aggressive fiscal consolidation than the previous programme. The general government (GG) balance for 2019 was revised slightly lower to -1.7% of GDP (-1.5% in 2018), but markedly higher for the following years: +0.2% in 2020 (-1.1% previously) and -0.3% in 2021 (-0.7% previously). Lower deficit carries into lower public debt profile with gross debt falling to 47.9% of GDP in 2019 (50.4% expected previously), 46.0% in 2020 (48.7% previously), 42.9% in 2021 (46% previously) and 40.6% in 2022. The macroeconomic assumptions underlying the plan are rather conservative, assuming GDP growth at 4.0% in 2019, 3.7% in 2020, 3.4% in 2021 and 3.3% in 2022. Inflation is expected at 1.8% in 2019 and 2.5% in 2020-2022.

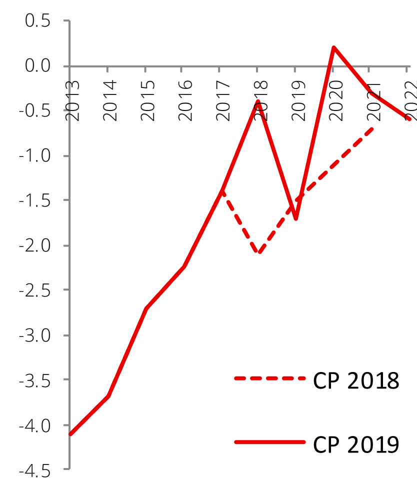
What is the most surprising is that the Convergence Programme Update predicts the general government balance moving into surplus in 2020, despite the implementation of the costly set of five election promises of the ruling party (so-called "PiS Five"), while only few days ago it seemed most likely that the recently announced spending spree would result in widening of fiscal deficit towards 3% of GDP in 2020. Even the Prime Minister Mateusz Morawiecki admitted earlier that the fiscal balance would probably deteriorate in the coming years (although he reassured that breaching 3% limit was unlikely). Before the publication of the document we also saw a risk that the stabilizing expenditure rule will be tampered with in order to allow the government to deliver its pre-election proposals, but the document shows the way how to avoid it, it seems.

How to reach the fiscal surplus in 2020?

As we were arguing in our last MACROscope, the stabilising expenditure rule did not provide enough room for the fiscal package announced in February. One solution to deal with this problem was to alter the rule, another to find new revenues or cut spending. It seems that the Finance Minister Teresa Czerwińska was determined to obey by the rule and the current Convergence Programme is the effect of this work.

The GG revenues planned for 2020 were revised up to 43.0% of GDP from 39.9% of GDP expected in the previous Convergence Programme. It implies revenues higher by cPLN73.5bn than expected last year (if we take the FinMin's assumptions of nominal GDP). Correction for higher starting point in 2019 is estimated by us at cPLN33.0bn and the residual can more or less be covered by discretionary measures and one-off revenues totaling PLN41.5bn, which include:

GG deficit – government forecasts in Convergence Programme Updates



Source: Ministry of Finance, Santander Bank Polska

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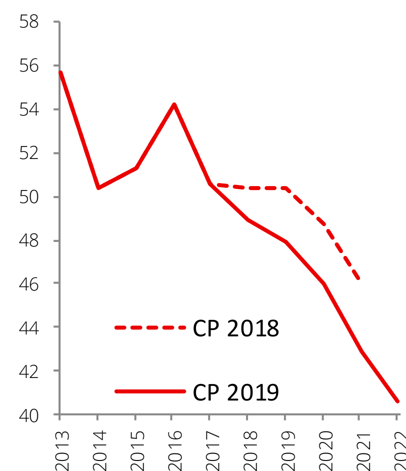

Source: Ministry of Finance, Santander Bank Polska

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1) OFE overhaul (PLN22.8bn)
2) Abolition of 30x limit for social security contributions (PLN5.2bn)
3) Improved tax compliance (PLN15.6bn)
4) New taxes and hikes in existing taxes (PLN2.5bn)
5) Sales of CO2 permits (PLN5.7bn)
6) Sales of rights for 5G frequencies (probably less than PLN3.5-5.0bn)
7) PIT reduction, lowering the total revenues (-PLN10.4bn)

We elaborate more on each of those measures in the document below, but it looks quite obvious that the outright taxation of households' pension savings play the key role in this puzzle.

But higher revenues is only part of the story. The GG budget surplus in 2020 was also possible to achieve thanks to relatively low estimates of expenditures. Spending is expected to drop from 43.3% of GDP in 2019 to 42.8% in 2020. In nominal terms, this means a rise in spending by PLN47bn. This seems surprisingly low increase given: (1) the new fiscal package ("PiS Five"), and (2) spending increases pre-determined by the already existing laws and regulations.

According to our estimates, the assumed increase in total spending is barely enough to cover the above-mentioned items (additional costs of 500+ extension and support for local buses, plus higher expenditures on pensions, healthcare, defence and science resulting from the applicable law, plus the assumption that local governments' spending-to-GDP remains flat – see the margin table), leaving virtually no room for any other rise of expenditures. Interestingly, the Ministry of Finance admits it, stating in the document that: "as a result, the rise of residual spending will be possible at 1-3% y/y level. This means a necessity to shift spending paths determined in sector acts (bound to macroeconomic parameters) and to prioritise on spending.". The CPU2019 assumes declining spending paths (relative to GDP) on labour costs, investment (but a small jump in 2020), public consumption.

Simply speaking, the Ministry of Finance admits that the assumed path of fiscal consolidation would be difficult to accomplish without the legislative changes that would curb spending growth in other areas, to create more room for the "PiS Five" package.

Change in spending in 2020 determined by regulations, our estimates, PLNbn

	2020
Local governments	15.9
Pensions	14.7
500+	10.0
Healthcare	9.8
Defence	4.7
Other	7.8
13th pension	-10.8
Energy reimbursements	-4.5
Total	**47.6**

Source: Ministry of Finance, Santander Bank Polska

Less generous PIT cut

The expected costs of the proposed reduction in personal income taxation (PIT) are lower than our initial estimates, but this is due to modifications to the original proposals (the details were presented on Monday). The zero PIT rate for the young (under 26Y) will only cover income up to cPLN43k. Instead of replacing the 18% PIT rate with a 17% rate for everyone, the package introduces another PIT bracket, 17% up to PLN42,764, then 18% rate until reaching PLN85,528 (the current income threshold).

As a result, the Ministry's cost estimates for the two measures are significantly below our calculations: zero PIT for the young is expected to cost PLN1.7bn per annum - we had thought the annual cost would be PLN2.5bn; introduction of a 17% PIT rate would cost PLN5.3bn (vs. our estimate of PLN8bn), and a more than twofold rise of PIT tax-deductible costs would cost PLN3.4bn (vs. our estimate of PLN3.5bn) in 2020. In total this means that the tax changes proposed in the fiscal package could cost **PLN10.4bn** (0.45% of GDP) instead of PLN14bn (0.6% of GDP).

Cost of "PiS Five" election promises, PLN bn

	2019	2020
Extension of 500+	9.6	20.0
13th pension	10.8	-
Zero PIT for the young	0.4	1.7
PIT 17%	-	5.3
Higher tax-deductible costs	-	3.4
Local buses	0.5	1.0
Gross total	**21.3**	**31.4**
To return in taxes	3.0	3.8
Net total (PLN bn)	**18.3**	**27.6**
Net total (% GDP)	**0.8%**	**1.2%**

Source: Ministry of Finance, Santander Bank Polska

Abolition of 30x limit for social security contributions

Currently the social security contributions are not levied on annual income exceeding the average salary 30 times. The government planned to abolish this limit starting from 2019, but the bill was dismissed by the Constitutional Tribunal. However, the Tribunal objected to the details of the legislative process, not the the abolition itself, so the government is probably going to try with the bill again. Estimated revenue for the general government sector sits at **PLN5.2bn** per annum. It has to be stressed, however, that the change will also boost the future liabilities of the pension system, raising concerns about its the long-term stability.

Improved tax compliance

Improved tax compliance has been a major source of rise in GG revenues in the previous years. For 2020, the government plans further to increase revenues by **PLN15.6bn**, mostly thanks to improvement in VAT compliance (PLN7.9bn), social security compliance (PLN4.3bn), taxes connected with cross-border activities (WHT, MDR, GAAR – PLN1.3bn),

"entrepreneur test" aiming at eliminating "fake" self-employment (PLN1.2bn). In our view, the Ministry's plans regarding further gains in VAT compliance are too ambitious.

New taxes and hikes in existing taxes

New taxes or hikes in existing taxes are expected to yield **PLN2.5bn** in 2020. These include: "solidarity tax" – 4% on personal income exceeding PLN1.0mn per year (generating PLN1.2bn budget revenue), hike of excise on tobacco and alcohol by 3%, introduction of excise on nicotine liquids (PLN1.1bn), "digital" tax on international IT companies (PLN0.2bn).

Sales of unused CO2 permits

The government plans to sell unused CO2 permits from the previous years and raise **PLN5.7bn** in 2020. The idea to use this sort of funding came first when there was need in late 2018 to find financing for the electricity price freeze bill. CPU2019 has rather conservative assumptions about the price forecasts of the permits (c15% below current prices) and, on average, uses a 2% lower EURPLN rate than our forecasts to convert the proceeds from CO2 permit sales to PLN.

Sales of rights for 5G frequencies

The Ministry also aims at selling rights for 5G frequencies. This requires some legislative changes, and is expected to bring **PLN3.5-5.0bn** in 2020, but in our view this will only partially affect the GG deficit (as was the case with incomes from LTE auction), so we omit this revenue in our calculations.

OFE overhaul

On April 15th Polish government proposed changes to the pension system, to be implemented in January 2020. According to the proposal, the Open Pension Funds (OFE) will be transformed into mutual investment funds, and by default the pension savings collected at individual OFE accounts will be transferred to individual pension accounts (IKE) in those mutual funds. The transfer will be charged with a 15% 'transformation fee'. The government argues that the latter is justified by the fact that the payouts from these funds will not be charged with income tax once the insured reach the retirement age. The transformation fee will be collected in two even tranches, in 2020 and 2021. Alternatively, every OFE participant will have the option to chose the transfer of savings to the first pillar, i.e. the Social Security Fund (FUS), without the 15% haircut, but these funds will be charged with the personal income tax once the pension payments start (currently PIT rates are at 17/18/32%, but who knows what they would look like in future). After the transfer to FUS the funds will no longer be subject to inheritance, which could be discouraging people from choosing this option.

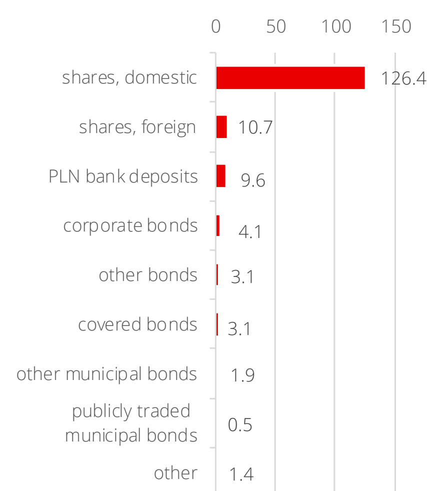
Fiscal consequences of the OFE reform: From the point of view of next year's fiscal balance, the key feature of the pension system reform is the transformation fee, treated as a one-off revenue for the public finances. A large benefit to the budget is also the permanent redirection of all pension contributions to the first pillar.

The transformation fee could amount up to PLN24bn, if everyone chooses the default IKE option (as OFE assets are cPLN160bn). The Ministry of Finance assumed in the CPU2019 that 80% of people will approve transferring their money to IKE, in which case the fee would be **PLN19.3bn**. This will increase the public sector revenues and will be paid in two equal tranches – in 2020 and in 2021. As a result, budget deficit will be lower. According to ESA accounting the whole amount will be treated as 2020 revenue, despite half of it coming in the following year.

Another benefit for the public sector is no more flow of a part of pension contributions to OFE, improving the cashflow of FUS (MinFin estimate is **PLN3.5bn** for 2020). On the other hand, the so-called zipper mechanism, moving capital of people close to the retirement age (c.PLN7bn per year) from OFE to FUS, will no longer apply, but it has not been treated as GG sector revenues anyway.

Money obtained from the fee will also lift the spending limit for the central budget and FUS implied by the stabilising expenditure rule, as will the one-off and discretionary measures regarding taxes and social contributions listed earlier in this note (which, to be precise, lift limit for the whole GG sector). Therefore, **we no longer assume there will be need for the ruling party to modify the spending rule itself to fit the fiscal package in the next year's limit** (assuming the government delivers most of the legislative changes needed to raise new revenues and curb spending).

OFE portolio structure, Feb 2019, PLN bn



Source: KNF, Santander Bank Polska

Market consequences of the reform: The collection of the fee will reduce the budget deficit and thus the financing needs in 2020 and 2021, which means also correspondingly lower bond supply. The redirection of all pension system contributions to the first pillar will also improve the budget on a cash basis, but the cancellation of the zipper mechanism means that after 2021 the net cashflow result of the OFE overhaul will be negative for the Social Security Fund, to the tune of cPLN3.5bn per year.

The reform may also cause higher demand for government bonds in the long run, as OFEs were forbidden to buy government bonds, while the new IKE funds will be allowed to do it. However, the effect will not be large, we think, and will take time. First of all, the 'transformation fee' to be paid upfront would be most likely covered from the most liquid OFE assets: deposits in the first step, and possibly cashing some foreign equities and/or corporate bonds if needed. At the end of February 2019 deposits in OFEs portfolios totalled PLN9.6bn, but please note that before the overaul takes place the funds will benefit from the inflow of fresh cash from dividends and pension contributions (at least PLN5bn this year and PLN3bn in 2020). Anyway, the payout of 'transformation fee' would leave the funds with relatively high equity exposure (over 90% of their total assets). The natural tendency to rebalance portfolios afterwards would be capped by the government's proposal that the new IKE funds would not be allowed to sell more than 2.5% of their equity holdings per year. Thus, in the following years the **IKE demand for bonds could amount to cPLN2bn annually**, according to our estimate. There is no other information regarding the investment policy restrictions to apply to the transformed OFEs. We think that at first the bond purchases will be focused on POLGBs (80%), while later their share will drop to 60% of purchases, as the supply of high quality corporate bonds increases (e.g. as bank issuance increases).

The assets of those future pensioners who opt out from IKE (20% of total, according to the government's assumption, i.e. cPLN32bn) will be transferred to and then managed by the Demographic Reserve Fund (FRD). But if the assets are moved proportionately, which seems to be the concept, then c80% would be in shares of Polish listed companies. Thus, the FRD's additional appetite for the government bonds would probably not exceed PLN7bn, at least at the beginning.

Timeline of the reform: The bill on the pension reform will be released for social consultations in May. Government approval is expected in June-July and the bill should be voted in the parliament in September-October. The implementation will start in January 2020.

Conclusions

The government has found a way to deliver the costly election promises without breaching the expenditure rule or even without halting the fiscal consolidation. This was achieved through (1) indication of new sources of revenues (with the upfront taxation of pension savings playing the key role), (2) trimming the room for expenditures other than those linked to the pre-election promises, except maybe a few areas where increases are obligatory from the legal point of view. If government plans are implemented, it would imply that (our) worries about fiscal easing and increased debt issuances were overblown. It needs to be stressed, however, that the indicated measures on both the revenue and the spending side require a considerable legislative effort – to be made still before the autumn elections. And important part of this legislation is not what the voters would love to see before going to the polls (new/higher taxes, substantial narrowing of room for spending in areas like healthcare, education, salaries in the public sector). We see the risk that at least part of the government's plans presented in the document could be abandoned later this year, especially if PiS does not score well in the European Elections in May and would have to fight harder for voters' support. Still, the Convergence Programme Update, seen as a formal expression of government's fiscal plans (feasible or not), removes some of the uncertainty from the fiscal outlook, and even if achieving the GG surplus in 2020 is not our base-case scenario, the risk of substantial fiscal easing seems to be off the table, as the fiscal deficit in 2020 should not be much higher than 1% of GDP even in the 'risk-case' scenario.

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