30 August 2019

Economic Comment

Budget: Zero for the first time

The government planned balanced 2020 budget, which was possible thanks to some increase of taxation, large one-off revenues, but also due to restricted spending, in line with the Stabilising Expenditure Rule. In general, this is good news for the market, implying low bond supply next year and confirming Poland's fiscal prudence. However, at least part of the deficit improvement is temporary and the general direction of changes in spending structure may raise concerns, as it generates temporary consumption boost and permanent burden for the economy. Note also that a major part of new budget revenues was not yet enacted. The main risk for Polish public finances is deeper economic slowdown, especially that planned tax revenues already seem ambitious. Meanwhile, rising cost pressure on firms and restraining non-social spending may not help in maintaining long-term growth potential and weathering the global economic turmoil.

Macroeconomic assumptions: not conservative, but realistic

The 2020 budget was constructed based on assumption of a mild economic slowdown to 3.7% y/y in 2020 from 4.0% y/y in 2019 with inflation accelerating from 1.8% in 2019 to 2.5% in 2020. In our view these assumptions are not very controversial. Inflation is even slightly conservative, as we expect CPI to average 3.5% in 2020. GDP growth is a bit above the consensus, but given low inflation forecasts, the balance seems to be skewed towards more conservative variant – our expectations for nominal GDP volume are even c.2% higher than assumed by the government. We also see some upward potential for private consumption, as the fiscal package is likely to secure a higher growth rate than 3.8% assumed by the government, which would be favourable for tax revenues. On the other hand, we see some downward risk for exports (expected at 4.8% y/y), given negative global economic outlook. Assumptions for the labour market (wages decelerating to 6.0% y/y from 7.6% y/y and employment to 0.5% y/y from 2.2% y/y) seem legit. The government's forecasts of other economic variables also seem probable for us, with some mild slowdown across the board.

2019 Budget: deficit lower than planned again

The government expects that 2019 budget revenues will be PLN17bn higher than planned while expenditures will be in line with the initial agenda. That implies that budget deficit in 2019 may reach PLN12bn vs the planned PLN28.5bn.

The main positive deviations from the plan on the revenue side are in VAT, CIT and non-tax revenues (PLN5-6bn extra revenue expected in each of these categories). We do not question those forecasts. Our model of effective VAT rate, which takes account of its cyclicality, points to almost exactly the same figure. The non-tax revenues are also on course to be higher-than-planned (boosted mainly by the sale of CO_2 emission rights). CIT might fetch even a bit more than the government expects thanks to the rebound of corporate profit margins, but this could be offset by a couple of PLNbn less coming from PIT, due to the changes applied in August (zero PIT rate for the young) and October (higher fixed costs in PIT calculation, reduction of PIT rate for the lower income bracket) which are to have instant effect on tax-payers' income.

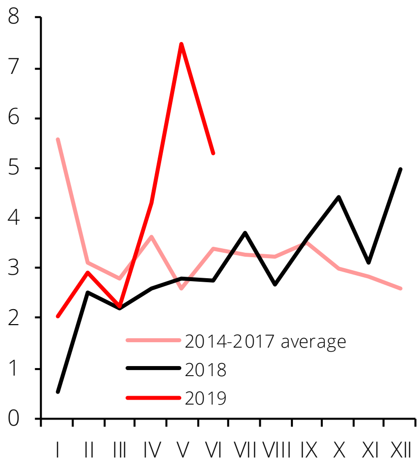
More puzzling is how the government will manage to keep spending within the planned limit even though substantial cost items have been added after the budget had been approved: the payment of the 13th pension (PLN10.8bn), the expansion of the 500+ child benefit program to all first-born children (PLN10bn), the electricity price freeze (PLN4.3bn additional expenditure). Our guess is that some room for this extra spending is provided by the much-larger-than-necessary planned subsidy for the Social Security Fund (FUS). In 2019 PLN49bn have been earmarked for FUS. PLN28bn has been already transferred in January-July. By trimming sharply this subsidy later this year the government could effectively pass over the cost of extra 13th pension to FUS, relieving the central budget. Other options include seeking savings in various other areas (current expenditures of budgetary units, co-financing of EU funded projects, for example). It is also still possible that after the parliamentary elections some minor budget amendment will take place, lifting the spending limit slightly, yet still keeping deficit at or below the initial plan thanks to higher revenues.

Budget macroeconomic assumptions

	2019	2020
Nominal GDP	2236.5	2373.3
Real GDP	4.0	3.7
Consumption	4.0	3.8
Export	5.3	4.8
Import	6.0	5.1
CPI	1.8	2.5
Current account	-1.2	-1.4
Employment	2.2	0.5
Unemployment	5.5	5.1
Wage growth	7.6	6.0

Source: Ministry of Finance, Santander

Monthly subsidies to FUS, PLNbn



Source: Ministry of Finance, Santander

Economic Analysis Department:

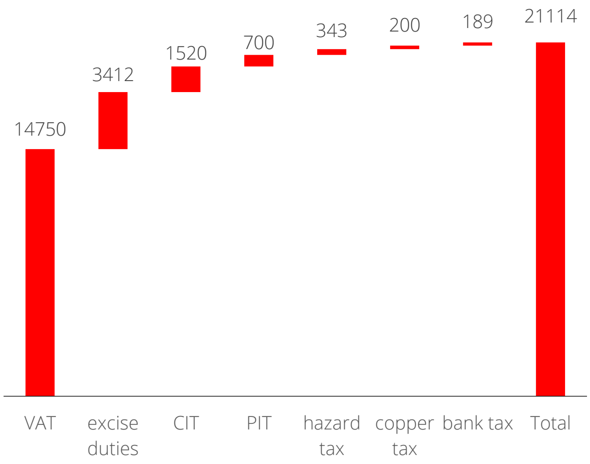
al. Jana Pawła II 17, 00-854 Warszawa
email: ekonomia@santander.pl
website: santander.pl/en/economic-analysis
Piotr Bielski +48 22 534 18 87
Marcin Luziński +48 22 534 18 85
Wojciech Mazurkiewicz +48 22 534 18 86
Grzegorz Ogonek +48 22 534 19 23
Marcin Sulewski, CFA +48 22 534 18 84

Main parameters of 2020 budget (PLNbn)

	2019 plan (1)	2019 forecast (2)	2020 plan (3)	change (3) / (2)
Total revenues	387,735	404,248	429,480	*6,2%*
Tax revenues	359,731	371,393	392,507	*5,7%*
VAT	179,600	185,400	200,150	*8,0%*
CIT	34,800	40,280	41,800	*3,8%*
PIT	64,300	65,815	66,515	*1,1%*
Excise duties	73,000	71,493	74,905	*4,8%*
Bank tax	4,551	4,689	4,878	*4,0%*
Non-tax revenues	25,806	30,768	34,631	*12,6%*
Total expenditure	416,235	416,235	429,480	*3,2%*
Budget balance	-28,500	-11,987	0	*N/A*
GG balance(% PKB)	-1,8%	-1,0%*	-0,3%	

Source: Ministry of Finance, Santander ** Santander forecast*

Main sources of tax revenue growth in 2020 vs 2019 (PLNm)



Source: Ministry of Finance, Santander

2020 Budget Revenues: ambitious, yet achievable

Revenues in 2020 were planned at PLN429.5bn (+6.2% y/y versus projected 2019 realisation). Increase in tax revenues looks quite ambitious, and is based on bold assumptions about further elimination of tax loopholes. On the other hand there is a chance for the 2019 NBP profit payout (given weaker zloty and the NBP investment in gold), which is not included in the draft, so risks for revenues seem to be balanced. At least in macroeconomic terms, because many of the additional revenues have not been enacted yet, so an important part of planned budget adjustment (e.g. OFE) is based on still uncertain measures.

The budget assumes neither implementation of retail tax nor digital tax in 2020, but it does include a hike in excise on alcohol and tobacco, additional revenues from recycling fee, solidarity tax, and some one-offs (auctioning CO2 certificates and 5G frequency). The government also assumes elimination of 30x threshold for social security contributions and pension system changes (dismantling OFE), which does not affect directly the revenues of the central budget, but boosts inflows of cash to Social Security Fund (FUS), which is an important part of balancing the 2020 budget (through lower subsidy).

Higher VAT receipts are the main source of planned revenue growth, as they are expected to reach PLN200.1bn (+8.0% y/y or PLN15bn vs projected 2019 realisation). Assumed increase seems to be overly optimistic, in our view: despite slowing economy and consumption, VAT inflows are expected to rise faster than this year (6% or PLN10bn). And it is hardly even explained by the planned further elimination of tax evasion, as the government assumed extra revenues stemming from this source at PLN7.9bn in 2020 versus PLN7.4bn in 2019. According to our estimate, the government's forecast implies further increase of the effective VAT rate in 2020, to its all-time high, despite anticipated economic slowdown; it seems to be a risky assumption.

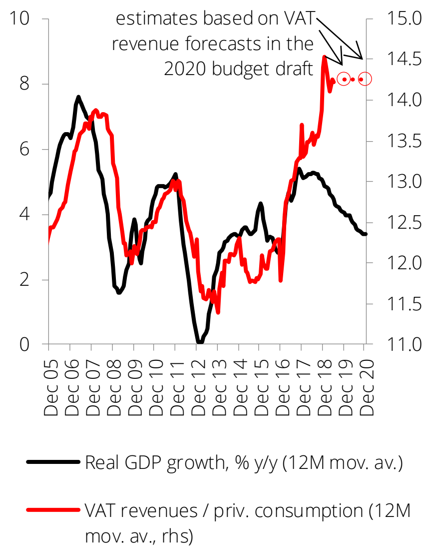
Excise duties are expected to rise by 4.3% to PLN74.9bn from PLN71.5bn. PLN1.1bn is to be achieved thanks to hike of duties on alcohol and tobacco.

Personal income tax (PIT) revenues were assumed at PLN66.5bn in 2020 versus PLN65.8bn in 2019 (+1.0% y/y). While this may look as a conservative forecast, bear in mind that PIT revenues will be under negative spell of reducing tax wedge: introduction of 0% PIT rate for people aged below 26, lowering of first tax levy to 17% from 18% and cancellation of limit for social benefits. The total impact of those measures lowers the PIT incomes by about PLN7.0bn. This means that the government assumed the underlying PIT growth to be near 9% y/y, which seems to be quite optimistic given expected rise in wage bill by 6.5% y/y and in pension bill by 5.0% y/y.

Corporate income tax (CIT) revenues are expected to rise to PLN41.8bn from PLN40.3bn (3.8%). In our view this forecast is achievable, unless economic slowdown proves deeper and/or banking sector results are under strong pressure.

Other taxes: hazard game tax is expected to yield PLN2.55bn (PLN2.2bn in 2019), copper tax PLN1.7bn (PLN1.5bn in 2019), banking tax PLN4.9bn (PLN4.7bn in 2019).

Cyclicality of effective VAT rate and its estimate implied by 2020 budget draft



Note: estimate based on budget plan of VAT revenues and our own forecast of GDP/consumption

Source: Ministry of Finance, GUS, Santander

Non-tax revenues are expected to rise to PLN34.6bn from 30.8bn (12.6%) which is mostly achieved thanks to incomes from sales of CO2 emission rights (c.PLN6.0bn).

2020 Budget Spending: restrained growth

Total budget spending is planned to reach PLN429.5bn in 2020, i.e. PLN13bn (3.2%) more than expected in 2019. According to government's estimate it would imply the spending-to-GDP ratio decreasing to multi-year low of 18.1%, versus this year's 18.6%. In our view this ratio will be even lower (17.7%) as nominal GDP is likely to be higher than the government assumed.

At the first glance the increase in expenditure vs. the current year looks surprisingly small and raises a question how the government is going to cover all the expenses, including those determined by the existing laws plus the announced pre-election promises. Meanwhile, the document claims it provides the necessary financing for the government's key initiatives, including extension of 500+ programme, 6% wage hikes in the public sector, pensions indexation by 3.24%, higher spending on defence, higher spending on education and science. The large part of this puzzle seems to be explained by a massive reduction of the budget subsidy to the Social Security Fund (FUS), which goes down to PLN26bn in 2020 from this year's plan PLN49bn. This offsets vast part of the expenditure growth (quite restrained, anyway) in other areas, leaving the total spending increase at modest PLN13bn. Please see the margin table for the list of changes in major spending tickets in 2020.

There is no single mention in the budget draft about the payment of 13th pension, and there is no money allocated for it in the central budget, even though the government officials pledged many times the payment will be repeated if PiS is re-elected in the autumn. However, please recall that this measure was also not included in 2019 draft, and yet it has been paid out without even lifting the budget spending limit. We think the government may deliver the 13th pension in 2020, if it wants, without changing the budget deficit, but rather by boosting gap in social security (and thus worsening total public finance position). It is worth noting, by the way, that some part of budget deficit is already being phased out to other public sub-sectors, which is reflected by the fact that the planned balance of the entire general government (GG) in 2020 would be -0.3% of GDP despite the central budget balance at zero. The last update of Convergence Programme assumed the opposite proportions.

The budget does not secure any funding for the extension of energy tariff freeze in 2020, which confirms our bet that energy prices will become market-driven next year, pushing up CPI growth at the start of the year.

Overall, the low level of total expenditure (even though partly achieved thanks to dismantling OFE and thus lowering FUS subsidy) proves that fiscal discipline is maintained and the Stabilising Expenditure Rule still works as an effective fiscal anchor, even when the government tries to boost its election chances by higher money redistribution. Still, in our view the way how the government sets priorities for its fiscal policy is a challenge for medium-term growth prospects and fiscal stability. The problem with such approach is that it generates short-term consumption booms at the expense of higher long-term tax burden or/and constraint on non-social spending.

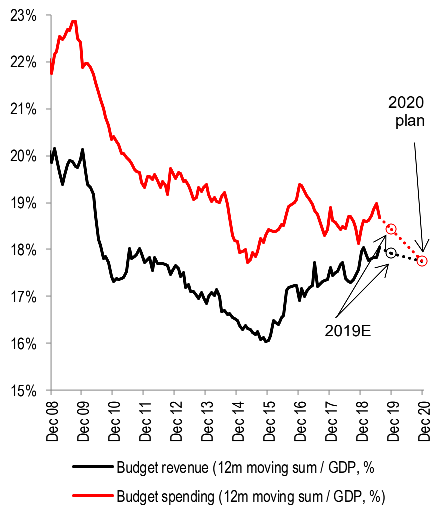
Social Security Fund: boost of revenues

As we stated above, lower subsidy for the Social Security Fund (FUS) is a major contribution to low growth in budget spending.

Total FUS revenues are expected at PLN259.3bn and PLN233.2bn ex government subsidy. Expectations for FUS revenues ex government subsidy in 2019 stood at PLN195.6bn, thus the government is expecting a whopping 19.2% rise. This rise can be achieved thanks to cancellation of 30x limit on social contributions (PLN7bn), payment of OFE transformation fee (PLN10bn) and improved collection of social contributions (PLN2.6bn). The latter is probably related to the planned introduction of social security contributions for civil contracts. Growth of FUS revenues ex these factors equals c.10% y/y and this in our view is plausible, given that actual results of 2019 are likely to be somewhat better than planned in 2019 budget.

Total costs of FUS in 2020 are expected at PLN257.9bn and social benefits at PLN252.2bn versus 2019 expectations at PLN246.3bn and PLN240.6bn, respectively. Note that rise in social benefits is planned at 4.8%, which in our view is another sign that the government did not include the 13th pension in the 2020 budget.

Budget revenues and expenditures (12M rolling) as % of GDP



Source: Ministry of Finance, Santander

Changes in budget spending in 2020 on selected items (PLNbn)

500+ programme	+10
Wages in the public sector	+5
Pensions	+12
Defence	+5
Higher education and science	+2,2
Healthcare	+1
EU contribution	+1.1
FUS subsidy	−23
Debt servicing	−0.7
NET	+12.6

Source: Ministry of Finance, Santander

Borrowing needs: low, but higher than in 2019

Net borrowing needs of 2020 budget are planned at PLN19.4bn and gross at PLN137.4bn. This would be higher by PLN4.3bn and PLN2.8bn, respectively, than the predicted realization in 2019.

Like this year, the government assumes that in 2020 the effort of purchasing Polish bonds would be on the domestic market. The net domestic issuance is planned to amount PLN35.5bn vs PLN31.5bn expected for 2019. Within this amount, PLN31.5bn would come from the sale of wholesale bonds and PLN4bn from the sale of retail saving bonds.

The foreign-currency denominated debt outstanding would shrink by PLN16.2bn continuing the Ministry of Finance strategy to cut the external exposure. In the Debt Management Strategy for 2019-2022, the Ministry said that it wants to cut the share of FX denominated debt to 30% and make if fall gradually further later on. At the end of 2Q19 the ratio stood already at 28.1%. According to the Debt Management Strategy, the average debt maturity should hold near 5 years and at the end of July 2019 it stood at 5.07 (6.13 years for the foreign debt and 4.62 for the domestic debt).

According to the most recent data, in the January-June period, the total outstanding amount of the Polish PLN-denominated marketable bonds rose by PLN23.6bn. Polish investors purchased bonds for the nominal amount of PLN41.3bn out of which PLN40.4bn was bought by the commercial banks. The non-residents sold debt for PLN17.7bn, mainly the central banks (-PLN16.4bn).

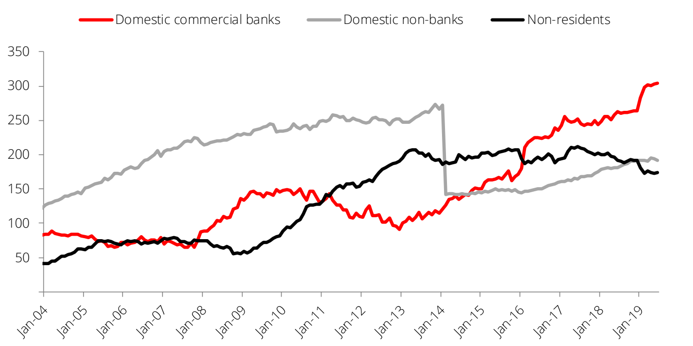
We do not see many reasons why the abovementioned structure of buyers should change in 2020. Regulatory issues and bank tax encourage Polish banks to purchase POLGBs and as long as the deposit growth is decent (currently near 10% y/y) there will be constant demand for bonds from the domestic market. There is also a clear upward trend in the amount of state debt accumulated by private individuals: at the end of June 2019 their holdings of wholesale bonds reached PLN22.5bn after the YTD rise of PLN2.5bn, and holdings of retail bonds reached PLN22.1 (+PLN2.4 YTD). In 2018, individuals purchased wholesale bonds worth PLN4bn and retail bonds worth PLN4.3bn.

Financing of borrowing needs (PLNbn)

	2019 plan (1)	2019 forecast (2)	2020 plan (3)	change PLNbn (3) - (2)	change % (3) / (2)
Net borrowing needs	46.0	15.1	19.4	*4.3*	*28%*
Financing of borrowing needs:					
Domestic, including:	57.1	31.5	35.5	*4.0*	*17%*
- treasury bonds	57.1	26.4	35.5	*9.1*	*34%*
- other	0.0	5.0	0.0	*-5.0*	*-100%*
External financing	-11.1	-16.4	-16.2	*0.2*	-
- bonds	-5.6	-15.7	-14.8	*0.9*	-

Source: Ministry of Finance, Santander Bank Polska

Holdings of POLGBs by investor groups (PLNbn)



Source: Ministry of Finance, Santander

Additional information is available on request. Please contact Santander Bank Polska S.A. Financial Management Division. Economic Analysis Department. al. Jana Pawła II 17. 00-854 Warsaw. Poland. phone +48 22 534 18 87. email ekonomia@santander.pl. http://www.santander.pl.