

Economic Comment

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2023 Budget: Something is missing

Piotr Bielski, tel. +48 691 393 119, piotr.bielski@santander.pl

Jarosław Kosaty, tel. +48 887 842 480, jaroslaw.kosaty@santander.pl

Marcin Luźniński, tel. +48 510 027 662, marcin.luzinski@santander.pl

The government has approved a draft budget for 2023 with a budget deficit at PLN65bn and a general government deficit at 4.4% of GDP. Budget revenues are expected to increase by PLN106bn and expenditure by PLN148bn compared to this year.

The macroeconomic assumptions behind the budget do not create much safety margin, in our view. At the same time, we believe that budget revenues are overstated by around PLN35bn, as the plan is based on the unrealistic assumption of the withdrawal of the 'Anti-Inflation Shield' at the end of 2022. In our view, this is difficult to do in the face of high inflation and given that 2023 is an election year. In addition, the budget does not include the 14th pension and possible compensation related to higher energy prices, which, in our opinion, generates the risk of a PLN20-30bn increase in spending. On the other hand, it may prove difficult to fully implement the ambitious plan to increase spending on national defence.

We see a risk that the 2023 deficit will turn out to be higher than the government's target and could reach 5.5% of GDP (compared to c4.5% of GDP in 2022). This could push borrowing needs higher, even though they are already swelling. The government is hoping for a massive sale of retail bonds, but we think they may be a bit too optimistic. Despite the growing deficit, on the financing side there is not much risk for the central budget, given the large liquidity surplus accumulated by the Finance Ministry. Financing of expenditure pushed out to external funds may prove more challenging, though.

The government has approved a draft budget for 2023 with a budget deficit at PLN65bn. The expected realisation of the 2022 deficit is to be at PLN23bn as compared to PLN29.9bn planned in the Budget Act. This is to be possible thanks to revenues higher by around PLN7 bn than planned and expenditure more or less in line with assumptions. It appears that the government will be able to keep the expenditure below the 2022 Budget Act limit mainly by pushing costs resulting from intervention measures taken during the year, e.g. in response to the war in Ukraine and the energy crisis (e.g. expenses related to the influx of migrants, subsidies for energy raw materials, fertilisers) away from the central budget, mainly to the COVID-19 Fund, operated by BGK. The government also supplied the Fund with a large part of this year's budget revenues (e.g. revenues from the sale of CO₂ emission allowances, NBP profit). As a result, there will be no need to amend the Budget Act this year.

The general government deficit (EU methodology) in 2023 was assumed at PLN147bn (4.4% of GDP), with the central budget deficit at around 2% of GDP. The draft budget does not explicitly indicate (as in previous years) the projected outcome of the GG balance in that year. Nevertheless, the forecast level of public sector debt implies, in our view, a deficit in the vicinity of 4.5% of GDP.

Main budget parameters

	2021 realisation	2022 expected realisation	2023 draft
Revenues (PLNmn)	494 843	498 872	604 431
Expenditure (PLNmn)	521 217	521 837	669 431
Balance (PLNmn)	-26 373	-22 965	-65 000
GG balance (% GDP)	-1.9%	-4.5%*	-4.4%
GG debt (% GDP)	53.8%	52.2%	53.1%

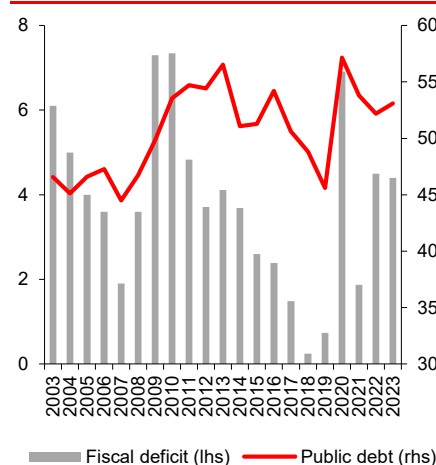
Source: Ministry of Finance, Santander, * estimate based on change in GG debt

Macroeconomic forecasts for 2023

	Budget	Bloom berg	Santan der
GDP level, PLN bn	3317.7	-	3384.3
GDP growth, %	1.7	1.9	0.5
Consumption, %	2.2	1.6	2.6
CPI inflation, %	9.8	10.1	11.8
Employment, %	-0.5	-	0.0
Unemployment, %	5.4	5.2	5.6
Wages, %	10.1	-	7.8

Source: Ministry of Finance, Bloomberg, Santander

General government debt and deficit, % GDP



Source: Eurostat, Finance Ministry, Santander
Until 2021: actual data, 2022-2023 according to Draft Budget Bill

Economic Analysis Department:

al. Jana Pawła II 17, 00-854 Warszawa
email: ekonomia@santander.pl
website: santander.pl/en/economic-analysis
Piotr Bielski +48 691 393 119
Jarosław Kosaty +48 887 842 480
Marcin Luźniński +48 510 027 662
Grzegorz Ogonek +48 609 224 857

Macroeconomic assumption without safety margin

While the macroeconomic assumptions are more or less in line with market consensus, we would not call them conservative, as the economic outlook has been changing rapidly to the downside in recent months, which we believe the consensus has not kept up with. The budget was built on the assumption that GDP will grow by 4.6% this year and 1.7% next year. Our assessment is that GDP will advance by 3.5% in 2022 and by 0.5% in 2023, so we deem government's forecast as too optimistic. Perhaps this will be partly offset by higher inflation: the government has assumed CPI at 9.8%. This is close to market forecasts (Bloomberg consensus is 10.1%), but the risks seem asymmetric on the side of higher realisation. However, it appears that the Budget Bill is based on the assumption that the so-called 'Anti-Inflation Shield' would not be extended beyond 2022. The expiration of the "Shield" would add approximately 4 percentage points to the CPI print - in such a scenario, inflation would reach over 17% at the beginning of next year even if household energy tariff stay flat. In such a situation, achieving average CPI inflation below 10% in 2023 is, in our view, extremely unlikely. In other words: the inflation forecast presented by the government is inconsistent with its assumptions on 'anti-inflationary' measures.

The government has assumed that consumption will grow by 2.2% in 2023, investment by 6.2%, unemployment will rise slightly in the labour market (to 5.4% from 5.0%) and employment will fall (by 0.5%). Wages, meanwhile, will continue to advance at double-digit rates (10.1% in 2023 and 11.2% in 2022). We believe that assumptions regarding investment and perhaps the labour market may be too optimistic.

Budget revenue: to be revised downwards

Budget revenue was assumed at PLN604.4bn, 21.1% more than the planned realisation in 2022. Almost 90% of the increase is due to assumptions for three items: VAT, PIT and budget unit revenues / other non-tax revenues. However, the increase is largely based on unrealistic assumptions (no "Anti-inflation Shield" in 2023) and accounting effects (diversion of some 2022 revenues to other sources). In our view, the revenue plan will need to be updated to the region of PLN570bn.

VAT receipts were assumed at PLN286.3bn, 23% higher than the planned 2022 performance. Such a result in 2023 would be possible only if the 'Anti-inflation Shield' was not extended. And we deem such a scenario extremely unlikely in an election year. We therefore estimate that some PLN31.5bn should be deducted from total VAT revenues, resulting in an increase by 9.5% y/y, which we believe is consistent with macro assumptions.

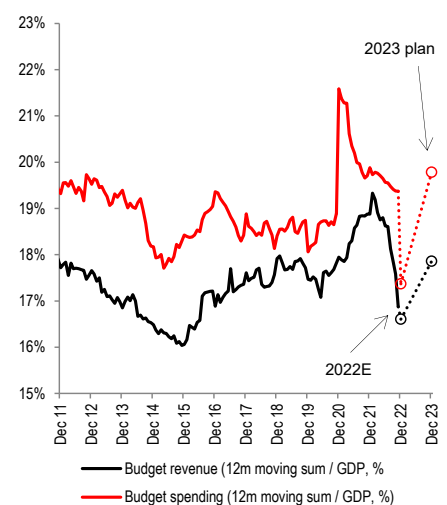
PIT revenue is planned at PLN78.4bn versus a planned realisation at PLN63.4bn in 2022. The nominal increase is therefore 23.6%, which may seem high. However, it should be borne in mind that in 2022 the government plans to redirect an additional PLN13.7bn of PIT revenue to local governments (but then in 2023 the government will deduct this sum from subvention to local governments). PIT revenue also needs to be adjusted for the effects of the reduction of the first PIT tax rate to 12% from 17% from 1 July 2022 (due to this change in the tax code, the entire GG sector is to witness PLN6.6bn lower PIT advance payments in 2022, PLN15.2bn lower PIT advance payments in 2023 and PLN7.2bn tax returns of the first half of 2022, payable in 2023). PIT revenue adjusted for these changes grows by around 11-12%, which is roughly in line with the macroeconomic assumption (wage fund growth at 9.6% and pension fund growth at 16.3%).

The marked increase in '**revenues of state budgetary units and other non-tax revenues**' is an accounting effect - in 2022, the government transferred proceeds from the sale of CO₂ emission permits to the COVID-19 Fund (PLN10bn) and to the Price Difference Payment Fund (PLN9.42 bn), there are no such plans for 2023, so the revenues levels in this category is similar to 2021.

The increase in **excise revenue** is assumed at PLN6bn (up 7.3% y/y) - quite modest in our view, given that the indexation of excise duty on alcohol and tobacco (by 5% on alcohol, the specific rate on cigarettes up 10%) is expected to bring in PLN5bn, and the withdrawal of the 'Shield' around PLN3bn.

In the case of **CIT**, the government expects an increase of 6.2% y/y, However, in 2Q2022, corporate margins started to deteriorate, due to strong growth in materials and energy, among other factors. This process is likely to intensify in the following quarters, which we believe will result in a deterioration of results and negatively impact revenues from this tax, so we think this assumption may be too optimistic.

Budget revenue and spending in relation to GDP (12M moving sum, % of GDP)



Source GUS, Santander

The budget assumes a zero NBP profit in 2023. It turns out that it will also be close to zero this year, as the effect of the Coal Allowance Act introduced in August is to transfer more than 90% of the profit (almost PLN10bn) to the COVID-19 Fund. In 2023, it may be similar.

Budget revenues (PLNmn)

	2021 realisation (1)	2022 expected realisation (2)	2023 draft (3)	2023 change (3) - (2)
Dochody budżetu	494 843	498 872	604 431	105 559
1. Tax revenues	432 170	464 598	545 328	80 730
VAT	215 734	232 600	286 300	53 700
Excise	75 798	82 530	88 597	6 067
Gambling tax	3 049	3 600	4 000	400
CIT	52 374	69 300	73 607	4 307
PIT	73 606	63 425	78 368	14 943
Mining tax	3 687	4 200	4 600	400
Bank tax	5 291	5 860	5 980	120
Retail sales tax	2 632	3 083	3 876	793
2. Non-tax revenues	60 521	31 425	55 664	24 239
Dividends	1 801	1 677	2 218	540
Payment from NBP profit	8 877	844	0	-844
Custom duties	6 413	8 168	8 677	509
Budgetary units revenues and other non-tax revenues	40 285	17 285	40 530	23 245
Payments of local governments	3 146	3 451	4 239	789
3. Non-refundable funds from the EU and from other sources	2 152	2 848	3 439	591

Source: Finance Ministry, Santander

Spending: higher debt servicing costs and defence spending, but where is the 14th pension?

The recently revised Stabilising Spending Rule (SRW) formula has been applied in 2023. The public finance sector spending limit set by the rule sits at PLN1316.4bn in 2023, compared to PLN1054.8bn in 2022. **The nominal increase in the sector's spending limit is therefore as high as 25%** and in relation to GDP it jumps to 39.7% of GDP from 35.0% of GDP in 2022. This will be the highest limit relative to GDP since the onset of the spending rule (first applied in the 2015 budget).

Budgetary expenditure is set to increase to PLN669.4bn from PLN521.8bn enacted in the 2022 Budget Act, an increase of 28%. Compared to GDP, spending will increase to 20.2% of GDP from 17.3% in 2022. The main factors behind this increase are higher debt servicing costs, inflation and wage increases (which translate into higher current costs), and increased spending on national defence. National defence expenditure (put in the Bill under heading 752) increases to PLN85.5bn from PLN47.6bn in 2022 Budget Act. The expenditure included in headings 92 and 752 (i.e. after including military pensions, for example) is expected to be at PLN97.4bn and, after adding the expenditure realised outside the budget, PLN130-140bn as compared to PLN58bn in 2022.

In our opinion, however, what is important is what is missing from the budget. There is no 14th pension (there is PLN14.8bn envisaged in the Solidarity Fund for additional pensions as compared to PLN12.7bn in 2022, i.e. only for the 13th pension). We actually believe that payment of 14th pension is highly likely, especially in an election year. There are also no funds earmarked for possible compensation for higher energy commodity prices (which this year exceeded PLN20bn). Therefore, we believe that additional expenditure items worth PLN20-30bn may emerge in 2023. On the other hand, it may prove difficult to fully implement the ambitious plan to increase spending on national defence.

The most serious increase in expenditure is planned in **debt service expenditure**: to PLN66bn from PLN26bn, i.e. by 154%, and this has to do with the marked increase in government bond

Budget expenditures in 2023 by sections (PLNmn)

	2022 (1)	2023 (2)	change (2) - (1)
Budget expenditures	521 837	669 431	147 594
Agriculture and hunting	7 960	8 582	622
Forestry	22	8	-13
Fisheries	143	192	48
Mining	385	1 357	972
Manufacturing	1 386	1 335	-52
Trade	559	185	-374
Hotels/restaurants	20	34	14
Transport, Communication	10 218	16 401	6 184
Tourism	72	104	32
Housing	469	1 638	1 170
Services	577	696	118
IT	24	132	108
Higher education	27 312	28 621	1 309
Public administration	18 140	20 229	2 089
Offices of supreme state authorities, control and protection of law and the judiciary	3 052	3 673	621
Defence	47 577	85 497	37 919
Social security	91 389	117 777	26 388
National security and fire protection	19 061	21 919	2 858
Justice	17 214	20 198	2 984
Debt servicing	26 000	66 000	40 000
Various expenditures	149 810	174 198	24 389
Education	2 553	2 891	338
Health	20 945	17 465	-3 480
Social aid	4 311	4 398	87
Other tasks of social policy	4 101	4 369	268
Educational care	162	224	62
Family	62 297	63 642	1 345
Communal services and environment protection	1 702	1 847	145
Culture and heritage protection	3 755	3 901	146
Botanical and zoological gardens, areas and items of nature protection	157	159	2
Physical education	464	1 757	1 294

Source: Finance Ministry, Santander

yields. However, this is hardly a surprise: already in the Convergence Programme Update of April, the MF signalled an increase in debt servicing costs of a similar magnitude.

Expenditure under **'grants and subsidies'** is set to increase by PLN20bn or by 7.8%. Within this category, subsidies and subventions streamed to families will fall by PLN156.bn, which will, however, be offset by an increase in the expenditure in the 'benefits to individuals' category, so in total, spending on families will increase by PLN1.3bn. It appears that the government has reclassified some of the benefits from the voivodships' budgets to the ZUS (social security) budget. Subsidies in compulsory social insurance category are set to increase by PLN21.4bn (including PLN20bn for FUS – Social Security Fund), which is probably a result of the high indexation of benefits by 13.8%, which will consume a total of around PLN45bn), in 'miscellaneous settlements' category by PLN7.8bn (including rise in general subvention for local governments by PLN10bn), in 'transport and communications' by PLN4.9bn (including PLN4.8bn for railway infrastructure).

Expenditure under **'benefits for individuals'** will increase by PLN24.3bn or 42.2%. The bulk of this is an increase in the family category (by PLN16.4bn), resulting from a transfer of spending categories, as we noted in the previous paragraph. Expenditure pertaining to compulsory social insurance will increase by PLN5.0bn (mainly due to an increase in pension benefits, e.g. in internal affairs by PLN2.4bn, in national defence by PLN1.3bn) and by PLN 2.3bn in national defence, including by PLN2.3bn in the army, which may be linked to the planned expansion of the armed forces' personnel.

Current expenditures of budget entities are to increase by PLN28.4bn (26.1%), including PLN13.0bn for the armed forces, PLN6.5bn in miscellaneous settlements (including PLN6.9bn more in reserves), PLN6.2bn in total for: justice (including PLN1.9bn for courts), public administration, public security (including PLN1.6bn for the police), health care (including PLN1.1bn for medical internships and specialisations).

Property expenses are to increase by PLN27.8bn or 94.1%, including PLN21.2bn in national defence (for the modernisation of the armed forces) and PLN2.6bn in miscellaneous settlements (including PLN2.1bn in reserves).

The costs of the **Social Security Fund** are set to increase to PLN361.2bn from PLN304.7bn in 2022 (by 18.7%), mainly due to an increase in expenditure on old-age and disability pensions: to PLN314.6bn from PLN264.9bn in 2022 (by 18.8%), largely driven by the high indexation of benefits.

As part of the European funds budget, expenditure (and at the same time revenue) of PLN26.8bn was planned within implementation of the **National Recovery Plan** (grant part). The assumption that payments from the Recovery Plan would start coming in 2023 was a contributor to the government's rather optimistic forecast of investment growth in 2023. For the time being, however, there are no prospects for disbursements of these funds, in our view.

Budget expenditures by economic groups (PLNmn)

	2021 realisation (1)	2022 Budget Act (2)	2023 draft (3)	2023 change (3) - (2)
Budget expenditures	521 217	521 837	669 431	147 594
Grants and subsidies	289 607	255 416	275 426	20 010
Transfers to households	28 985	57 546	81 851	24 305
Current expenditure of budgetary units	90 600	108 884	137 315	28 430
Capital expenditure	37 403	29 607	57 453	27 846
Debt servicing	25 958	26 000	66 000	40 000
Contribution to the EU	32 230	30 376	35 260	4 884
Co-financing of EU funds-based projects	8 812	14 007	16 127	2 120
Non-expiring spending	7 621			

Source: Finance Ministry, Santander

Borrowing needs

The budget's net borrowing needs in 2023 are expected to amount to PLN107.5bn. This is PLN48bn more than this year's expected realisation. The burden of financing fell most heavily (PLN74.7bn) on treasury securities issuance. This amount consists of gross issues at PLN204.4bn minus redemptions at PLN129.8bn. Foreign financing is set to net at about PLN32.9bn and to depend mostly on flows on foreign currency accounts (about PLN29.6bn). It seems that the Finance Ministry plans to markedly reduce its foreign currency stocks (PLN36.1bn at the end of July 2022). This will be supplemented by a loan from SURE (a loan to protect jobs and workers). In contrast, net redemptions of foreign bonds and loans from international institutions will be negative.

Borrowing needs in 2022 have already been fully financed, so as of September this year, any net bond sales should already pre-finance next year's needs.

Borrowing needs and their financing (mln PLN)

	2022 budget act (1)	2022 expected realisation (2)	2023 draft (3)	2023-22 change (3) - (2)
State budget deficit	29 900	22 965	65 000	42 035
EU funds deficit	10 221	2 609	16 182	13 573
Loans and advances granted	1124	1 171	17 614	16 443
Pre-financing of tasks from the EU	69	69	319	250
Payments related to shares in international institutions	1 770	1 785	1 982	197
Liquidity management	15 173	18 100	2 900	-15200
European funds management	-3	13 799	3 540	-8 809
Other	-18	-1 100	-21	979
Total (net borrowing needs)	58 236	59 398	107 516	48 118
Of which:				
1. Domestic financing	54 522	93 782	74 655	-19 127
1.1 Treasury securities	54 522	43 939	74 655	30 716
1.2 Funds on budget accounts	0	49 843	0	-49 843
2. Foreign financing	3 714	-34 384	32 861	67 245
2.1 Treasury bonds	-16 060	-12 717	-9 137	3 580
2.2 Loans received	-1 633	2 431	-1 039	-3 470
2.3 Loans from SURE	13 620	14 184	13 471	-713
2.3 Flows related to foreign currency accounts	7787	-38 282	29 566	67 848

Source: Finance Ministry, Santander

When one takes a closer look at the net amount of PLN74.7bn attributed to treasury securities, one can see that, once again, financing with treasury bills was abandoned. The largest increase relative to the 2022 expected execution was assumed in floating-coupon bond issuance: by PLN31.2bn. Net issuance of fixed-coupon bonds is expected to be (again) negative in 2023: new sales will be PLN4.5bn below redemptions. Index-linked bonds will also see negative issuance in 2023 (-PLN6.3bn).

Such a breakdown of marketable bonds issuance, maintaining negative net issuance of fixed-coupon bonds and significantly increasing net issuance of floating-coupon bonds seems to be not very compatible with the expected scenario of slowing GDP growth and inflation, as well as NBP rate cuts in 4Q2023.

Net issuance of savings bonds next year is expected to amount to PLN57.7bn, and will be by about PLN3.1bn lower than expected issuance in 2022. However, if one additionally takes into account 2023 redemption of savings bonds, the gross issuance rises to PLN103.6bn as compared to PLN73.2bn planned for 2022. It is worth noting, however, that the gross issuance of savings bonds originally planned in the Budget Act for 2022 was not PLN73.2bn, but only PLN26.8bn (redemptions were planned at PLN14.4bn). However, high demand in 2022,

probably triggered by high inflation and increased uncertainty about developments in stock markets, resulted in a significant increase in the net issuance of savings bonds from the originally planned sum of PLN12.4bn to PLN60.8bn.

The plan for financing gross borrowing needs for 2023 is thus based on the following assumptions: 1) demand for floating-coupon bonds will be similar to that projected for the current year (PLN27.8bn in 2023 vs. PLN28bn in 2022), 2) demand for fixed-coupon bonds will increase by about 10% (from PLN65.6bn to PLN73bn), and 3) demand for savings bonds will increase by as much as 29% compared to the record year of 2022. The latter, in particular, seems a very ambitious assumption amid the anticipated economic slowdown, the depletion of households' purchasing capacity, and the fact that banks' deposit offers have already become competitive with retail bond rates, which probably means that it may prove difficult to count on their sales performance in the following months being as good as in the record June and July 2022.

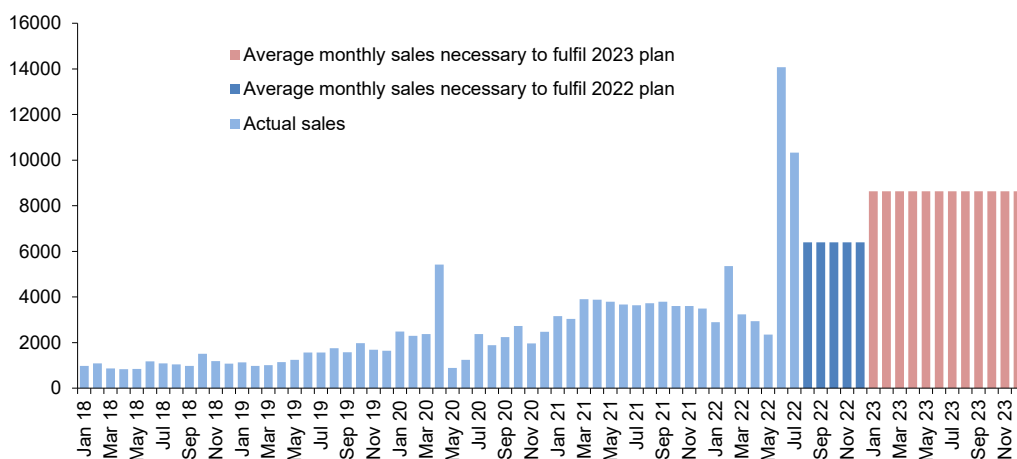
All in all, due to the significant surplus of funds accumulated in the budget accounts, which amounted to PLN142bn at the end of August this year, the financing of borrowing needs for 2023 seems feasible, with possible greater use of this "liquidity cushion" and/or more favourable bond pricing terms. However, it is worth remembering that actual borrowing needs (like the deficit) may turn out to be higher. It will probably be more challenging to obtain additional financing for off-budget funds than for the central budget.

Treasury securities issuance assumed in 2023 budget plan (mln PLN)

	2023 draft			2022 expected realisation	Net change (2023 - 2022)
	Net	Redemptions	Gross	Net	Gross
Treasury bills	0	0	0	0	0
Marketable bonds – fixed coupon	-4 569	77 553	72 984	-13 476	8 907
Marketable bonds – floating coupon	27 827	0	27 827	-3 397	31 224
Marketable bonds – index-linked	-6 307	6 307	0	0	-6 307
Saving bonds	57 704	45 906	103 610	60 811	-3 107
TOTAL	74 655	129 766	204 421	43 938	30 717

Source: Finance Ministry, Santander

Saving bonds sales (mln PLN)



Source: Finance Ministry, Santander

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