Enhancing Fiscal Framework in Poland

Aligning the Stabilizing Expenditure Rule to the European Union Fiscal Framework

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International Monetary Fund

Ministry of Finance
Republic of Poland

Outline

- Assessment of the current stabilizing expenditure rule (SER)
- Implications of alignment with EU fiscal framework
- Proposed refinements to the SER

I. Assessing the SER—implementation, strengths, and weaknesses

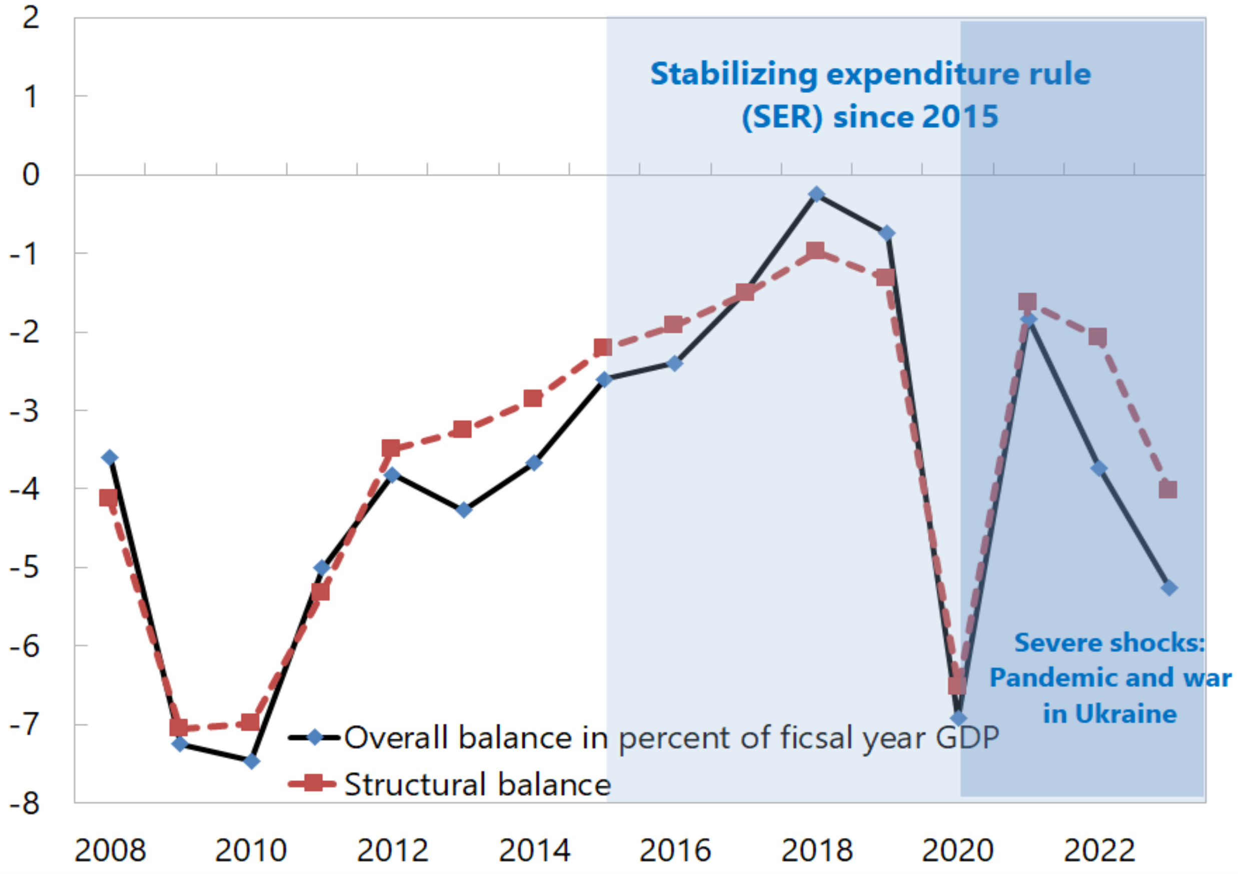
An overview of the stabilizing expenditure rule

- Set an upper limit for public expenditure for **next** budget year.
- A **formula-based** rule that accounts for economic growth, adjusted by inflation rate and discretionary revenue measures.
- **Legally-binding limit** covers ~70 percent of general government expenditure (based on Poland's definition in the Public Finance Act).
- Provisions on **escape clause and correction mechanism** to manage unexpected circumstances and deviations from the limit.
- **Ex-post compliance** monitored by the Supreme Audit Office (NIK).
- Several **amendments** have been made since its introduction in 2015, particularly in recent years.

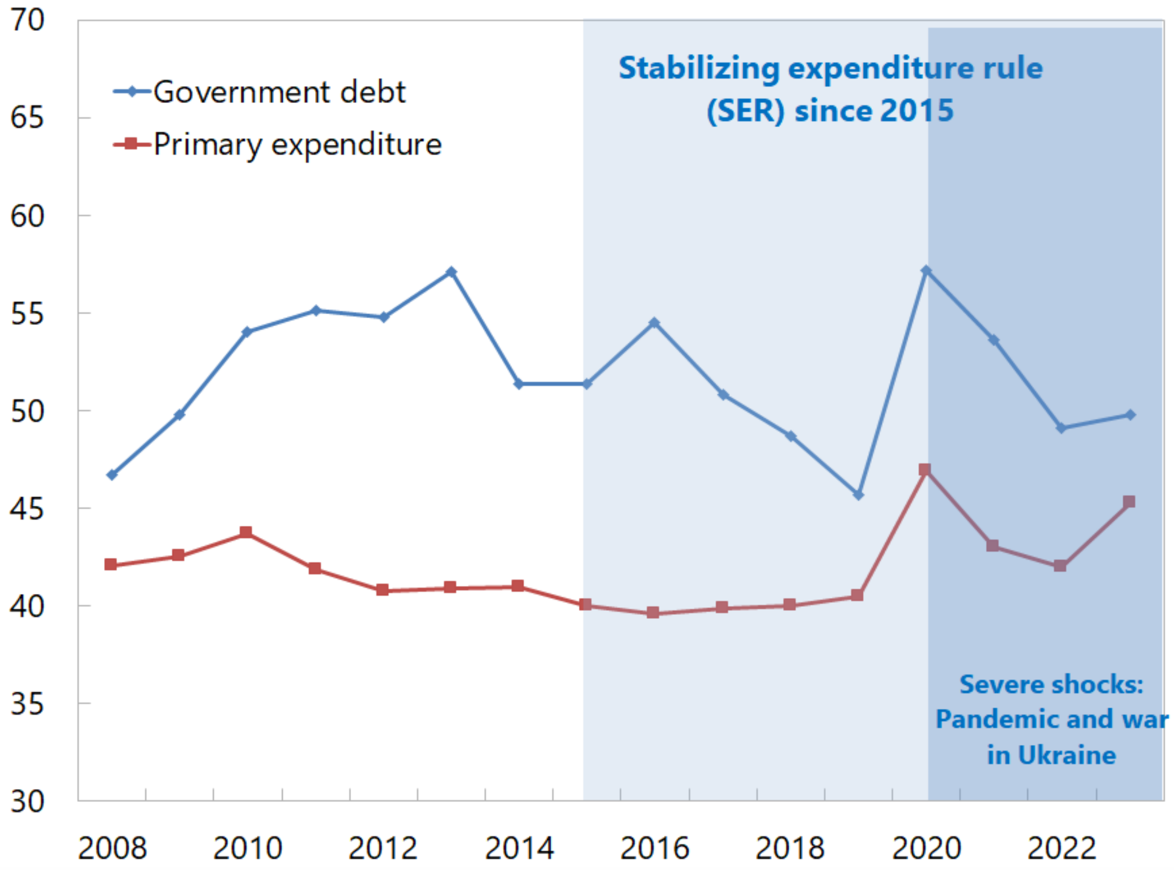
The SER was instrumental in fostering fiscal discipline leading up to the pandemic

- Declining deficits and debt and maintaining stable share of government expenditure to output during 2015-19.

Fiscal balance (Percent of GDP)



Government debt and primary expenditure (Percent of GDP)

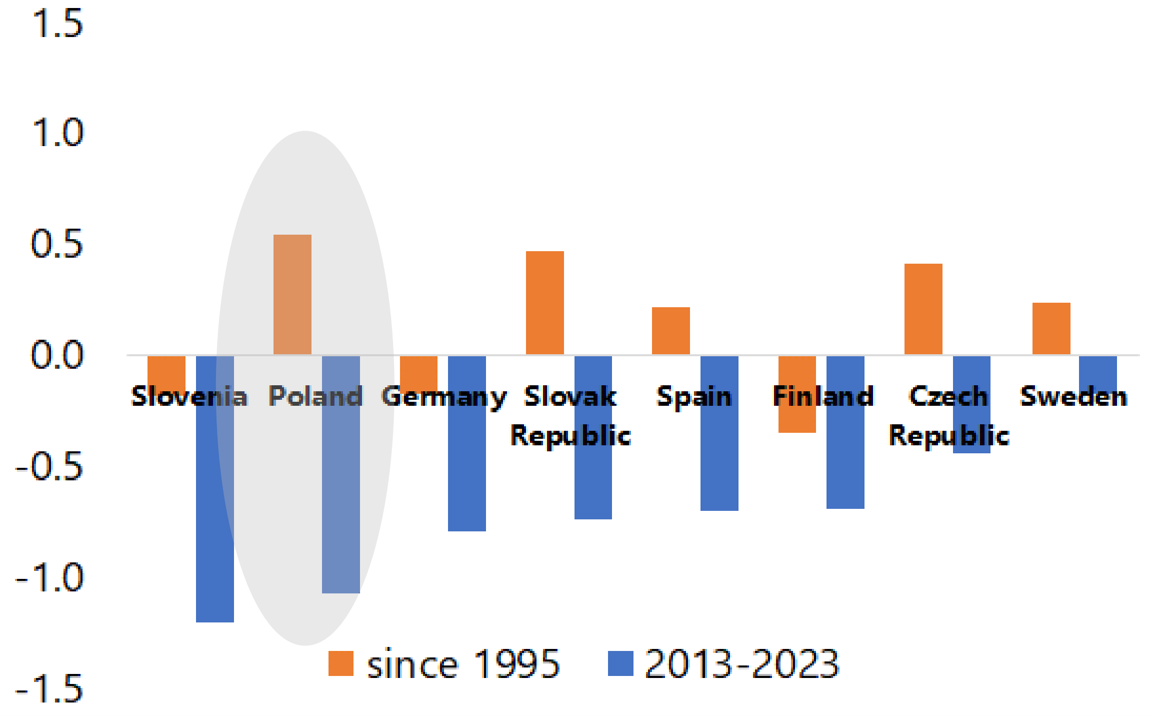


Source: IMF WEO database.

Good design features in the SER foster counter-cyclical fiscal response during adverse shocks…

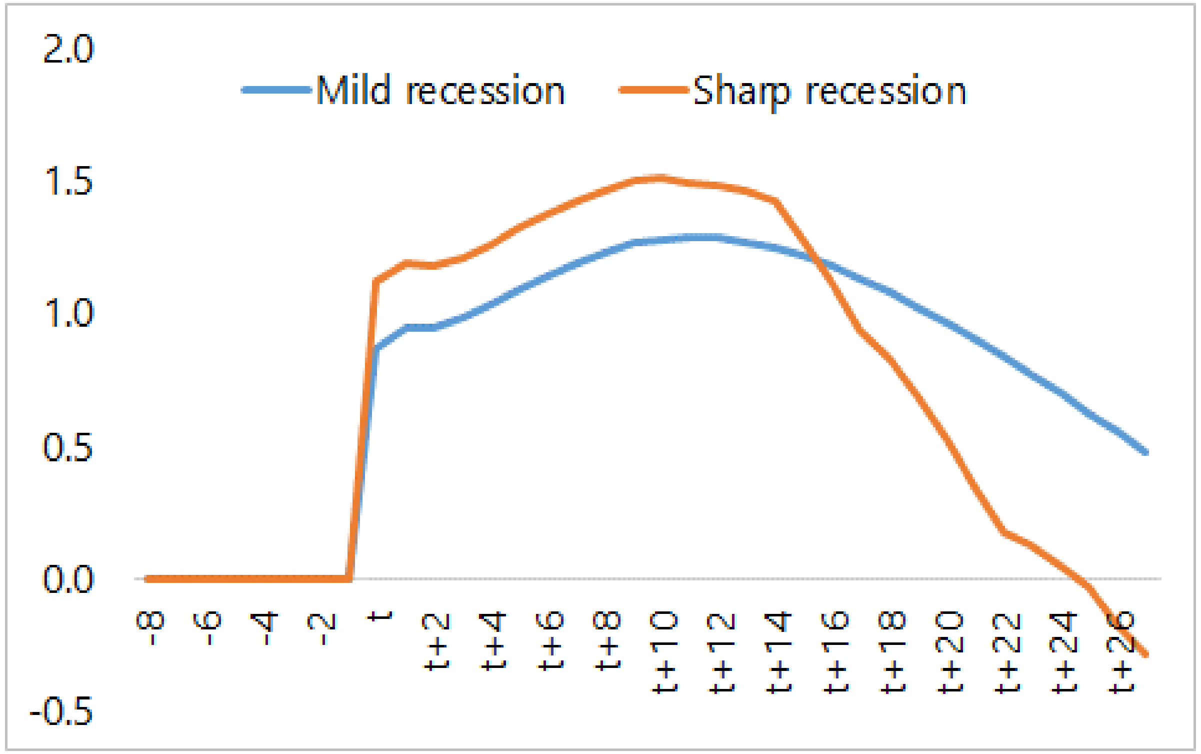
- Stronger countercyclical fiscal responses to business cycles after the introduction of the SER. Countercyclical fiscal policies also observed in quantitative exercise.

Countercyclicality of Fiscal Policy across Selected EU Countries (estimated coefficients)



Sources: IMF WEO database and IMF staff estimates.
Note: The coefficients of the Procyclicality are calculated based on the method in Bova et al 2014. We conduct linear regressions to calculate correlation coefficients of the cyclical components of real spending and real GDP. Data on general government spending and GDP are from the IMF's WEO database and the cyclical components are obtained through the Hodrick-Prescott filter with a smoothing parameter of 100.

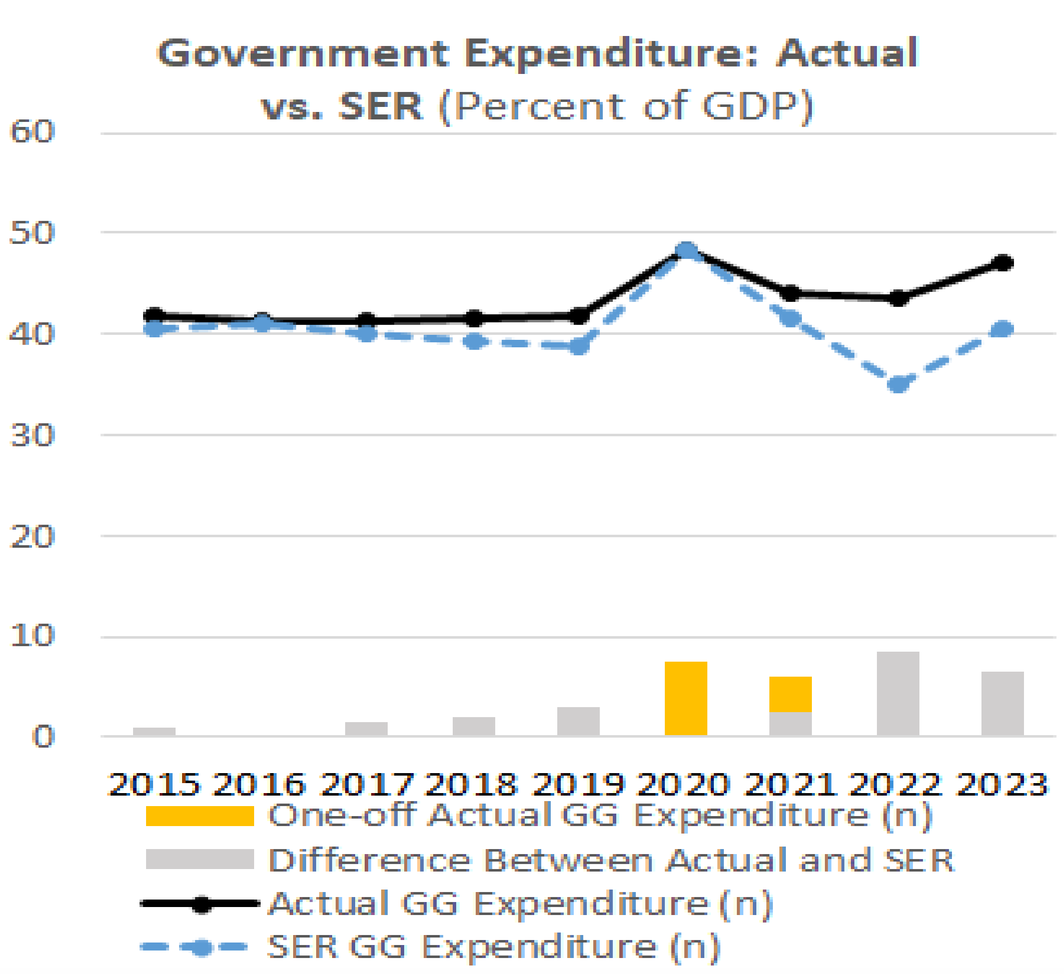
Government Expenditure in Response to Adverse Growth Shock (percent of GDP relative to baseline)

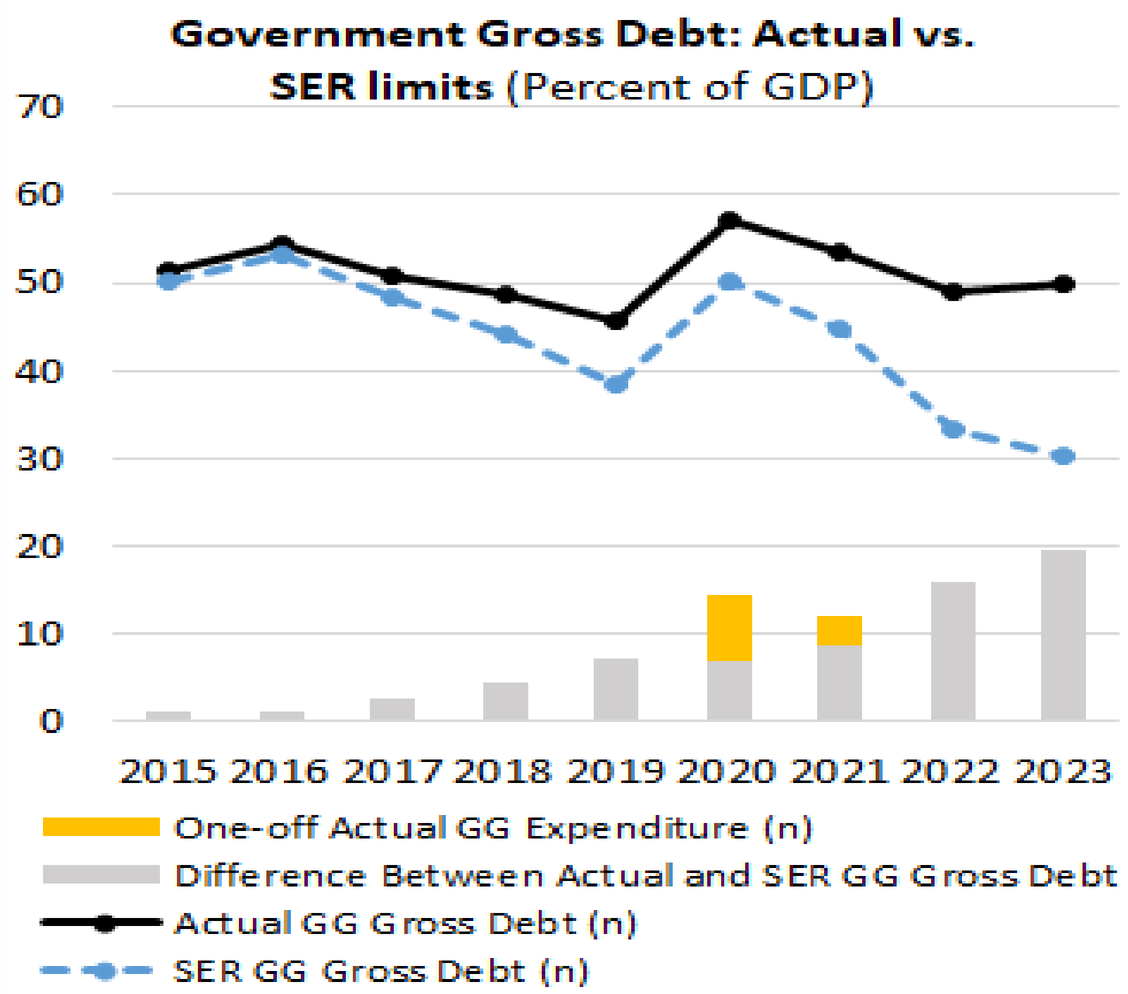


Source: Ministry of Finance model-based simulations.
Note: The temporary adverse growth shock is assumed to be 2.5 percentage points below the baseline in the mild scenario for four quarters and 3 percentage points below the baseline for the severe recession. Growth shock occurs at time t.

… as well as ensuring debt sustainability.

- Counterfactual simulations suggest the SER has contributed to fiscal discipline through stabilizing expenditures and reducing debt.



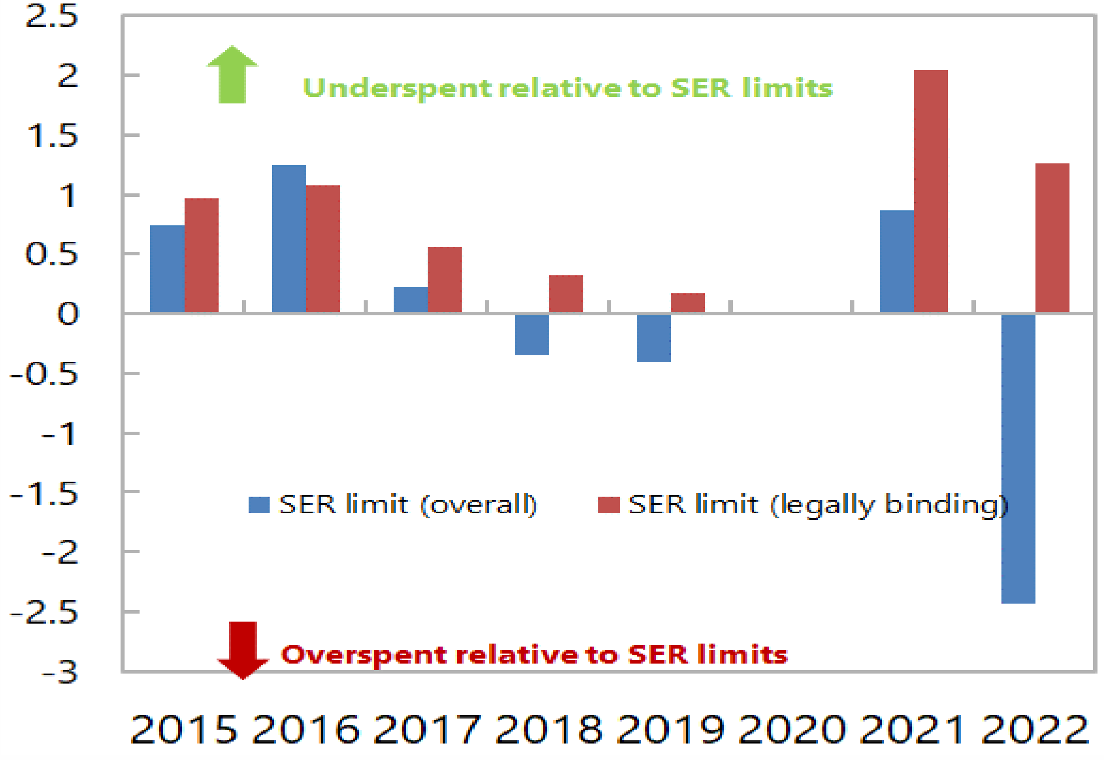


Source: IMF WEO database and IMF staff estimates.

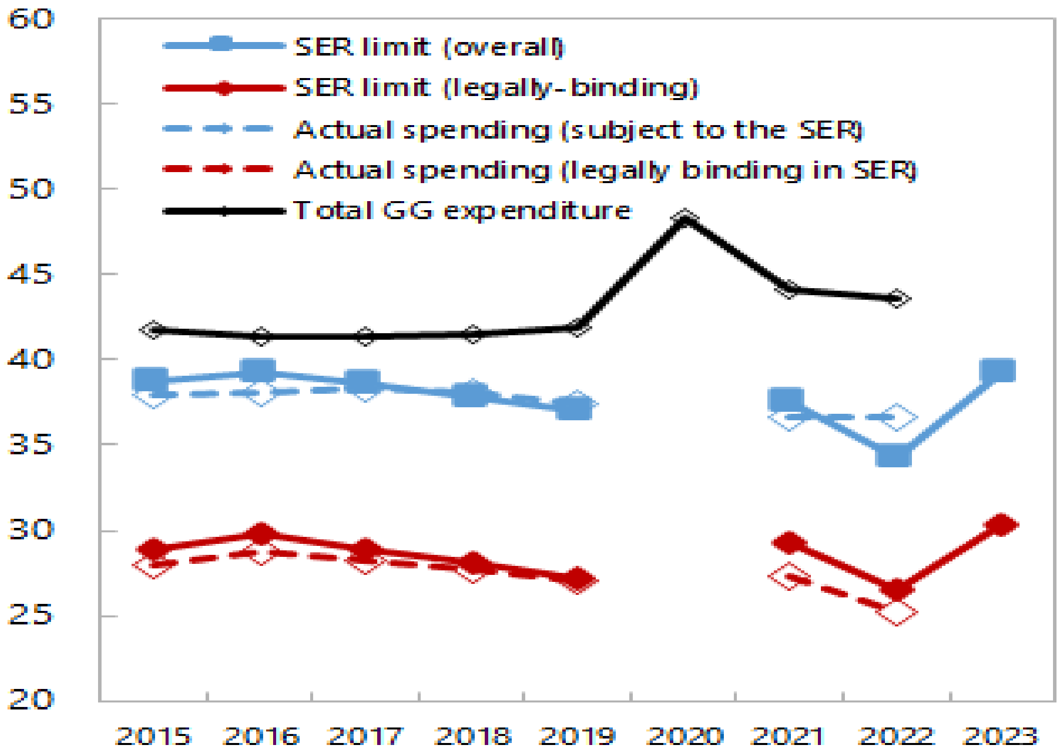
The pandemic and subsequent shocks severely tested the SER

- The escape clause was appropriately activated in 2020 to allow for additional fiscal support.
- The subsequent shocks (war in Ukraine and surge in inflation) made it challenging to return to the rule.

Difference between SER Limits and Actual Government Expenditure (percent of GDP)



SER Expenditure Limits (percent of GDP)



Source: IMF WEO database

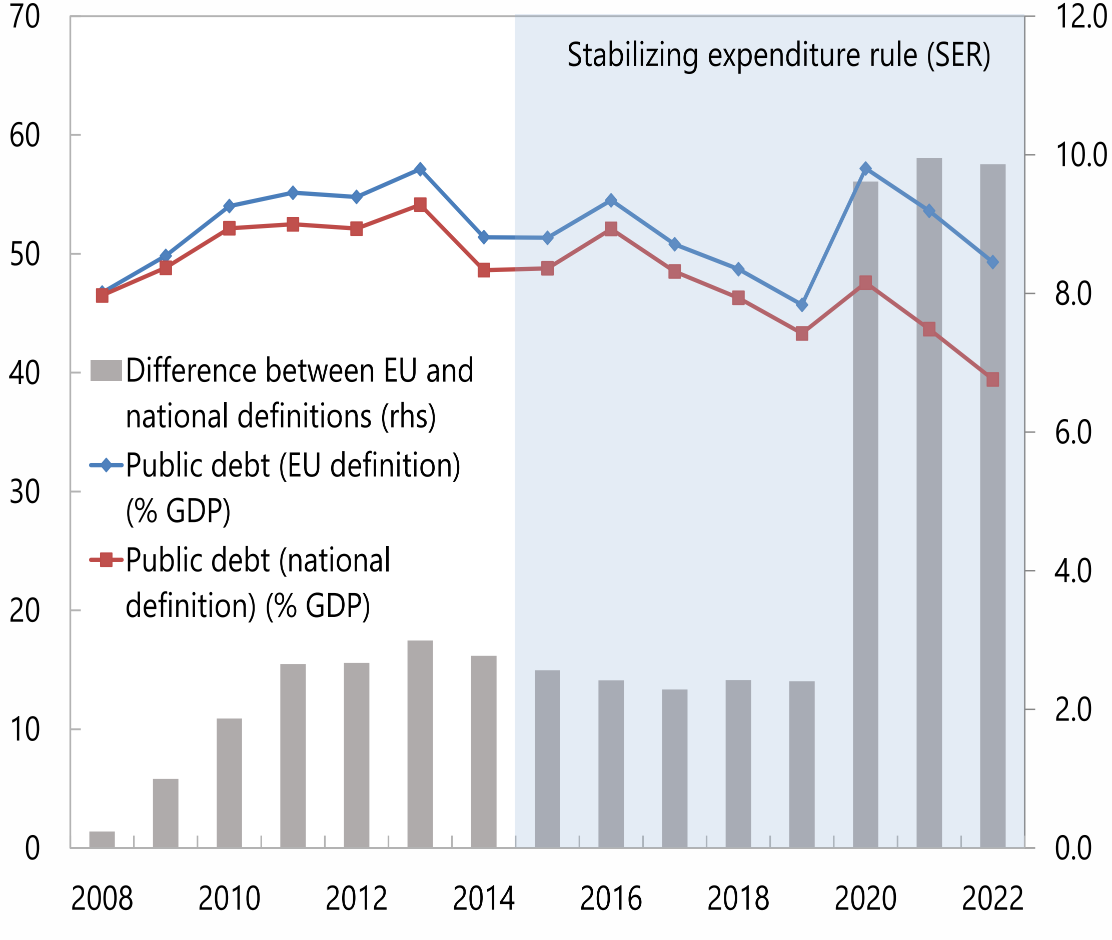
1/ Data for 2020 are not included as the escape clause provision of the SER was activated.

Design and implementation challenges in the SER were exposed as Poland faced consecutive severe shocks

1. At hindsight, the SER was insufficiently resilient to consecutive shocks (energy price spikes, inflation surprises, war in Ukraine).
2. Ad-hoc amendments owing to rigid return requirements after the escape clause expired.
   - Use of extrabudgetary funds (e.g., transfer of government securities to support fiscal operations via BGK).
   - One-off exclusions of spending (e.g., investment clause) from the SER.
3. Without independent fiscal oversight, difficult for the public to understand the validity of the amendments.
4. Lack of multi-year expenditure limits constrained the capacity to anchor fiscal policies within a credible medium-term fiscal plan.

- Ad-hoc amendments might have undermined the credibility of the SER.
- A widening between national definition and EU definition of government debt—less binding for the national debt brake.

Government Debt—Gap Widening between Definitions (Percent of GDP)



Sources: IMF WEO database and IMF staff estimates.

Additional challenges to the current SER

SER formula largely backward-looking

- Present challenges of greater fiscal pressures when medium-term growth slows (as in current projection).
- Quality of macro-fiscal forecast more important.

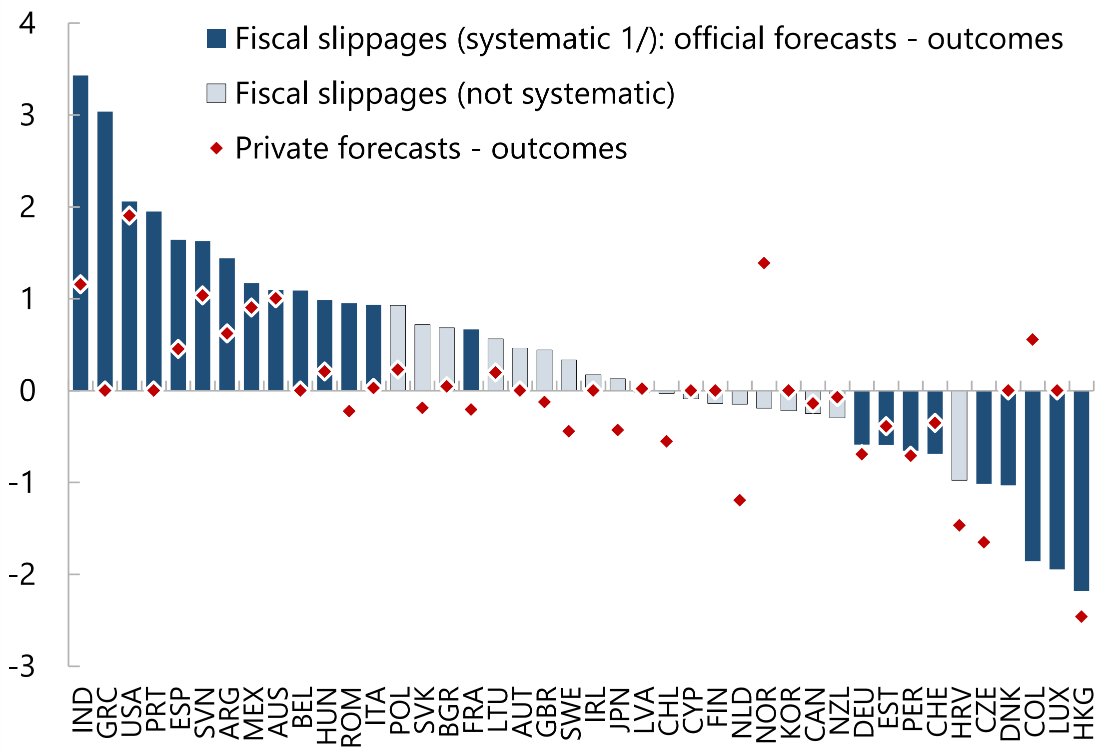
Gaps in coverage

- Adjustments to discretionary revenue measures include entities outside SER.
- Transfer of government asset to support extra-budgetary operations not covered in the SER.

Aligning the SER with the EU fiscal rule

- Multi-year EU net expenditure path and annual SER limit
- Implications of differences in coverage and accounting treatments.

Fiscal Slippages from Differences in Forecast: A comparison of official and consensus forecast
(Percent of GDP)



Sources: IMF WEO database and IMF staff estimates. Analysis covers the period from 2000-19.

II. Implications of alignment with EU fiscal framework

Multiple "moving parts" determine countries' fiscal paths in the EU fiscal framework

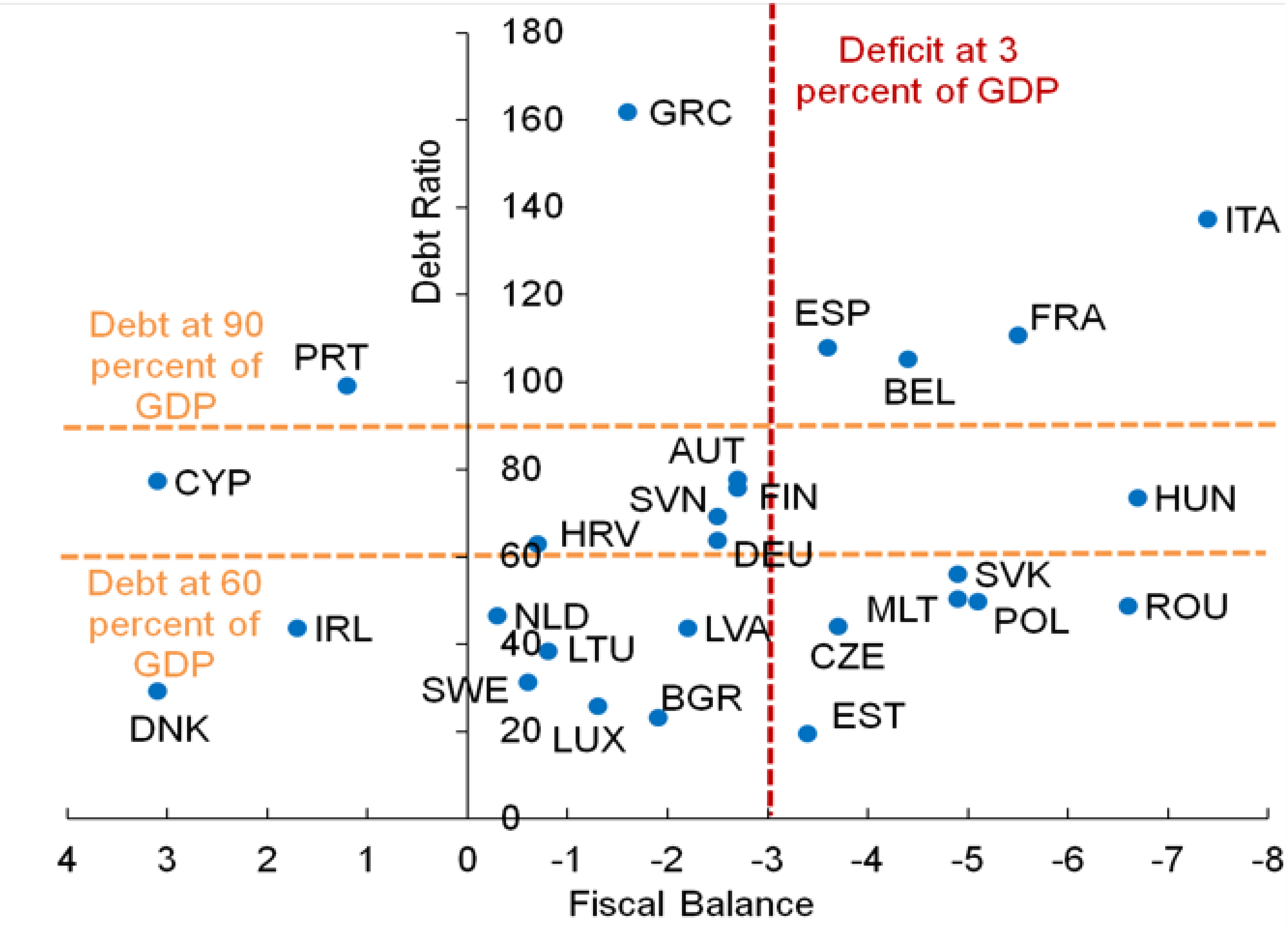
- Differentiated fiscal adjustments (technical trajectories) across countries based on multiyear expenditure paths.
- A risk-based approach based on a common DSA methodology (EC-DSA).

Adjustment period:
- 4-year or 7-year

Built-in safeguards:
- Debt sustainability
- Deficit resilience
- Excessive deficit procedure

Scenarios:
- Baseline (EC)
- A set of adverse scenarios common across countries

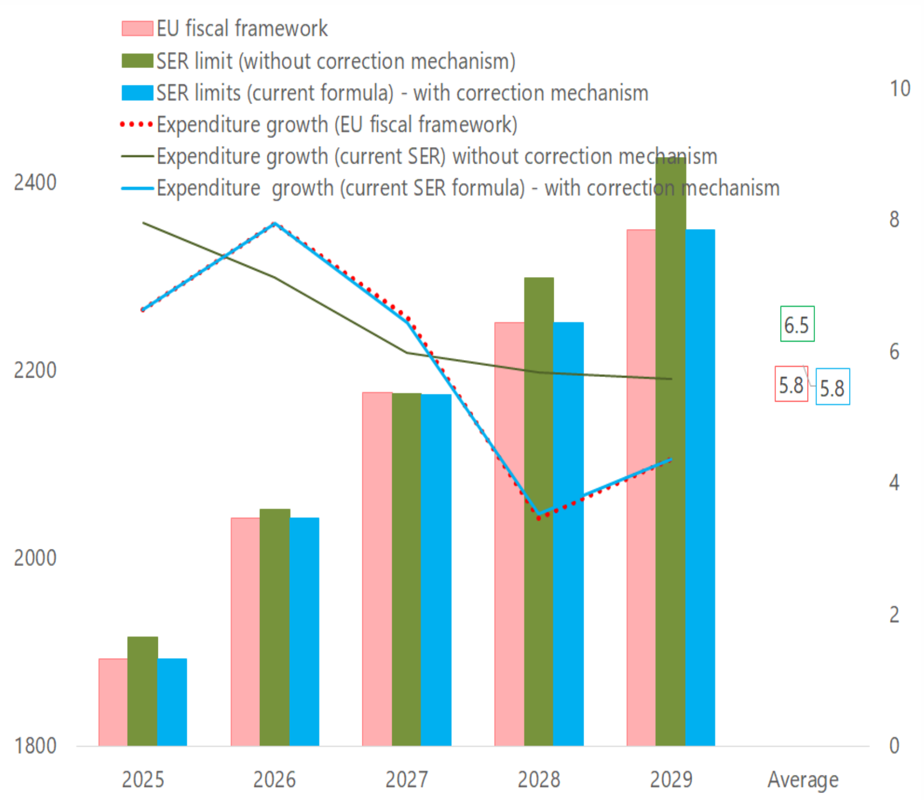
Initial debt and deficit levels



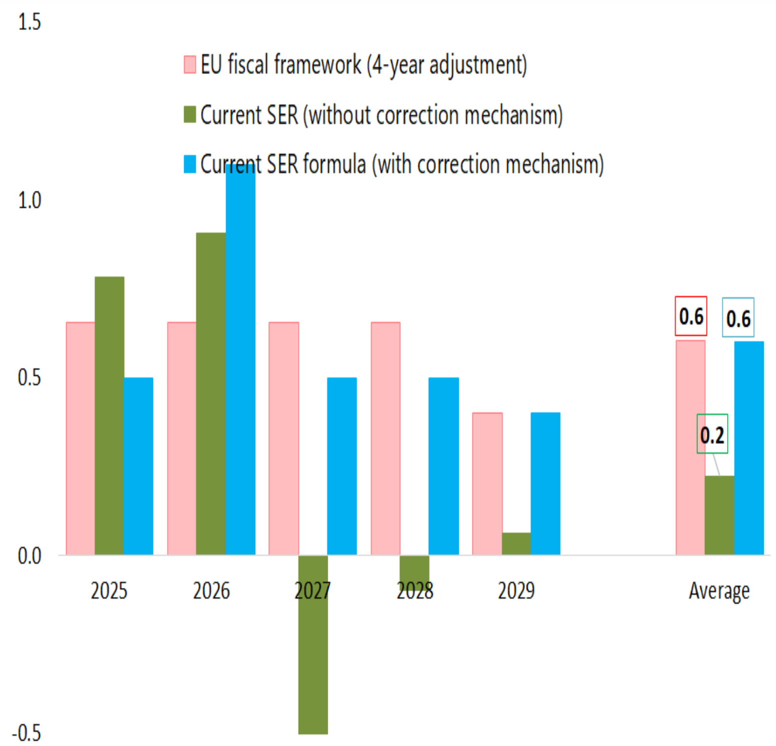
The correction mechanism plays an important role in aligning the SER to the EU fiscal framework

- Without correction mechanism, expenditures implied by the SER would be larger than that of the potential EU net expenditure path ➡ smaller fiscal adjustments and higher government debt over the medium term.
- The current correction mechanism could align better the expenditure implied by the SER closer to the potential EU net expenditure path—reduce debt in the medium term.

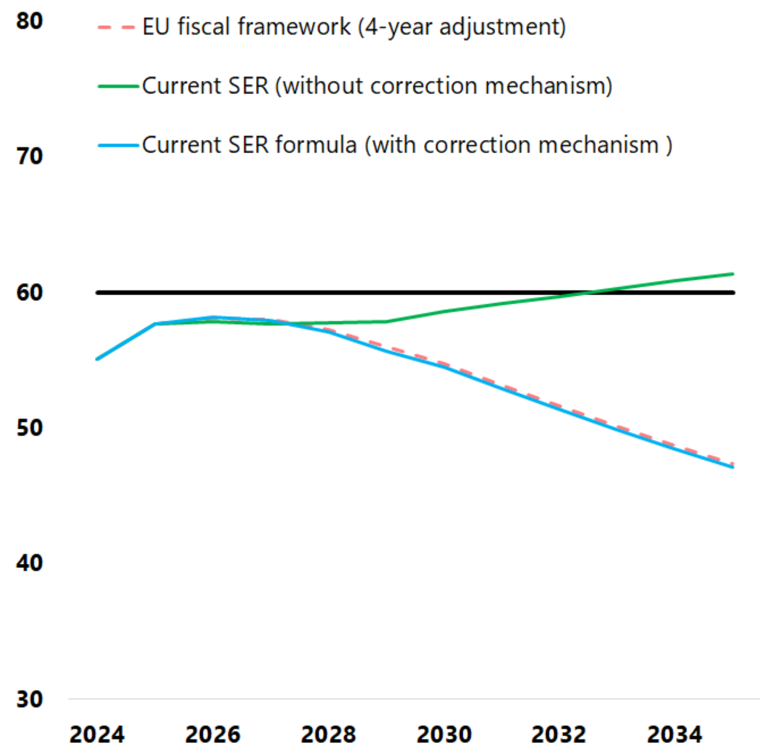
Total Government Expenditure
(Million zloty left scale; annual percentage growth, right scale)



Adjustment in SPB (percent of potential GDP)



Debt (percent of GDP)



Differences in coverage and accounting basis between SER and EU fiscal rule could raise challenges in implementation

Comparison of Poland's SER and EU Net Expenditure Indicators

	Poland's Stabilizing Expenditure Rule (SER)	EU Net Expenditure Indicator
1. Definition of Expenditure		
· Redemption of loans and credits	National budget accounting	ESA2010
· Transfer of secruities to entities covered by the SER limit	National budget accounting	ESA2010
· Government and departmental programs, state-aid not treated as the entity's expenditures	National budget accounting	ESA2010
2. Horizontal Coverage		
· Universities, Social Insurance Institution, Independent Public Healthcare Facilities, Cultural Institutions etc.	Not included	Included
· Local Government, National Health Fund, Covid-19 and Help Fund, etc.	Included; only central government transfers in the legally-binding SER limit	Included
3. Vertical Coverage		
· Expenditure on EU programs financed by EU Grants	Not Included	Not Included
· Co-financing of EU programs	Included at the moment	Not Included
· Cyclical unemployment benefits	Included	Not Included
· Interest expendiure	Included	Not Included
4. Accounting basis	Cash	Accrual
Military investments	Defense clause [1/]	Accrual
National Health Funds	Accrual	Accrual
Adjustment for discretionary revenue measures	Cash	Accrual

Sources: National authorities and IMF staff compilation.
Note 1: Cash-expenditure adjusted for the time of delivery of defense equipment.

III. Proposed refinements to the SER

1. Strengthen compliance and broaden coverage of the SER

- **Preserve credibility of the SER** by restricting ad-hoc amendments -> instead conduct comprehensive periodic reviews of the SER (every 5-6 years) to ensure consistency with fiscal objectives and economic outlook.
- **Strengthen compliance—**
  - Publish an in-depth assessment of ex-ante and ex-post compliance of the SER, in conjunction with an assessment of fiscal rule and fiscal risks.
  - Establish an independent fiscal council to strengthen fiscal oversight.
- **Broaden coverage** of the SER, including the legally-binding part of the SER (e.g., transfer of treasury securities to entities for the purpose of conducting fiscal policy).

2. Include more forward-looking parameters in the SER, provided with unbiased forecasts

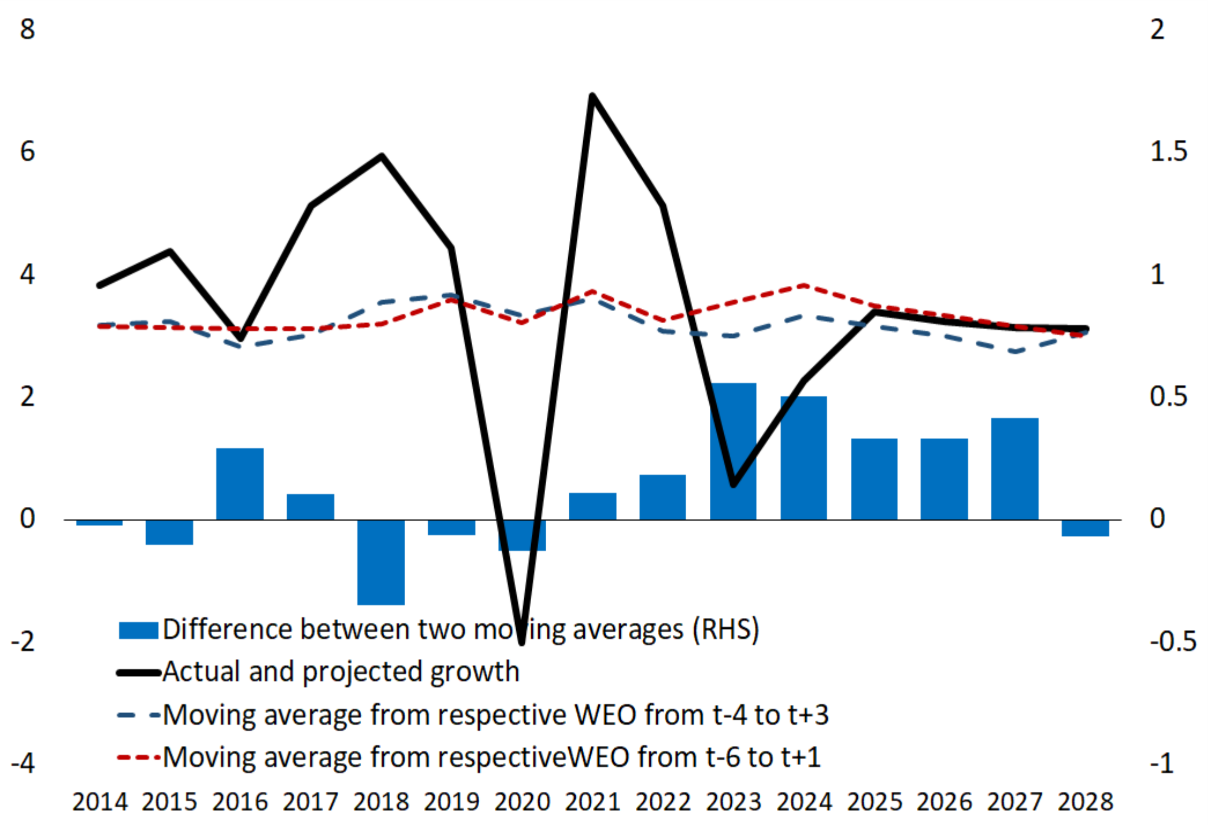
- Merits to have (i) more forward-looking indicators over the medium term *(e.g., 4 years of historical growth and 4 years of expectations of current and future growth)*; (ii) less reliance on volatile inflation indicators (e.g., headline CPI); (iii) ex-post revisions to adjust for forecast errors.

- Quality of forecast important—
  - Continue to strengthen forecasting capacity in MoF
  - Fiscal council should have mandate to assess quality of macro-fiscal forecasts.

- Maintain transparency of discretionary revenue measures (DRM) and adjustor (K) in SER formula.

- SER formula to include correction of forecast errors on growth and calibrated to maintain fiscal discipline.

Forward-looking Growth Indicators
(Percent)



Sources: IMF WEO database and IMF staff estimates.

3. Refine the provisions on the escape clause and correction mechanism

A. Escape clause

- Include “severe economic slowdown” as a standalone trigger for escape
- Consider *both economic conditions and debt sustainability* when setting size and pace of adjustment
- Fiscal council to assess the activation, implementation, and exit of escape clause.

B. Correction mechanism

- In the near term, a practical way to align the SER limit to the net expenditure path under the EU fiscal framework
- When determining the pace/size of fiscal adjustments, consider whether EU-wide escape clause is activated or not.
- Publish detailed explanations if expenditure outturns exceed the SER limit

Provide an explanation on the sources of differences between SER expenditure and EU-agreed net expenditure to help implement the fiscal rules and facilitate compliance.

4. Align the SER to the EU fiscal rules

- Align the expenditure implied by the SER with the net expenditure path agreed with the Commission and Council under the new EU fiscal framework.
    - Conduct quantitative assessment (including sensitivity analysis) of how the implied SER limits would compare with the EU-agreed net expenditure path.
    - Provide an explanation on the sources of differences between expenditures implied by the SER limit and EU-agreed net expenditure path
    - Undertake the necessary adjustment through the correction mechanism if needed.

- Prepare a communication strategy on the revision of the fiscal rules to gain credibility and garner public support and trust.

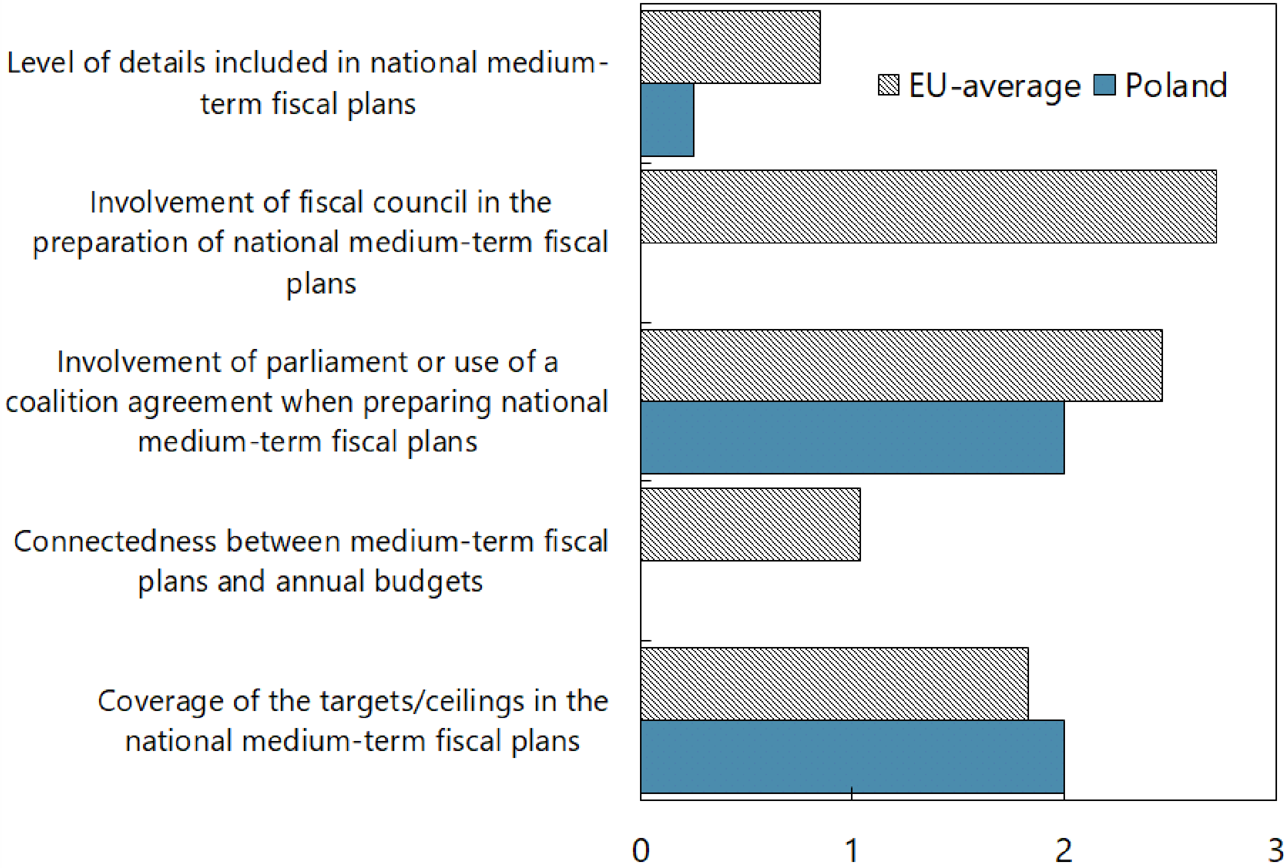
5. Transition to binding multi-year expenditure limits over the medium term

- Several successful examples from European countries adopting multi-year expenditure rules (e.g., Denmark, Finland, the Netherlands, Slovak Republic, Sweden)

- Expenditure limits set well in advance of the annual budget process allow for strategic fiscal planning and policy formulation—in turn guide expectations and improve credibility.

- Transition requires broad political support and strong technical capacity across ministries.

Characteristics of Medium-Term Fiscal Plans



Sources: European Commission Fiscal Governance Database.
Note: EU average excludes Poland.

Main takeaways

- The stabilizing expenditure rule (SER) has been instrumental in anchoring fiscal policy—several desirable features despite some potential shortcomings. Ad-hoc amendments in response to consecutive severe shocks might have undermined the credibility of the SER.
- Aligning to the EU fiscal framework would require (i) setting SER expenditure limits consistent with the EU net expenditure path (through a robust correction mechanism in the near term); (ii) explaining differences in coverage and accounting treatment.
- Preserve credibility of the SER:
  - Strengthen compliance (e.g., establish a fiscal council, comprehensive periodic review) and broaden coverage
  - Include forward-looking components in the SER formula (over the medium term) and improve forecast capacity
  - Refine provisions in the escape clause and correction mechanism
  - Align the SER to the EU fiscal framework
  - Transition toward multi-year expenditure limits over the medium term

Supporting reforms to improve the implementation of SER

Revisions to SER

Strengthen the SER and align to the EU fiscal framework **(current session of IMF analysis)**

Fiscal council

· Assess macro-fiscal forecasts and the use of escape clause; give opinion on the compliance with fiscal rules (forthcoming report by World Bank)

Budget System Reforms

1. A *new budget classification system*—stemmed from revised standardized charts of account (COA) (IMF support 2018-22)

2. A *re-defined medium-term budget framework*—build on progress made to prepare no-policy change baseline (MoF regulation in 2022)

3. New model of *state-budget management*—improve the quality and coverage of budget presentation; facilitate reallocation of expenses during a budget year.

Thank you

Background Slides

Country Examples of Multi-year Expenditure Rules

Country	Coverage	Exclusion	Limits in real or nominal terms	Multi-year expenditure rules	Adjustments	Approved by
Denmark	Separate ceilings for central government, regions, and municipalities	Interest on government debt, unemployment benefits, employment measures, some investment	Nominal, but adjustments to changes in price and wages are possible	4-year rolling basis	Reallocation of tasks between government levels, new tax expenditure, discretionary changes of expenditure not covered by ceilings	Parliament
Finland	Central government	Interest on government debt, cyclical expenditure, financial investments	Real—ceiling for t+1 adjusted to updated price and wages	4-year fixed corresponding to the government term	Reclassification of expenditure, change in the time period that an expenditure is reported	Government
The Netherlands	General government	Interest on government debt, cyclical component elements of social and unemployment benefits	Real—indexed to price and wage inflation	4-year fixed corresponding to the government term	Statistical corrections	Government
Sweden	Central government budget and old-age pension system	Interest on government debt	Nominal	3-year rolling basis	Technical adjustments to ensure unchanged bindingness, e.g. accounting changes, reallocation between government levels	Parliament

Sources: Davoodi et. al. 2022 and IMF Fiscal Rules Database 2022.

Cross-country comparison of escape clause provision

Countries	Triggering factors (e.g., type of shocks)	Procedures to trigger	Duration and size	How to return	Usage
Germany	· Natural disasters or extraordinary situations beyond government control.	Parliamentary supermajority	Discretion of the parliament	Amortization plan to reduce extra borrowing "within a reasonable time frame".	2020-2021
The Netherlands	National escape clause: extraordinary circumstances beyond the control of the government, and also, direct application of escape clauses as defined by the EU fiscal governance framework.	Government proposal, parliamentary approval	National escape clause is not explicitly defined in duration and size.	Consistent with requirement under the EU fiscal governance framework.	European general escape clause was activated in 2020
Slovak Republic	A severe decline in nominal GDP, war, and natural disasters.	Proposed by the government for parliamentary approval.	Certain sanctions or adjustment in the fiscal rule framework will not be applied.		2020
Sweden	Not specific (In the event of a crisis with far-reaching economic consequences)	The government proposes a new expenditure ceiling, which is adopted by the parliament (Riksdag)	No limit on duration and size	None	New expenditure ceiling for 2020 adopted in 2019, new expenditure ceiling for 2021 and 2022 adopted in 2020
Switzerland	· Exceptional circumstances (e.g., severe growth slowdown or natural disasters) considered by the government	Parliamentary approval by qualified majority	· Parliamentary decision on "extraordinary expenditures" via supplementary budgets. · The excess from the spending ceiling is debited from the 'equalization account' (Ausgleichskonto), while the surplus will credit to the acocunt.	- Deficits arising from extraordinary expenditures are accumulated in an account, and need to be redeemed over the next 6 years by running structural surplus through expenditure cuts, once the compensation account balance becomes nonnegative.	Used in 2017 "to accommodate migration-related spending"; in 2020 in respond to the COVID-19 pandemic shocks.

Sources: IMF WEO database and IMF staff estimates.

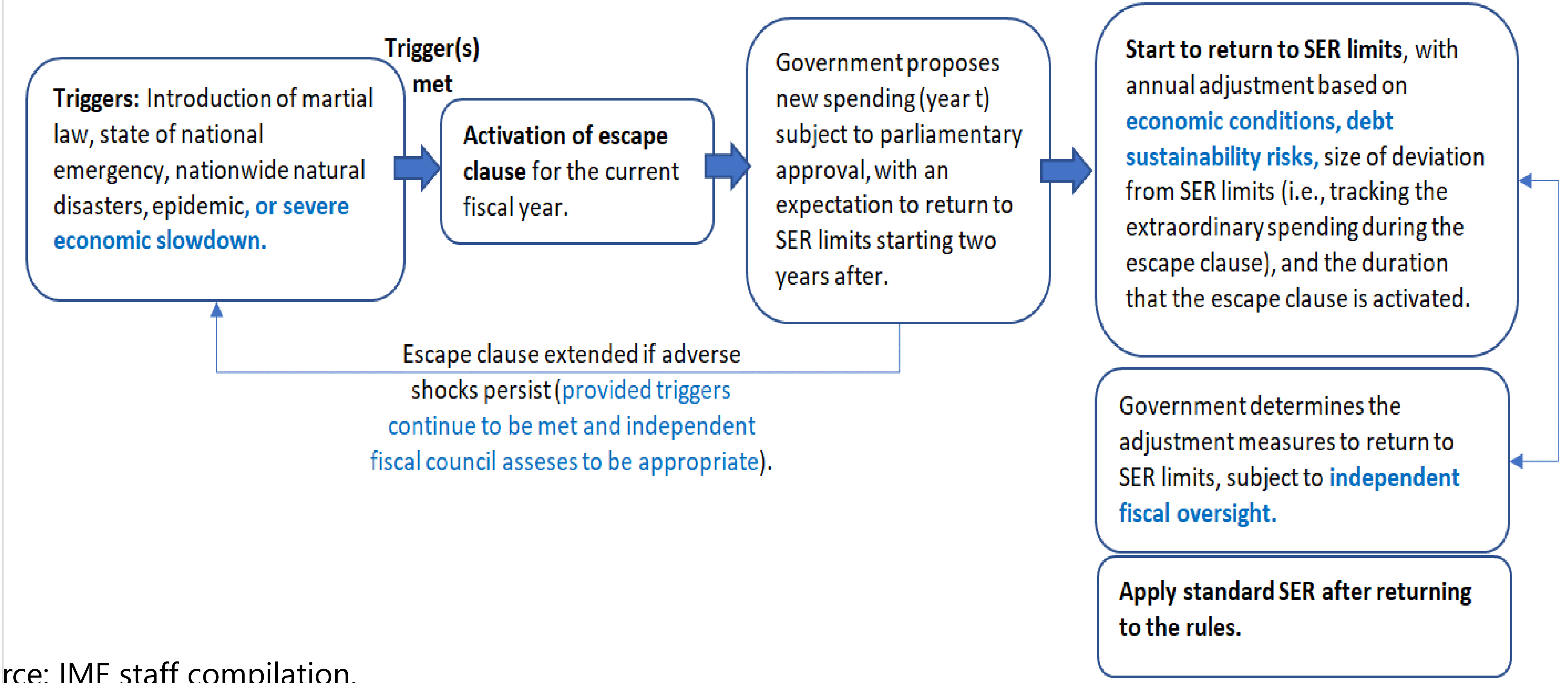
Links to presentation

3: Refining the provisions on the escape clause and correction mechanism

A. Escape clause

- Include “severe economic slowdown” as a standalone trigger for escape
- Consider *both economic conditions and debt sustainability* when setting size and pace of adjustment
- Fiscal council to assess the activation, implementation, and exit of escape clause.

Proposed Refinements on the Provision of Escape Clause



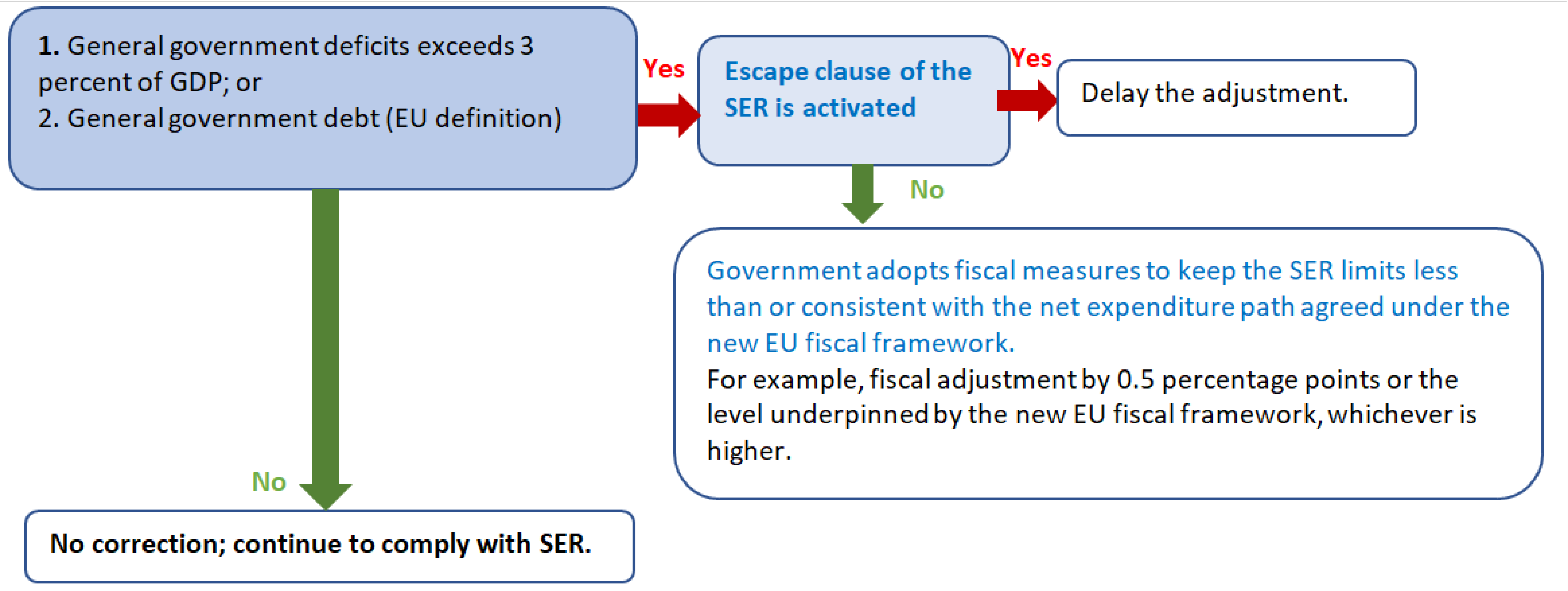
Source: IMF staff compilation.

3: Refining the provisions on the escape clause and correction mechanism

B. Correction mechanism

- The mechanism should support the SER implementation through reducing deficits and ensuring fiscal discipline
- Revise the criterion in the correction mechanism from 'economic conditions' to 'the activation of escape clause when determining the pace/size of fiscal adjustments.
- Publish detailed explanations if expenditures exceed the SER limit.
- Align the national rule(s) to the potential net expenditure path under the EU fiscal framework

Proposed Refinements on the Provision of Correction Mechanism



Source: IMF staff compilation.