

6 September 2017
Article

Poland: A feasible - and not ambitious - budget

Recent tax receipt rises are not a blip and sound growth and a reasonable fiscal stance should support Polish bonds

Contents

- At a glance
- The budget details
- The taxation question
- We're optimistic

At a glance

The 2018 draft budget draft aims at 2.7% of GDP deficit. It assumes a modest reduction of central budget expenditure (by 0.25% of GDP, despite costs of lowering the retirement age) and a significant but justified increase in effective tax rates. In our opinion, the 2018 deficit is likely to surprise positively and not exceed 2.0% of GDP. A strong fiscal stance will continue to support Polish government bonds (POLGBs), countering the effects of the government's controversial political agenda.

The budget details

The Polish Ministry of Finance has presented a preliminary budget for 2018, but the final version shouldn't change much. The document looks feasible, but also not very ambitious in terms of improvement in the structural balance. The general government deficit is expected to be 2.7% of GDP, only slightly lower (0.2ppt) than assumed in the 2017 budget bill and 0.2ppt higher than expected in the Convergence Programme (from April 2017). In our opinion, however, there is a good chance for a much better result – a 2018 deficit of c.2% of GDP. The following arguments support our view:

1. Successful tightening of the tax system was crucial for the unexpected improvement in fiscal stance in 2016-17 despite the introduction of costly social programmes. While there had been some speculation that this tightening was due to the unsustainable delaying of VAT returns by the government, MoF data has proved otherwise. In 1H17 the average waiting time for VAT returns has shortened from 43 to 40 days. The amount of VAT withheld has fallen by PLN1,8bn YoY and the companies themselves filled for lower VAT returns (by PLN4.2bn). The government plans to continue these efforts in 2018. VAT revenues are expected to grow by 10.3% compared to the 2017 forecast. This might seem a lot, but one should bear in mind that until Aug-17 VAT revenues have grown by 25% YoY YtD. This is partially due to one-off factors, but overall 2017 VAT revenue growth should still reach 15% YoY.
2. The 2018 budget assumes a central budget deficit at only 2% of GDP. The government expects a very high deficit at other government agencies (mainly the social security and health funds) and at local governments (c.0.7% of GDP), presumably due to the acceleration of EU-investments, which require costly co-financing from regional authorities. However, favourable macroeconomic conditions should allow local governments to co-finance EU investments

without the necessity to rely on debt to a similar extent as in the previous EU financial perspective (2007-13). Therefore we expect that the contribution of local governments to the deficit will not exceed 0.3ppt of GDP, far below the 1ppt of GDP reached at the peak of the previous perspective.

3. We expect that in 2018 the economy will grow at a relatively fast 4%YoY, fuelling fast wage growth (6.5% YoY) and further declines in unemployment. Tax bases will grow accordingly. Moreover, some cyclical improvement in effective tax rates might be expected - around the peak of the business cycle people tend to buy more luxury products with higher VAT rates than for necessities.

The taxation question

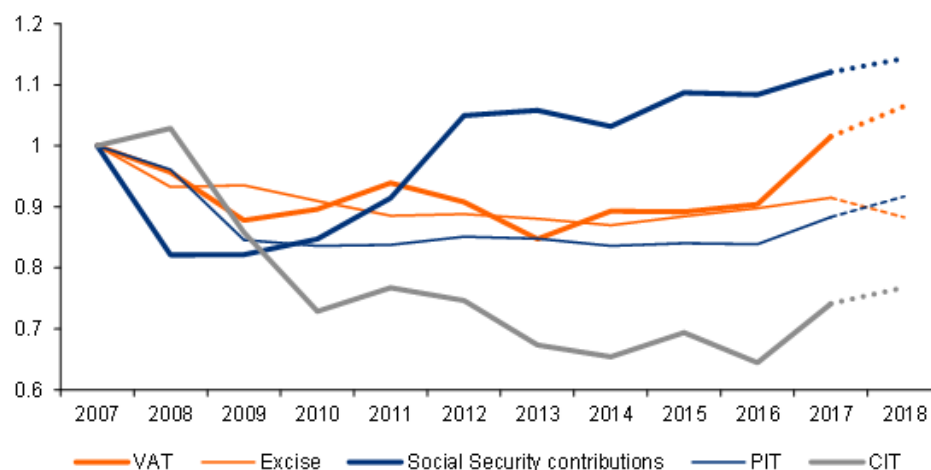
From this perspective, another 10% YoY increase in VAT revenues in 2018 doesn't seem to be wishful thinking, especially if one bears in mind that there is some space for structural improvement in the effective VAT rates due to lagged effects of the anti-tax evasion measures launched gradually over the last 18 months. Even if VAT disappoints, excise might come to the rescue.

Excise revenue estimates were conservative and a positive surprise is likely.

The 2018 budget seems to be most optimistic with regard to labour taxation. Revenues from PIT (personal income tax) are expected to grow by nearly 9% YoY and Social Security contributions by 6% YoY. From 4Q17 the retirement age for men and women will be lowered from 66 and 61 to 65 and 60. The cost of this is expected to be PLN10bn in 2018 and the government expects to cover this mainly through higher effective tax rates - something which might prove difficult and poses the biggest risk for the budget. However, unemployment is at a record low and the resulting wage pressure may indeed push up PIT revenues and social security contributions. Moreover, Poland benefits from high Ukrainian worker migration - these workers are increasingly covered by a standard employment contract with income taxes and social contributions. All in all, the expectations of the 2018 budget from labour taxation include some risk but aren't without justification.

Effective tax rates

2007=1



Tax bases: Consumption for VAT and excise, GDP for CIT and Wage Bill for PIT and Social Security contributions
Source: ING based on data of MoF and Statistical Office

We're optimistic

Summing up, we are optimistic with regard to the 2018 budget. Even though at this point of the business cycle one would wish for a lower deficit or even a surplus, the fiscal stance of the government is stable and the deficit target for 2018 of 2.7% of GDP is not only feasible but, we believe, also susceptible to a significant positive surprise. We expect the deficit to reach c.2.0% of GDP. A strong fiscal stance is not new and has supported POLGBs for some time already, not only

because it allows a lower supply of Polish debt. It also encourages new more risk-averse entities to participate in the market. We expect that this effect will last for at least 2018.

Karol Pogorzelski

Economist, Poland

+48 22 820 4891

Karol.Pogorzelski@ingbank.pl

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group NV and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. The producing legal entity ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is subject to limited regulation by the Financial Conduct Authority (FCA). ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.