Election-induced fiscal stimulus

Will hefty fiscal stimulus, worth around 1% of GDP this year and twice as much next year, be as easily financed as first round of 500+ introduced two years ago? In order to do so, Poland would need to cut VAT gap to 0.1% of GDP, and even such improvement in tax collection may not be enough to cover all expenses. Expected economic slowdown is likely to put additional pressure on the budget.

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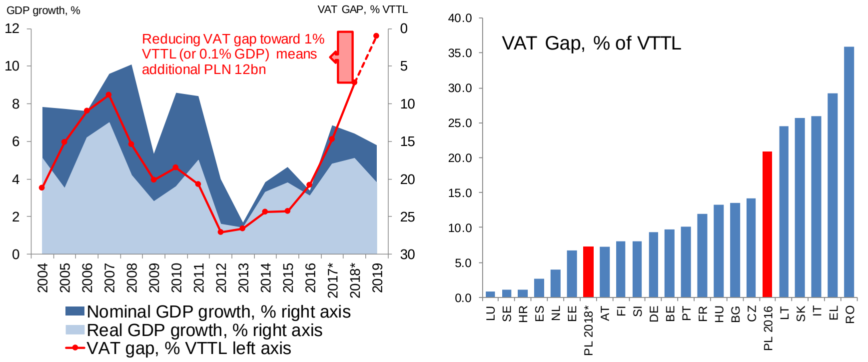
The election year opened up the pockets of the government. The governing Law and Justice party just promised social benefits worth at least 0.8% of GDP this year (the cost of 500+ and the 13th pension alone). In 2020, the total cost of all fiscal promises is estimated at around 2% of GDP. This will also include the lowering of some taxes.

Lowering taxes is definitely not going to help to finance the increase in spending. According to the prime minister, the central budget deficit cap at PLN 28.5 is not planned to be amended this year. The government seems to rely on further improvement of tax collection, but how much is really left in this pot? The Ministry of Finance has been extremely successful in improving tax collection. Strong economic momentum and a systemic solution aiming at limiting tax evasion resulted in **double-digit growth of tax revenues, in particular VAT revenues, over the last two years**.

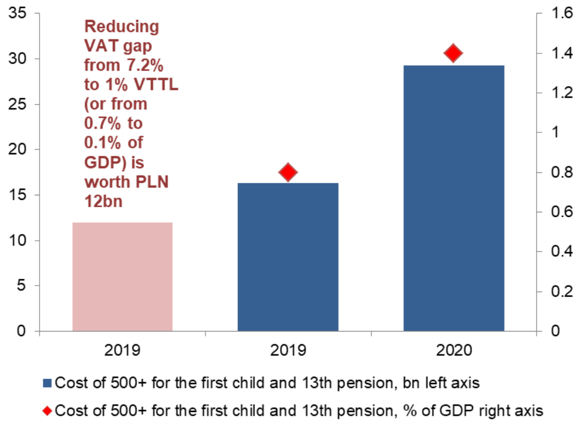
Substantial reduction in VAT gap



Source: European Commission, CSO, CASE, Erste Group Research
**VAT Gap is EC estimates as of EC for all countries, data for 2017 and 2018 are CASE estimate as reported in media https://www.pb.pl/case-luka-w-vat-w-polsce-spadla-do-72-proc-954954*

According to Polish think tank CASE, the VAT gap dropped from 14.7% in 2017 to 7.2% in 2018 of total tax liabilities (or 1.9% and 0.7% of GDP, respectively). The estimates of the European Commission in previous years suggest that the VAT gap was above 20%. With the VAT gap at 7.2%, Poland surpassed Germany. If the VAT gap drops further, it could become the lowest in the EU at some point. Having it at 0.1% of GDP, however, means at most an additional PLN 11-12bn. We consider such scenario as ambitious and optimistic. At the same time, the cost of extending the 500+ program and the 13th month pension is estimated at around PLN 16bn this year alone and another PLN 29bn in 2020. Other promises such as lower tax income only add to the bill.

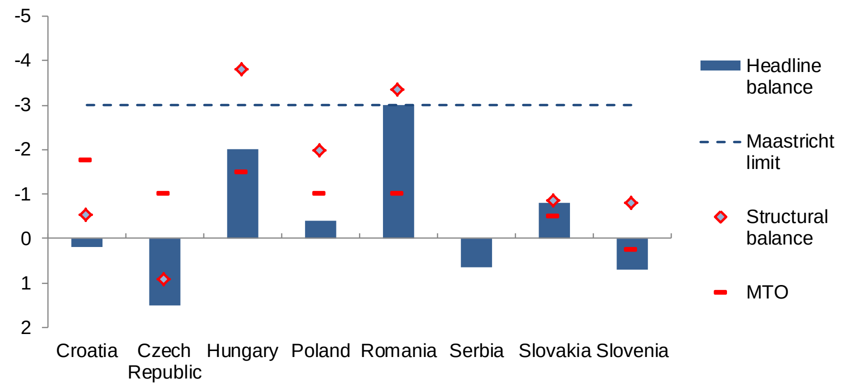
Reducing VAT gap to 0.1% of GDP is worth PLN 12bn



Source: CSO, Erste Group Research

Obviously, part of the stimulus will return to the budget in the form of increased VAT intake. This year, there is indeed some fiscal space to increase spending at the cost of a higher deficit, as last year's budget deficit was at a bare -0.5% of GDP. In structural terms, the situation does not look that rosy, as the structural deficit is above MTO at -2% of GDP. In the following year, financing social benefits may become cumbersome task**. Being successful in closing the VAT gap this year makes the improved tax collection story hard to sell next year.** With a weakening global outlook, growth prospects may remain soft in 2020 as well. How likely will hitting the 3% of GDP limit become then? We also cannot exclude further increase in government expenditures as there are other social groups (teachers, health and social care workers) that may ask for wage increases. Is this the whole fiscal loosening, then? The European elections will happen ahead of the national elections. Will Law and Justice be tempted to increase public spending further in the case of a loss in the European elections in May?

Fiscal position, % of GDP 2018



Source: European Commission, AMECO, CSO, Erste Group Research

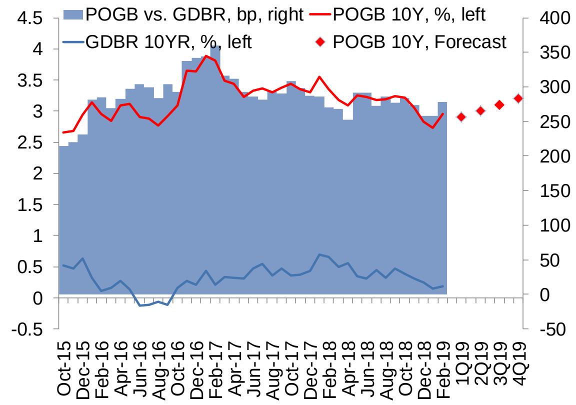
The fiscal stimulus moved the risks to our current GDP forecast at 3.8% to the upside. We expect that supporting private consumption will mostly outweigh the negative effects of the slowing external environment. Next year, we see growth even lower, depending on the extent of the global slowdown.

We also believe that there are other areas where **the expenditures could be used to achieve long-term benefits**. For example, the European Commission points to gaps in access to and provision of early childhood education, healthcare system struggles due to low or misallocated resources (Poland has the EU's lowest number of practitioners and nurses relative to the population) and challenges ahead of the energy sector (greenhouse gas intensity remains among the highest in the EU). Improving access to childcare could have a positive impact on women's employment; in particular, the gender employment gap is above the EU average. The healthcare system will need investment, as costs related to ageing will increase and burden the budget. On top of that, high air pollution also has negative health related effects.

In response to the fiscal stimulus, the long end of the yield curve went up sharply, pricing in higher growth and inflation expectations. Financing such a stimulus also means a higher bond supply, which is negative for the bond market and may be the source of upward pressure on yields. Although this year's budget is claimed not to be amended, higher public spending is likely to be financed through a higher deficit then would be otherwise.

As an election year is usually filled with fiscal promises that may bring volatility to the market, we see risks for our yield forecast to the upside currently. The risk premium as evidenced by the spread vs. Bunds may rise in case next year's deficit goes dangerously close to the nominal 3% Maastricht limit of GDP or fiscal stimulus is increased. On the other hand, our expectations for monetary policy to remain stable could put a cap on the expected increase in 10Y yields at around 3%. A dovish ECB stance favoring a lower level of yields in the Eurozone should also prevent long-term interest rates from rising in Poland.

10Y yield and spread vs. Bunds development in Poland



Source: Bloomberg, Erste Group Research

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