On The Mechanisms of Achieving Fiscal (Un)Sustainability – The Case of Poland[1]

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Non-technical summary

Aim of the paper is to empirically assess the sustainability of budgetary policy in Poland in Years 1992-2005. The issue of fiscal sustainability in the new member of the European Union is now gaining importance, since Poland is expected to join the Economic and Monetary Union, in which member states' fiscal sustainability is considered a precondition for independency of the European Central Bank. However, Poland (similarly to Czech Republic and Hungary) has already undergone in years 2001-2003 a period that can be viewed as fiscal crisis, characterized by high deficits and rapid debt growth, which raises concerning its ability to conduct fiscal policy in a sustainable way.

The study uses the time-series approach to sustainability, according to which the sufficient condition for sustainability is the positive link between debt and primary surplus, which eventually stabilizes the level of debt in case of any adverse fiscal shocks. It emphasizes the role of institutions in achieving sustainability and explicitly test for the impact on large institutional change that took place in the late nineties on the debt-surplus relationship.

The empirical analysis of the behaviour of key fiscal variables suggests a consistent, though negative picture of institutions in Poland that are responsible for running budgetary policy. Our results show that structural surplus did not respond to fiscal shocks in a way that would stabilize the level of public debt, thus not fulfilling the key condition of sustainability. The behaviour of expenditure and revenue side was not symmetric, however. While revenues tend to adjust to the level of debt in a stabilizing manner, expenditures move independently from debt and in a non-stationary way, which makes fiscal policy unsustainable in the long run. This pattern was

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confirmed by tests of Granger causality that showed that while revenues do adjust to both changes of expenditures and debt, primary expenditures are Granger-independent from both other main fiscal variables. Fiscal institutions in Poland were unable to respond in a debt-stabilizing manner to two large negative budgetary shocks: structural reforms of the public sector undertaken in year 1999, and joining the EU in 2004. This makes them unlikely to respond to the future fiscal shocks, and suggests that fiscal institutions lack the ability to run sustainable fiscal policy.

Clearly, the criterion of sustainability used in the study is only sufficient by its nature, whilst not necessary. For sustainability to hold it would be sufficient if positive reactions of primary surplus to fiscal debt took place for higher debt levels, possibly higher than those achieved in Poland within the analyzed period. This concern has no clear answer, since the "next year we will start repaying the debt" policy is seemingly always a solution to sustainability problems. However, such fiscal adjustments made when debt is high are likely to require also adjustments of the fiscal institutions, which in turn means that the present institutions were not sustainable. Hence, the existing evidence shows that the existing fiscal institutions in Poland are not sustainable, if one rules out as unlikely the possibility that they suddenly start behaving responsively while some high debt level is achieved.