TECHNICAL ASSISTANCE REPORT

REPUBLIC OF POLAND

Aligning the Stabilizing Expenditure Rule to the European Union Fiscal Framework

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Abbreviations and Acronyms

CG	Central Government
BGK	Bank Gospodarstwa Krajowego (BGK) (Bank of Domestic Economy)
DRM	Discretionary revenue measures
DSM	Debt Sustainability Monitor
EGF	Economic governance framework
ESA	European System of Accounts
EU	European Union
FAD	Fiscal Affairs Department
FRL	Fiscal Responsibility Law
FY	Fiscal Year
GFC	Global Financial Crisis
GFSM	Government Finance Statistics Manual
MFU	Macro Fiscal Unit
MoF	Ministry of Finance
MOF-EM	Ministry of Finance Economic Model (NEMPF in Polish)
MTFF	Medium-Term Fiscal Framework
MTOs	Medium-Term Budgetary Objectives
MYFSP	Multi-year State Financial Plans
NBP	National Bank of Poland
NFPS	Nonfinancial Public Sector
PFM	Public Financial Management
SALM	Sovereign Asset and Liability Management
Sejm	Parliament of the Republic of Poland (Sejm Rzeczypospolitej Polskiej)
VAR	Vector autoregression
WEO	World Economic Outlook

Preface

In response to a request from the Minister of Finance, a Fiscal Affairs Department (FAD) mission conducted virtual discussions from November 10, 2023, to May 31, 2024, to provide technical advice to (i) review the current stabilizing expenditure rules, (ii) strengthen the provisions of escape clause and correction mechanism in the fiscal rule; and (iii) align the stabilizing expenditure rules to the EU fiscal framework. The mission was led by W. Raphael Lam and comprised Hassan Adan, Fazeer Sheik Rahim, Tjeerd Tim (all FAD), Kareem Ismail, and Gösta Ljungman (both EUR).

At the Ministry of Finance (MoF), the mission held discussions with Ms. Joanna Bęza-Bojanowska, Ms. Agnieszka Szczypińska, and project team in the Macroeconomic Policy Department. The mission also met with Slawek Dudek, Mateusz Szczurek, and Andrzej Torój (Warsaw School of Economics in Poland), and staff of the Budget Department at the Ministry of Finance.

The mission expresses its gratitude for the excellent cooperation it received from all government officials and for the candid discussions. Particular thanks are due to Ms. Joanna Bęza-Bojanowska, Ms. Agnieszka Szczypińska of the MoF for their insights and excellent cooperation before and during the mission. The mission also received inputs from Alla Myrvoda and Robert Sierhej, administrative support and research assistance from Claudia Díaz Saldías, Sheilanina Zagala, and Chenlu Zhang (all FAD) and Can Ugur (EUR).

Executive Summary

The stabilizing expenditure rule (SER) in Poland has served the country well since its implementation in 2015. It has been a core component of the fiscal framework. The SER instilled budgetary discipline and coalesced political debate, which facilitated a downward trajectory of government debt before the pandemic.

The SER has several good design features. It has facilitated steady expenditures during recessions and enhanced debt sustainability. It also provides flexibility, with provisions that govern escape from the rule during severe shocks and subsequent return to the expenditure rule.

Nonetheless, the SER also has several limitations. The SER is largely backward looking and does not fully account for slower growth prospects over the medium term. Below-the-line financing, such as transfer of government securities to public entities outside of the SER to circumvent the SER, hence contributing to a rise in general government debt. As the SER only sets the limit for next fiscal year, the lack of multi-year binding limits for budgetary entities makes it difficult to link well to the medium-term fiscal framework (MTFF). This creates challenges to aligning the SER with the new EU economic governance framework, which will set a multiyear binding expenditure path.

The pandemic and subsequent shocks severely tested the fiscal framework, making clear the need to revise the SER. During the pandemic, the escape clause was appropriately activated to provide necessary support. Returning to the SER limits has been challenging particularly with the impact of the war in Ukraine and the related energy price spikes. Several ad-hoc amendments, expenditure exemptions, and transfer of government securities to Bank Gospodarstwa Krajowego (BGK) to support spending through extrabudgetary funds might have undermined the credibility of the fiscal rule. These call for government action to address the design and implementation challenges of the SER.

The SER should remain a key instrument in anchoring fiscal policies and further refinements are necessary to strengthen its credibility. The SER formula should adjust for forecast errors on growth, and over the medium term, incorporate 2-3 years ahead growth forecasts to determine the limit. This requires the government to continue improving its forecast capacity and publish in-depth assessment on the compliance of the rule (both ex-ante and ex-post). Broadening the coverage of the SER, including its legally-binding limit, will further raise its credibility. The planned fiscal council should have a mandate to assess the quality of the MoF's macro-fiscal forecasts and monitor the implementation of the SER.

Over the medium term, transitioning to a multi-year expenditure rule from the current one-year ahead horizon of the SER would better anchor debt sustainability. Binding medium-term expenditure limits create strong incentives to assess how spending programs are expected to evolve over the course of several years. This will require building broad political support and strong technical capacity across ministries over time.

Refinements to the escape clause can further strengthen the flexibility to respond to severe shocks while preserving credibility. The escape clause was revised in 2020 to include epidemics as a trigger and appropriately activated to provide flexibility in response to the pandemic. As a sharp economic slowdown represents a key risk facing Poland, the escape clause should include a separate trigger to account for a severe recession. The size and pace of adjustments in the return clause will need to account for debt sustainability risk in addition to economic conditions. Tracking the extraordinary support during the period using the escape clause can help set an appropriate expenditure base when returning to the SER limit. The planned new fiscal council should also be mandated to monitor the implementation of escape clause, including its activation, extension, and return to SER limit, as well as costing extraordinary fiscal support and its implications on fiscal sustainability.

The recent simplification of the correction mechanism goes in the right direction and further improvements are needed to align it with the EU fiscal framework. Instead of multiple layers of

triggers and pace of adjustments, the simplification sets a minimum of annual fiscal adjustment when deficits or government debt exceed prespecified limits. Further refinements can provide stronger guidance on fiscal policies and better align the SER with the EU fiscal framework. Specifically, the pace of fiscal adjustments in the correction mechanism can be set at levels that ensure the implied expenditure from the SER is consistent with the EU-agreed net expenditure path. An additional provision that specifies corrective action when expenditure outturn exceeds the SER limit can strengthen the accountability of the government.

Poland should conduct a periodic comprehensive review of the SER every five to six years. Good international practice points to the merits of periodic review of the fiscal rules rather than resorting to ad-hoc amendments or exemptions to the fiscal rule. The periodic review can ensure the SER parameters are well calibrated and consistent with macroeconomic outlook and fiscal objectives. This will help attune the fiscal rule to evolving structural conditions in Poland (for example, changes to potential growth, demography, and tax revenue collections).

Ensuring the consistency of the SER with the EU net expenditure path will require reconciling coverage and strengthening monitoring. While simulations show that the expenditure implied under the SER (with the right correction mechanism) is similar to that under the potential EU-net expenditure path, aligning to the EU fiscal framework will need to address several challenges given the differences in expenditure coverage and classification. As the EU net expenditure path is set at the start of a four-year period, it may not fully account for the subsequent update of macro-fiscal forecasts in determining annual SER limits. Refinements to the correction mechanism and regular reconciliation of differences in sectoral coverage, accounting treatment, expenditure classification will be necessary to ensure compliance with both the national SER and the EU net expenditure path.

Table of Key Recommendations

Main Recommendations	Short (ST) or medium term (MT)[1]	Implementing entity / department
Revising the SER framework		
• Preserve the credibility of the SER by restricting ad-hoc amendments to the SER.	ST	MoF
• Revise the SER formula to include correction of forecast errors on real growth to better align with the EU framework.	ST	Macroeconomic Policy Dept., MoF
• Include forward-looking indicators on real growth in the SER formula to maintain fiscal discipline. Strengthen the forecasting capacity at MOF.	MT	Macroeconomic Policy Dept., MoF
• Over the medium term, transition the SER to include multi-year limits on government expenditures to improve fiscal planning and credibility.	MT	MoF
• Publish an in-depth assessment of ex-ante and ex-post compliance of the SER, in conjunction with an assessment of the fiscal rule and fiscal risks after the establishment of the fiscal council.	MT	MoF; Fiscal Council
• Establish an independent fiscal council as planned to assess the compliance of the SER.	ST	MoF; Government
• Broaden the coverage, including the legally-binding part of the SER.	ST	MoF
• Conduct a periodic, comprehensive review on the SER every 5-6 years to ensure the SER parameters are consistent with macroeconomic outlook and fiscal objectives.	ST	Macroeconomic Policy Dept., MoF
Refining provisions on the escape clause and correction mechanism		
Escape clause		
• Amend the provision (Article 112d in Public Finance Act) to include severe economic slowdown as a standalone trigger to activate the escape clause.	ST	MoF; Government
• Revise the return clause such that the size and duration of adjustments will consider both economic conditions and debt sustainability risks.	ST	Macroeconomic Policy Dept., MoF
• An independent fiscal council is tasked to monitor the escape clause, including the activation, extension, and return to SER limits, as well as the costing of extraordinary measures and implications for debt sustainability.	ST	MOF; Government
Correction Mechanism		
• Revise the criterion in the correction mechanism from 'economic conditions' to 'the activation of escape clause' when determining whether fiscal adjustments should be undertaken.	ST	MoF
• Publish detailed explanations if expenditures exceed the SER limit.	MT	MoF
Aligning the SER to EU fiscal framework		
• Align the SER limits to be consistent with the EU economic governance reforms, including the EU net expenditure path; reconcile the differences in accounting treatments and exclusions.	ST	Macroeconomic Policy Dept., MoF
• Prepare a communication strategy to explain the revisions to the SER and garner public support and trust.	ST	Macroeconomic Policy Dept., MoF
Note: Short-term (ST) indicates the recommendations can be completed by mid-2025, while medium-term (MT) indicates recommendations to be initiated and gradually implemented over the next 2-3 years and to be reflected in the next periodic review.		

I. Introduction

1. **Poland has achieved significant income convergence with the EU over the last decade, while maintaining low debt levels.** The real GDP per capita has increased from about 65 percent of the EU average to over 80 percent over the last decade. Economic growth has been driven by productivity gains, while the public and private sectors maintained relatively low debt levels following the Global Financial Crisis. Fiscal restraint has been supported by alignment with the EU fiscal framework and national fiscal rules.

2. **The stabilizing expenditure rule (SER) has been a core component of fiscal framework in Poland.** The rule, effective since 2015, has complemented the constitutional national debt limit of 60 percent of GDP (Figure 1).[1] The SER helped instill budgetary discipline and coalesced political consensus around fiscal prudence, which facilitated public debt reduction before the pandemic and provided fiscal buffers for Poland to respond to the pandemic.

3. **The pandemic and subsequent shocks severely tested the fiscal framework, which call for an upgrade of the SER.** Poland suspended temporarily the SER during the pandemic to ensure adequate fiscal support during the crisis. Returning to the rule has proved challenging considering shocks in relation to the war in Ukraine and rigidity in the return clause. Looking forward, the SER will also need to account for rising structural headwinds as medium-term growth prospects weaken and the demographic and green transition exacerbate spending pressures.[2]

4. **Poland will also need to align the SER to the recently agreed EU economic governance framework (EGF).** The recently adopted EU fiscal framework involves a risk-based approach that requires a binding multi-year net primary expenditure path, differentiated across member states depending on their debt sustainability risks. Ensuring consistency between the national SER and the net expenditure path under the EU framework is imperative. For Poland, this includes revisions to the correction mechanism, accounting treatments, and sectoral coverage, and the transition to a risk-based multi-year expenditure rule.

5. **This report aims to support the authorities with reviewing the SER.** It will i) assess the design and fiscal performance under the SER since its implementation in 2015 to identify strengths and potential shortcomings; ii) propose options to strengthen the SER; and (iii) highlight areas to align the national SER with the EGF.

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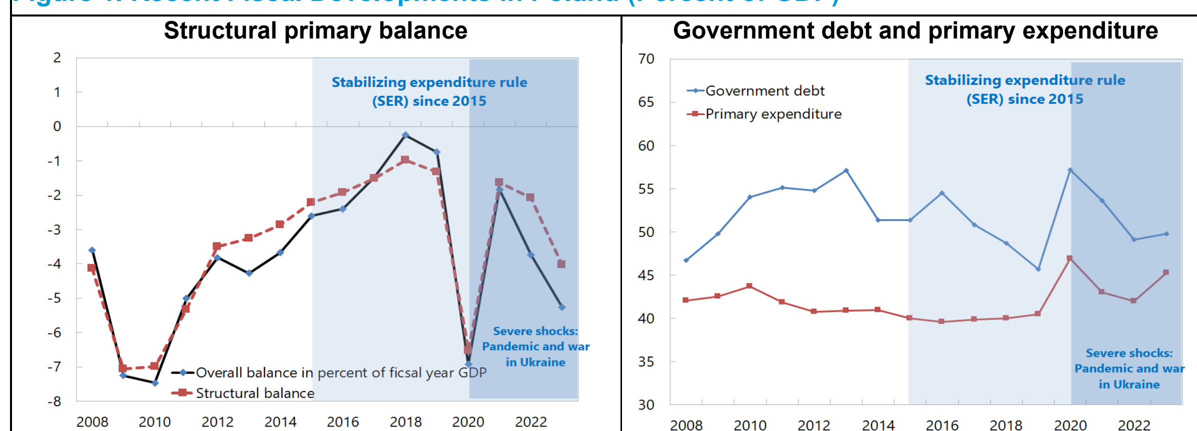
[1] The national debt limit is the sum of the gross debts of the central government, local government, and Social Security Fund. It does not capture all general government debt given its exclusion of debt by public entities and extrabudgetary funds such as the BGK. The Public Finance Act include a debt brake at national debt levels of 55 percent of GDP.

[2] With one of the fastest aging economies in Europe, medium-term growth prospects are likely to slow. Imbalances from a pay-as-you-go pension system could add to fiscal cost. As Poland is one of the most carbon-intensive economies in the EU, financing needs from the climate transition likely add to government spending.

II. Assessment of the Current SER

6. **The objective of the SER is to ensure sustainability of public finances and adhering to the European Union Stability and Growth Pact.** It constitutes an implementation of EU Council Directive on requirements for budgetary frameworks (2011/85/EU), which obliges member states to use numerical fiscal rules. The SER became first binding during the 2015 budget process, the first year that Poland met the deficit limit of three percent of GDP under the Stability and Growth Pact. The SER complemented a constitutional debt limit of 60 percent of GDP. This constitutional debt limit is on the national debt definition of government debt (39.3 percent of GDP in 2022 compared to a general government debt of 49.2 percent of GDP).

Figure 1. Recent Fiscal Developments in Poland (Percent of GDP)



Source: IMF WEO database.
The SER was first introduced in budget year 2015.

7. **The SER in the Public Finance Act sets an upper limit for the public expenditure for the next year.** The limit is set based on a formula comprising of growth and inflation rates, adjusting for DRMs if they are related to policy changes in taxes or social security contributions that is expected to exceed 0.03 percent of GDP for the fiscal year after their implementation (Box 1). This allows additional revenues to be expensed without affecting deficit or debt levels. The rule also contains an escape clause and a correction mechanism to manage exceptional circumstances and deviations from the rule limit (Section IV). Compliance with the rules as well as the appropriate application of the Budget Act is monitored by the Supreme Audit Office (NIK).

Box 1. Main Features of SER and Changes since Its Implementation in 2015

The SER in the Public Finance Act sets an upper limit for the public expenditure for the next year. It entered into force on 28th December 2013 pursuant to the amendment of the Act on Public Finance and was binding for the first time in the budget process for 2015 (Article 112aa). It was established to ensure the sustainability of public finance and maintenance of reference values of deficit (3 percent of GDP) and debt (60 percent of GDP) resulting from the EU Stability and Growth Pact. Modifications were introduced in subsequent years, particularly during 2020-22 (Annex II).

The calculation of the expenditure value in the SER is based on the level of expenditure increases, as a rule, by 8-year geometric average means of the real GDP growth (6 years in the past, the current year and the year ahead) and the expected inflation rate. Expenditure limit can be adjusted for discretionary revenue measures (DRM) in taxes and social security contributions (according to ESA2010) provided that the expected DRM exceeds a threshold of 0.03 percent of GDP.

$$SER_t = SER^*_{t-1} * E_t(CPI_t) * GDP\ indicator_t \quad + \boldsymbol{K}_t + E_t(\Delta DRM_t)$$

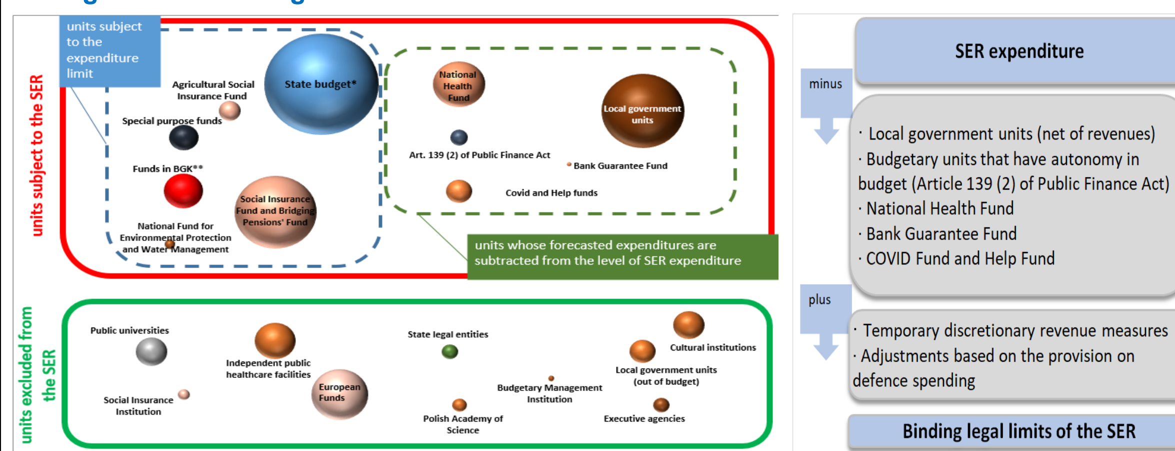
$$\text{where} \qquad SER^*_{t-1} = SER_{t-1} * \frac{CPI_{t-2}}{E_{t-1}(CPI_{t-2})} * \frac{E_t(CPI_{t-1})}{E_{t-1}(CPI_{t-1})}$$

$$GDP\ indicator_t = \sqrt[8]{\frac{GDP_{t-2}}{GDP_{t-8}} * E_t\left(\frac{GDP_{t-1}}{GDP_{t-2}}\right) * E_t\left(\frac{GDP_t}{GDP_{t-1}}\right)}$$

where SER_t is the expenditure determined by the SER formula in year t, CPI is the headline CPI forecast by MOF (budget forecast with forecast error correction), GDP indicator is the geometric mean of output growth in real terms. The notation for time for year *t* is the next budget year. For example, the budget for the year for 2025 (t) is set in 2024 (t-1) and by then the outturn for 2023 is fully available. As such the expectations refer to the expected 2024 outcome and 2025 forecast. Parameter K is the exogenous adjustor related to the correction mechanism, and ΔDRM is the change in discretionary revenue measures (DRM).

Since the 2023 budget, the SER has included backward corrections for inflation forecast errors, which was previously set as the inflation target of the National Bank of Poland.

Box Figure 1.1. Coverage of the SER



Source: Ministry of Finance, Poland.
Note: SER expenditure here is based on Poland's definition according to the Public Finance Act. SER expenditure account for 90 percent of general government expenditure and the legal-binding limits account for about 70 percent of general government expenditure (based on Poland's definition of government expenditure in the Public Finance Act).

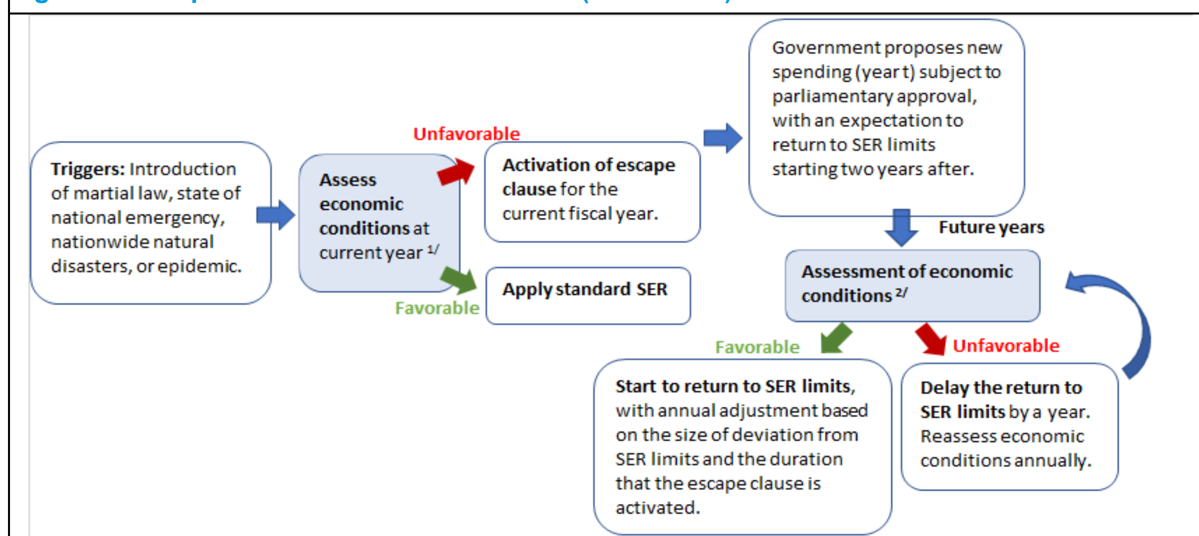
The SER covers the central government, Social Insurance Fund and Bridging Pension Fund, local government units in the budget, and several funds such as the National Health Fund and Bank Guarantee Fund (Box Figure 1.1). The overall SER limit based on the above formula will net out the forecast net expenditures by autonomous public entities, including the National Health Fund, local government units, the Bank Guarantee Fund, the COVID-19 Counteracting Fund, and the Help Fund to obtain the legally-binding limit for the state budget and other selected funds. Some funds—the largest among which is the EU Fund—are excluded from the coverage of the SER (similarly to EU fiscal rules).

The SER has undergone several amendments (Annex II). Some amendments were rightly motivated to bring the rule closer in line with requirements under EU rules and to allow flexibility in the face of exceptional shocks, while ad-hoc amendments were also made, particularly during 2022-23 when facing severe shocks following the expiration of the escape clause. Additional provision on defense (defense clause) was introduced in 2023 to smooth the discrepancy between delivery and payment of defense spending. A larger net payment relative to delivery would temporarily raise the expenditure limits to be subsequently offset over time, and thus may not change the underlying fiscal adjustments over the long run.

8. **Poland revised the escape clause to strengthen the flexibility in responding to COVID-19 pandemic.** The provision (Article 112d of the Public Finance Act) was revised in 2020 to include (i) national epidemic as a trigger; (ii) an activation criterion based on economic conditions; and (iii) a

mechanism to return to the expenditure limit after the deactivation of the escape clause (Figure 2). The government has the discretion on the size of additional spending (subject to parliament approval) upon the activation of the escape clause.

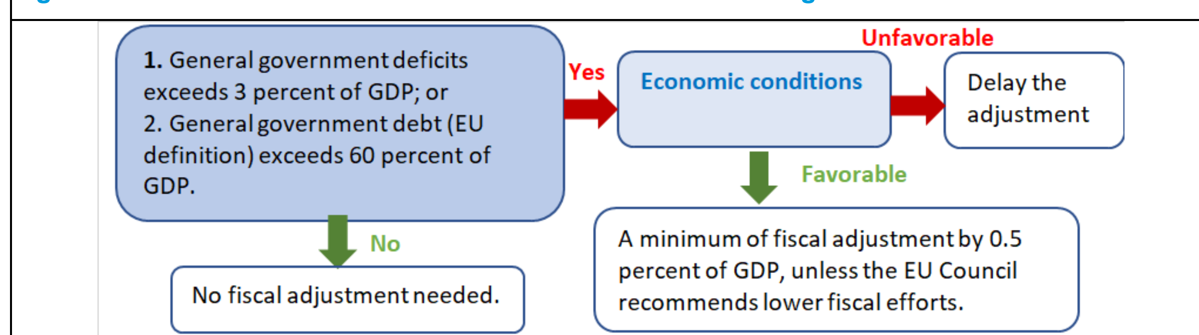
Figure 2. Escape Clause Provision in Poland (since 2020)



1/ Forecasted real GDP growth for the budgetary year is lower by at least 2 percentage points from the medium-term growth indicator projected in the budget for the previous year.
2/ Favorable conditions when the average forecasted real GDP growth for the budgetary year and the one year ahead is not lower by more than 2 pp. from the medium-term growth indicator projected in the budget for the year preceding escape clause activation. The return to the SER limit ranges from 2-4 years, depending on the pace of economic recovery.

9. Poland has simplified its correction mechanism starting from the budget year 2024. During the years 2015-2023, the correction mechanism was fairly complex with several criteria and adjustment requirements.[3] The government simplified the correction mechanism in late 2023 and set a minimum of annual fiscal adjustment of 0.5 percent of GDP (unless the EU Council recommends a lower fiscal adjustment) when deficit exceeds or is projected to exceed 3 percent of GDP or general government debt (EU definition) exceeds 60 percent of GDP, provided the economy is not in recession (Figure 3).

Figure 3. Poland: Correction Mechanism of the SER since Budget Year 2024



Source: National authorities.
Note: Unfavorable economic conditions refer to the expected growth is less than 2 percentage points of the average of the previous 6 years, the current year, and the one year ahead. The triggering conditions are based on EC forecasts.

[3] During the years 2015-2023, the correction mechanism institutionalized several criteria with an increasing intensity of fiscal adjustments to restore public finances. First, a mandatory correction of 2 percentage points in SER expenditure per year was required when deficits in the previous period exceeded 3 percent of GDP. Second, a progressive set of "debt brakes" (initially set at 50 and 55 percent of GDP on national definition of debt, later revised to 43 and 48 percent of GDP) was in place that called for tighter fiscal adjustments. Third, corrective actions in the form of tighter fiscal stance were established when the cumulative deviation from the EU Medium-Term Budgetary Objectives (MTOs) exceeded 6 percent of GDP, even though current deficits and debt are within the limits. As the deviations were large as Poland exited consecutive shocks from the pandemic and the energy price spikes in 2023, the required corrective adjustments were significant and could pose a large economic cost.

A. Criteria in Assessing the SER

10. Fiscal rules need to balance between the objectives of economic stabilization and debt sustainability and should be well integrated with the budgetary framework. Rules should have a broad coverage, flexibility to respond to severe adverse shocks, and be well-integrated into a credible medium-term fiscal framework (MTFF). International practices point to several desirable features in expenditure rules. An aggregate limit on government expenditure, set at a level consistent with macroeconomic and fiscal sustainability, could strengthen fiscal discipline (Caselli et al. 2018; Eyraud et al. 2018). An expenditure rule helps contain raising expenditures owing to a temporary rise in revenues (from one-offs or cyclical upturns) that are hard to unwind. It also allows automatic stabilizers on the revenue side to operate during business cycles. Expenditure rules are easy to operate and to verify its compliance (compared to a structural balance rule) because governments often have direct control on expenditures and report on them regularly in budget documents.

11. This technical report assesses the economic design of the SER along these criteria:

- *Stabilizing expenditures amid cyclical shocks.* An expenditure rule should help protect primary expenditures and shield the budget from economic volatility—avoiding excess spending during booms and abrupt tightening during recessions. It should correct for imbalances in public finances over economic cycles and contain a mechanism to avoid persistent forecast bias.
- *Safeguarding debt sustainability.* Good expenditure rules should help promote sound public finances. They should contribute to safeguarding debt sustainability by constraining expenditures and keeping government debt and borrowing costs at prudent levels (Blanchard 2019; Mian et al. 2022). For example, the rules will need to account for the budgetary impact of discretionary measures so that deficits will not widen or tighten unintendedly.
- *Allowing flexibility.* Fiscal rules should have sufficient flexibility to allow governments to respond to exceptional events (such as an epidemic or a financial crisis) without undermining fiscal credibility. The flexibility should not be too broad to avoid fiscal adjustments in normal times. The government must justify the use of such clause and return to the fiscal rule limits after the shock ends to preserve credibility.
- *Broad coverage of public finances.* In order to control the aggregate fiscal developments, an expenditure rule should have a broad coverage of general government expenditure. The precise coverage should balance this objective and the practical concerns that the central government can only control directly a subset of general government expenditure.
- *Supporting multi-annual fiscal planning and budget process.* Expenditure rules should be well integrated to the budgetary framework, including the preparation, implementation, and monitoring. Well-designed rules can facilitate efficient allocation of resources over a multi-annual horizon. Expenditure limits should be complied with both ex-ante in the budget formulation as well as ex-post in fiscal outturns. Macro-fiscal forecasts that are used to calculate the expenditure rule limits should be objective and not contain persistent forecast bias. An independent fiscal oversight could help monitor the compliance with the rules, support transparency and accountability.

B. Design Features of the Current SER: Strengths and Weaknesses

12. Based on the above criteria, the SER in Poland has several good design features.

- *Countercyclicality.* As in other expenditure rules, the formula-based SER shields partially expenditures from the cyclical volatility of revenues as the SER limits are set by a moving average

of real growth rates, adjusted by expected inflation. Any significant DRMs would affect the expenditure limits (for example, a tax cut could imply lower expenditure limits to reduce the impact on fiscal balance). This helps reduce procyclical spending during economic booms and recessions.

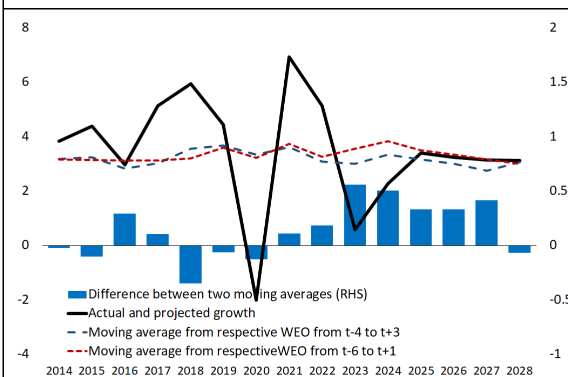
- *Avoiding expenditure drift.* The SER limit is set based on trend growth and expected headline inflation. If calibrated right, it would ensure that public expenditures stay at a stable share of GDP over the medium term.
- *Debt sustainability.* While the SER formula is not directly linked to the debt level, the rule is supportive of debt sustainability through the correction mechanism anchored on debt and deficit levels consistent with the EU Stability and Growth Pact. The correction mechanism in the SER requires reducing expenditure limits by at least 0.5 percent of GDP when debt exceeds 60 percent of GDP or deficits exceed 3 percent of GDP unless the EU Council recommends lower fiscal adjustments.
- *Flexibility.* The SER includes an escape clause to manage exceptional events (Article 112d Public Finance Act). Following a temporary exit of the SER, the subsequent pace of required fiscal adjustment accounts for economic conditions, which could prevent an abrupt unintended fiscal tightening. These provide space for fiscal support in the event of severe shocks, without undermining credibility of the fiscal rules.
- *Enforcement.* The government has reporting obligations regarding the SER, including submitting to the parliament a report detailing whether the rule is met (Article 182 of the Public Finance Act). The NIK is responsible for auditing the ex-post compliance with the expenditure limits.

13. However, the SER also presents several design issues.

- *Calibration of the SER formula.* The SER formula is largely backward looking and presumes a stable long-term trend growth. While this mitigates a potential bias of overly optimistic growth forecasts, it presents a challenge if trend growth is slowing down (Figure 4).[4] As a result, expenditure as a share of GDP could grow and lead to upward fiscal pressures. Moreover, the indexation of the SER limit to headline inflation could push up the SER limit in an environment of high headline inflation, which could hinder disinflation efforts by the National Bank of Poland (NBP). In addition, these initial small discrepancies or forecast bias on growth would accumulate through the base effect in the formula over time. The current SER partially addresses this through ex-post adjustment on inflation forecast errors since 2022, but there is currently no systemic framework in place to account for growth forecast errors and potential forecast bias. In a broader context, relying on a formula to set the expenditure limits without considering a medium-term fiscal anchor could put public finances on a 'wrong' path (either too loose or too tight). For example, if revenue growth lags behind nominal GDP growth, maintaining a stable share of expenditures to GDP may not stabilize the structural fiscal balance, possibly leading a buildup of debt.

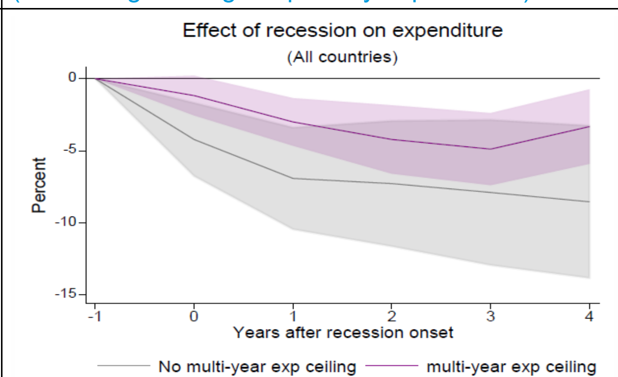
[4] Conversely, if the expected trend growth is higher than the previous years, the SER would constrain expenditure growing at a rate slower than the real GDP growth and contribute to fiscal discipline.

Figure 4. Economic Growth: Actual and Moving Averages (Percent)



Source: IMF World Economic Outlook database and staff estimates.

Figure 5. Multi-Year Expenditure Are Less Procyclical
(Percentage change in primary expenditure)



Source: Caselli and Lagerborg (Forthcoming)

- *Annual SER limit.* The SER is binding for the year-ahead budget only, while the outer year limits (second and third years) published in the budget documents are only indicative and subject to revisions. It does not fully support medium-term budgeting. Fiscal policies could focus overly on near-term priorities rather than taking a broader medium-term perspective on fiscal objectives such as development needs and ensuring debt sustainability (Figure 5). Several European countries set their limits of expenditure rules over several years (Table 1).

- *Provisions on escape clause and correction mechanism.* The current escape clause provision cannot be triggered solely by a major economic slowdown such as arising from a global financial crisis. The correction mechanism also does not address the potential noncompliance of actual expenditures exceeding the SER limits (See Section IV).

- *Coverage.* The legally-binding limit of the SER is applicable to a portion of budget (IMF 2017; IMF 2019). The SER has on average covered about 90 percent of general government expenditure, which included several autonomous entities (World Bank 2022). Netting out the expenditures of those autonomous entities covered in the SER, the legally-binding limit of the SER covered about 70 percent of total government expenditure. The sectoral coverage of the SER is different from the scope of entities which are required to be included in the general government by the EU fiscal framework.[5] As the current DRMs include revenue measures of entities outside the SER coverage, ensuring consistency of the coverage within the SER is also important.

[5] There is no clearly defined administrative segment corresponding to budgetary accountability in the current classification system. In Poland's public finance framework, a budget part—refers to a segment of the overall budget often allocated to a specific ministry or governmental entity—may be assigned to one ministry while spending may be channeled through budgetary parts administered by other ministries.

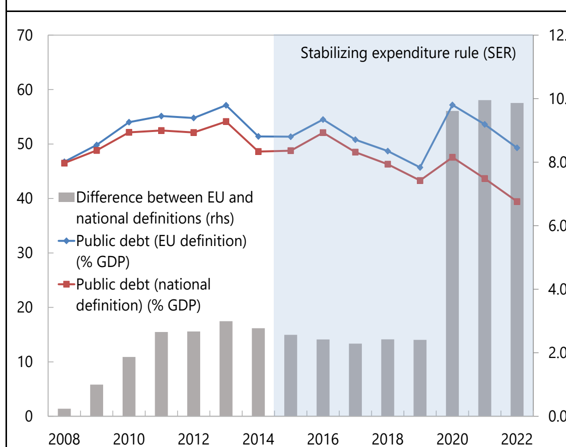
Table 1. International Experience of Expenditure Rules

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

Source: Davoodi et. al. (2022); IMF Fiscal Rules Database 2022.

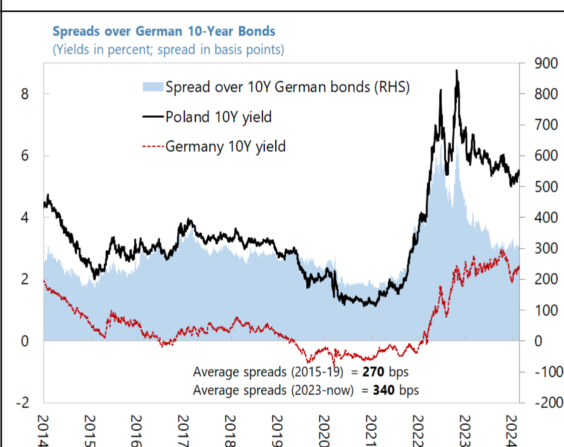
- *Containing debt.* In the current setup, off-budget activity could contribute to debt sustainability risks even if government expenditures comply with the SER limits. This could occur through (i) the transfer of government securities for policy purposes to support expenditure by public entities not covered under the SER (below-the-line financing)—for example, the transfer to the BGK at zero cost or below market pricing; (ii) direct borrowing by government entities. These could lead to a divergence between national and EU definitions of government debt and possibly higher spreads (Figures 6 and 7). Even if expenditure remains within the SER limit, debt could continue to build up before triggering the general government debt threshold of 60 percent of GDP as defined under the EU Stability and Growth Pact. Moreover, the DRM covered by the SER includes revenue measures of entities outside the SER coverage.

Figure 6. Government Debt—Gap Widening between Definitions (Percent of GDP)



Sources: IMF WEO database and national authorities.
Note: The national debt definition is the sum of debt by the central government, local government, and the social security fund.

Figure 7. Sovereign Spreads in Poland (Yields in percent; spreads in basis points)



Source: Haver Analytics.

- *Limited linkages of SER with MTFF and multi-annual budgetary guidance.* The government does not set multi-year expenditure limits (nor guidance) for budgetary entities that are

subject to the SER.[6] Moreover, while there is an audit on the ex-post compliance, currently, there is no independent fiscal entity that offers a detailed, retrospective, or prospective analysis nor an assessment of the realism of macro-fiscal forecast in the SER formula (see Section III).

C. Simulations of the SER

14. Two sets of analyses are used to assess how the SER performs in terms of counter-cyclicality, debt dynamics, and flexibility in response to severe shocks. The first set is a counterfactual exercise that applies the current SER (abstracting from various amendments over the years) to see if it exhibits countercyclical features over past business cycles and assess its role in debt dynamics.[7] The second analysis uses the economic model developed by MoF to understand how SER performs in a range of adverse shocks, including a growth slowdown, a surge in interest rates, inflation surprises, and rise in expenditures outside the SER legally-binding limits (details in Annex III). The simulated fiscal paths (expenditures, fiscal balances, and debt) will inform if the current SER has desirable properties of an expenditure rule.

15. The counterfactual exercise suggests that strict compliance with the SER would have contributed to fiscal discipline through stabilizing expenditures and reducing debt. The exercise simulates a full compliance with the current SER formula starting from 2015 (with the escape clause activated in 2020 and a return to SER limit in 2022), assuming other macroeconomic variables were identical to the actual outturns. Under this scenario, government expenditures would have stabilized around 40 percent of GDP, placing debt on a steady downward trajectory during 2015-19 (Figure 8).

- Prior to the pandemic, the successful implementation of the SER kept the actual outturn close to the counterfactual scenario. The gap between the two started to widen, partly owing to the deviations from the non-binding limit under the SER in 2018-19 and the move of some social spending outside the SER coverage at that time (IMF 2021).
- The strict application of the escape clause implies expenditures are identical in the two scenarios for 2020. The assumption of compliance with the return clause would mean a lower government expenditure as a share of GDP (42 percent of GDP) in the counterfactual scenario than the actual outturn (around 44 percent of GDP). Subsequently, given spending pressures from the war in Ukraine, expenditure outturn remained high. But the counterfactual scenario would point to an ex-ante reduction of expenditure (given the compliance with the return clause) to 40 percent of GDP (ex-post levels would have depended on correction to inflation in 2022, which would be reflected in 2023 in line with the current SER). Overall, the fiscal path under the counterfactual scenario would have been very tight, despite a downward trajectory on debt.

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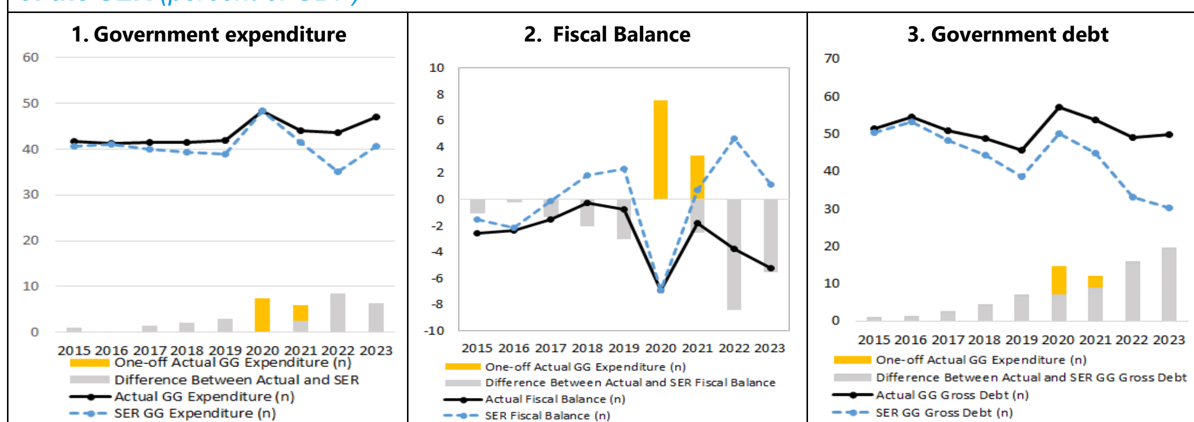
[6] By only setting next-year annual expenditure limits in July, pressures are put on the budget negotiation process to meet the September deadline for the draft budget submission to the Sejm. The tight timeline could place challenges on efficient allocation of public resources.

[7] This exercise abstracts away from the impact of compliance with SER non-binding limits on other macroeconomic parameters including on growth, revenues, inflation, and real interest rates. The simulation substitutes the expenditure path alone with that implied under the SER assuming expenditure outside of its coverage follow an identical dynamic. During the escape years (2020 and 2021), the scenario assumes expenditure the same as actual levels for 2020 with the difference to the SER limit for that year corresponding to one-off spending to address the pandemic. For 2021, compliance with the return clause on that basis is assumed for the non-binding limit (within 2 years as consistent with the current clause).

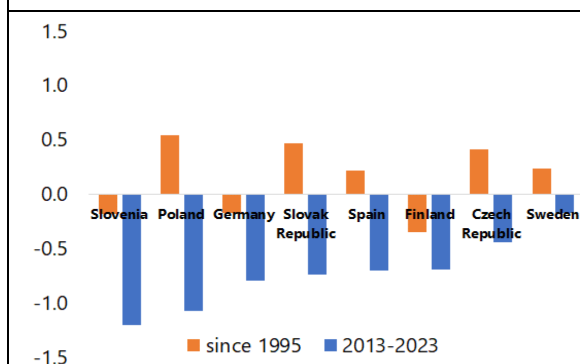
Figure 8. General Government Expenditures and Debt Based on Counterfactual Application of the SER *(percent of GDP)*



Source: IMF staff estimates, IMF WEO database, and national authorities budget documents.

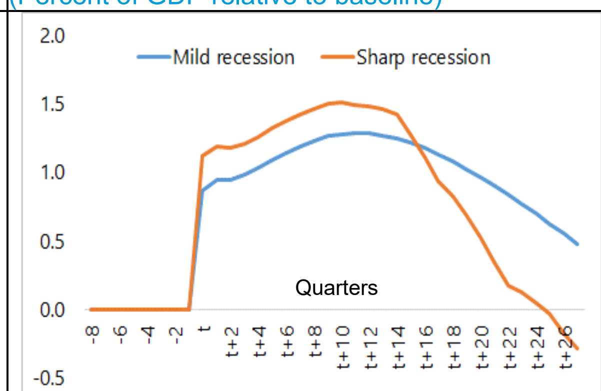
16. **Simulations also show that the SER has contributed to macroeconomic stabilization and debt sustainability.** Complying with the SER would have required tighter expenditure in 2019 and 2022.[8] Moreover, data show stronger countercyclicality after the introduction of the SER (Figure 9). The estimated covariance of primary expenditure to output gap in the counterfactual exercise is comparable to other EU countries and is lower than the covariance using Poland's actual fiscal outturns. This provides evidence that stronger compliance with the SER would have countercyclical properties. Third, model-based simulations using MOF-EM model show that government expenditure exhibits some countercyclical response to a growth slowdown (Figure 10). The model shows structural primary balances decline initially with the adverse shock before returning to the baseline, while debt also returns to the baseline downward trajectory after the shocks to growth are phased out.

Figure 9. Countercyclicality under the SER (estimated coefficients)



Sources: IMF WEO database and IMF staff estimate
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.

Figure 10. General Government Expenditure in Response to Adverse Growth Shock (Percent of GDP relative to baseline)

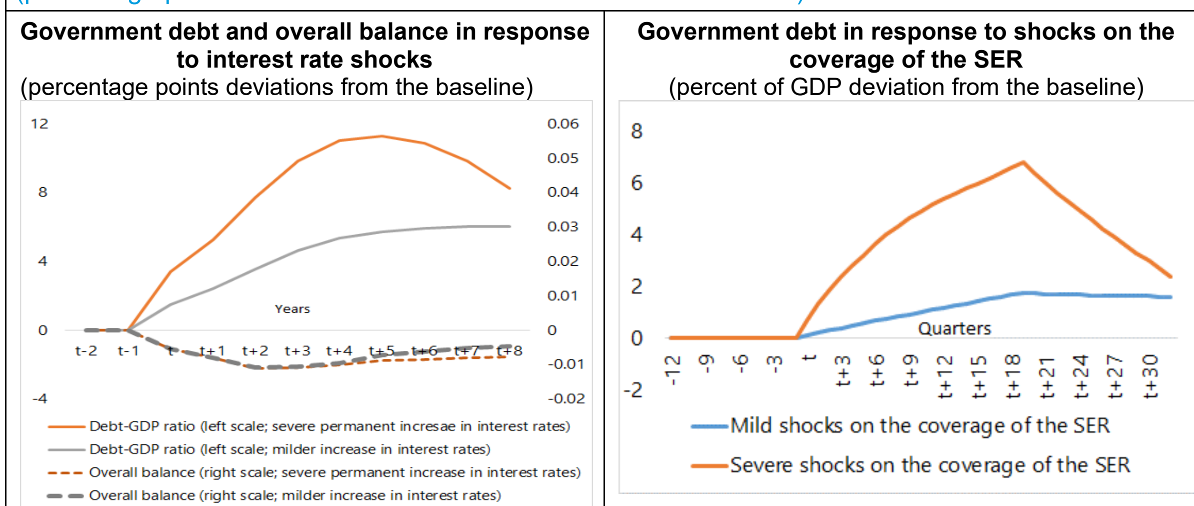


Source: Ministry of Finance model-based simulations.
Note: The temporary adverse growth shock is assumed to be 2.5 percentage points below the baseline in the mild scenario for four quarters and 3 percentage points below the baseline for the severe recession. Growth shock occurs at time t.

[8] For 2019, the difference would have been 2 percent of GDP less in terms of government expenditure, though the forecasted primary balance would have been about 1 percent higher than actual owing to lower forecast revenues. For 2022, the adjustment would have been larger (about 7 percent of GDP), largely reflecting sizable spending following multiple consecutive shocks during 2020-22.

17. Simulations also support the abovementioned features in the current SER. The SER has provided a relatively stable expenditure amid volatility of output. The debt outlook is sensitive to a permanent change in long-term interest rates but less so to exchange rate volatility, largely because of the short maturity of outstanding debt and the low share of foreign-currency denominated debt (Figure 11, left panel; Annex III Scenario 2). Inflation surprises would raise the expenditures indexed to inflation (such as pension benefits), thereby crowding out public investment under the same aggregate SER limits (Annex III). An unexpected rise in expenditure outside the SER legally-binding limits would lead to a rise in debt even though the legally-binding limits are complied with (Figure 11, right panel; Annex III).[9]

Figure 11. Simulation Results on the SER under Adverse Shocks
(percentage points relative to the baseline unless otherwise stated)



Sources: Ministry of Finance model-based simulations.
Based on simulation results on scenarios in Annex III. The adverse shock is assumed to take place at time period *t*.

D. Implementation of the SER

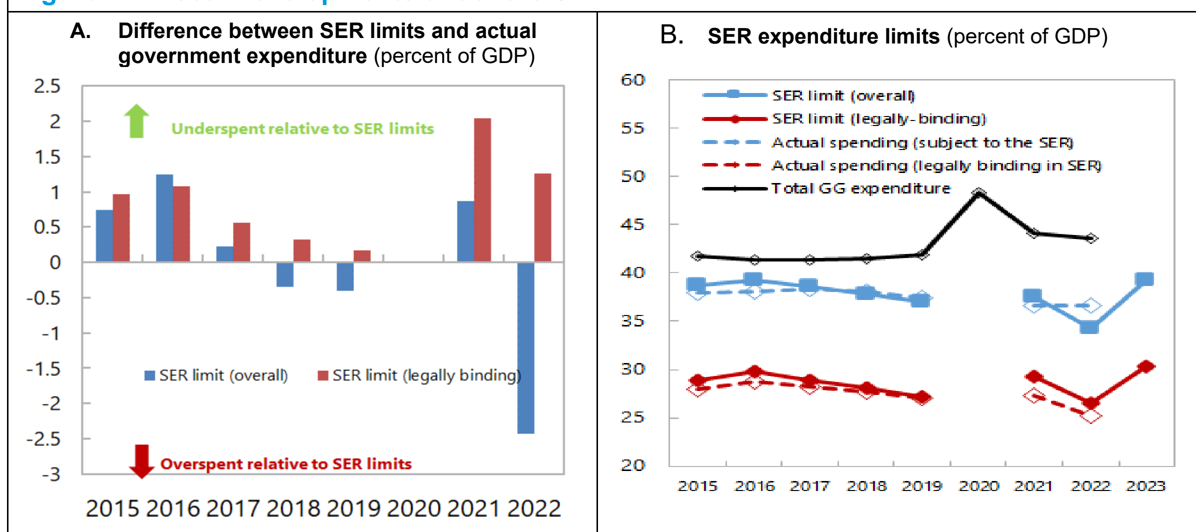
18. The SER has been instrumental in anchoring fiscal policies in the years leading up to the pandemic. The SER was largely complied with before the pandemic, contributing to an improvement in fiscal balances and reduction in debt (Figure 12). The expenditure outturns followed largely the SER limits, notwithstanding some deviations from the non-binding limits around election years. Strong growth during 2015-19 also kept government expenditure declining as a share of the GDP and debt on a downward trajectory, declining from 51.4 percent of GDP at end-2014 to 45.7 percent of GDP by end-2019. The SER limits were also published when formulating the annual budgets, which, according to the authorities, helped coalesce political debate and promote fiscal discipline.

19. Nonetheless, some challenges to the implementation of the SER emerged before the pandemic. The government accommodated extra spending in 2019 related to the move of the 13th pension (cash transfer) program to an extrabudgetary fund to avoid exceeding the legally-binding SER limit. Moreover, economic parameters entering the SER formula were occasionally revised. For example, the move from expected headline inflation to the NBP inflation target in 2015 at a time of low inflation was later revised back to the expected headline inflation in 2022 when inflation surged significantly above target.

[9] Moreover, the simulations also suggest that the correction mechanism might have posed some unintended tightening through the cumulative impact on the SER expenditure base.

20. The COVID-19 pandemic posed a severe test to the SER and the escape clause was appropriately activated. A timely revision in the escape clause at the onset of the pandemic—to include national epidemic as a trigger—enhanced the flexibility of the SER to respond swiftly to the shock.[10] The government introduced fiscal support amounting to PLN 105.2 billion in 2020, according to the Ministry of Finance. Following the return mechanism of the SER, most pandemic-related measures were unwound in 2021, leading to significant improvement in cyclically-adjusted primary balance by 5 percent of GDP. Nonetheless, the government expenditure reached 44 percent of GDP in 2021, about 2.2 percentage points higher than in 2019, suggesting further adjustments were needed in 2022 and after to return to the SER limits (requiring a 2.6 percent of GDP in lower expenditures).[11]

Figure 12. Fiscal Developments under the SER



Source: Ministry of Finance, Poland Budget Justification reports, and IMF staff estimates.
1/ Data for 2020 are not available as the escape clause provision of the SER was activated. Difference between SER limits and the actual government expenditure during 2020-22 was partly driven by the severe shocks Poland faced as well as the adjustments to the SER.

21. Challenges to return to the SER limits were compounded further in 2022-23 by the war in Ukraine and the subsequent energy price spikes. These unexpected shocks necessitated extraordinary measures to mitigate the adversity of energy price spikes and high inflation, as well as bolster defense spending and support 1.3 million refugees from the war in Ukraine. The government adhered to the return to the expenditure rule after the 2020 activation of the escape clause expired but resorted to several ad-hoc amendments to exclude certain expenditures and adopt a higher inflation component in the SER formula (Annex II; Figure 12).[12] Additional investment clauses were introduced in subsequent budgets (2021-23) to exempt some capital expenditures from the SER limit (for example, the capital expenditures of local government units in the Budget Act 2021).[13]

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[10] The government had the discretion on the size of fiscal measures upon the activation of the escape clause, subject to parliament approval.

[11] The difference between the SER limits (calculated based on compliance) and the actual government expenditures in 2022.

[12] One of the considerations for the government for not triggering the escape clause is that GDP growth was expected to be strong in 2022 (ex-post 5.6 percent with a positive output gap of 2 percent of GDP), which would imply that the triggering condition for the escape clause was not met. At the same time, the provision would require the government to pursue tightening fiscal measures in the return mechanism following the deactivation of the escape clause in 2021.

[13] In addition, the SER limit did not include capital expenditures of the state budget and investment expenditures planned for 2021 included in the draft financial plans of funds established, entrusted or transferred to BGK. A similar investment clause was used in budget years 2022 and 2023.

22. The design and implementation challenges of the SER were exposed as the economy experienced multiple severe shocks. First, while the fiscal framework has provisions of escape clause and correction mechanism, it required several revisions to respond to the shocks and smooth adjustments thereafter. However, it was difficult for the public to understand the validity of revisions to the SER without an independent fiscal oversight. Second, the ad-hoc exclusions of expenditures and increased use of extrabudgetary bodies for fiscal policy could have undermined the credibility of the SER. The resulting widening discrepancy between national definition of government debt and the general government debt (9.9 percentage points of GDP as of end-2022) makes the constitutional national debt limit an insufficient safeguard for containing debt vulnerabilities. Third, the lack of a multi-year expenditure path in the SER has constrained the transition to a more risk-based approach and limited the capacity to anchor a credible MTFF.

23. Looking forward, the SER should continue to play an instrumental role in anchoring fiscal policies with some refinements. Overall, the SER has fostered fiscal discipline leading up to the pandemic, and further refinements could help strengthen credibility. The SER has been effective in maintaining fiscal discipline leading up to the pandemic during 2015-19. The SER, in hindsight, was insufficiently resilient in the face of multiple severe shocks. In many ways, the ad-hoc adjustments reflect the limitations of the SER in guiding the exit from the escape clause and return to rule limits.[14] While these changes individually give flexibility, the combination of ad-hoc changes could have undermined the credibility of the SER. Institutional safeguards can be strengthened to ensure that fiscal policies, including countercyclical responses during severe shocks, remain consistent with the debt sustainability objective.

[14] As a result, the correction mechanism was revised—starting from the Budget 2024—to have a fiscal adjustment of 0.5 ppt of GDP (consistent with the Poland's EU convergence program). This was calibrated by setting the SER expenditure base for 2023 (1.2 percent of GDP lower) in order to calculate the 2024 SER limits.

III. Revising the Stabilizing Expenditure Rule

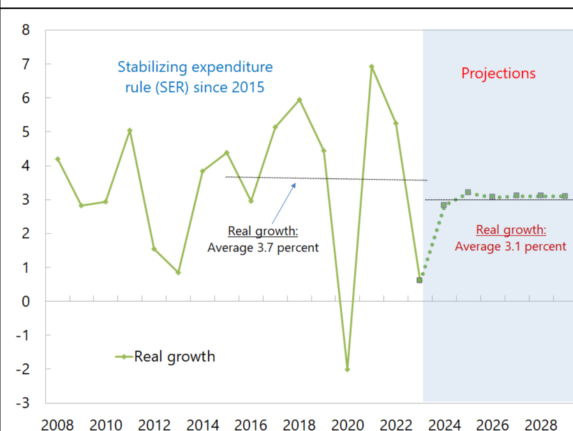
A. Consideration of SER Parameters

24. Revising several economic parameters in the SER formula could improve its effectiveness in maintaining fiscal discipline.

- *Growth parameter.* As growth prospects are slowing in line with the MOF and IMF WEO forecasts, the current SER limits that place large weights on historical growth could give rise to overspending (rising in terms of GDP) over the medium term (Figure 13). In that context, revising the SER formula to have a more forward-looking growth indicators will help maintain fiscal discipline. For example, a shift to a 3-year backward and 4-year forward (that is, t-3 to t+4 with t as the current year) will better align with the EU framework as well as reflect latest economic developments in determining the SER limits (Figure 14). Separately, the authorities' simulation presented to the mission team also exhibits stronger performance under this forward-looking formula than the current one in terms of smoother expenditure growth, stronger fiscal balance, and less buildup of debt. The transition to more forward-looking formulation could be introduced after the independent fiscal council is established to assess the quality of macro-fiscal forecast.

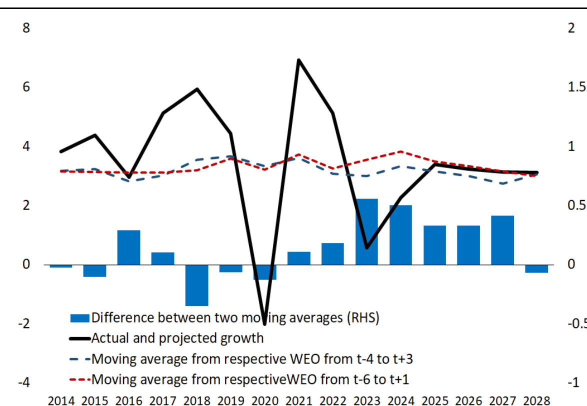
- *Inflation parameter.* The current SER adjusts for inflation of the fiscal year in the expenditure limit, which is appropriate. But the adjustment based on the forecast of headline inflation could give rise to volatile expenditure limits because headline inflation is typically more volatile than the core inflation rate or the central bank target (Figure 16). In theory, expenditures should be adjusted to prices that correspond to government consumption and investment, which could be different from the headline CPI inflation that mostly reflects household consumption basket. In Poland, pension benefits are automatically indexed to changes in prices measured by the CPI. While other expenditures such as healthcare are not directly indexed to inflation, some of those expenditures are set as a fixed share of nominal GDP and account for price effects (Table 2). As the price adjustments affect the current and future (through the base effects) SER limits, it is not advisable to use the moving average of headline inflation rates. Simulation results based on MOF-EM model (NEMPF) suggests that using moving averages of historical headline inflation rates will raise the SER limits, leading to higher deficits and debt in the coming years. Consideration could be given to adjust for prices based on a less volatile indicator (e.g., GDP deflator) than the headline CPI.

Figure 13. Real GDP Growth in Poland (Percent)



Sources: IMF WEO database and staff estimates.

Figure 14. SER Formula and Growth Parameters (Percent)



Sources: IMF WEO database and staff estimates. The moving averages are calculated based on respective WEO vintage at specific year.

25. Regardless of the indicators chosen in the SER formula, getting the unbiased forecasts will be important. Overoptimistic forecast on growth and inflation will raise government expenditure limits, leading to weakening fiscal discipline. In contrast, negative forecast bias will constrain expenditures and lead to political pressures to amend or circumvent the rules.[15] It is thus important to adopt an unbiased macro-fiscal forecast on key variables. There are different options to do so, including by using independent forecasts, strengthening the forecasting capacity within the MoF, or assessment by independent fiscal council. For example, some countries, such as the United Kingdom and the Netherlands, are obliged to use the macro forecast published by their fiscal councils in the budget.

Table 2. Indexation of Government Expenditures and Revenues

Countries	Pension benefits	Social assistance benefits	Public sector wages	Personal income tax threshold
Austria	p	p	0	Automatic Adjustment
Belgium	p	p	p	Unclear process
Croatia	m	0	m	No
Cyprus	p	p	p	No
Czech Republic	m	0	0	No
Denmark	w	m	0	Automatic adjustment
Finland	m	p	0	Unclear process
France	p	p	0	Unclear process
Germany	m	m	0	Unclear process
Hungary	m	0	0	Flat rate PIT
Italy	p	p	0	No
Malta	m	m	p	No
Netherlands	w	p	0	Automatic adjustment
Poland	m	0	0	No
Romania	m	p		Flat rate PIT
Slovak Republic	p	0	m	Automatic Adjustment
Slovenia	m	p	0	No
Spain	p	0	0	No
Sweden	m	0	0	Unclear process
Switzerland	m	p/m	0	Unclear process

Source: Balasundharam, Kayastha, and Poplawski-Ribeiro (2023).
For various types of government expenditure, "0" refers to No Automatic Indexation; "p" refers to automatic indexation to consumer price index; w refers to automatic indexation to wages; "m" refers to automatic indexation to a combination of prices, wages, or other indicators. For personal income tax thresholds, "No" refers to ad-hoc adjustment without indexation; "Automatic adjustment" refers to automatic adjustments by law; "Unclear process" means de-facto regular adjustment but no specific law.

Figure 15. Fiscal Slippages from Differences in Forecast: A comparison of Official and Consensus Forecast, 2000-19
(Percent of GDP)

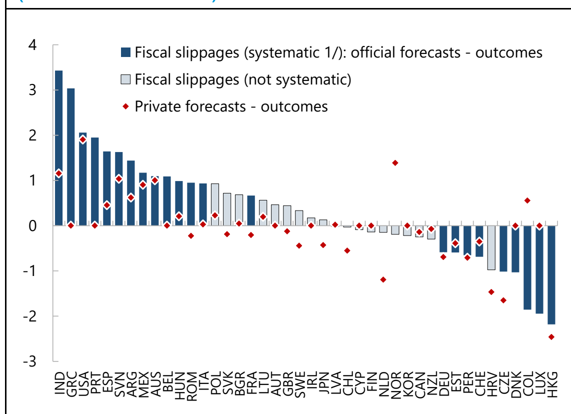
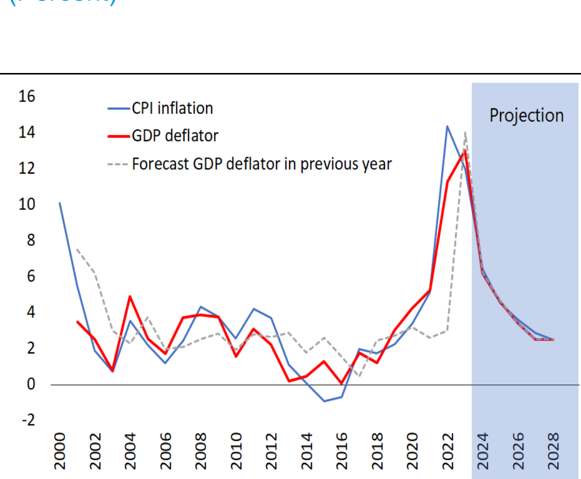


Figure 16. GDP Deflator and CPI Inflation
(Percent)



[15] Cross-country analysis shows that the difference between official and consensus forecast (about 1 percent of GDP) is not statistically significant and there are no systematic fiscal slippages, although the consensus forecast tends to be closer to the actual outcome (Figure 15).

Sources: Caselli et al. 2022 and IMF staff estimates. Note: Fiscal slippages are measured by the difference between the government's announced plans (one-year ahead) and final fiscal outcomes. Private forecasts are proxied by Consensus Forecast. 1/ Systematic = statistically significant from zero. 2/ "Slippages" refers to the cases where fiscal slippages repeated for three consecutive years. Sample of 43 countries including advanced and emerging market economies in Europe, Americas, and in Asia.	Sources: IMF WEO database.

26. Transparency in the discretionary revenue measures (DRM) and the adjustor parameter (K) in the SER formula would continue to ensure credibility of the SER. There is scope to include other discretionary revenues under the regulation (such as those related to the strengthening of revenue or customs administration but not change in tax policy). However, the DRM adjustment should be narrowed only to those government entities covered by the SER. In this regard, fiscal oversight on the revenue yields from DRM, such as through a fiscal council, would be important. The adjustor parameter (K) will be necessary to provide a reconciliation between the SER limit and the EU fiscal framework, but its adjustment should be transparent and well disclosed (both the current and historical levels) to enhance accountability. All individual components that enter the SER formula—including expenditure base, growth and inflation projections, DRM levels, and the adjustor K)—should continue to be reported in the explanatory note of the Budget Act.

B. Broadening the Coverage of the SER

27. A broader coverage of the SER and its legally-binding limit could further support aggregate fiscal discipline. It is necessary to ensure unambiguous accountability for compliance with the limit, so that it forces a prioritization of competing spending needs. A lack of clarity of which entity bears the responsibility for ensuring that spending stays within the limit will reduce the effectiveness of the SER. In this context, the current separation between the overall SER—covering close to 90 percent of general government expenditure—and the legally binding part of the SER—covering around 70 percent of expenditure—could be sensible, but the government should consider broadening the coverage of the legally-binding portion of the SER such as covering the expenses of COVID Prevention Fund and the Help Fund under the SER limit.

28. The central government should have full control and responsibility for all expenditures that fall under the legally-binding portion of the SER. In addition to the state budget, the legally binding part of the SER covers various funds, including the funds in the BGK. While there can be multiple reasons (historical, legal, or organizational) for extra-budgetary activity, such practices undermine budget unity and introduces ambiguity on which entity bears the responsibility of a mismatch between budget allocations and expenditure commitments. The mission was informed that the inclusion of non-budget entities in the legally binding part of the SER does not pose any practical problems, and that controls are in place to avoid overspending. To ensure no buildup of expenditure liabilities that will eventually affect the SER compliance, the government should have full authority over—and insight into—the finances of these extra budgetary funds.

C. Strengthening Compliance

29. An in-depth discussion on the compliance with the SER is absent in budgetary documents without an independent fiscal council. While key budgetary documents such as Budget Act outline the SER limits, those documents do not contain a thorough assessment of past or expected ex-ante compliance with the SER. At the moment, the NIK, an independent state audit body, conducted an ex-post verification of spending against the SER limits as well as its application in the Budget Act. The Regional Chamber of Audit provides an audit for local government units (Budget Act Articles 230-240). But there is a clear gap in oversight because no independent fiscal council offers a detailed, retrospective, or prospective analysis of adherence to the SER. Such an assessment of

budgetary discipline could be conducted not only at a general level but also at the level of budgetary entities.

30. **The compliance assessment with the SER should be conducted in conjunction with fiscal risks, other rules, and factors relevant to medium-term planning.** The SER primarily addresses government expenditures, whereas the below-the-line financing activities—those affecting debt dynamics but not recorded as expenditures under the SER—could also carry significant implications for fiscal planning and sustainability. The MOF has other provisions outside the SER to control, for example, local government finances such as restricting their borrowings and their ability to incur deficits or losses.

31. **Upgrading the monitoring mechanism is necessary, especially to align with the EU fiscal framework.** As the authorities revise the SER, it will be important to ensure its compliance through measures beyond what the budget and finance committee of Sejm and the NIK do at the moment. Monitoring should be extended to assessing the macroeconomic assumptions underlying the government budget and fiscal plans and the costing of policy measures, typically conducted by an independent fiscal council.[16]

32. **An independent fiscal council should be established to have broad mandate and autonomy to provide fiscal oversight.** The EU Directive defines the minimum requirements related to functioning and mandate of the independent fiscal councils. In Poland, the new fiscal council would (i) evaluate the macro-fiscal projections underpinning the MTFF and SER formula, including through debt sustainability analysis; (ii) assess fiscal performance and the compliance with the SER in ex-ante, during the year, and ex-post developments; and (iii) assess the activation, implementation, and the exit of escape clauses and the implementation of correction mechanisms (World Bank 2024). The fiscal council should have operational independence with resources commensurate its mandates and speak with one voice (Davoodi et al. 2022).

D. Transitioning to a Multi-year Expenditure Rule over the Medium Term

33. **Several European countries set multi-year limits in their expenditure rules to maintain fiscal discipline.** Countries such as Denmark, Finland, the Netherlands, and Sweden have operated binding aggregate multi-year expenditure limits for a long time and cited their expenditure rules as important contributing factors to their fiscal prudence (Table 1). Effective management of binding multi-year expenditure limits requires strong fiscal institutions. The MTFF comprises the institutional arrangements for prioritizing, presenting, reporting and managing fiscal aggregates over a medium-term horizon. Concurrently, the medium-term budget framework (MTBF) supports the government in prioritizing, presenting, and managing the budget across multiple years and government entities, ensuring expenditures stay within the defined limits of the fiscal rules. These frameworks not only provide numerical projections of multi-year revenue and expenditure but also incorporate systems, rules, and procedures that help budget planning within the fiscal rule.

34. **Expenditure limits set well in advance of the annual budget process can help separate aggregate fiscal policy decisions from the discussion of budget prioritization**. An important argument for setting multi-year expenditure limits is that they can operationalize and strengthen the prominence of aggregate fiscal constraints when deciding to accept or reject spending priorities in the budget. To avoid expenditures being incrementally pushed up, a binding total expenditure level is ideally set for multiple years in advance. While countries with good experience with multi-year

[16] In Poland, the NIK only provides assessment on the implementation of Budget Act and the ex-post fiscal performance and, thereby partially fulfilling some monitoring functions typically undertaken by a fiscal council. Some think-tanks also provide commentary on fiscal policy, such as the Institute for Responsible Finance, Center for Strategic Thought but they are not legislated entities to oversee fiscal policy.

expenditure rules all have mechanisms to adjust medium-term limits, they all aim to keep the underlying constraint constant. Some countries—such as Finland—update limits to reflect changes in inflation. Expenditure limits need to be adjusted to off-set accounting or classification changes, or reallocation of expenditure responsibilities between entities within and outside of the limits. These adjustments are reconciled and explained in budget documents. In countries where multi-year expenditure limits play an important disciplining role, medium-term expenditure limits are not adjusted to create budgetary room if spending requests exceed the expenditure limits.

35. Binding medium-term limits create strong incentives to assess how spending programs are expected to evolve over the course of several years. One of the strongest benefits from multi-year limits is an improved understanding of how expenditure responds to exogenous factors, and what expenditure pressures may arise beyond the annual budget horizon. To ensure that the policies in the annual budget are consistent with not only the upcoming year's limits but also the limits of outer years, countries have to assess that they comply with expenditure limits for all years. By introducing a multi-year horizon into an early stage of budget discussions, governments are also able to better plan new policies. Governments can show that while savings from fiscal measures (such as closing down agencies or phasing out programs) may be modest in a one-year perspective, over several years it could free up substantial room for priority expenditures.

Consideration for Poland

36. The SER in Poland sets the expenditure limit binding only for next fiscal year, limiting the forward-looking budgetary guidance. While the legally-binding SER limit—corresponding broadly to central government expenditure and a number of other entities—sets the constraint for the budget year, medium-term expenditure limits (anchored on an overall fiscal objective) are not set. Hence, the expenditure forecast plays a limited role in medium-term budgeting processes. Having in place a multi-year (no-policy-change) expenditure baseline related to expenditure ceilings that are based on well-defined outcomes and activity can help assess the affordability within the expenditure limits over time. This also facilitates the effective allocation of public resources. Overall, there is limited forward-looking budgetary guidance at the aggregate level and at the level of spending agencies governed by the SER.

37. Over the medium term, transitioning to a multi-year expenditure rule should be considered. The SER has gaps from successful expenditure rules in some other European countries, where binding multi-year limits are set and benchmarked against more rigorous medium-term expenditure forecasts to inform budgetary planning and the preparation of the annual budgets. In the explanatory note to the budgetary act, the SER expenditure is presented for the next four years but are indicative only. Transitioning to a multi-year expenditure rule supported by a credible medium-term fiscal framework is a priority. This would strengthen the linkages of the SER with annual budgets and medium-term fiscal plans and allow a risk-based approach in setting the SER limits, which in turn guide expectations and improve fiscal credibility. The transition also allows the government to plan better, particularly if facing structural pressures on expenditures such as the green transition, defense, and energy security. A multi-year expenditure rule is consistent with the requirements of the new EU economic governance reforms that are based on a 4-year or 7-year net expenditure path.

38. Medium-term limits allow for more strategic fiscal planning and policy formulation. Once the aggregate SER limit is determined, MOF nets out forecast expenditure for the non-binding part of the ceiling (also allowing some flexibility for new discretionary spending). While this approach is pragmatic, it reduces the ability to make strategic reallocations. If the SER limits are set for several

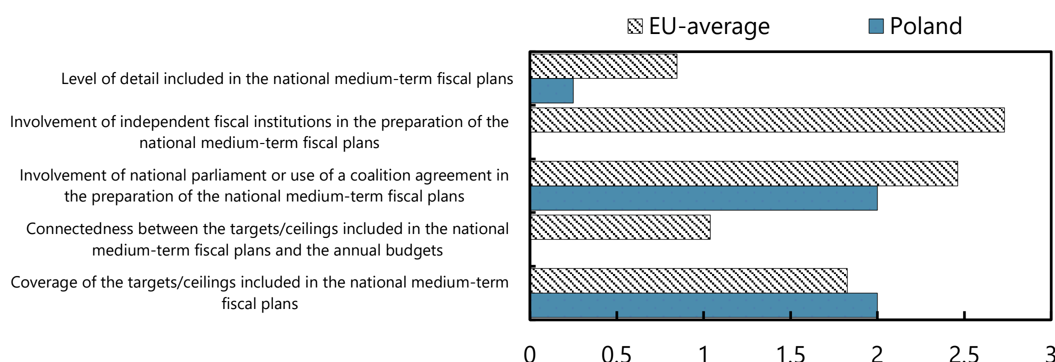
years—for example, for the third additional year—there will be more scope to phase out existing programs or to take a strategic view on expenditures that reflect policy priorities.[17]

39. Moreover, the division between the legally binding and non-binding parts of the SER should be separated into two stages. During the first—*technical*—phase, the MOF determines the overall limit based on the formula, the baseline (no-policy-change) expenditure for entities, and the expenditure room (or alternatively the savings requirement) available to the government. During the second—*fiscal policy*—phase, the government determines the broad allocation between legally binding and non-binding parts, and also between broad categories within the legally-binding part.[18] The government can adjust relative to the baseline in view of fiscal priorities. Discretionary fiscal policy can be allocated with the difference between the overall SER limits and the baseline expenditures.

Box 2. European Commission Assessment of the Quality of Medium-Term Budgetary Frameworks

The European Commission's fiscal governance database provides the survey-based information on MTBFs for all EU member states. In the latest 2023 survey, the MTBF index highlighted a specific deficiency in Poland's MTBF related to the "Connectedness" aspect of its national medium-term fiscal plans. The survey suggests that the medium-term plans are indicative and do not have detailed explanations for deviations from set fiscal targets. Moreover, the survey indicates that budget limits are not predetermined for a set number of years.

Box Figure 2.1. Characteristics of Medium-term Fiscal Plans



Sources: EC Fiscal Governance Database 2023, IMF staff compilation.
Note: EU average excludes Poland.

40. Transitioning toward multi-year expenditure rule would warrant a consideration in managing uncertainty. Setting fixed expenditure limits for several years (3-4 years) in advance is only practical if there is sufficient fiscal room (or a margin) left uncommitted within the expenditure limit so that revision to forecasts or other uncertainty can be absorbed within the aggregate expenditure limit in a given year. Maintaining a margin between the SER limit and budget expenditure—possibly rising over time—helps manage uncertainties. This goes beyond the current prudent practices by individual entities to leave a buffer for unforeseen expenses when planning their expenditures to avoid overspending.[19]

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[17] Multiannual plans are currently prepared but only at the aggregate level, based on an accrual basic not cash basis. MoF has information on the anticipated financial plans of the majority of units in the public sector units according to the Polish perimeters of the public sector. Those entities submit nonbinding draft of financial plans for the few years ahead at the stage of the budget act draft).

[18] Such broad categories would be a division of the state budget into some 20–50 broad areas (corresponding to ministries, programs or some other classification that is appropriate to how the government is organized and operated), as well as the extra-budgetary funds included under the legally binding part of the SER.

[19] The actual execution of expenditure is often below the planned expenditure in the Convergence Program (an average difference of 1.4 percent of GDP between 2016 and 2022).

41. The transition to multi-year expenditure rule will certainly require broad political support well as strong technical capacity across ministries in the government. This will likely take time to build consensus and expertise (such as forecasting and expenditure controls) and should be taken through a well-developed reform process and political support, drawing on successful country experiences such as Finland, the Netherlands, and Sweden. The mission identifies three broad options to gradually transition toward a multi-year expenditure rule over the medium term.

i. Continue with the current annual SER that sets limits for next budget year (t+1), and complemented with an application of the SER formula in the second to fourth years (t+2 to t+4) for information only;

ii. The binding SER limit is set for next budget year (t+1) and indicative limits are set for the second to third years (t+2 to t+3), while there is an explicit requirement in the SER (possibly through additional provision in the Public Finance Act) to reconcile the revision of limits when they are updated (that is, when the second year (t+2) becomes the upcoming budget next year); and

iii. Binding limits for all years in the expenditure horizon (second to the fourth year), with updates to off-set accounting or classification changes, activation of escape clause or if expenditure is shifted between sectors governed by the SER and outside the SER. Changes are clarified in budget documents.

E. Periodic Review of the Fiscal Rules Framework

42. Good international practice points to the merits of a periodic review of fiscal rule frameworks. Fiscal rules are designed to be robust to macroeconomic shocks, but structural side of the economy as well the nature and type of the shocks may evolve over time. Hence, fiscal rules should be periodically revisited for their performance and recalibrated accordingly, by fiscal council or a committee of experts. Several European countries conducted periodic reviews of their fiscal rule frameworks. For example, the Netherlands have conducted 17 periodic reviews since 1971 through an independent non-partisan high-level expert advisory group, even though there is no legal obligation to do so.[20]

43. In Poland, the performance and design of the fiscal rule should be subject to periodic comprehensive reviews, ideally no more frequently than once every five or six years. As the SER is revised, structural parameters in Poland (for example, growth prospects, government revenues, and population dynamics) as well the frequency and size of shocks may change, which may render the SER limit not fully consistent with fiscal objectives. As such, the authorities have concerns that the formula-based SER could set the expenditures on a 'wrong' trajectory (either too loose or too tight) over the long term as the structure of the economy changes. They see the need of some mechanism in the SER to rectify and ensure expenditures are consistent with fiscal objectives on growth and debt sustainability.[21] In that context, periodic reviews of the whole fiscal rule framework could ensure the SER is well calibrated and is consistent with long-term fiscal objectives. It is welcome that the government is now taking steps to strengthen the fiscal rules under the Multi-Annual Plan adopted by the government in April 2024. Future periodic reviews can be conducted through an independent committee of experts and could be informed by compliance assessment by independent fiscal council. The periodic review, however, should not be too frequent—what provides credibility to fiscal rules (relative to annual budget targets) is that they provide long-lasting constraints on fiscal policies.

[20] Studiegroep Begrotingsruimte | Ministerie van Financiën - Rijksoverheid (rijksfinancien.nl)

[21] For example, even if the parameters are well calibrated to stabilize expenditures as a share of GDP, trends in structural revenues could imply a non-stabilizing structural fiscal balance, leading to a buildup or an unnecessary reduction of debt.

F. Recommendations

- Preserve the credibility of the SER by restricting ad-hoc amendments to the SER, reporting all individual components that enter the SER formula, and aligning it to the EU fiscal framework. For example, the transfer of treasury securities to government entities should be included in the SER to avoid below-the-line financing activity as a circumvention.
- Revise the SER formula to include correction of growth forecast errors, more forward-looking indicators on real growth (for example, comprising 3-year historical growth rates, the current growth rate, and the 4-year growth forecast) after an independent fiscal council is established; include alternative indicator (such as GDP deflator instead of volatile headline CPI inflation rates) to adjust for price movements in the SER.
- Improve forecasting by (i) strengthening the forecasting capacity at MOF (including analyzing forecast errors); (ii) mandating the fiscal council to assess the realism of macro-fiscal forecast published by MOF.
- Broaden the coverage, including expanding the entities and funds within the legally-binding part of the SER.
- Publish an in-depth assessment of ex-ante and ex-post compliance of the SER, in conjunction with an assessment of the fiscal rules and fiscal risks.
- Establish an independent fiscal council to provide fiscal oversight.
- Over the medium term, transition the SER to include multi-year limits to strengthen the linkages of the SER with the annual budgets and MTFF and improve fiscal credibility.
- Conduct a periodic comprehensive review on the SER every 5-6 years to ensure it is well-calibrated and consistent with macroeconomic outlook and fiscal objectives.

IV. Provisions of Escape Clause and Correction Mechanism

A. Escape Clause

44. Well-designed escape clauses provide flexibility to deal with exceptional events, without undermining the credibility of the fiscal rule. Escape clauses are provisions in the fiscal rule that relax or suspend the rule temporarily when severe shocks occur. They provide the flexibility to raise expenditure beyond the rule limits, and if well designed, preserve credibility of the fiscal rule.

45. National escape clauses in several European countries are linked to the EU framework. In several cases such as *France* and *Italy*, national escape clauses are typically triggered automatically with EU-wide escape clause (Gbouhoui and Medas 2020). Other countries, such as *Germany*, specify more stringent rules beyond the deficit or debt limits.

46. Cross-country experience points to several considerations in the design of sound escape clauses

- *The nature (and possibly the size) of triggers.* Exceptional events that call for a relaxation or suspension of fiscal rules typically include natural disasters, war, state of national emergency, epidemics, or sharp economic slowdown. In certain measurable triggers, such as a growth slowdown, some countries specify the minimum size of shocks. Tradeoff exists between precision (avoiding abuse) and discretion related to the uncertainty on the size and nature of adverse shocks. It could be difficult (or counterproductive) to pre-judge which events or magnitudes would warrant a temporary suspension of the rule. One option to strike a balance between precision and discretion is to limit the size of deviation from the fiscal rule rather than the triggers, or to have a fiscal council monitoring the activation.
- *The activation and monitoring of escape clause.* Activating an escape clause typically requires parliamentary approval of the government proposal. It often requires an evaluation by the independent fiscal council. For example, in Sweden, the government proposes a change to the set level of expenditure ceiling and explains the exceptional circumstances that warrant the change. The parliament (*Riksdag*) decides on the activation, and the independent fiscal council (Swedish Fiscal Policy Council) assesses the government proposal.
- *Procedures for returning to fiscal rule compliance.* Provisions of escape clauses often set a timeframe or procedures for (i) re-instating rule compliance and/or (ii) correcting the deviations from the rule limits. For example, in Switzerland, deficits from exceptional spending during the activation of the escape clause would accumulate in a notional account, which needs to be remedied over the next six years. Germany has a similar but less specific clause that requires the government to put forward a plan to reduce the extra borrowing “within a reasonable time frame.”

Table 3. Escape Clause Provisions for Selected European Countries

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 staff compilation; national authorities.

Considerations for Poland

47. Although the escape clause was revised during the pandemic, it contains some limitations. First, the escape clause is not applicable for a severe growth slowdown (for example, a global financial crisis) because economic condition is not a trigger on its own. Second, the triggers for the escape clause are subject to economic conditions that narrowly focus on GDP growth. While this provides some safeguards against the misuse of the escape clause, this could have limited the ability to respond to severe shock. For example, the government may need humanitarian responses and other spending during major natural disasters that do not necessarily slow growth (growth may not slow immediately given reconstruction needs). Third, the rigid return clause may not be resilient to multiple adverse shocks. For example, Poland activated the escape clause appropriately in response to the pandemic but resorted to ad-hoc exemptions to meet the additional spending needs during energy price spikes and the war in Ukraine in 2021-23.[22] Finally, there is no independent fiscal council to evaluate the implementation of the escape clause (activation, costing of fiscal support, or its exit and return to SER limit).

48. Options to further strengthen the escape clause can focus on:

- *Triggers and thresholds.* Economic slowdown represents a key risk facing Poland, which could call for flexibility in government to respond to severe recessions (IMF 2023a). The escape clause should thus include "severe growth slowdown" as a standalone trigger, rather than a criterion currently provisioned for other triggers (Figure 17). The threshold could be set sufficiently low (for example, at 2−3 percentage points below the current moving average of historic growth and growth forecast and when growth is expected to be in the negative territory) to avoid the escape

[22] An investment clause was introduced on an ad-hoc basis to exclude capital expenditures of local government units, state budget and BGK funds (2021-22) and investment spending by state special purpose funds (2023). The implied fiscal adjustment in the return clause would yield a much deeper consolidation than required in the EU fiscal rules. To avoid an abrupt fiscal adjustment, the government resorted to revising the SER expenditure base for 2024 (1.2 percentage points lower) to accommodate a gradual adjustment.

clause being misused. The inclusion of a standalone trigger allows a swift response to severe shocks that do not pose an immediate threat on growth.

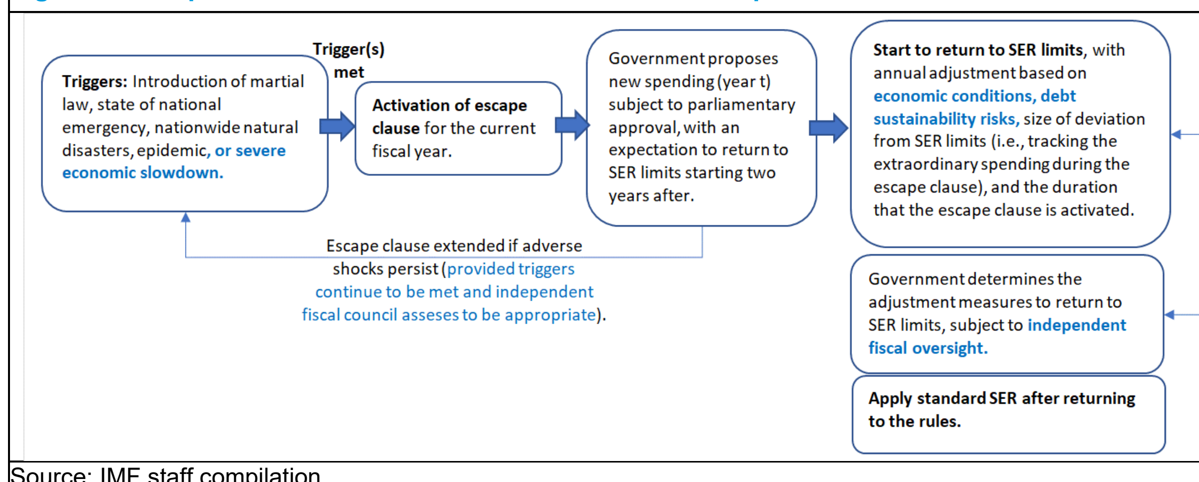
- *Procedures to trigger.* The authority to trigger the escape clause should continue to reside at the Sejm. As the authorities strengthen fiscal oversight, an independent fiscal council could be tasked to assess whether it is appropriate to activate (or extend) the escape clause, as well as provide the costing of additional fiscal measures. During the pandemic, more than half of fiscal councils across the world evaluated the use of escape clauses in fiscal rules. Many of those also assessed the implications of additional government spending on medium-term fiscal sustainability (Davoodi et al. 2022).

- *The duration of the suspension*. The duration of the escape clause could be set at the current fiscal year only. Limiting the duration of the rule suspension is an option to balance the discretion on having qualitative triggers in activating the escape clause and on the size of additional spending. The escape clause could have the option to extend for another fiscal year to address persistent severe shocks, provided that the triggering criteria continue to be met and the fiscal council assesses such extension to be appropriate (Figure 17). The fiscal council will also provide an opinion on the costing of extraordinary measures and the impact on debt sustainability. For example, the EU-wide escape clause was activated owing to the pandemic in 2020-21 and was extended in 2022-23 given the emergency related to the war in Ukraine.

- *The transition to re-instating the SER limits.*
  - *Pace of adjustment.* The current provision to return to SER limits two years ahead appears appropriate. A larger deviation more than 2-3 percent of GDP from the limit (equivalent to an adjustment of 1 ppt of GDP per year) may require a gradual but steady adjustment to strike a balance between macroeconomic stabilization and debt sustainability risk. The current provision considers economic conditions in a mechanic way and will benefit from incorporating debt sustainability risk as a criterion to determine the return to the SER limit, which will align better to the risk-based EU fiscal framework. For example, if debt sustainability risks are assessed to be high, fiscal adjustments may be necessary even if economic conditions remain unfavorable. In contrast, if debt sustainability risks are modest, fiscal adjustments could be more gradual.
  - *Expenditure base in SER.* A key parameter to consider when exiting the escape clause is to determine an expenditure base for compiling next-year SER limit (formula in Box 1). Without explicitly tracking the excess spending during the adverse shocks as in the current provision, Poland had made an ad-hoc adjustment to set the 2023 expenditure base to formulate the SER limit in the 2024 budget. It would benefit from tracking the size, persistence, and types of extraordinary measures when the escape clause is activated (for example, the notional account in Sweden or Switzerland). This would help determine the appropriate expenditure base when re-instating the SER limits and guide the pace of adjustment.[23]

[23] The unwinding of excess spending depends on the type of measures, for example, some one-off fiscal support to protect households during the pandemic could quickly unwind when the pandemic subsidies. In case of countercyclical fiscal support during severe recessions, the unwinding can be attuned to the gradual recovery of economic conditions and debt sustainability risks (IMF 2022).

Figure 17. Proposed Refinements on the Provision of Escape Clause



Source: IMF staff compilation.

B. Correction Mechanism

49. A correction mechanism specifies how the government puts public finances back to a sound footing when the fiscal rule is not complied or not well anchored. It often involves fiscal adjustments through raising revenues, expenditure freeze or cuts, and/or greater oversight by the parliament. By indicating the set of remedial actions, the government will take when deviating from the fiscal rule limits, a correction mechanism could enhance predictability of fiscal policy and hence the credibility of the fiscal rule. The design of the correction mechanism should correct for repeated fiscal slippages and restore the fiscal anchor following exceptional circumstances or structural changes that threaten debt sustainability.

50. Corrective action usually takes place reactively (ex-post) after the fiscal rule is breached, but action is called for preemptively in some cases. For example, the corrective mechanism in the EU Fiscal Compact trigger remedial measures after excessive deficits. Some fiscal rules include provisions that trigger preemptive action to contain surging risks of fiscal slippages. For example, fiscal frameworks in Croatia, Poland, and Slovak Republic contain 'debt brakes' that require increasingly tight fiscal action when debt-to-GDP ratio approaches its ceiling (Table 4). Empirical research suggests that a robust corrective mechanism, such as debt brakes, could help reduce sovereign risks (Hatchondo et al. 2022). Most correction mechanisms are trigged quantitatively when fiscal outturns exceed the numerical fiscal rules, in which governments must take remedial action. In a few cases (for example, *Belgium* and *France*), the triggers for remedial actions are based on the severity of the deviation.

51. The design of the corrective mechanism should consider:

- *Trigger based on one-off or cumulative deviations.* Corrective action is usually triggered by deviations from the fiscal rule limits, which may be driven by present or past fiscal activity. For example, in *Finland, Ireland, and Italy*, the assessment of the non-compliance is based on fiscal performance either in the current year, previous year, or over the previous two years. In other countries (for example, *Germany, Jamaica, Slovak Republic, and Switzerland*), corrective action is needed when cumulative deviations from the rules over time reach a critical threshold, even if deviations in any particular year is small. Triggers can be set on a single threshold or a set of progressive triggers with corresponding tighter measures (*Croatia*).

- *Magnitude of correction.* Some fiscal rules require restoring the compliance of fiscal rules in future years, while others require a full or partial unwinding of previous deviations through tighter fiscal stance progressively or in one go. For example, the "debt brake" in *Switzerland* accrues deviations from its spending limit in a notional account. Once the negative balance in the account exceeds 6 percent of expenditure, the government is required to take sufficient measures to bring the account within the limit in 3 years.

- *A timeframe for correction.* In many fiscal rules the corrective action must happen within one and a half to two years (*Belgium, Finland and France*), and sometimes or even within three years (*Grenada*). A more stringent correction mechanism may require immediate action or measures to be included in the next budget. For example, *Slovak Republic* requires the government to submit a balanced budget to Parliament in the next fiscal year if debt is within three percentage points of GDP of the ceiling. In *Colombia*, the government sets a timeframe for returning within the deficit limits.

- *Adjustment measures.* Some correction mechanisms are prescriptive about the measures to be taken. For example, the *Slovak Republic*'s rule freezes public sector wages if debt exceeds 50 percent of GDP and require a spending cut by 3 percent if debt surpasses 55 percent of GDP. Other mechanisms leave some or full discretion of fiscal measures to the government (*Germany and Switzerland*), or require qualitative action (for example, presenting to parliament an explanation for the deviations and submitting a supplementary budget upon parliamentary request.

Table 4. Selected Cross-Country Experience with Correction Mechanisms in Fiscal Rules

	Activation		Corrective action		
Countries	Criteria	Ex-ante / ex-post	Timeframe	Magnitude	Measures
Germany	Yes (balance on control account)	Ex-post	No	Offset deviations	Discretion
Italy	Yes (signifincat deviation from structural balance	Ex-post	Yes	Restore compliance	Discretion unless time limit is breached
Spain	Yes, quantitative for the central govenrment	Ex-ante (debt of 95 percent ceiling) and ex-post	Yes	Restore compliance	Discretion unless time limit is breached
Switzerland	Yes, quantitative for the central govenrment	Ex-ante	Yes	Restore compliance on the compensation account	Discretion
Brazil	Yes	Ex-post	Yes	Offset deviations from debt rule; restore compliance with wage bill limits	Discretion except for wage bill

Sources: IMF staff estimates.

Considerations for Poland

52. The recent simplification of the correction mechanism strikes a balance between macroeconomic stabilization and debt sustainability risks. The revision has made the mechanism more forward-looking and easier to communicate and implement. Looking forward, the correction mechanism should (i) continue to support the implementation of the SER through reducing deficits and restoring fiscal discipline; (ii) align the national SER to the net expenditure paths agreed with the European Commission under the EU fiscal framework (see section V); and (iii) limit the likelihood of debt buildup exceeding 60 percent of GDP, including in stress scenarios.

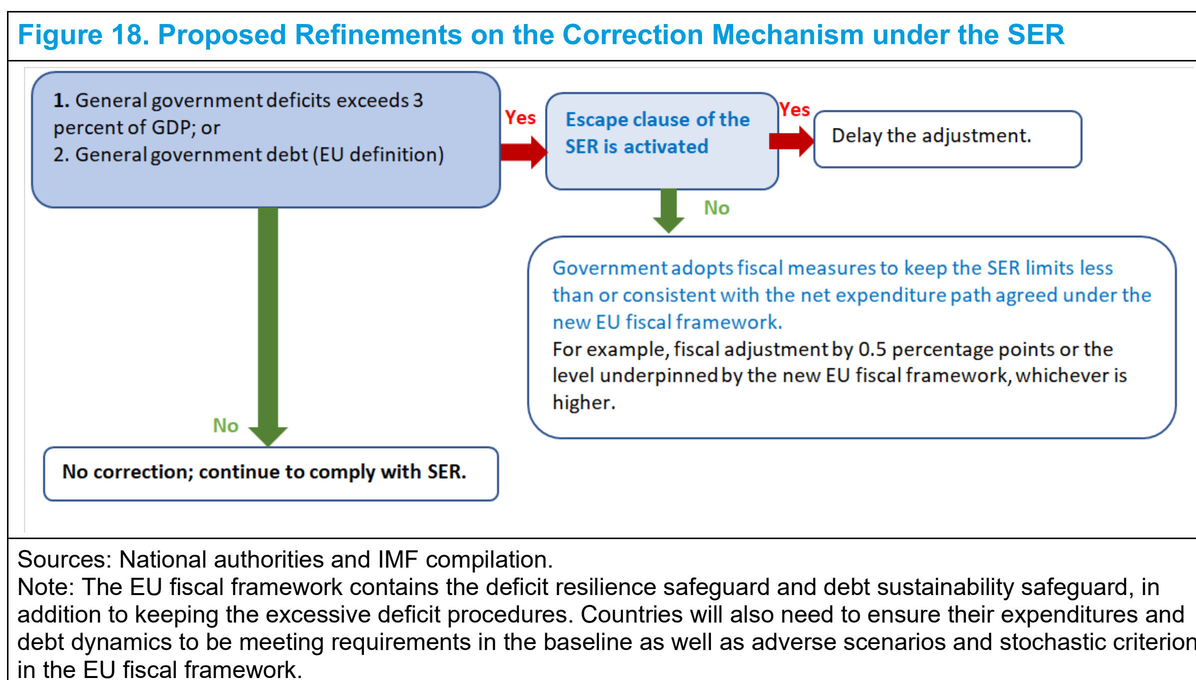
53. Further refinements should be considered to support the SER implementation.

i. To better align with the EU fiscal framework, instead of using 'economic conditions' as a criterion for fiscal adjustments, the criterion can be revised to whether the escape clause of the SER is activated or not. It is because the EU net expenditure path needs to be complied with unless the EU-wide escape clause is triggered. The new criterion will encompass the adverse economic conditions (given the proposed refinements in escape clause suggested in Section IV.A) in the existing correction mechanism, while considering other exceptional events. While the national escape clause may not be fully identical to the EU one, it is easier to monitor and communicate

than forecasts of economic conditions (Figure 18). Moreover, the implied expenditure path derived from the SER formula may not be identical to the EU net expenditure path (Section VI). The provision in the correction mechanism can help keep the two rules consistent by requiring a minimum fiscal adjustment to the SER that matches to the EU-agreed net expenditure path through an adjustment in the parameter *K*.

ii. Irrespective of the deficit and debt levels, the SER would benefit from specifying the government action for the ex-post non-compliance of expenditure limits. This could be done in a separate provision in the Public Finance Act or embedded in the correction mechanism. For example, the government can be required to submit a report to the Sejm explaining the noncompliance and indicate corrective action or adjustments. Precise measures could be left for government decisions and do not necessarily involving fiscal consolidation (especially if deficits and debt are at prudent levels much lower than the thresholds). The fiscal council should provide opinions on the noncompliance and recommend measures. As the compliance of the SER can only be verified at the end of a fiscal year, any corrective measures will take place in future budgets.

Figure 18. Proposed Refinements on the Correction Mechanism under the SER



Sources: National authorities and IMF compilation.
Note: The EU fiscal framework contains the deficit resilience safeguard and debt sustainability safeguard, in addition to keeping the excessive deficit procedures. Countries will also need to ensure their expenditures and debt dynamics to be meeting requirements in the baseline as well as adverse scenarios and stochastic criterion in the EU fiscal framework.

C. Recommendations

Escape clause

- Amend the provision (Article 112d in Public Finance Act) to list severe economic slowdown as a standalone trigger to activate the escape clause.
- Revise the return clause following the expiry of the escape clause such that the size and duration of adjustments will consider both economic conditions and debt sustainability risks; track the extraordinary spending during the activation of escape clause to help determine the expenditure base of the SER when returning to the rule.
- Mandate the new independent fiscal council to assess the implementation of escape clause, including the activation, extension, and return to SER limits, as well as the costing of extraordinary measures and implications for debt sustainability.

Correction mechanism

- Revise the criterion in the correction mechanism from 'economic conditions' to 'the activation of escape clause' when determining whether fiscal adjustments should be undertaken. This helps

strengthen the role of the correction mechanism in aligning the SER to EU-agreed net expenditure path.

- Specify action or measures the government need to take when expenditure outturn exceeds the SER limit in a given year, regardless of deficit or debt levels. This could be set as a new provision in Public Finance Act or embedded in the correction mechanism. The type of measures and horizon can be left for government decision subject to parliamentary approval and opinions by an independent fiscal council.

V. Aligning SER to EU Economic Governance Framework

A. The EU Economic Governance Framework

54. The Council of the European Union and Parliament agreed to a reform of the economic governance framework for EU member states in February 2024. It involves a revision of the EU fiscal framework that member states agree with the Commission and the Council to have a medium-term fiscal structural plan and a multi-year expenditure path (net primary expenditure limits) that will meet the criteria of a debt sustainability framework, complemented by several safeguards (Box 3).

55. Poland will need to ensure its national expenditure rule is consistent with the expenditure path under the new EU framework, both at the outset and during the implementation period of the EU-agreed expenditure path. While there is nothing in the EU framework that prevents countries to undertake more adjustment than agreed in the structural-fiscal plan, net general government expenditure—as defined by the governance framework—implied by the SER limits cannot be higher than the net expenditure limits in the fiscal plan.

56. This brings several challenges in ensuring the consistency of the SER with the EU framework. First, the implied expenditure growth paths under the SER may be different from that under the EU fiscal framework. Second, besides the numerical parts, the coverage and classification of SER expenditures differ from the EU definition of net expenditure in some ways. For example, the SER includes interest payment, cyclical unemployment benefits, and co-financing of EU projects. Third, the SER is accounted on a cash basis, while the concept for EU net expenditure is based on European System of Accounts (ESA) 2010 (Table 5). Fourth, another challenge is that four-year net-expenditure paths are set as part of the new framework, while a new SER limit is introduced each year for next fiscal year, on the basis of updated outturn and forecast data. The SER needs to avoid a situation where projected SER limits for future years are initially consistent with the agreed net expenditure path, but later become mismatched as the SER parameters are updated in later years.

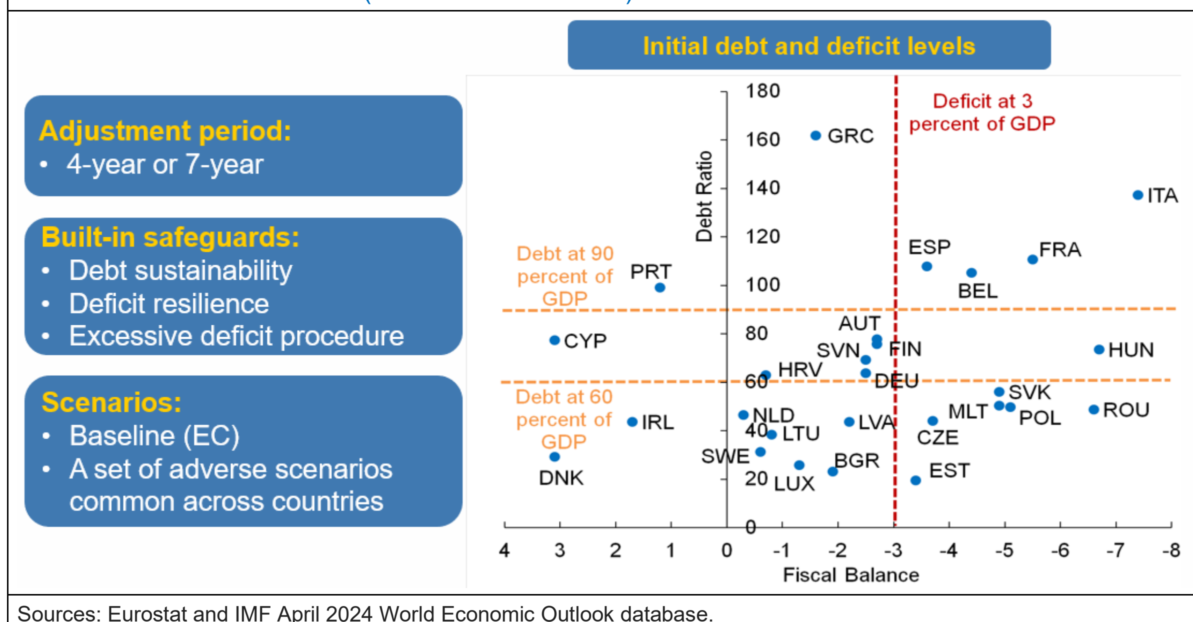
Table 5. Comparison of Poland's SER and EU Net Expenditure Indicators

	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 expenditure	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 compilations.
Note 1/ Cash-expenditure adjusted for the time of delivery of defense equipment.

57. Poland is expected to enter the Excess Deficit Procedures (EDP) with the projected fiscal deficit declining from 5 percent of GDP in 2023 to around 3 percent of GDP in 2028. According to EDP requirements in the Corrective Arm, a minimum annual adjustment of 0.5 percent of GDP is required. The minimum adjustment is set in terms of the structural balances but can be adjusted by the increase in interest payment in the period 2025–27. Member states remain in the EDP until the fiscal deficit falls below 3 percent of GDP (deficit reference value). In addition, for countries with debt higher than 60 percent of GDP and/or a deficit higher than 3 percent of GDP, the EU *deficit resilience safeguard* requires member states to establish a 1.5 percentage points '*resilience*' margin. According to the EU framework, that would require a minimum adjustment of 0.4 (or 0.25) percent of GDP in the structural primary balance in a four-year (or seven-year) adjustment period. When a country leaves the EDP with debt below 60 percent of GDP, a technical information, that could include the deficit resilience safeguard, can be provided at the request by a Member State, however it is not mandatory (Figure 19).

Figure 19. Multiple Moving Parts in Determining the Fiscal Adjustment Paths under the New EU Fiscal Framework Euro (Percent of 2023 GDP)



Sources: Eurostat and IMF April 2024 World Economic Outlook database.

58. The mission conducted simulations to evaluate how the fiscal adjustments under the EU fiscal framework will stand relative to that implied by the SER, with a perspective of aligning the annual SER limits to the EU framework. The methodology considers debt sustainability risks of the EC framework and incorporates the criteria, benchmarks and safeguards under the new EU governance reforms (Annex IV; using 2022 and 2023 Debt Sustainability Monitor (DSM) as an operational guide i.) The simulations aim to answer two questions:

i. What is the size of fiscal adjustments required under the new EU economic governance reforms? What are the implications on fiscal balances and debt dynamics for Poland?

ii. How does the fiscal path under the EU framework compare to that based on the SER formula?

Box 3. New Reforms of European Union Economic Governance Framework

In April 2024, the European Parliament approved a reformed economic governance framework for European Union members. The new framework aims at promoting sustainable public finances, while encouraging growth-supporting reforms and investments. Countries which are considered to face long-term risks to their public finances are required to submit a multi-year adjustment plan that—with a high likelihood—restores fiscal sustainability. The fiscal adjustment should be gradual and realistic, while also allowing for countercyclical policy. In line with this, member states are asked to agree with the Commission and the Council a four-year *fiscal-structural plan*, relying on *net primary expenditure* as the single operational indicator. The implementation of this plan will be monitored through *annual progress reports*, allowing the Commission to verify compliance with the net primary expenditure path.

The framework distinguishes two phases: an *adjustment period*—as set in the fiscal-structural plan—and a ten-year *debt trajectory phase*, over which long-term fiscal sustainability is assessed. The baseline adjustment period is four years. However, countries committing to structural reforms and public investments—that enhance economic resilience or growth prospects, or strengthens fiscal sustainability—can be allowed to extend the adjustment period to seven years, thereby reducing the pace of annual fiscal adjustment. During the post-adjustment phase, the primary balance is assumed to be constant, with the exception that costs related to an ageing population are added.

Restoring and securing fiscal sustainability—the primary objective of the framework—is specified along two dimensions. Public debt should be plausibly placed on a downward path, or—if already low—maintained at prudent levels. This is referred to as the *debt criterion*. Fiscal deficits should—if high—be reduced, and subsequently be kept moderate, referred to as the *deficit benchmark*.

The *debt criterion* is assessed based on debt-sustainability analysis (DSA) according to a common European Commission methodology, covering the ten-year debt trajectory phase. The DSA examines the debt dynamics under various pre-specified scenarios and shocks, such as lower GDP-growth or higher fiscal deficits. In the DSA, if debt is above 60 percent of GDP it should decline with a high probability. If below 60 percent of GDP, it should not exceed this threshold at the end of the ten-year horizon in the adjustment scenario as well as all deterministic stress tests. The *deficit benchmark* requires that by the end of the adjustment period, the general government deficit is below 3 percent of GDP, and is projected to remain below this level for the entire ten-year debt trajectory phase.

In addition, the framework includes two minimum adjustment *safeguards*. According to a *debt sustainability safeguard*, over the adjustment period the debt-to-GDP ratio should fall on average by no less than 1 percentage point of GDP annually if debt is above 90 percent of GDP, and 0.5 percentage points of GDP annually if debt is between 60 and 90 percent of GDP. According to the *deficit resilience safeguard*, as long as the general government structural balance is less than -1.5 percent of potential GDP, the annual improvement of the structural primary balance should not be less than 0.4 percentage points of potential GDP for countries with a four-year adjustment period, and 0.25 for those with a seven-year adjustment period.

B. Simulation Results for the Potential Net Expenditure Path24

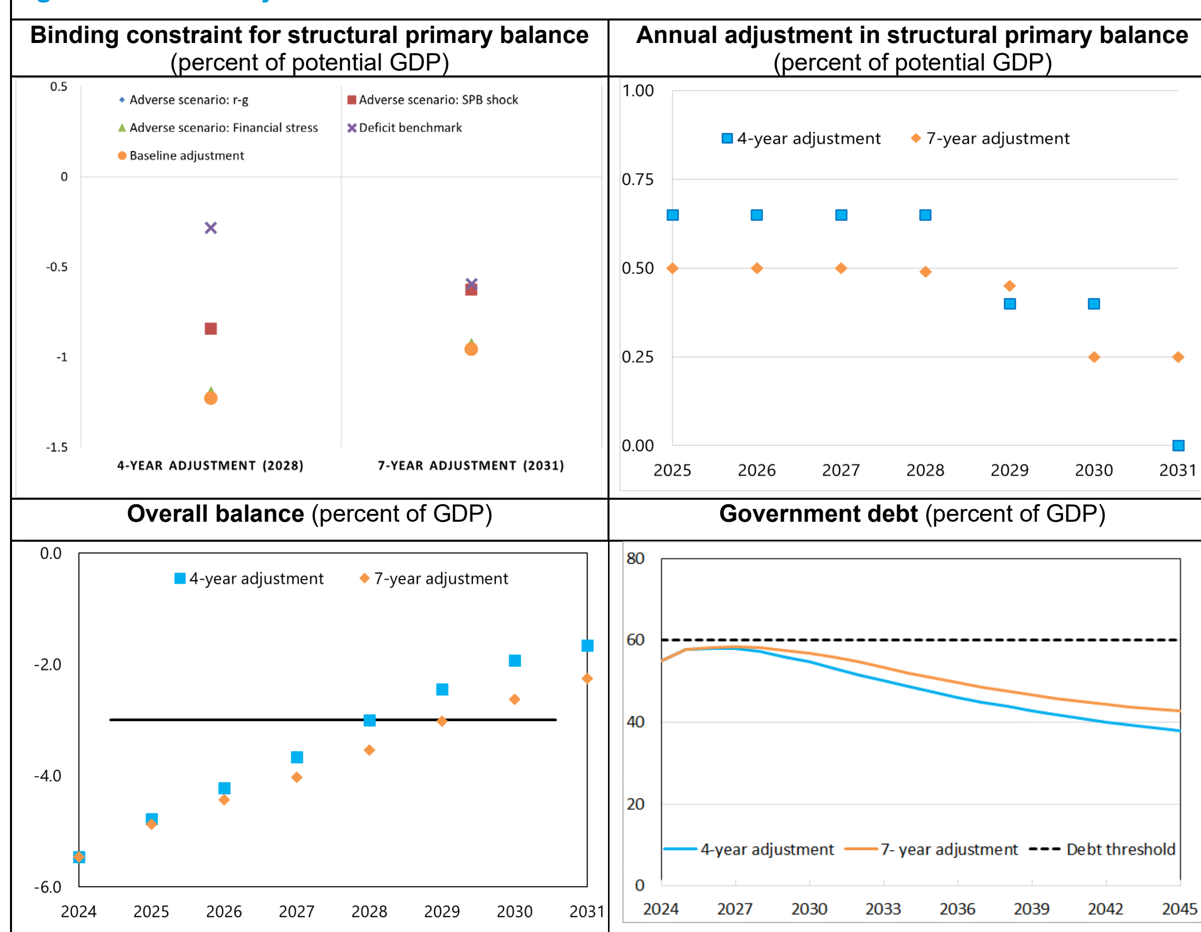
59. Simulations suggest that the EU fiscal framework would require potential adjustments of the structural primary balance of 0.5-0.6 percent of GDP per year. The magnitudes following

[24] While the methodology uses the DSM 2023, the results may not be fully identical to the official EC net expenditure path given different input data. The updated application of the fiscal rule (based on the 2024 Spring forecast and the 2024 Ageing Report) will be handed over to member states on Jun 21, 2024. The simulated results here are indicative only.

the projected exit of EDP by 2029 will be more gradual as Poland builds buffers to achieve the deficit resilience.

- *Four-year adjustment (2025-28).* Under a four-year adjustment, among various safeguards and specified adverse scenarios, the *deficit benchmark (deficit criterion)* would generate the largest fiscal adjustments for Poland under the new EU framework. According to the mission's calculations, in order to attain the binding SPB target by 2028, Poland would be required to improve its structural primary balance by about 0.6 percent of GDP until 2028, while not a requirement for Poland, an adjustment of 0.4 or 0.25 could be pursued in the consecutive plan to comply with the deficit resilience safeguard (Figure 20). As Poland is expected to be under the EDP until 2028 in the simulation, the minimum SPB required is comparable but somewhat higher than the one derived from the deficit *criterion*.
- *Seven-year adjustment (2025-31).* Alternatively, under a seven-year adjustment (2025-31), Poland is expected to stay under the EDP until 2029 in the simulation exercise, the adjustments under the deficit criterion could only be activated in 2030 with the requirement of a minimum SPB of -0.6 percent of GDP by 2031 (Figure 20). In this case, Poland is envisaged to adjust by 0.5 percent of GDP until 2029 under the EDP (with the exclusion of higher interest expenditure ending in 2027 not having a material impact on the adjustment). For the last two years in the seven-year adjustment period, while the deficit resilience safeguard is not a requirement for Poland, the authorities could establish a resilience margin of 1.5 percent of GDP to the deficit criterion by pursuing an adjustment of 0.25 percent in 2030 and 2031.

Figure 20. Fiscal Adjustments under the EU Fiscal Framework



Sources: IMF WEO database; European Commission; national authorities, and IMF staff estimates.
The 2024 level is standardized across 4-year and 7-year adjustment periods. It is assumed that the fiscal adjustment starts in 2025. Growth, interest rate, and inflation projections are based on the World Economic Outlook Database, April 2024.

60. Based on the MOF macro-fiscal forecast assumptions, the debt ratio is expected to stay below 60 percent of GDP in both adjustment horizons. The strict adjustment required either in EDP (2025-28) or the deficit resilience safeguard (if requested in the second plan) is projected to keep debt in check (Figure 20 right bottom panel). If stochastic shocks are introduced during the adjustment period, there is a high probability (over 70 percent) that debt would stay at or below 60 percent of GDP.

C. Fiscal Adjustment Paths Implied by SER

61. The expenditure path implied by the SER is compared to the net expenditure path of the EU fiscal framework. Using the latest MOF projections and assuming stable revenue to GDP ratio over the years, we illustrate the expected SER limits over the next few years based on the *mechanic* applications of the SER formula. The simulation assumes no discretionary revenue measures (DRM=0) in the projected horizon. Other variables such as real growth, inflation, and the revenue-to-GDP ratio are taken from the authorities' projections or IMF World Economic Outlook database.

62. We consider two simulation cases to illustrate the comparison: 1) the implied SER limits based on the *mechanic* applications of the current SER formula and the implied SER limits based on the proposed SER formula with forward-looking growth components (see Section III), both without adjusting for correction mechanism (parameter K=0); 2) the two implied SER limits adjusting for correction mechanism (parameter K takes the values such that the implied fiscal adjustments in the two implied SER limits is at least or higher than that under the potential EU net expenditure path).

Simulations based on current SER formula without adjusting for correction mechanism

63. In the first set of simulations, expenditures implied under the current SER would lead to higher expenditures than that under the EU net expenditure path, particularly in outer years 2027-29 (Figure 21). Without adjusting for the correction mechanism, the near-term expenditure is expected to grow fast and begin to slow only gradually. This is partly because without correction the base effect in the SER will carry forward higher expenditure to future limits. This would imply less fiscal tightening and a weaker structural primary balance and higher debt than that implied by the net expenditure path in the EU fiscal framework (Figure 21). Average adjustment in the structural primary balance would be 0.2-0.3 percent of GDP, relative to 0.5 percent of GDP under the EU framework. Based on the current SER formula without accounting for the correction mechanism, debt could reach 60 percent of GDP in 2033 and stay elevated for some time. Numerical results with stochastic shocks also show that the likelihood of debt staying below 60 percent of GDP may be lower in the near-term. In that context, additional fiscal efforts, possibly through the correction mechanism in the SER, are needed to meet the net expenditure paths in the EU framework.

Figure 21: Implied Fiscal Adjustments under the Current SER (Without Correction Mechanism) and Net Expenditure Path in the EU Fiscal Framework

Sources: IMF WEO database; European Commission; IMF staff calculations.
Note. The net expenditure path assumes a 4-year adjustment under the EU fiscal framework. The adjustments are assumed to start in 2025. In the SER scenarios, macro-fiscal assumptions (e.g., growth, interest rate, and inflation rates) are based on authorities' projection as of March 2024, while macro-fiscal assumptions in the EC scenario are based on the World Economic Outlook Database, April 2024. Revenue to GDP ratios in the outer years are assumed to be stable. The forward-looking SER assumes a moving average of three-year ahead growth projections and four-year historical growth outturns. It is assumed that the total general expenditure will grow at levels implied by the SER, not just the share that is subject to the SER at the moment.

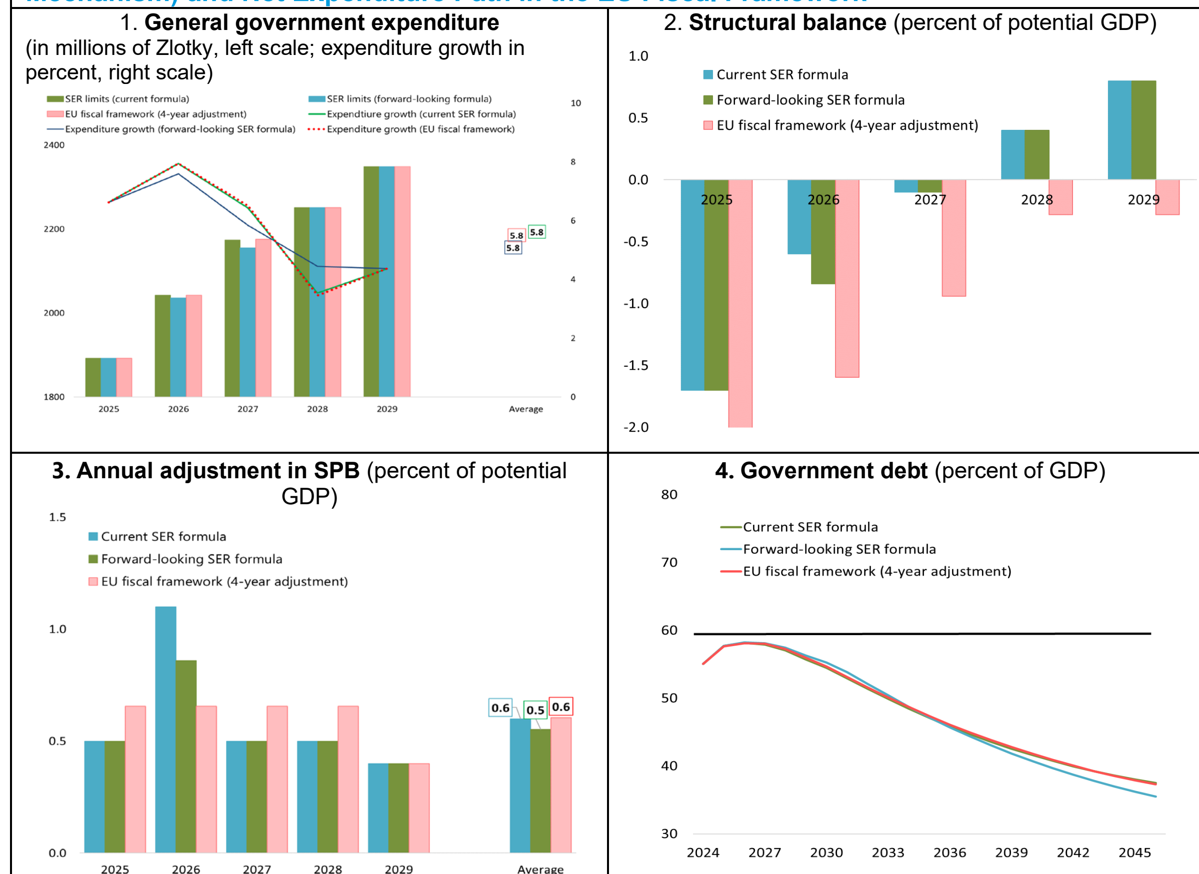
Simulations based on the proposed SER formula

64. In the second set of simulations, the analysis is based on a SER formula with forward-looking growth components and adjusting for correction mechanism. The proposed SER formula will have a moving average of growth projections 3 years ahead and a 4-year historical growth as discussed in Section III.A. In addition, the adjustment clause in the correction mechanism is included such that the minimum fiscal adjustment is at least 0.5 percent of GDP each year, unless the Commission recommends a lower adjustment.

65. Simulation results show that expenditures implied under the SER would be similar to that under the potential EU net expenditure path (Figure 22). Given the application of correction mechanism, the near-term expenditure is expected to grow slower starting from 2027 at about 6 percent each year in nominal terms. The implied expenditure path is smoother than that under the EU net expenditure path. This would imply a gradual fiscal tightening of 0.5 percent of GDP over the adjustment period, with the exception of 2026 owing to the phasing out of the strong growth in 2023-24 in the SER formula (Figure 25 left bottom panel). The pace of adjustment is slightly more prudent than the EU net expenditure path, leading to a gradual and stronger improvement in the structural primary balance. Government debt is expected to stay below 60 percent of GDP over the horizon,

slightly more favorable than that implied under the EU net expenditure path (Figure 22 right bottom panel). Overall, the proposed revision to a SER formula with correction mechanism will align better with the net expenditure path in the EU fiscal framework.

Figure 22: Implied Fiscal Adjustments under a Forward-Looking SER (with Correction Mechanism) and Net Expenditure Path in the EU Fiscal Framework



Sources: IMF WEO database; European Commission; IMF staff calculations.
Note. The net expenditure path assumes a 4-year adjustment under the EU fiscal framework. The adjustments are assumed to start in 2025. In the SER scenario, macro-fiscal assumptions (e.g., growth, interest rate, and inflation rates) are based on authorities' projection as of March 2024, while macro-fiscal assumptions in the EC scenario are based on the April 2024 World Economic Outlook database. Revenue to GDP ratios in the outer years are assumed to be stable. The forward-looking SER assumes a moving average of three-year ahead growth projections and four-year historical growth outturns. It is assumed that the total general expenditure will grow at levels implied by the SER, not just the share that is subject to the SER at the moment.

66. **Aligning the fiscal adjustment paths between the national SER and the EU governance reforms may require additional revisions.** However, the revisions should not aim to alter the SER formula in ways to replicate the precise adjustment path agreed with the Commission and the Council. The uncertainty on macroeconomic variables would also leave the SER limits in outer years at a range rather than precise levels. Revisions should adhere to the good principles of fiscal rules balancing flexibility and credibility in the fiscal framework.

i. The implied expenditure path derived from the SER formula may not be identical to the net expenditure path for the next 4 or 7 years agreed with the Commission and the Council. One option could be through well-designed provisions in the correction mechanism (Section IV) to ensure that the fiscal adjustment path implied in the SER would be consistent with the expenditure path agreed under the EU framework. For example, the mechanism correcting excessive imbalances requires a minimum fiscal adjustment of 0.5 percentage points of GDP (to reflect the net expenditure path under the EU framework), unless the EU Council recommends a different fiscal effort. Mechanically, the provision of the correction mechanism will enter the SER formula through the one-off adjustment (parameter K as shown in Box 1).

ii. The SER is set on an annual basis, with subsequent forecasts updated annually, while the net expenditure path agreed with the Commission and Council is set for the next 4 and subsequent forecasts will not be updated. A reconciliation is needed to map the implied SER limits to the net expenditure path in the EU fiscal framework. This could be reflected in the parameter K in the SER formula.

iii. The government will need to ensure compliance with the SER as well as the EU-agreed net expenditure path. At present, there are important differences in what expenditure items are excluded from the expenditure limits as well as accounting treatments on expenditures (Table 5). For example, interest payments and cyclical unemployment benefits are excluded from EU-agreed net expenditures but not in the SER expenditure limits. Expenditures are accounted on a cash basis in Poland while the EU adopts an accrual basis in the European System of Accounts 2010. Providing an explanation on the sources of differences between SER expenditure and EU-agreed net expenditure would help implement the fiscal rules and facilitate compliance.

iv. While the expenditure on projects co-financed with the EU is envisaged to be excluded from the EU net expenditure path, maintaining that expenditure in the SER could maintain a broader coverage to ensure a direct link of the SER limit in debt-creating flows (depending on the size of projects and co-financing arrangements) and strengthen fiscal transparency. This does not limit the capacity to use the flexibility provided in the EGF to scale up EU co-financed projects as the ex-post assessment could account for the potential acceleration to ensure consistency with the EU fiscal framework.

v. In determining the SER limit for next budget year, occasional adjustments may be necessary to ensure after reconciliation, the government expenditures are expected to comply with the SER limit as well as the EU-agreed net expenditure path (Table 5).

67. When the SER is revised and upgraded, a well-crafted communication strategy would be instrumental to garner public support and trust. Cross-country experiences suggest that successful communication has largely relied on (i) simple, clear messages aimed at educating the public about the merits of fiscal responsibility; and (ii) an inclusive dialogue and consultation process with major stakeholders (Corbacho and Ter-Minassian 2013). Effective communication should begin early and be disseminated through multiple channels (speech, reports, press interviews, conferences) to a wide audience. It should stress the benefits of revising the SER to align with the post-pandemic economic outlook facing Poland and comply with the new EU economic governance reforms. Other provisions in the SER (such as the correction mechanisms, escape clauses, periodic review) and accompanying reforms (transition to medium-term expenditure rules and fiscal council) should be seen as part of a coherent and robust framework. This will strengthen the national ownership as well as credibility of the fiscal rules, address policy priorities and improve Poland's resilience against shocks.

D. Recommendations

- Align the SER limits to be consistent 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 SER expenditure and EU-agreed net expenditure to help implement the fiscal rules and facilitate compliance.
- Prepare a communication strategy on the revision of the fiscal rules to gain credibility and garner public support and trust.

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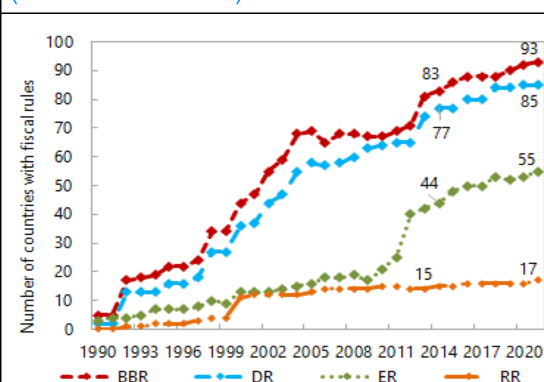
Annex I. Fiscal Rules across Countries and Selected Examples of Expenditure Rules

1. **An increasing number of countries have adopted numerical fiscal rules in their fiscal framework.** Over 100 countries have adopted at least one rule as of end 2021. A combination of budget balance rule with a debt rule has been common in practice. As of 2021, 85 countries adopted fiscal rules that included an explicit ceiling on government debt, and this number has been increasing over time (Figure A.1.1). At the same time, more than 80 percent of countries with a debt ceiling have also rules imposing constraints on the (nominal or structural) budget balance, and among those, almost a third has expenditure limits.

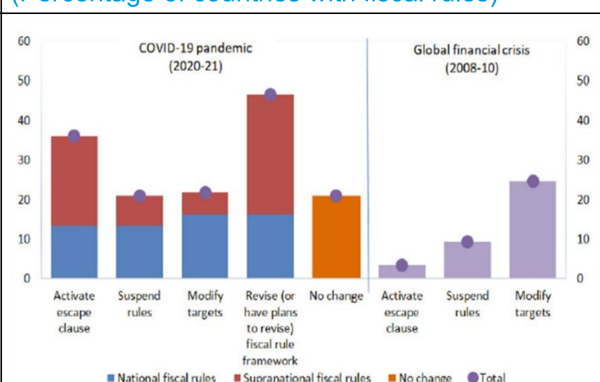
2. **The pandemic put the fiscal rules and frameworks to test.** During the pandemic, over 80 percent of countries with fiscal rules have activated the escape clauses or suspended temporarily fiscal rules, a much higher percentage than during the global financial crisis (Figure A.1.2; Davoodi and others 2022). About half of countries with fiscal rules have had deficits or debt exceeding the limits of their fiscal rules. Many countries are facing the challenge of how to return to the fiscal rules (Figure A.1.3).

Figure A.1.1. Types of Fiscal Rules
(Number of countries)



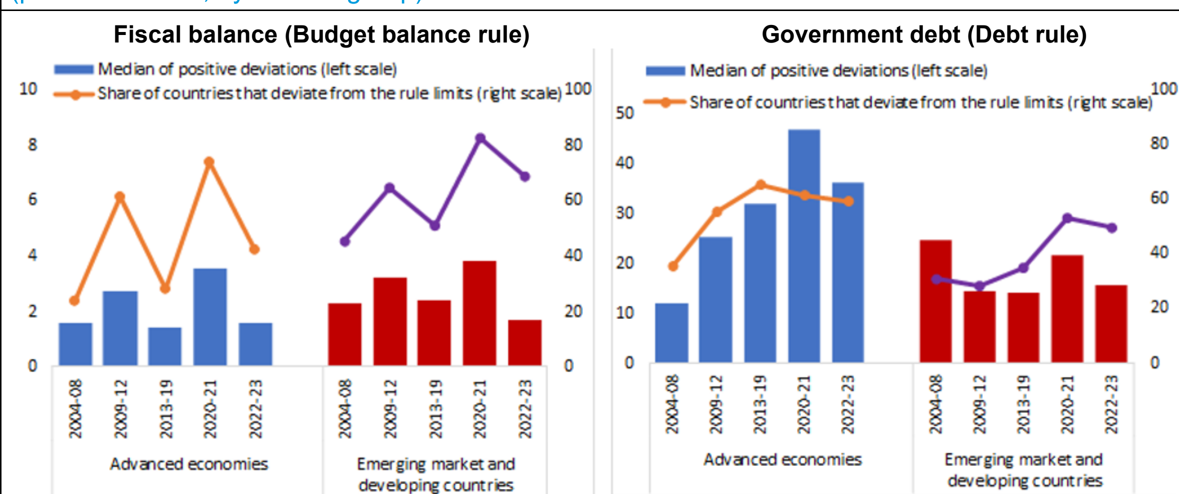
Source: Davoodi and others 2022, IMF Fiscal Rules Dataset 2021.

Figure A.1.2. Changes in Fiscal Rules
(Percentage of countries with fiscal rules)



Source: Davoodi and others 2022, IMF Fiscal Rules Dataset 2021.

Figure A.1.3. Deficits and Debt Levels Exceeding the Rule Limits
(percent of GDP, by income group)



Sources: Davoodi and others 2022; IMF Fiscal Rules Dataset: 1985-2021; IMF WEO Database.

EU Countries with Multi-Year Expenditure Limits

Denmark. Expenditure limits were introduced in the Organic Budget Law in 2012. The limits, proposed by the Ministry of Finance, set legally binding nominal limits for expenditures of the central government, municipalities, and regions, respectively. Limits are approved by parliament and cover a rolling period of four years. Improved budget management and economic sanctions are used to support compliance with the expenditure limits.

Finland. Since 2003, successive governments have set annual limits to primary non-cyclical expenditure in real terms for the four-year term of their office. These limits are not set in law. They are proposed by the government, usually formed by a coalition of 4-5 parties which commit to the limits in the fiscal plans and fiscal policy objectives they publish at the beginning of their term of office. Currently, about 75 percent of total central government spending, and about 37 percent of total general government spending fall under the limits.

Netherlands. Since 1994, limits are fixed in real terms for aggregate expenditure and currently cover the general government sector. Limits are also then set specific ministries, subnational governments, and budgetary sectors (social security, and health care) for each year of the government's four-year term of office. The legal framework requires the setting of multiannual expenditure limits, which are operationalized in a government agreement at the start of a government term. The coverage of expenditure has changed over the years, reflecting fiscal challenges. For example, between interest payments and the cyclical component of unemployment expenditure were excluded from the expenditure ceiling to reduce the procyclical nature of the limits. If it is expected that the limits will be breached, the Minister of Finance is expected to propose corrective action.

Slovak Republic. In March 2022, Slovakia adopted an expenditure rule, consisting of annual public expenditure limits (PELs) over a *fixed* four-year period. These limits are set in nominal terms over aggregate general government expenditure (excluding interest payments, EU Funds including RRF, state budget funds intended for EU co-financing programs, one-off expenses, and unemployment benefits). These exclusions account for approximately one-quarter of general government spending. At the beginning of each new government's four-year term, PELs are calculated using a formula designed to improve the structural balance by the end of the term. The required improvement in the structural balance is determined by an indicator of fiscal sustainability risks. In addition to the expenditure rule, Slovakia has a debt brake mechanism that imposes additional expenditure constraints. The expenditure rule contains a provision of escape clause. The PEL can only be adjusted when exiting the escape clause or when the updated revenue forecast deviates by 3 percent of GDP or more from the initial forecast. The country's Fiscal Council estimates the limits and proposes them to Parliament for approval at the start of a government's mandate. The formula used is based on a methodology jointly agreed upon by the Ministry of Finance and the Fiscal Council.

Sweden. An expenditure rule has been implemented since 1997. The Organic Budget Law requires the Government to propose in its Budget Bill an expenditure ceiling for central government and old-age pension system expenditures for the third year ahead. Parliament (the Riksdag) then sets the ceiling. It is a rolling framework, with one additional year being added annually. The limits cannot be adjusted except for technical issues. A budgetary margin is used as a buffer. Interest expenditure is excluded from the ceiling. The audit office occasionally reviews compliance with the limits.

In all these countries, the limits are initially estimated by the Ministry of Finance, then proposed by the Government and ultimately approved by Parliament.

Annex II. Recent Amendments to the Fiscal Rules, 2015-23

Table. Amendments in the Act of Public Finance related to SER

	Amendments	Details
1	Act of 8 November 2013 amending the Act on Public Finance and some other acts (Dz.U. 2013poz. 1646)	**The stabilising expenditure rule** replaced the temporary disciplinary expenditure rule. The SER has been first applied to the Budget Bill for 2015.
2	Act of 9 May 2014 amending the Public Finance Act and the Act amending the Public Finance Act and other acts (Dz.U. 2014 poz. 911)	1. The prudential thresholds in correction mechanism of the rule reduced by 7 percentage points from level of 50% and 55% to **43% and 48%** respectively. 2. Consolidation of financial flows between funds managed by the Social Insurance Institution (ZUS).
3	Act of 22 July 2015 amending the Act on Public Finance (Dz.U. 2015 poz. 1190)	**Inclusion of the Bank Guarantee Fund** to the scope of SER.
4	Act of 10 December 2015 amending the Act on Public Finance (Dz.U. 2015 poz. 2150)	1. Change in the formula: the forecasted CPI and its following revisions due to forecast errors replaced by **the inflation target** of the National Bank of Poland. 2. The expenditure limit increased by the sum of positive **one-off and temporary revenue measures** which value is higher than 0.03% of GDP. 3. Consolidation of financial flows between funds managed by the President of the Agricultural Social Insurance Fund (KRUS).
5	Act of 9 November 2018 on the amendment of acts regarding the enhance of supervision over the financial market and the protection of investors in this market (Dz. U. 2018 poz. 2243) and the Act of 15 March 2019 amending the act on financial market supervision and other acts (Dz.U. 2019 poz. 875)	**Modification of the SER starting point due to the exclusion of the Office of the Polish Financial Supervision Authority from the scope of units covered by the SER** (in regard to its legal transformation).[25]
6	Act of 28 May 2020 amending the Act on Public Finance (Dz. U. 2020 poz. 1175)	1. Introduction of a possibility to **suspend SER during epidemic and simultaneous significant deterioration of the macroeconomic situation**. 2. Introduction of a **mechanism of automatic return** to the application of the stabilising expenditure rule in a 2 to 4 years horizon.
7	Act of 24 July 2020 amending the act on the delegating workers as part of the provision of services and other acts (Dz.U. 2020 poz. 1423)	Introduction of the **investment clause**: 1. the spending limit for 2021 was de-facto increased by the capital expenditure of local government units; 2. the capital and investment (including co-financing of EU expenditure) state budget expenditure planned for 2021, together with investment expenditure planned for 2021 in the draft financial plans of funds created, entrusted, or transferred to the State Development Bank of Poland were excluded from the expenditure limit.
8	Act of 11 August 2021 amending the Act on Public Finance (Dz.U. 2021 poz.1535)	1. **Amendment of the escape and return clauses** in SER to modify them in line with suggested policies in EU (extended general escape clause, clearing the growth indicator and correction mechanism from the pandemic impact). 2. **Deactivation of a correction mechanism in the years of the escape clause and return clause**.

[25] The value of the change amounted to PLN 245 million which corresponded to 0.03 percent of SER expenditure of 2019.

		3. **Inclusion of the other special purpose funds** to the scope of SER (A3G RRP milestone). 4. **Amendment of the investment clause** - increase of the spending limit for local government capital expenditure and the capital expenditure of budget, and funds created, entrusted, or transferred to the State Development Bank of Poland for a whole period of the return clause in SER (2021-2022). 5. **Exclusion the COVID-19 Counteracting Fund** from the binding spending limit in SER (due to its temporary and "rescue" character).
10	Act of 23 June 2022 amending the Act on Public Finance and the Act on Environmental Protection (Dz. U. 2022 poz. 1747)	1. In the SER formula, **the inflation target of the Monetary Policy Council has been replaced by the forecast CPI** and its forecast errors revisions; 2. **Recalculation of the starting amount** for calculating the SER for 2023 resulting from the replacement of the inflation target with the CPI rate, and replacing deflation with the index of 1.000; 3. Introduction of an ex post **correction of inflation forecasts errors** (starting from the 2022 forecast); 4. **Inclusion of the National Fund for Environmental Protection and Water Management** in the scope of the SER; 5. **Extension of an investment clause** for 2023 (with minor changes to its scope).
11	Act of 16 November 2022 amending the Act on Tax on tax on certain financial institutions and certain other acts (Dz. U. 2022 poz. 2745)	**Modification of the method of implementing the expenditure limit in 2022 -** possibility to exceed the expenditure limit by the sum of the financial effects resulting from additional measures aimed at combating the negative effects of the energy crisis and the increase in the average annual consumer price index, as well as the financing of the armed forces. Their value amounted to PLN 26,023,418 thousand (3,4% of expenditure limit).
12	Act of 13 July 2023 amending the Public Finance Act and certain other acts (Dz. U. 2022 poz. 1641)	1. **Change to the correction mechanism** which makes the required fiscal effort resulting from the SER consistent with the one implied by the EU rules. 2. **Introduction of the defence clause**. 3. **Recalculating the base for SER expenditure** for 2024 as the level corresponding to sum of the amount of SER expenditure in 2023. 4. Introduction of **higher correction for 2024** – equal to 1.2% of GDP.

Source: National authorities.

Annex III. Scenario Analysis on the Performance of SER

The annex outlines the scenarios used to analyze the performance of SER during different types of adverse shocks. The analysis uses Ministry of Finance Economic Model (MOF-EM) in Poland, which contains a system of equations based on estimated parameters using the vector autoregression model (VAR) (Ministry of Finance 2024). The Ministry of Finance runs and maintains the model and provides the scenario results to IMF staff during the mission.

The scenarios are designed to examine (i) the countercyclical properties of the SER; (ii) the medium- to long-term implications for debt sustainability; (iii) sensitivity of priority spending such as public investment or social transfers to a change in the SER limit; (iv) flexibility of the SER in responding to severe shocks; and (v) the ability to return to the baseline following the shocks.

The baseline scenario takes the MOF model results based on the standard parameters in the MOF-EM model and MOF's own macro-fiscal forecast as of December 2023. Simulations are conducted for the following adverse shocks scenarios.

1. *Growth slowdown.* An adverse growth slowdown scenario that occurs in a typical business recession. The type and size of the shocks is set to be a 1-standard deviation of real GDP growth for 2 consecutive years. Revenue to GDP and primary expenditures are assumed to following the built-in elasticity identical to the baseline. An alternative of more severe shocks is also conducted to examine the impact of correction mechanism.

2. *Tightening of global financing conditions.* This scenario examines the impact of an abrupt tightening of global financing conditions, leading to a rise in sovereign yields in key advanced economies (US and Euro-area) and the risk premium in Poland. The simulation considers a permanent increase of 100bps and 200bps for sovereign spreads in Poland. An augmentation of capital outflow and a sharp depreciation of exchange rate—including the pass through to domestic inflation—is conducted to examine the sensitivity on the results.

3. *A deterioration of primary balance.* This scenario considers a temporary (one-year) deterioration of primary balance owing to unexpected developments. The magnitude of the shock is set to be 1 and 2.5 percent of GDP over 3 years, with the latter large enough to examine the properties of correction mechanism as well as the cumulative base effects on the SER. A deterioration of primary balance will have endogenous effects on interest rates that are built in the model.

4. *Stronger inflation than expected.* This scenario assumes the moderation of inflation is slower than the forecast used in the SER formula. The inflation surprise will lead to a rise in nominal spending indexed to inflation (relative to baseline), raising the likelihood of expenditures exceeding the SER limit but also higher revenues and lower debt. To comply with the overall SER limit, other types of expenditures, such as public investment, will tighten. The size of the shock is set at 2ppts or 4ppts higher for two consecutive years.

5. *Coverage of the SER.* This scenario consists of an unexpected rise in net expenditures of entities not covered by the SER, which could lead to a rise in debt while complying with the SER. The size of shocks is assumed to be 0.5 percent of GDP per year for five year and another more severe shock to examine the properties when the debt level will be pushed above 60 percent of GDP to trigger the correction mechanism. An alternative of an unexpected rise in net expenditures of local governments (entities that are outside the legally-binding SER limits but covered in the SER) is considered (but not conducted in the simulations), which leads to a reduction of legally-binding expenditures (such as investment or priority spending) to comply with the overall SER, while debt remains largely the same as in the baseline.

6. *A tail-risk scenario.* This considers a tail-event in which several adverse shocks occur at the same time with strong interactions, combining the scenarios of growth slowdown, a surge in risk premium, and a deterioration of primary balances.

In addition to the scenarios, several sensitivity analyses were performed to examine the impact of the SER on key fiscal variables such as government debt, interest payment, expenditure, and fiscal balances.

Annex IV. Fiscal Adjustment Paths under the SER and EU Fiscal Framework

This annex summarizes the methodology to derive the potential fiscal adjustment path under the EU fiscal framework.

The new EU fiscal framework aims at completing the fiscal adjustment within a four- or seven-year period. The new fiscal framework requires setting the SPB at the end of the adjustment period (2028 or 2031, under the four- or seven-year adjustment, respectively) at levels such that the projected debt to GDP ratio and fiscal deficit as a share of GDP meet the conditions specified in the debt sustainability analysis and the related safeguards. In this analysis, the SPB after the adjustment period is assumed to remain unchanged SPB* (the minimum level that meets all requirements of the new EU framework), except for ageing-related expenditure, which are added to the SPB.

The methodology for the numerical analysis is largely based on the European Commission's 2023 Debt Sustainability Monitor (DSM).[26] The DSM specifies methods for stress scenarios; interest rates projections, and the stochastic analysis, among other technical details. To apply those methods in the context of the new economic governance framework, the current analysis relies on (Darvas, Welslau, and Zettelmeyer 2023), which is not entirely identical to the European Commission's approach described in the DSM 2023.

According to the simulations, the potential fiscal adjustments in the new framework are determined by ensuring a decline in debt-to-GDP ratio and deficits staying below 3 percent of GDP even when the baseline—where applicable—is subject to deterministic stress scenarios and stochastic shocks. Those scenarios and criterion are considered after the adjustment period, i.e., in 2029 (or 2032) in case of four-year (or seven-year adjustment period, respectively.

Deterministic stress scenarios

- **Lower SPB.** In the adverse scenario of lower SPB, the SPB is assumed to be permanently lower than the baseline SPB* by 0.5 percent of GDP in every year after a short transitory period following the end of the adjustment period. The SPB is gradually lowered by 0.5 percentage points of GDP in two years if the adjustment lasts for four years (that is, by 0.25 percentage points in both years), and in three years (that is, one-sixth percent of GDP in each year) if the adjustment lasts for seven years.
- **Adverse r-g.** The interest rate-growth differential is permanently higher by 1 percentage point than assumed in the baseline following the end of the adjustment period. It immediately lowers growth by 0.5 percentage points in the first year after the end of the adjustment period and all subsequent years. The 0.5 percentage-point higher interest rate applies to new borrowing from the first year after the end of the adjustment period but does not influence the interest rate on existing debt, so it takes time before the average effective interest rate to increase by ½ percentage point.
- **Financial stress.** The adverse scenario assumes the government borrowing rates to rise temporarily, for one year only, by 1 percentage point for countries with a debt ratio below 90 percent of GDP, and 1 percentage point plus 0.06 times the gap between the debt level and 90 percent for countries with debt levels exceeding 90 percent of GDP.

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[26] European Commission (2023d) Debt Sustainability Monitor 2022, Institutional Paper 199, Directorate General of Economic Affairs, available at https://economy-finance.ec.europa.eu/publications/debtsustainability-monitor-2022_en. While the methodology uses the DSM 2023, the results may not be fully identical to the official EC net expenditure path given different input data. The updated application of the fiscal rule (based on the 2024 Spring forecast and the 2024 Ageing Report) will be published on Jun 21. The simulated results here are indicative only.

Stochastic criterion. The stochastic projection of the debt to GDP ratio is based on drawing multiple shocks (10,000) from a joint-normal distribution of historical quarterly shocks for the primary balance, nominal short- and long-term interest rates, nominal GDP growth, and the exchange rate. After transforming the shocks to annual frequency and constructing the shocks to the implicit interest rate, each series is combined with the projected deterministic path of the respective variables. Recalculating the debt path for each draw is based on standard debt equation to arrive at a probability distribution of projected debt.

In addition to the above-mentioned debt sustainability requirements, related safeguards in the new economic governance reforms also account for:

- **Excessive Deficit Procedures (EDP).** For countries in the EDP, the SPB needed to abide by the EDP adjustment requirement at 0.5 percent of GDP adjustment in structural primary terms until 2027 and 0.5 percent of GDP adjustment in overall structural balance after.
- **Debt sustainability safeguard.** During the adjustment period, the debt-to-GDP ratio should fall each year by no less than 1.0 percentage points of GDP for countries with a debt-to-GDP higher than 90 percent, and by no less than 0.5 percentage points of GDP for countries with a debt-to-GDP between 60 and 90 percent. This safeguard does not apply to countries while they are in the EDP.
- **Deficit resilience safeguard.** As long as the structural balance is below -1.5 percent of potential GDP, countries need to ensure that the fiscal adjustment is consistent with a minimum improvement of the SPB. This minimum adjustment is 0.4 percent of potential GDP for countries in a four-year adjustment period, and 0.25 percent of GDP for countries in a seven-year adjustment period. The safeguard is in practice optional for countries with debt-to-GDP below 60 and deficit-to-GDP below 3.0.