COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of compliance with the balanced budget rule in 2013

July 2014

 The CBR thanks the Ministry of Finance for the data provided.

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Summary

This is the first year in which the assessment of compliance with the balanced budget rule for the previous year is prepared; the rule was transposed into Slovakia's national legislation on the basis of an obligation arising under the international Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. Under its Title III named Fiscal Compact, Member States are required to define their medium-term objective (MTO), to assess, on a yearly basis, whether the progress towards their respective MTOs has been sufficient and, should any deviations occur, to trigger an automatic correction mechanism to bring the key indicators back on their original adjustment path. In Slovakia, responsibility for the assessment of compliance with the rule rests with the Ministry of Finance. The credibility of this national rule is enhanced through compliance monitoring by an independent fiscal institution. Slovakia has entrusted this task to the Council for Budget Responsibility (CBR). Following each assessment, the Ministry of Finance should provide its opinion to the CBR, in line with the European Commission principles.

According to CBR estimates, Slovakia's general government structural deficit reached 3.0% of GDP in 2013, having improved by 1.9% of GDP year-on-year. Even though the medium-term objective expressed as structural deficit of 0.5% of GDP was not achieved, the pace of deficit reduction considerably exceeded the required improvement at a level of 0.9% of GDP, which should ensure the MTO is met in 2017 as planned. For this reason, the CBR concludes that no significant deviation occurred in 2013 and hence there is no need to trigger a correction mechanism. Despite a different evaluation method applied by the CBR, the conclusions contained in its opinion conform to the conclusions presented by the Ministry of Finance.

The government debt reached 55.4% of GDP in 2013, triggering sanction brackets under the Fiscal Responsibility Act. At the same time, the long-term sustainability indicator reached 3% of GDP which is in excess of the acceptable level of 1% of GDP as defined by the CBR. Thus the conditions allowing a less stringent medium-term objective at 1% of GDP were not met. The CBR considers the structural deficit at 0.5% of GDP as the medium-term objective for Slovakia. Based on the 2012 figures, the European Commission set the deadline by which the MTO must be achieved for 2017.

The structural balance reached 4.9% of GDP in 2012, calculated using the CBR methodology; it means that it must improve by 0.9% of GDP on average each year in order to meet the 2017 medium-term objective. The 2013 structural balance reached 3.0% of GDP, having improved 1.9% of GDP year-on-year. The considerable improvement in the structural balance in 2013 creates room for a slower pace of consolidation in the years to come, by 0.3% of GDP on average compared to the originally expected adjustment path. An auxiliary indicator monitoring the development of government expenditure confirmed the results of the analysis of the change in structural balance. No exceptional circumstances occurred in 2013 which would have to be considered in assessing compliance with the balanced budget rule.

The CBR agrees with the results of the assessment of compliance with the rule in 2013 prepared by the Ministry of Finance despite the fact that the two institutions have taken different approaches to the 2013 assessment. The CBR estimates that the 2013 structural deficit was 1% of GDP higher, resulting from the combination of a lower contribution of the economic cycle and higher one-off effects. The Ministry of Finance takes fully on board the methods used by the

European Commission which, taking into account current assumptions, does not have to lead to the attainment of the medium-term objective by 2017.

Tab 1: CBR assessment - compliance with the balanced budget rule in 2013

	Definition	CBR assessment	Criterion	Outcome in 2013	Fulfill ment
1.	**General government structural balance**				
A.	debt significantly below 60% of GDP	not exceeding sanction brackets under the constitutional law	< 50% of GDP	55.4% of GDP	✘
B.	low risks in terms of long-term sustainability of public finances	long-term sustainability indicator of not more than 1% of GDP	<= 1.0% of GDP	3.0% of GDP	✘
		risk assessment by the Commission using the S2 indicator	low risk	medium risk	✘
	Target value of the general government structural balance: deficit not exceeding 0.5% of GDP; deficit may be as high as 1% of GDP, if both foregoing conditions are met (A, B)		**>= - 0.5% of GDP**	**-3.0% of GDP**	✘
2.	**Change in the structural balance**				
	Rapid convergence towards MTO	**steady improvement in the structural balance between 2012 and 2017**	**>= 0.9% of GDP**	**1.9% of GDP**	✓
3.	**Development in adjusted expenditure**				
	Rapid convergence towards MTO	**expenditure growth rate that ensures an improvement in the structural balance by 0.9% of GDP**	**<= -0.7%**	**-2.5%**	✓
4.	**Exceptional circumstances**				
C.	event with a major impact on the financial position	public expenditure incurred to restore the proper functioning of the banking sector affected by the financial crisis, public expenditure incurred to remedy the consequences of natural disasters and catastrophes in the Slovak Republic, and public expenditure incurred in connection with commitments arising from international treaties that have exceeded 3% of GDP in a single year	> 3% of GDP	0% of GDP	✘
D.	period of a negative annual growth in real GDP	a year-on-year drop in real GDP	< 0%	0.9%	✘
E.	protracted period of very low GDP growth relative to potential	negative output gap at least at 3% of potential GDP	<= -3%	-1.6%	✘
F.	severe economic downturn in the euro area (a period of a negative annual real GDP growth or a protracted period of very low GDP growth relative to potential economic growth)		taking into account a Commission assessment		✘
	Exceptional circumstances occur if at least one of the foregoing conditions is met (C, D, E, F)		**at least 1**	**0**	✘
5.	**Significant deviation**				
G.	change in the structural balance: a deviation from the necessary improvement in the structural balance of at least 0.5% of GDP in a single year or 0.25% of GDP on average for two consecutive years*		<= 0.4% of GDP	1.9% of GDP	✘
H.	adjusted expenditure growth: an overall negative impact of the deviation on the general government balance of at least 0.5% of GDP a year, or in two consecutive years cumulatively*		>= 0.7%	-2.5%	✘
	Significant deviation occurs if both foregoing conditions are met (G, H). If only one is met, an overall assessment is performed.		**both conditions met**	**0**	✘
6.	**Assessment of compliance with the balanced budget**		**fulfilled**		✓

** since the required change in the structural balance does not exist for 2012, the change has been evaluated in one year only (2013).*

Source: CBR

Introduction

An amendment to the Act on General Government Budgetary Rules introduced the balanced budget rule into the national legislation with effect from 1 January 2014, as required under the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The Ministry of Finance is responsible for evaluating compliance with the rule; subsequently, the CBR offers its independent evaluation. In accordance with the principles published by the European Commission[1], government authorities should publish their opinion on the CBR's evaluation. Compliance with the rule is evaluated twice a year.

The evaluation process consists of several steps: defining the value of the medium-term objective, estimating the structural balance, considering whether or not significant deviation has occurred, and identifying any exceptional circumstances occurred in the previous year that justify non-application of the rule. The process should result in an opinion that does, or does not, as the case may be, recommend the triggering of a correction mechanism. Through this mechanism, the government's fiscal performance should be brought back to the adjustment path enabling the medium-term objective to be met by the deadline.

Even though the basic procedures and practices are set out in the national legislation, directly in the Fiscal Compact and in pre-defined principles, or the legislation refers to the concepts and practices under the Stability and Growth Pact, the application of some provisions is ambiguous in certain cases[2]. Opinions on the meeting of individual criteria[3] may therefore differ, which may lead to different overall evaluations by the Ministry of Finance and the CBR[4].

In the present document, the CBR describes its approach to the evaluation of compliance with the rule in 2013 and defines criteria it intends to apply in the future. The CBR considers the Fiscal Compact complementary to the existing European fiscal framework with the aim of enhancing the responsibility for attaining medium-term fiscal objectives at the national level. Any automatic adoption of the Commission's practices and methods of evaluation, which are also based on non-public documents[5], could impair transparency of the evaluation procedure. In compliance with its mandate, the CBR will provide assessment which it believes reflects the actual development in the most objective way.

The document is divided into three parts. **Part One** provides an overview of the legislative framework that defines the basic practices and tasks of individual institutions in the assessment of compliance with the balanced budget rule. **Part Two** presents the evaluation prepared by the CBR. Since this is the first evaluation of its kind, the report specifies in detail the concepts and rules which the CBR intends to use in its evaluation. The last part, **Part Three**, contains a CBR

1 Communication from the Commission: Common principles on national fiscal correction mechanisms of 20 June 2012.
2 See Annex 1 for more information.
3 Beyond differing estimates of output gap and one-off effects.
4 A different assessment may also be made by the European Commission when evaluating compliance with the Stability and Growth Pact.
5 With respect to the Stability and Growth Pact, they are documents that specify procedures taken by the Commission when evaluating countries in those cases when the legislation permits a flexible interpretation. They are non-legislative documents containing Commission opinions, approved by Member States' government officials. They are not available to public, or published with a delay. The CBR has no access to such documents through official channels.

opinion on the evaluation prepared by the Ministry of Finance. **Annexes** provide a more detailed explanation of differences between the Stability and Growth Pact and the Fiscal Compact; more specific information concerning the estimate of cyclical component; the description and justification of identified one-off effects; and the calculation of discretionary revenue measures entering into calculation of the expenditure benchmark.

1. Balanced budget rule

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union came into force on 1 January 2013. This inter-governmental treaty was signed by 25 European Union Member States, including Slovakia. Its provisions are binding upon all euro area members. Under the Treaty (namely its Title III entitled 'Fiscal Compact'), Member States are required to **implement the rule on the development of structural balance and medium-term objective** (the balanced budget rule) **into their national legislations** through permanent binding provisions, preferably enacted by a constitutional majority, within one year of the entry of the Treaty into force. The time frame for convergence towards this objective should be proposed by the European Commission, taking into account country-specific risks related to the sustainability of public finances.

The rule also contains a correction mechanism which should apply in the event of significant deviations, and defines the exemptions when it will not apply. The correction mechanism should be proposed by individual Member States on the basis of common principles published by the European Commission[6] (see Box 1 for more details). These principles foresee the existence of independent institutions responsible for monitoring the observance of the rule, specify their roles and define requirements concerning their independence.

The balanced budget rule was transposed into the Slovak legislation by an amendment to the Act on General Government Budgetary Rules[7] that came into force on 1 January 2014. Under this Act, the general government budget is deemed balanced (i.e., the rule is deemed complied with), if the value of the **general government structural deficit[8] does not exceed 0.5% of GDP**. If the general government debt is significantly below 60% of GDP and only minimal risks exist in terms of long-term sustainability of public finances, as defined in the Fiscal Responsibility Act[9], the structural deficit may be equal to or less than 1% of GDP.

The correction mechanism should be applied in the event of a significant deviation from this objective or from the adjustment path towards achieving it; 'significant deviation' is defined in the preventive arm of the Stability and Growth Pact[10]. The progress towards meeting the MTO is evaluated on the basis of an overall assessment of structural balance development and development in adjusted expenditure, net of discretionary revenue measures.

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6 Communication from the Commission: Common principles on national fiscal correction mechanisms of 20 June 2012.

7 Namely, §30a, entitled Special provisions on balanced general government budget, of Act No. 523/2004 Coll. on the general government budgetary rules.

8 The structural balance of the general government is defined as a general government balance adjusted for economic cycle and one-off effects.

9 Article 2(a) of constitutional Act No. 493/2011 Coll. on fiscal responsibility.

10 'Significant deviation' is defined in Article 6(3) of Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (the preventive arm of the Pact). The definition, including its application for the assessment of compliance with the balanced budget rule, is contained in part 2.5 of this document.

The correction mechanism will **specify the maximum amount of accrual consolidated general government expenditure** (public expenditure ceiling) **and measures to be undertaken for the period of correcting this deviation.** The correction should take account of the size of deviation that occurred, respecting the attainment of the medium-term objective and yearly reduction in the general government deficit to gross domestic product ratio on the basis of recommendations of the Council of the EU[11]. The obligation to use the correction mechanism does not apply to periods of exceptional circumstances as defined in the Treaty[12].

The Act also describes procedures and assigns roles to individual institutions (chart 1). In compliance with the procedures contained in the Stability and Growth Pact[13], the Ministry of Finance must report twice a year (by 30 June and 30 November[14]) whether a significant deviation has occurred. **The CBR, as an authorised independent institution, reviews and publishes an evaluation on the application and/or non-application of the correction mechanism.**

If the Ministry of Finance reports that a significant deviation has occurred, it will propose to the government **a public expenditure ceiling and measures to be taken to correct that deviation.** The government decides on the application of the correction mechanism. **The CBR reviews the proposal prior to the government's decision.** If the government decides not to apply the correction mechanism, it will send a written explanation to the parliament, giving reasons for its decision.

The beginning and end of the duration of exceptional circumstances is declared by the government upon proposal of the Ministry of Finance**. The CBR reviews the proposal before the government makes such declaration.** The Ministry of Finance publishes opinions on all evaluations made by the CBR (the "comply or explain" principle).

[11] Article 5 and 6 of Regulation (EC) 1466/97 and Article 3(4) of Regulation (EC) 1467/97.

[12] 'Exceptional circumstances' are defined in Article 3(3)(b) of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. Their definition, including the application for the assessment of compliance with the balanced budget rule, is contained in part 2.4 of this document.

[13] Article 5 and 6 of Regulation (EC) 1466/97 and Article 3(4) of Regulation (EC) 1467/97 contain analytical indicators (change in the structural balance and change in the adjusted expenditure net of discretionary revenue measures) that are evaluated, including the method of calculation and benchmark against which they are assessed.

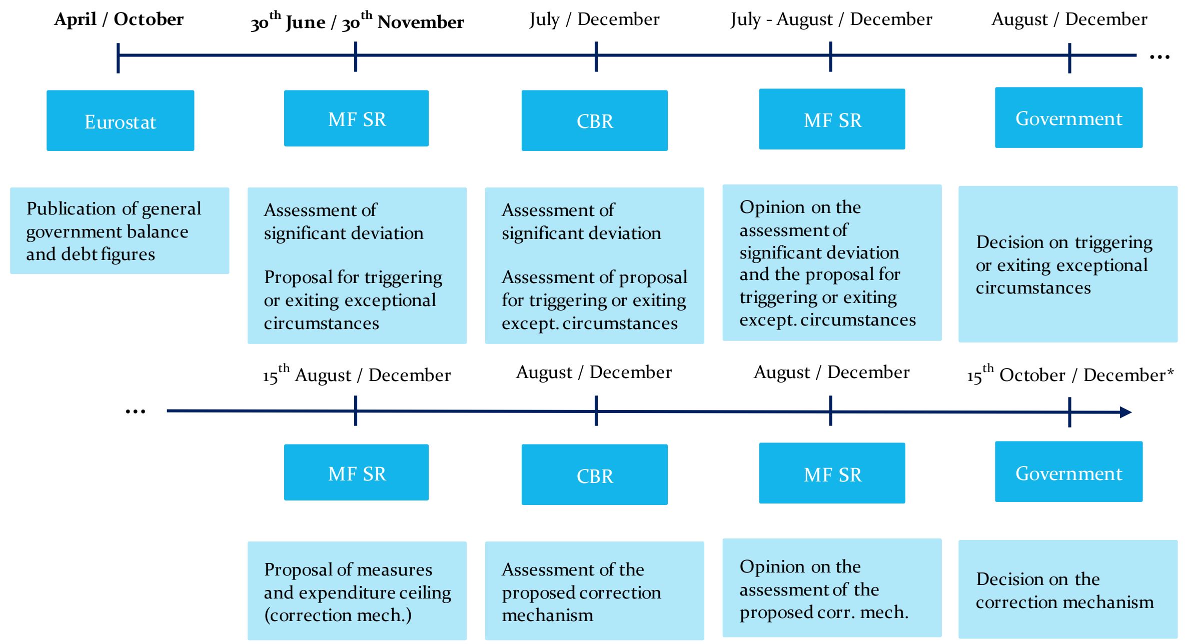
[14] Dates and number of such reports are determined with respect to dates of deficit and debt notifications of Eurostat. By 1 April each year, Member States provide Eurostat with the data on revenues, expenditure, balance and debt of the general government for a preceding year and confirm definitive data for previous years. Subsequently, in the second round as of 1 October, the figures reported for the preceding year are subject to revision after which, in the absence of additional methodological changes, they should not change significantly.

Box 1: Common principles on national fiscal correction mechanisms

The European Commission identified the following seven principles that the national correction mechanisms should follow:

1. **Legal status** – the correction mechanism shall be enshrined in national law through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes.
2. **Consistency with EU framework** – the correction mechanism shall rely closely on the concepts and rules of the European fiscal framework. This applies in particular to the notion of a 'significant deviation' and the definition of possible escape clauses. The correction, in terms of size and timeline, shall be made consistent with possible recommendations addressed to the concerned Member State under the Stability and Growth Pact.
3. **Activation** – the activation of the correction mechanism shall occur in well-defined circumstances characterising a significant deviation from the MTO or the adjustment path towards it. The activation triggers may comprise EU-driven or country specific criteria, to the extent that they meet the above condition.
4. **Nature of the correction** – the size and timeline of the correction shall be framed by predetermined rules. Larger deviations shall lead to larger corrections. Restoring the structural balance at or above the MTO within the planned deadline, and maintaining it there afterwards, shall provide the reference point for the correction mechanism. The correction mechanism shall ensure adherence to critical fiscal targets as set before the occurrence of the significant deviation. At the onset of the correction Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.
5. **Operational instruments** - the correction mechanism may give a prominent operational role to rules on public expenditure and discretionary tax measures, including in activating the mechanism and implementing the correction, to the extent that these rules are consistent with attainment of the MTO and the adjustment path towards it. The design of the correction mechanism shall consider provisions as regards, in the event of activation, the coordination of fiscal adjustments across some or all sub-sectors of general government.
6. **Escape clauses** – the definition of possible escape clauses shall adhere to the notion of 'exceptional circumstances' as agreed in the Stability and Growth Pact. This would include an unusual event outside the control of the concerned Member State with a major impact on the financial position of the general government, or periods of severe economic downturn as defined in the Stability and Growth Pact, including at the level of the euro area. The suspension of the correction mechanism in the event of an escape clause shall be on a temporary basis. The correction mechanism shall foresee a minimum pace of structural adjustment once out of the escape clause, with the requirement from the Stability and Growth Pact a lower limit.
7. **Role and independence of monitoring institutions** – independent bodies or bodies with functional autonomy acting as monitoring institutions shall support the credibility and transparency of the correction mechanism. These institutions would provide public assessments over: the occurrence of circumstances warranting the activation of the correction mechanism; of whether the correction is proceeding in accordance with national rules and plans; and over the occurrence of circumstances for triggering, extending and exiting escape clauses. The concerned Member State shall be obliged to comply with, or alternatively explain publicly why they are not following the assessments of these bodies (comply or explain). National legal provisions ensuring a high degree of functional autonomy shall underpin the above bodies, including: i) a statutory regime grounded in law; ii) freedom from interference; iii) nomination procedures based on experience and competence; iv) adequacy of resources and appropriate access to information to carry out the given mandate.

Figure 1: Procedures and responsibilities of individual institutions



April - fixed deadline
July - indicative deadline

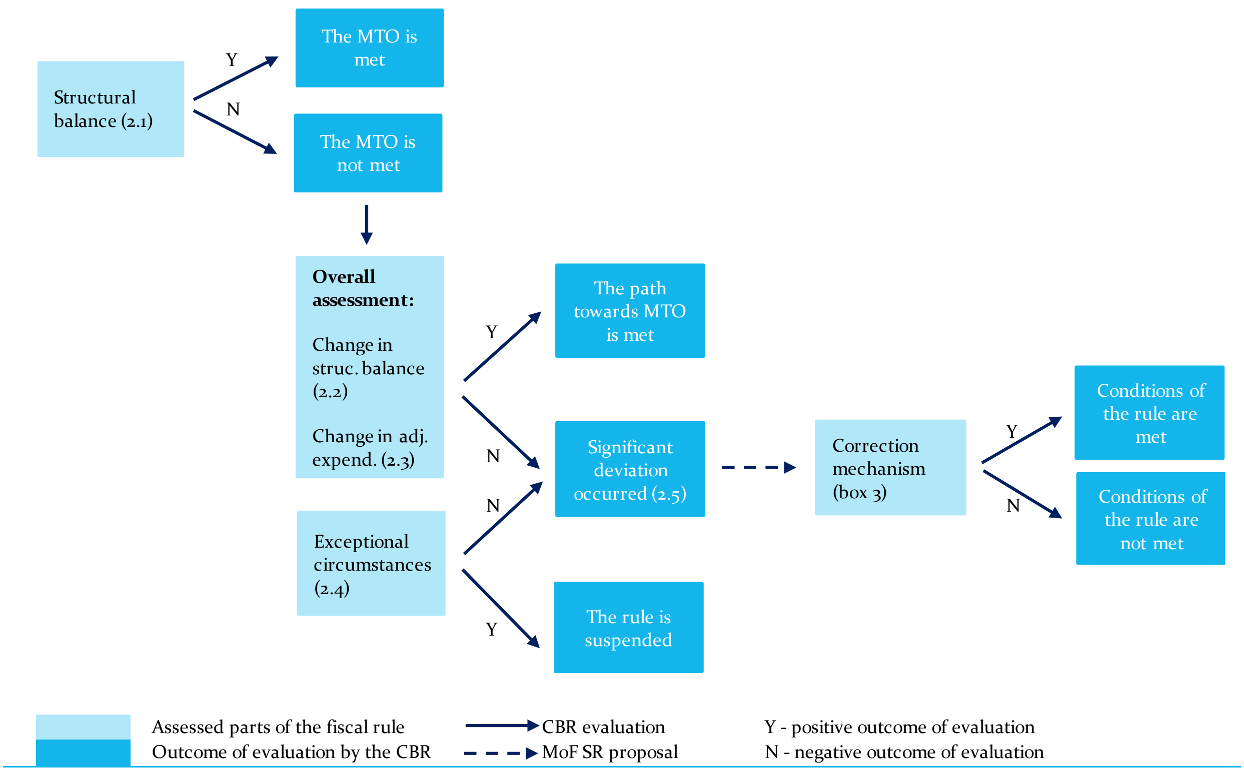
MF SR - Ministry of Finance of the SR
CBR - Council for Budget Responsibility

*Note: * Due to a short time period between the publication of the assessment of significant deviation by the Ministry of Finance (deadline until the end of November) and the end of the year, the proposed measures might be incorporated in the following year, either via an amendment of the adopted budget or within the next year´s budget preparation.* *Source: CBR*

2. Procedure and assessment of compliance with the rule for 2013

The CBR's evaluation of compliance with the balanced budget rule consists of several steps (figure 2), using actual figures. As the first step, **the minimum amount of the structural balance target value** pursuant to the General Government Budgetary Rules Act **is set** and **compared against the value of the structural balance in 2013. If it is not met,** the CBR evaluates whether Slovakia has made sufficient progress toward this objective, using two fiscal indicators. In particular, it **compares a change in structural balance and change in adjusted expenditure, net of discretionary revenue measures in 2013,** against the required change in these indicators. At the same time, the CBR assesses whether **exceptional circumstances have occurred (or persist)** during which the balanced budget rule is not applied. Based on these analyses, the CBR then **evaluates whether a significant deviation has occurred and whether the correction mechanism needs to be triggered. If the correction mechanism is triggered and the Ministry of Finance proposes corrective actions, the CBR will evaluate this mechanism, as well.**

Figure 2: Evaluation of the balanced budget rule - description of procedure



Source: CBR

2.1 Level of the structural balance

As the first step, the CBR will assess whether the currently estimated structural balance meets the target value set in the General Government Budgetary Rules Act. The structural balance of the general government is defined as a general government balance adjusted for the impact of the economic cycle and one-off effects.

The maximum permitted value of structural deficit set by law is 0.5% of GDP. If the general government debt is significantly below 60% of GDP and if risks in terms of long-term sustainability of public finances (as defined under the Fiscal Responsibility Act) are low, structural deficit may be higher, but must not exceed 1% of GDP.

The terms "*significantly below*" and "*low risks in terms of long-term sustainability*" are not specified in detail, but it is necessary to define them in order to properly evaluate compliance with the balanced budget rule. The CBR will explain them by reference to the rules and indicators contained in the constitutional Fiscal Responsibility Act:

- **A debt '*significantly below*' [a threshold] can be understood as a level of debt with which no sanctions under the constitutional act are associated**. The sanctions, whose severity increases as the debt approaches its upper limit, should prevent the debt from exceeding a threshold that could cause problems to the Slovak economy. Therefore, any level of debt to which no sanctions apply meets the definition of a debt significantly below the threshold. The actual value of the threshold will change over time, in keeping with the provisions of the Fiscal Responsibility Act. The current threshold is set as a gross debt below 50% of GDP; from 2018 on, the threshold starts to decrease 1 percentage point a year to reach the final level of 40% of GDP in 2027.

- ***'Low risks in terms of long-term sustainability'* of public finances can be defined as a long-term sustainability indicator (GAP) value of not more than 1% of GDP. The assessment of long-term sustainability by the European Commission will also be taken into account.**

  This value implies that, in order to ensure the long-term sustainability of public finances[15], immediate permanent measures amounting to 1% of GDP are necessary. The value meets the definition of low risk because such improvement in the fiscal position can be attained within one year without any major negative impacts on the economy. At the same time, since the calculation is based on long-term projections with a higher degree of uncertainty, this value also covers possible inaccuracies in the measuring of the indicator.

  The European Commission regularly assesses the long-term sustainability of public finances (as part of annual updates to stability programmes) on the basis of its long-term projections of the impacts of population ageing on public finances, categorising individual Member States as high, medium and low-risk countries. When assessing the long-term sustainability risks, the CBR will also take account of this assessment.

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15 Article 3(a) of the Fiscal Responsibility Act defines the long-term sustainability as such fiscal performance of the Slovak Republic under which the general government balance and general government debt remain at levels which ensure that no expected change in general government revenues and expenditures compared to the baseline scenario causes the general government debt to exceed its upper limit in the nearest 50 years.

The gross debt of the general government stood at 55.4% of GDP at the end of 2013, which is subject to sanctions under the Fiscal Responsibility Act, and the long-term sustainability indicator stood at 3% of GDP for the same period[16]. At the same time, the European Commission included Slovakia among countries at medium risk regarding the sustainability of public finances[17]. The CBR therefore holds that neither of the two necessary conditions have been met to permit a less stringent structural balance target. **Hence the structural deficit not exceeding 0.5% of GDP is considered the target value[18].**

The structural deficit reached 3.0% of GDP in 2013 (Table 3), being considerably far from its target value. On that account, it is necessary to assess, as the next step, whether Slovakia has made **sufficient progress towards its MTO**, using two fiscal indicators. It involves the assessment of a **change in structural balance** (part 2.2) and **development in adjusted expenditure net of discretionary revenue measures** (part 2.3). Evaluation is also made of **whether exceptional circumstances have occurred for the duration of which the application of the balanced budget rule is temporarily suspended** (part 2.4).

2.2 Change in the structural balance

Under the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, Member States should ensure **rapid** convergence towards their respective MTOs within a time-frame proposed by the European Commission.

In June 2013, the Commission proposed and the Council approved, as part of the assessment of Slovakia's stability programme[19], that the medium-term budgetary objective expressed as structural deficit of 0.5% of GDP be met by 2017. It is the only relevant document which defines the MTO deadline, but without giving any specific details (recommended change in the structural balance in individual years) on how to attain it.

This information is insufficient to evaluate whether Slovakia made sufficient progress towards a balanced budget in 2013. The CBR has therefore defined its own approach to ensure a consistent assessment of the progress achieved. The approach is based on the assumption of a **steady improvement in the structural balance over the period between 2012 and 2017.** The year 2012 was chosen because the Commission had also used the actual figures from that year when determining the deadline for Slovakia to meet its medium-term budgetary objective. The actual change in the 2013 structural balance will be compared against the adjustment path. **The change will be assessed on a cumulative basis;** i.e., **an overrun in one year may be offset by a slower change in the structural balance a year later.**

Table 2 shows the calculation of an average required change in the structural balance between 2013 and 2017. It is based on the current estimate of the structural balance in 2012 and its target

[16] CBR: Report on the long-term sustainability of public finances, April 2014.

[17] European Commission: Assessment of the 2014 national reform programme and stability programme for Slovakia, June 2014, pg. 12.

[18] This value of the medium-term budgetary objective was also presented by the Ministry of Finance in the current stability programme.

[19] Council Recommendation of 9 July 2013 on the National Reform Programme 2013 of Slovakia and delivering a Council opinion on the Stability Programme of Slovakia, 2012-2016.

value set for 2017. The overall required change in the structural balance is evenly spread over individual years; it means the balance should **improve 0.9% of GDP** every year of the period.

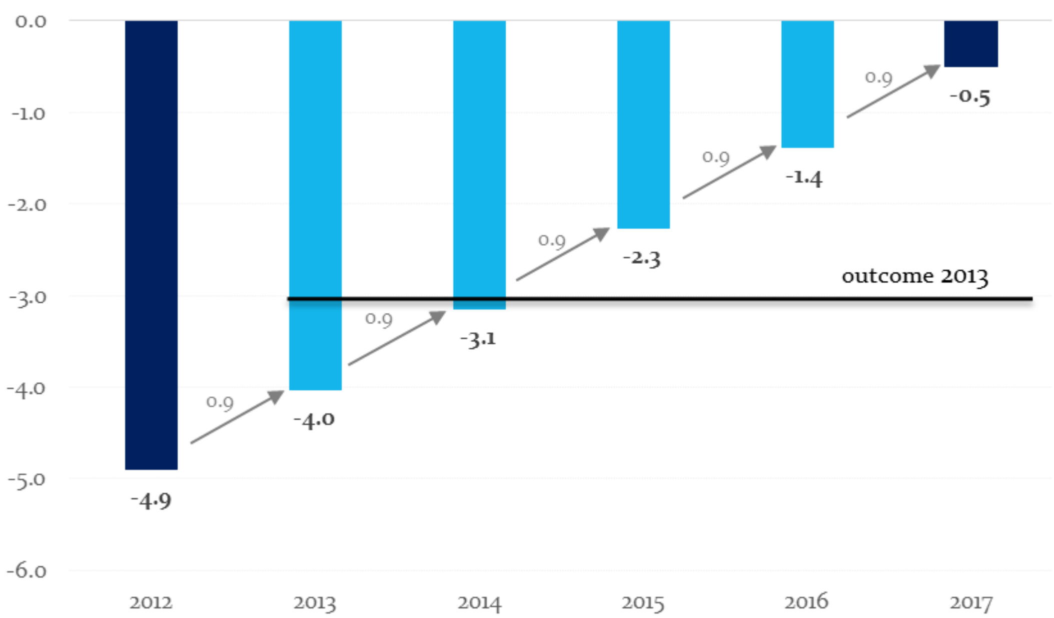
Tab 2: Calculation of required change in structural balance (ESA 95, % GDP)

	2012	2013	2014	2015	2016	2017
Required level of GG structural balance according to CBR	**-4.9**	-4.0	-3.1	-2.3	-1.4	**-0.5**
Change*	-	**0.88**	**0.88**	**0.88**	**0.88**	**0.88**

** Steady improvement in the structural balance over the period 2012-2017, that ensures achievement of MTO in 2017 (-0.5 % GDP)*

Source: CBR

Figure 3: Level of the structural balance required to achieve MTO in 2017 (ESA 95, % GDP)



Source: CBR

Table 3 shows the calculation of the change in the structural balance in 2013. The calculation is based on CBR's own estimate of the cyclical component (Annex 2). One-off measures were identified in accordance with published principles (specified in detail in Annex 3).

Tab 3: General government structural balance (ESA 95, % GDP)

	2012	2013
1. GG balance	-4.5	-2.8
2. Cyclical component	-0.1	-0.5
3. One-off measures	0.5	0.7
Structural balance (1-2-3)	**-4.9**	**-3.0**
Change in structural balance	-	**1.9**
Required change in structural balance	-	**0.88**
p.m. Output gap	*-0.8*	*-1.6*

Source: CBR

The structural deficit reached 4.9% of GDP in 2012. In order to bring the structural deficit down to 0.5% of GDP in 2017, **an average annual change in the structural balance of 0.9% of GDP** is required. **Since the structural balance improved by 1.9% of GDP in 2013, the change considerably exceeds the required improvement.** The assessment of a change in structural balance shows that Slovakia has made sufficient progress towards its medium-term budgetary objective.

2.3 Development in adjusted expenditure

The adjustment path towards the medium-term objective also needs to be evaluated on the basis of an auxiliary indicator. It **compares the development in adjusted expenditure against an expenditure benchmark**.

The underlying idea behind the expenditure benchmark is to set such a growth rate of expenditure that does not exceed the average potential growth of the economy[20]. This should apply to countries with sustainable public finances (they are meeting their medium-term budgetary objectives). In countries not meeting their medium-term objective, a growth in expenditure should be slower in order to ensure the necessary convergence. The exception from this rule are situations where expenditure is matched by discretionary revenue measures, or in the event of expenditure that is outside of government's direct control and/or that has no impact on the balance (a detailed method of computing adjusted expenditure and expenditure benchmark is included in Box 2).

Box 2: Adjusted expenditure and expenditure benchmark - European Commission approach

The general government expenditure as defined in the Stability and Growth Pact is adjusted for items that are not necessarily under the government's control and that have no impact on the general government balance. They are namely interest payments, expenditure related to programmes implemented jointly with the European Union, expenditure responding to changes in economic activity (unemployment benefits). Also, due to possible significant year-on-year changes in investments (implementation of large investment projects), their four-year average is taken into account, instead of actual values. Such adjusted expenditure (primary expenditure aggregate) is further netted of the discretionary revenue measures, while also taking into account the price development expressed as a GDP deflator.

The adjusted real expenditure aggregate is then compared against the expenditure benchmark which is the difference between a reference medium-term rate of economy's potential growth (a ten-year average taking into account the available data and a four-year forecast) and a reference growth rate of expenditure (this difference being known as the convergence margin). This rate is set so as to lead to the required improvement in the structural balance.

The European Commission sets the expenditure benchmark in advance, it means its calculations take into account forecast values (growth in potential output, GDP deflator - the average amount of spring and autumn GDP deflator forecast published in the previous years for the relevant year is used). The actual values of adjusted expenditure are then also compared against the value set that way. The main reason is to ensure that possible errors in the forecast do not result in the penalisation of individual countries.

The CBR has based its evaluation of compliance with the expenditure benchmark on the concept defined in the Stability and Growth Pact. The differences are in the data used

[20] The underlying assumption is that revenues grow at a rate of potential output and no changes in the general government balance occur.

and the purpose of the evaluation. Similarly to the calculation of the cyclical component of the structural balance, the CBR uses its own estimate of the cyclical component as regards unemployment benefits and its own computation of discretionary revenue measures (their list and impacts are included in Annex 4) based on a baseline scenario of the public finance development[21]. Since this is an ex-post evaluation designed to assess if the adjustment path towards the medium-term objective is sufficient, the CBR uses the actual value of the GDP deflator and the current estimate of the growth in potential output in the relevant year in line with the concept of output gap estimate according to the CBR (instead of forecast values and multiannual averages). At the same time, the reference growth rate of expenditure is derived from the required change in the structural balance calculated in part 2.2. (0.9% of GDP a year) to ensure consistency between both approaches applied.

Tab 4: Expenditure benchmark (ESA 95, € mill)

	2012	2013	source
1. General government expenditure	**27 165**	**27 918**	Eurostat, T200: TE
2. Interest payments	1 295	1 413	Eurostat, T200: D41
3. Gross fixed capital formation	1 585	1 497	Eurostat, T200: P51
4. Annual average gross fixed capital formation *($_{t-3}$ to $_t$)*	1 660	1 668	Eurostat, T200: ØP51
5. Expenditure on EU programmes fully matched by EU funds revenue	807	818	MF SR: FSBA[22]
6. Cyclical unemployment benefit expenditure	-0.4	6.1	CBR calculation
7. Expenditure fully matched by an increase in revenues mandated by law	0	0	weren't identified by CBR
8. Primary expenditure aggregate *(1-2-3+4-5-6-7)*	**25 138**	**25 852**	
9. Change in primary expenditure aggregate *(8_t-8_{t-1})*		714	
10. Change in discretionary revenue measures		1 219	CBR calculation
11. Nominal growth of expend. aggregate adjusted for revenue measures *((9_t-10_t)/8_{t-1})*		-2.0	
12. Change in GDP deflator		0.5	Eurostat (nama_gdp_p)
13. Real growth of expend. aggregate adjusted for revenue measures *(11-12)*		**-2.5**	
14. Potential GDP growth		1.7	CBR calculation
15. Convergence margin (p. p.) CBR change in SB/*(1_{t-1}-2_{t-1}/GDP_{t-1})*		2.4	Eurostat, T200: TE, D41, SO SR, CBR calculation
16. Expenditure benchmark *(14-15)*		**-0.7**	
17. Compliance with expenditure benchmark (13<16)		**yes**	

Source: CBR, MF SR

The adjusted real expenditure fell 2.5% in 2013, while the expenditure benchmark (which would ensure the improvement in the structural balance by 0.9% of GDP) assumed the expenditure to fall 0.7%. It means that, based on the assessment of the adjusted growth in

[21] The baseline scenario for the long-term development in public finances serves to calculate medium and long-term indicators to measure consolidation of public finances. The baseline scenario used in the assessment of compliance with the expenditure benchmark in 2013 was published as part of the Report on the long-term sustainability of public finances of April 2014 and was updated with impacts of tax measures adopted by the Ministry of Finance.

[22] FSBA = Final State Budgetary Account

expenditure, Slovakia has made sufficient progress towards its medium-term budgetary objective.

2.4 Beginning and end of exceptional circumstances

Along with the assessment of progress towards meeting the medium-term budgetary objective, the occurrence of exceptional circumstance is also assessed. Exceptional circumstances are defined in the Treaty[23], including by reference to the Stability and Growth Pact.

According to the Treaty, '*exceptional circumstances*' refers to the case of an unusual event outside the control of the country concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth Pact, provided that the temporary deviation of the country concerned does not endanger fiscal sustainability in the medium-term. A period of severe economic downturn applies to a relevant country and the euro area as a whole. The Pact defines this period[24] as a period of a negative annual real GDP growth or as an accumulated loss of output during a protracted period of very low GDP growth relative to potential economic growth.

Based on this definition, **three situations concerning the Slovak economy** were identified, which can be considered **exceptional circumstances:**

- **An event with a major impact on the financial position.** The relevant legislation contains no detailed definition of such an event. The CBR will therefore apply the definition contained in the constitutional act[25] which also permits exemptions from the application of sanctions in such situations. It namely involves **the public expenditure incurred to restore the proper functioning of the banking sector affected by a financial crisis, public expenditure incurred to remedy the consequences of natural disasters and catastrophes in the Slovak Republic, and public expenditure incurred in connection with commitments arising from international treaties that have exceeded 3% of GDP in a single year**. For the purposes of assessing compliance with the balanced budget rule, exceptional circumstances last as long as such expenditure exceeds the set threshold on a yearly basis[26].

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[23] Article 3(3)(b) of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union contains the definition of 'exceptional circumstances'.

[24] The corrective arm of the Pact (Article 2(2) of Council Regulation No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure) defines severe economic downturn as a period of a negative annual real GDP growth or as an accumulated loss of output during protracted period of very low GDP growth relative to potential economic growth.

[25] Article 5(11)(b) of constitutional Act No. 493/2011 Coll. on fiscal responsibility.

[26] Under the constitutional act, exceptional circumstances are defined to last 36 months from identification. It relates to the fact that debt is a stock value, that is, any one-off expenditure lead to its permanent increase. The defined time limit provides room for fiscal policy to respond to the increase in debt. In the case of the general government balance, being a flow value, one-off expenditure has impact in a relevant year. Therefore, longer duration of exceptional circumstance is unjustified.

- **A period of a negative annual growth in GDP** - The CBR will usually consider an annual drop in real GDP an exceptional circumstance while, at the same time, comprehensively assessing Slovakia's economic development.
- **A protracted period of very low GDP growth relative to its potential.** No legislation specifies this situation in more detail. However, it can be identified using a widening negative output gap that reaches the minimum set threshold. **According to the CBR, such threshold is a negative output gap of 3% of potential output[27].** The duration of this exceptional circumstance ends when the output gap begins to close (it means the real economic growth exceeds the potential output growth) and falls below that threshold. Also in this case, a comprehensive assessment of Slovakia's economic development will be made.

The same definition (a period of a negative annual GDP growth or a protracted period of very low GDP growth relative to its potential) will also apply **when assessing whether the euro area as a whole** has faced a severe economic downturn. Since the CBR does not evaluate the economy of the euro area as a whole, it will **take into account the Commission's opinion concerning the compliance with the rules of the Stability and Growth Pact.**

Exceptional circumstances should explain a deviation from the adjustment path towards balanced budget, but a link between macroeconomic development and development in public finances may not always quantifiable. Therefore, it is necessary to complement individual situations with a qualitative assessment. At the same time, the CBR will also evaluate their impacts on the sustainability of public finances in the medium term.

In 2013, none of the aforementioned events occurred with an overall negative impact on the balance amounting to at least 3% of GDP ; the criteria of a severe economic downturn were not met, either. The Slovak economy grew 0.9% year-on-year. Despite having increased from 0.8% in 2012 to 1.6% of potential output in 2013, the negative output gap remained significantly below the 3% threshold. The euro area recorded a 0.4% drop in real GDP and the negative output gap reached 3.3% of potential output, but the Commission did not consider it a severe economic downturn. It means that **no event occurred throughout 2013 which would have met the definition of exceptional circumstances.**

2.5 Significant deviation

A significant deviation is assessed on the basis of an overall assessment taking into account the change in structural balance, development in adjusted expenditure, and the occurrence of exceptional circumstances.

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[27] The threshold was chosen to capture exceptional adverse events in the Slovak economy. Only one such event has occurred since 1999 until the present day. In 2009 (a year when the Slovak economy was most badly hit by the global economic crisis), the output gap reached -3.1% of potential GDP. This is in parallel with the constitutional Fiscal Responsibility Act that also contains an exception (defined by reference to changes in the rate of economic growth) to be applied in the event of an extremely adverse economic development; it is exactly the year 2009 that meets the criteria for its application.

The General Government Budgetary Rules Act defines a significant deviation in accordance with its definition in the Stability and Growth Pact[28]. With respect to the change in structural balance, this deviation from the required improvement in the structural balance (defined in part 2.2 for the purposes of assessing compliance with the balanced budget rule) is set to at least 0.5% of GDP in a single year or to 0.25% of GDP on average for two consecutive years. When assessing the adjusted expenditure against the expenditure benchmark (defined in part 2.3), account is taken of whether the deviation has an overall negative impact on the general government balance of at least 0.5% of GDP a year, or in two consecutive years cumulatively.

The final evaluation of the occurrence of significant deviation may have **four outcomes:**

- If exceptional circumstances have occurred, there is no significant deviation (irrespective of the result of the evaluation of the change in the structural balance and adjusted expenditure). The evaluation of compliance with the balanced budget rule will be suspended for the duration of exceptional circumstances and the correction mechanism will not apply.
- If no exceptional circumstances have occurred and there was no significant deviation under any of the indicators, the rule is deemed complied with and there is no need to apply the correction mechanism.
- If no exceptional circumstances have occurred and there were significant deviations under both indicators, a significant deviation is deemed to have occurred and the correction mechanism needs to be triggered.
- If no exceptional circumstances have occurred and there was a significant deviation under one of the indicators only, the result is ambiguous. In that case, the reasons behind the differing results under individual indicators will be examined in order to justify the triggering/not triggering of the correction mechanism.

Considering the 2013 outcomes[29], no exceptional circumstances occurred. Also, both indicators were met. It means that **no significant deviation occurred and there is no need to trigger the correction mechanism.**

Box 3: Correction mechanism

If the Ministry of Finance concludes that a significant deviation has occurred, it will propose to the government measures to eliminate that deviation in the form of a general government expenditure ceiling (correction mechanism). The CBR will review the proposal prior to the government's decision. The government may decide not to apply the correction mechanism. In that case, it will send a written reasoning of its decision to the parliament.

The planned corrective action should take into account the size of the deviation, the original deadline for attaining the medium-term budgetary objective, as well as Council recommendations related to the elimination of the deviation.

From the procedural point of view, it would probably have the form of a separate document. The applicable legislation does not contain any specific timeframe for the submission of a proposal for correction mechanism, unlike the identification of a significant deviation. Given the fact it should

[28] Article 6(3) of Regulation (EC) 1466/97.

[29] The CBR evaluated the 2013 development only. Due to the absence of the required change in the structural balance in 2012, the significant deviation was not assessed in terms of two-year averages.

contain specific measures, it would very likely be submitted along with a budget proposal and/or it's amendments.

The CBR will examine the correction mechanism based on the anticipated development in the structural balance and adjusted expenditure. Unlike the evaluation of significant deviation, the plan for corrective action (not only its results) will also be assessed in this case.

3. Opinion on the evaluation by the Ministry of Finance

The Ministry of Finance published its evaluation of compliance with the balanced budget rule for 2013[30] on 30 June 2014. The evaluation concludes that Slovakia followed the adjustment path towards its medium-term budgetary objective and no significant deviation occurred in 2013. It means that despite different approaches applied by the Ministry of Finance and the CBR (Table 5), **final assessments of both institutions concur.**

Tab 5: Comparison of evaluation of compliance with the balance budget rule for 2013 (ESA 95, % GDP)

	CBR	MF SR	difference
Medium term objective (MTO)	**-0.5 (2017)**	**-0.5 (2017)**	-
GG balance	-2.8	-2.8	0.0
Cyclical component	-0.5	-1.1	0.6
One-off measures	0.7	0.3	0.4
Structural balance	**-3.0**	**-2.0**	**-1.0**
Compliance with MTO	**no**	**no**	-
Change in structural balance	1.9	2.0	0.0
Required change in structural balance	0.9	0.1	0.8
Compliance with structural balance rule	**yes**	**yes**	-
Real growth of expend. aggregate adjusted for revenue measures	-2.5	-4.0	1.5
Expenditure benchmark	-0.7	2.9	-3.6
Compliance with expenditure benchmark rule	**yes**	**yes**	-

Source: CBR, MF SR

The different approaches applied by the two institutions to evaluate the year 2013 did not produce diverging conclusions. However, this may not necessarily be the case in the future. The differences between the CBR and the Ministry of Finance primarily stem from their different understanding of the balanced budget rule in relation to the fiscal surveillance rules at the EU level (Box 4).

The Ministry's assessment is solely based on the common methodology applied by the Commission when assessing compliance with the rules of the Stability and Growth Pact. It focuses on international comparability of data to ensure equal treatment of all countries; this,

30 Available only in Slovak.

however, may lead to an oversimplified view of economic development in individual countries. In addition, the Ministry of Finance uses the interpretation of the rules of the Pact which is not always available to the public[31]. In this context, the whole balanced budget rule is linked to the conclusions of the European Commission and the Council, which impairs the relevance of its assessment by the Ministry of Finance and by an independent national fiscal institution.

The CBR understands the balanced budget rule as a national fiscal rule which is based on the statutory definitions contained in the Stability and Growth Pact (definition of the structural balance, adjusted expenditure, significant deviation and exceptional circumstances). However, it uses its own estimates and computations that reflect national specificities and can thus provide a clearer picture of Slovakia's economic development when compared to the common approach applied by the Commission. Despite having its own estimate, for example, of the output gap (presented before the Macroeconomic Forecasting Committee and being closer to CBR estimates), the Ministry of Finance uses Commission's estimates to assess compliance with fiscal rules (see Box 5 more details). Since the compliance with fiscal rules may have a major impact on the economic policy implemented in Slovakia, it would be advisable to evaluate such compliance using computations that reflect national specificities, even at the expense of impaired international comparability of data.

Box 4: Differences in computations made by the CBR and the Ministry

The differences between the two institutions may be illustrated using the figures for 2013. **While the Ministry estimates the structural deficit at 2.0% of GDP, the CBR estimate is considerably higher, standing at 3.0% of GDP.** The different figures result from a different cyclical component and one-off effects.

- The cyclical component results from an output gap estimate which is more robust in the case of the CBR as it involves several approaches to estimating the gap with more stable resulting time series. In addition, it takes into account different cyclical development of individual GDP components, netting out the flows generated by the public sector in the form of taxes and social security contributions, which the methodology applied by the Ministry does not cover (see Annex 2 for more details). The Ministry applies the uniform methodology of the Commission common to all countries that cannot capture national specificities as it must ensure the necessary international comparability. The overall impact of this difference in the cyclical component is 0.6% of GDP.

- The Ministry did not include certain effects in the total amount of 0.4% of GDP[32] which the CBR considers one-off effects (see Annex 3 for more details). They particularly involve a temporary levy on business operations in regulated sectors, a special levy in the banking

[31] Interpretation of certain specific parts of the Stability and Growth Pact is subject to consultations in Council working groups in the presence of European Commission representatives and Member States' government officials and to their approval. Their conclusions are not made available to public, or they are published with a delay (they were published in a document entitled "Specifications on the implementation of the Stability and Growth Pact", the so-called Code of Conduct, of September 2012 and in the European Commission study entitled "Vade mecum on the Stability and Growth Pact" of May 2013). The Ministry of Finance describes these parts in its evaluation report. Since they were not officially published, they cannot be considered official conclusions, even though they probably were used in the formulation of recommendations in the latest assessment of national reform programmes and stability programmes.

[32] The Ministry of Finance identifies one-off effects according to a manual published at its web site.

sector, corrections to EU funding resulting from past irregularities in the drawing of the funds, time-limited instalments of loans paid by the *Cargo* and *Vodohospodárska výstavba* companies, as well as different recording of debts of hospitals as compared to the period of their origin.

The required development in the structural balance, which serves as a benchmark to assess whether Slovakia is sufficiently converging towards its medium-term objective, **is also set differently**. The CBR estimates that the balance needs to improve 0.9% of GDP a year on average. The Ministry uses the interpretation of the rules of the preventive arm of the Stability and Growth Pact[33] applied by the Commission (the required change set at 0.1% of GDP for 2013) which may not necessarily lead to meeting the medium-term objective by 2017[34]. Given the absence of a detailed convergence calendar, the CBR derives the required change in the structural balance from its size in 2012 and the 2017 target, which ensures consistency with the attainment of the medium-term budgetary objective by the set year.

Considerable differences between the two institutions also exist with respect to the **development of adjusted expenditure and expenditure benchmark.** They primarily stem from their different understanding of these indicators in relation to the assessment of compliance with the balanced budget rule. The CBR considers them complementary to the evaluation of the change in the structural balance; they should be mutually consistent, which requires that the same actual data be used. The Ministry follows the application of this indicator as used by the Commission within the framework of fiscal surveillance, based on which the expenditure benchmark should serve as an instrument for the countries to formulate their fiscal policies. Under this approach, the value of the indicator is known in advance (based on forecast values and multiannual averages), while errors in macroeconomic forecasts do not result in the penalisation of individual countries when evaluating this indicator. However, the indicator constructed in this manner may considerably differ from an indicator that takes into account actual development that is relevant to assessing compliance with the balanced budget rule.

- **The Ministry estimates that real expenditure fell 4.0% in 2013, whereas the CBR estimates a drop of 2.5% only.** The differences in nominal expenditure are minimal (down by 2.2% according to the Ministry and down by 2.0% according to the CBR). The key difference is in the application of a specific GDP deflator which is used to estimate the growth in real expenditure. The CBR applied the actual value of the GDP deflator for 2013 (a year-on-year growth of 0.5%), whereas the Ministry used an average of forecast values (a year-on-year growth of 1.9%).

- **The expenditure benchmark also differs. According to the Ministry, the expenditure could increase by a maximum of 2.9% in 2013, while the CBR estimates its decrease by at least 0.7%.** There are two reasons to explain this difference. The first one is the difference in the required rate of improvement of the structural balance (described earlier) which is also reflected in this indicator. The second reason is the different assumption of the potential output growth rate. The Ministry's data include a ten-year average (the Commission forecast for 2007-2016 published in spring 2011) which means they also contain relatively high growth

33 Slovakia was subject to the Excessive Deficit Procedure in 2013, the provisions of the preventive arm of the Pact did therefore not apply to it.

34 According to the Ministry of Finance estimates, the structural deficit reached 2.0% of GDP in 2013. Applying the rules under the preventive arm of the Pact and its interpretation (included in the Council recommendations in the assessment of the national reform programme and stability programme for Slovakia), the balance should improve by 0.1% of GDP in 2014 and 2015 due to bad economic times. In the following years (2016 and 2017), the improvement should reach 0.5% of GDP a year. It means that keeping exactly this pace would reduce the structural balance to 0.8% of GDP in 2017, hence the medium-term budgetary objective would not be met within the set deadline (by 2017).

rates from before and at the early stage of the economic crisis and, therefore, are considerably overstated compared to the actual 2013 estimate used by the CBR (growth of 3.2% and 1.7%, respectively).

Annex 1 - Fiscal compact and the Stability and Growth Pact

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union originates from the turn of 2011/2012 as a response to the development in the euro area against the backdrop of the global economic and financial crisis. In terms of the fiscal rules, its most important component is the so-called Fiscal Compact (Title III of the Treaty) which contains the balanced budget rule. Attaining a balanced budget in the form of the defined value of the structural balance should ensure long-term sustainability of public finances.

The reason to enact this rule was the previous experience with the preventive arm of the Stability and Growth Pact which was supposed to encourage Member States to keep their public finances sustainable through the attainment of a medium-term budgetary objective, but was ineffective in the period of a relatively strong pre-crisis economic growth[35]. The 2011 revision of the Stability and Growth Pact strengthened its preventive arm by introducing, for the first time ever, the possibility of imposing moderate sanctions in cases where a Member State fails to respond to Council recommendations regarding a significant deviation from its MTO or from the adjustment path towards it. Subsequently, the Treaty was adopted, which also concentrates on achieving sustainable budgets.

The balanced budget rule under the Fiscal Compact was transposed into the national legislations of individual Member States in order to strengthen their responsibility at the national level for compliance with the rule. It is a national rule based on the principles of the EU fiscal surveillance. The rule also contains a correction mechanism to be triggered when certain defined circumstances occur in order to correct deviations from the medium-term objective. In order to ensure transparency and credibility of the monitoring of compliance with the rule, an independent national fiscal institution is also involved in the monitoring process.

The balanced budget rule is based on the underlying concepts defined in the Stability and Growth Pact. In addition to the uniform definition of the structural balance, it also contains a requirement to assess whether a country makes sufficient progress towards its medium-term objective based on the change in the structural balance and development in adjusted expenditure compared to a corresponding benchmark. The Treaty also defines exceptional circumstances as referred to in the Pact.

The implementation of the correction mechanism (from identifying a significant deviation through to the monitoring of the progress of a corrective action) should reflect the principles defined by the European Commission. These principles require that it is consistent with the EU fiscal framework, especially in the case of the definition of the significant deviation, exception clauses and linking the corrective action to Council recommendations.

At the same time, the principles allow for a certain degree of flexibility in the precise definition of a national methodology that would cover country-specific features. This is particularly important in view of the fact that the Commission's common methodology used under the

35 A majority of Member States particularly focused on not exceeding the 3% level of the deficit-to-GDP ratio, thus making it an objective of their respective fiscal policies rather than a ceiling for deficit development.

Stability and Growth Pact that concentrates on ensuring international comparability of data and equal treatment of all Member States may result in an oversimplified view of economic development.

The flexibility is also necessary for the purpose of evaluating compliance with the balanced budget rule by an independent institution. Any automatism in taking on board the results of evaluation produced by the European Commission[36] could impair the relevance of an independent assessment at the national level.

Also, fully linking the assessment of compliance with the balanced budget rule with the provisions of the Stability and Growth Pact may lead to a number of inconsistencies. An example to illustrate this is the way in which the medium-term budgetary objective is set, which follows different rules under the Pact and under the Fiscal Compact. The minimum value of the structural balance defined in the Stability and Growth Pact is less stringent than that set under the Fiscal Compact, which may result in differences in the assessment. Equally, the minimum adjustment path towards the medium-term budgetary objective as defined in the Stability and Growth Pact may not be sufficient to achieve the medium-term budgetary objective under the Fiscal Compact (see Box 4 for more details).

Some of the provisions of the Stability and Growth Pact are subject to interpretation based on consultations between Member States' government authorities and the European Commission, while such interpretation is not always made public, or is published with a certain delay[37]. Linking the assessment of compliance with the balanced budget rule to such provisions by an independent institution may decrease the transparency of the entire process.

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[36] The Ministry of Finance applies the same procedures and principles as the Commission The only possible difference between the Ministry's and Commission's assessment may be in the identification of one-off effects because the Ministry has its own principles defined.

[37] This involves, for example, setting the appropriate adjustment path towards the medium-term budgetary objective. The applicable legislation mentions that this adjustment path should have the form of an annual improvement in the structural balance at the level of 0.5% of GDP; a higher adjustment is required in good economic times, while it may be lower in bad times. Concrete values were defined by reference to this interpretation of the rule, which has not been officially published to date (only through the current Stability Programme of Slovakia).

Annex 2 - Cyclical component

The impact of cyclical development of the economy on the budget balance is captured by the so-called cyclical component. If the economy performs exceptionally well and yields additional budgetary revenues, the cyclical component is positive and contributes to the improvement in the balance. On the other hand, when times are tougher, the cyclical component has a negative impact on the balance. The budget balance adjusted for cyclical component shows what the position of public finances would be like if the economy grew at its potential level.

The cyclical component is an unobservable variable. It cannot be statistically measured, therefore it must be estimated. There are several approaches to estimating the size of the cyclical component. The first one is an aggregated approach which assumes existence of a direct link between the output gap[38] and cyclical component. This approach is applied, for example, by the European Commission and the Ministry of Finance of the Slovak Republic. The cyclical component is calculated as the product of the output gap and the corresponding budgetary elasticity estimated by the European Commission. The elasticity currently quantified for Slovakia is 0.33. The benefit of this approach is the simplicity of calculation it provides. The downside is that the output gap does not necessarily directly reflect development in individual budgetary components. For illustration, imagine a hypothetical situation when two economies are exposed to different shocks, either in domestic or foreign demand, that have the same impact on the output gap. Since the export has a lower direct impact on the balance than domestic consumption, the impact of the cyclical component should be weaker in the first economy than in the second one, even though their output gaps are equal. This shortcoming can be eliminated by the so-called disaggregated approach, used by the European Central Bank and by the central banks of EU Member States. The cyclical component is estimated using deviations of macroeconomic bases from their equilibriums, unlike the previous approach which only takes into account the output gap. The deviations of macroeconomic bases have a direct impact on selected budgetary items. The combination of budgetary items and budgetary elasticities gives the resulting cyclical component.

The CBR applies the disaggregated approach to quantify the cyclical component[39]. The CBR's approach is based on a modified methodology used by the European Central Bank. The calculation ensures compliance with the requirement that deviations of macroeconomic bases from their equilibriums correspond to the overall output gap. The output gap is determined on the basis of the CBR methodology[40] as an average of six different approaches. This ensures a greater stability of estimates, both over the short and the long term.

The cyclical component is affected by six macroeconomic variables with direct links to public finances. Four of them are on the revenue side (personal income tax, contributions to the Social Insurance Agency, corporate income tax and indirect taxes) and two of them are on the expenditure side (unemployment benefits and pension benefits). These items respond to

38 Output gap is the difference between actual and potential output, not affected by economic cycle.

39 CBR's approach to the calculation of the cyclical component is described in a study entitled The „True" Deficit (Marčanová and Ódor, 2014).

40 Details concerning the calculation of potential output and output gap can be found in a study entitled Finding Yeti (Ódor and Jurašeková Kucserová, 2014).

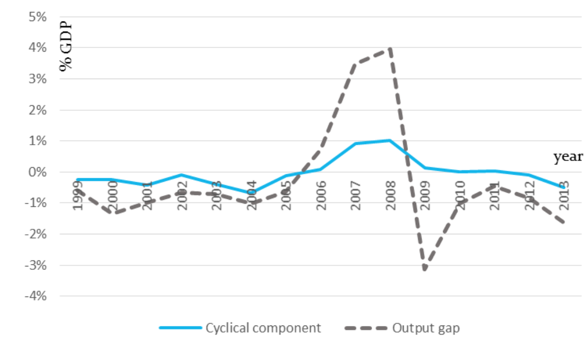
changes in corresponding macroeconomic bases. The personal income tax as well as social contributions respond to employment and compensations of employees in the private sector. Revenues from the corporate income tax are affected by profitability of companies. Indirect taxes respond to changes in private consumption. The unemployment benefits are influenced by unemployment and pension benefits, due to indexation, are linked to overall compensations of employees in the private sector in the previous year. For the purpose of calculation, deviations from equilibriums are first computed for each base and the overall cyclical component is then grossed up using the estimated budgetary elasticities.

The benefits of the CBR methodology can be summarised as follows:

- It takes into account a more robust estimate of potential output
- It reflects different cyclical development in GDP components in a consistent manner
- It 'nets out' the flows generated by the public sector in the form of taxes and contributions

Its disadvantage is that the resulting cyclical component does not necessarily has to have the same plus/minus sign as the output gap. This could be seen, for example, in 2009 (Figure 4). On the revenue side, a significant positive impact of the indirect taxes component outweighed the negative impacts of the remaining three components. In addition, on the expenditure side, the pension benefits, which are linked to overall compensations in 2008, contributed to a positive cyclical component. The cyclical component disaggregated by individual items is shown in figure 5. It can also be seen that the overall positive impact of the revenue components is greater than that of the expenditure components.

Figure 4: Cyclical component vs. output gap (% of GDP)



Source: RRZ

Figure 5: Detailed disaggregation of cyclical component (% of GDP)

Source: RRZ

Box 5: Cyclical component estimate by the Ministry of Finance for 2013

The cyclical component estimate made by the Ministry of Finance is based on the aggregated approach used by the European Commission which calculates the output gap, or potential output, via the Cobb-Douglas production function. It links the potential output with the level of technologies (TFP) and input factors such as labour (represented by employment) and capital. The Ministry publishes two estimates of potential output that differ in the periodicity of the data used (quarterly vs. yearly), the assumptions adopted (e.g, labour-capital ratio), etc.[41]. For the purposes of the assessment of compliance with the balanced budget rule, the Ministry adopted the output gap estimate from the Commission's spring forecast which projects a negative gap of 3.4% of potential GDP. On the other hand, the Ministry's own calculations presented at the Macroeconomic Forecasting Committee were at -1.2% of potential GDP in 2013, which is much closer to the CBR estimate at -1.6% of potential GDP.

Tab 6: Comparison of cyclical component in 2013 (% of GDP)

	CBR	MF SR (MFC)	MF SR (MTO assessment)
output gap	-1.6	-1.2	-3.4
cyclical component	-0.5	-0.4*	-1.1

*Cyclical component calculated as the product of budgetary elasticity of 0.332 and output gap presented to the Macroeconomic Forecasting Committee (MFC) in June 2014

Source: CBR, MF SR

The differences in the estimates of potential output are also reflected in the estimate of the cyclical component. According to the Commission estimates, the negative contribution of the economic cycle amounted to as much as 1.1% of GDP, which is significantly higher than the Ministry's own estimate with a negative contribution of 0.4% of GDP and that of the CBR with a negative contribution of 0.5% of GDP. The estimates those take into account national specificities (the Ministry and CBR) are better comparable despite the different methodologies used, increasing the structural deficit by 0.6 or 0.7% of GDP respectively compared to the Commission's estimate.

Annex 3 - One-off measures

This part describes the one-off measures which CBR takes into account when evaluating the compliance with MTO defined as general government's structural balance. The following Box contains 10 principles which the CBR considers in assessing the one-off measures[42].

1. **Possibility opt–out from the fully-funded pillar of the pension system**[43] – In response to the changes made in the fully-funded pillar at the turn of 2012 and 2013 (effective from 1 September 2012 until 31 November 2013), the government temporarily 'opened' the fully-funded pillar of the pension system allowing citizens to either exit or enter the scheme. The total effect in 2013 represented EUR 239.7 million.

   Reflected principles: 1, 7

[41] For details, see a Ministry of Finance document entitled "The Stability Programme of the Slovak Republic for 2014-2017", Box 2.

[42] For details, please consult the CBR's document "The 'True' Deficit".

[43] Under the new ESA2010 methodology, revenues from the transfers of pension liabilities will not have impact on the government balance.

Box 6: Principles to identified one-off measures according to CBR definition

The CBR assesses one-off measures particularly in the context of their impact on net worth (in contrast, the Commission takes into account the impact of measures on the medium-term fiscal position). According to the CBR, it is essential that the identification of one-off measures is made in a transparent and consistent manner in time. For this reason, the CBR has defined a set of rules facilitating clearer categorisation of these measures into one-off and temporary.

1. **Time horizon** – measures applicable in the medium term.
2. **Transaction value** – account will be typically taken of the measures which, in at least one year, exceed 0.05 % of GDP .
3. **Type/nature of transaction** – changes in the government balance, such as the sale of assets, revaluation of assets, workout of historical debts, remission of debts.
4. **Sign of budgetary impact** – deficit-improving impacts will be scrutinized more rigorously.
5. **Consistency in time** – several transactions relating to the same event should be recorded consistently in time.
6. **Legal power** – measures defined in constitutional acts will be considered as more permanent than measures defined in ordinary acts of parliament (adopted by a simple majority) or subordinate legislation.
7. **Implicit and contingent liabilities** – measures which change the present balance, but have no impact on long-term sustainability.
8. **Capital expenditures** – considered permanent.
9. **Accrual treatment** (period of transaction) – recording in time is more important than cash payment.
10. **Political risk** – shifts of impacts across political cycles.

In the case of the opening of the fully-funded pillar of the pension system, this measure does not have impact on the long-term sustainability of public finances because the higher revenues at present will be counterbalanced by higher expenditures in the future. The present government balance (through the revenues of the Social Insurance Agency) is influenced positively. The expenditures related to population ageing represent implicit liabilities for the government and the change has had a significant impact on the balance in the order of 0.3 % GDP. For similar reasons, this transaction will no longer be considered, pursuant to ESA2010, as a revenue for public finances.

2. **VAT receipt from a PPP project** – In 2011, the imputation of a claim towards the *Granvia* company as a consequence of VAT payment in connection with a PPP project for the R1 motorway in the amount of EUR 174 million had a positive effect on the deficit. In the next 30 years, the balance of the advance payment will be reduced every year by an aliquot portion amounting to EUR 5.79 million. This amount will have a negative effect on the general government budget during the 30-year period.

   Reflected principle: 5
   In 2011 and 2012, the investor paid VAT (on completion of the R1 motorway sections), which caused an increase in tax revenues. This income is considered as a one-off revenue. The payment of VAT by the government will be evenly recorded throughout the period of concession, together with the availability payments made by the state. Hence the impact of this measure is neutral throughout the entire period.

3. **Recording of hospital debts** – In 2011-2012, the deficits of general government subsumed higher debts of hospitals than the hospitals themselves reported, which deteriorated general government balances in both 2011 and 2012. On the other hand, the 2013 government balance was, for this reason, "improved" for the incorrectly recorded amount of the debts incurred by hospitals in the amount of EUR 93.8 million. The CBR considers the recording in time, which assigns the debt to the period when it was incurred, as having a one-off impact.

Reflected principles: 2, 9
The recording of the debt in time meets the principle of proper accrual accounting.

Tab 7: Impact of takeover of debt of healthcare facilities on the GG deficit (mill. €)

	2011	2012	2013
1. liabilities included in the debt according to ESA 95 (impact on deficit)	100.1	130	18.5
2. liabilities recorded by Ministry of Healthcare (impact on deficit)	67.2	69.2	112.3
3. difference in liabilities (one-offs) (1-2)	**-32.9**	**-60.8**	**93.8**

Source: MF SR

4. **Special bank levy** – As of 1 January 2012, the government imposed a bank levy of 0.093% from tax base identical to extended levy in banking sector. The measure increased revenue of general government by EUR 40,2 million in 2012.

Reflected principles: 1, 3
One-off measure laid down in law, which is unlikely to recur.

5. **Temporary levy on business operations in regulated sectors** – Effective from 1 October 2012, a levy on business operations in regulated sectors was introduced as one of the consolidation measures designed to reach the fiscal objectives. It applies to companies with revenues from regulated activities accounting for least 50% of their overall revenues and with profits in excess of EUR 3 million. The measure is effective in the 2012-2016 period. Its impact in 2013 was EUR 75.0 million. In 2014, the revenue from the levy is exceptionally increased by the amount of EUR 176 million from the *SPP* company. The positive impact of this measure in 2015 and 2016 is estimated at about EUR 90 million.

Reflected principles: 1, 2
The originally adopted legislation limited the applicability of this measure only to 2012-2013, but the 2014-2016 general government budget proposal extended it through 2016.

6. **Taxation of retained profits from before 2004** – The effect of the one-off withholding tax on retained profits from before 2004 (at the rate of 15 %) only applies to the 2013 tax period. This measure will yield about EUR 4.0 million in 2013 and about EUR 5.2 million in 2014.

Reflected principles: 1, 3
Since this is clear one-off measure laid down in the law, the CBR takes it into account despite its relatively low yield.

7. **Extended bank levy** – As of 1 January 2012 the government introduce a levy on selected financial institutions in the amount of 0.4 % of liabilities, net of equity and deposits covered by the Deposit Protection Scheme. As of 1 September 2012, the levy calculation base was extended to also include the value of protected deposits, which were initially exempt. Depending on the aggregate amount of the levy collected and the total assets of the banking sector, the bank levy rate could even drop to zero. In 2013, the levy increased revenues by EUR 157.1 million. Its positive contribution to the government balance in 2014 is expected to reach EUR 126 million, and then the revenue will be gradually falling to reach about EUR 50 million in 2017.

   Reflected principles: 1, 2, 7
   The bank levy, and the associated government revenue, is classified as a revenue of State Financial Assets and recorded on a separate extra-budgetary account. The revenue is specifically bound to cover the costs associated with the consequences of financial crises and stabilisation of the banking sector. For this reason, the bank levy can be considered a one-off measure; in substance, it is a contingent liability which will be paid in the future should need arise. Moreover, once the set amount of assets in the sector is attained, the rate of levy is reduced to zero and thus the revenue is temporary.

8. **Dividends**[44] – These are one-off transfers of revenues from dividends unrelated to the respective fiscal year, and/or special agreements on the payout of dividends between the state and other shareholders which do not have to be recognised under the ESA 95 methodology. In 2012 the general government balance was positively influenced by EUR 186 million due the shift of dividends.

   Reflected principles: 1, 2, 9
   This is a one-off revenue with significant impact on deficit, where accrual recording is of essence.

9. **JAVYS** – In the 2014-2016 general government budget the CBR has identified, among the revenues of the National Nuclear Fund, a one-off contribution from *JAVYS, a.s.* in 2013 in the amount of EUR 30 million.

   Reflected principles: 1, 3
   This is a one-off contribution which is unlikely to recur (time horizon).

10. **Financial corrections to EU funds** – These are moneys which the Slovak Republic must return to the EU budget due to the irregularities identified in the use of EU funds by general government entities. On the whole, these financial corrections are expected to have a negative impact on the balance in the amount of EUR 257 million in 2013-2015. In 2013 alone, financial corrections to EU funds reached EUR 124.5 million.

    Reflected principles: 1, 2
    Financial corrections to EU funds occur every year, but the present corrections are likely to have a significant impact on the government balance, which will be probably spread over three

[44] More detailed description can be found in Annex 6 of the CBR's document Evaluation of the General Government Budget Proposal for 2014-2016.

years. Moreover, corrections are imposed in reaction to concrete irregularities which are unlikely to be repeated soon.

11. **Loan instalment paid by *Cargo, a.s.*** – On 4 March 2009, the government approved the use of state financial assets for the provision of a loan to Cargo Slovakia a.s. in the amount of EUR 166 million. Under a contract with the Ministry of Finance and the Ministry of Transport, Post and Telecommunications, Cargo used the loan to finance its payroll and personnel expenditures, charges for the use of the railway infrastructure, and its own financial expenses. The payment of interest was set to begin in 2009, the payment of the principal in 2011, and the entire loan matures in 2020. In 2013, the instalment represented EUR 19.5 million.

12. **Loan instalment paid by *Vodohospodárska výstavba, š.p.*** - In 2002 and 2006, the state provided to *Vodohospodárska výstavba, š.p.* two loans which, due to the anticipated inability of the recipient to pay them back, were classified as capital transfer. The moneys were intended to restructure the debts of *Vodohospodárska výstavba* (VVB), š.p., Bratislava. EUR 160 million was repaid by 2011 and the remaining debt amounting to EUR 105 million is expected to be repaid in the following years, with the last instalment scheduled for 2015. In 2013, the company paid EUR 30.3 million.

    Reflected principle: 5
    The provision of loans to companies VVB and Cargo and their subsequent reclassification into capital transfer had a one-off negative impact on the balance and debt of general government debt (in 2002 and 2006 in the case of VVB, and in 2009 in the case of Cargo). The fact that these companies are repaying their debts has a positive impact on the balance (under the ESA95 methodology). In both cases, these transactions are recorded as one-off transactions.

Tab 8: One-off measures in 2012-2013 (ESA 95, € mill.)

	2012	2013	2012	2013	2012	2013
	CBR		MF SR		difference	
exit from the fully-funded pension pillar	44.2	239.7	44.2	239.7	0	0
VAT revenue/payment from a PPP project (Granvia)	-5.8	-5.8	-	-	-5.8	-5.8
accrualisation of hospitals´ liabilities	-60.8	93.8	-	-	-60.8	93.8
special levy in the banking sector (incl. CIT)	40.2	-	40.2	-	0.0	-
temporary entrepreneurial levy in regul. industries (incl. CIT)	30.9	75.0	-	-	30.9	75.0
taxation of retained earnings before 2004	-	4.0	-	-	-	4.0
extended levy in the banking sector (incl. CIT)	97.5	157.1	-	-	97.5	157.1
dividends	186.0	0.0	-	-	186.0	0.0
JAVYS (voluntary grant)	-	30.0	-	-	-	30.0
EU corrections	-	-124.5	-	-	-	-124.5
repayment of loans of Cargo	9.8	19.5	-	-	9.8	19.5
repayments of loans Vodohospodárska výstavba	27.0	30.3	-	-	27.0	30.3
TOTAL	**369.0**	**519.1**	**84.4**	**239.7**	**284.6**	**279.3**

(% GDP)	*0.5*	*0.7*	*0.1*	*0.3*	*0.4*	*0.4*

Source: CBR, MF SR

Annex 4 - Discretionary revenue measures

The following table shows the list of discretionary revenue measures in 2012 and 2013. Their y-o-y change served as an input into the calculation of adjusted expenditure growth.

Tab 9: Discretionary revenue measures in 2012 and 2013 (ESA95, € ths.)

	2012	2013
Changes in the fully-funded pillar of pension scheme	192 743	695 067
Extension of a special levy in the banking sector	63 344	91 770
Levy on enterprises in regulated industries	30 947	78 844
Increasing the excise tax on tobacco	0	8 089
Increasing the vehicle registration fee	5 447	26 219
Increasing other administrative fees (excl. the vehicle registration fee)	0	28 159
Changes in taxation of gambling	488	10 796
Increase and unification of the maximum assessment bases of social security contributions	0	159 828
Increase in social security contributions for self-employed and other related changes	0	26 924
Health and social security contributions for workers by agreement	0	133 996
Transition from 19% to 23% rate of PIT (already adopted measures)	0	-10 062
Changes in income tax rates - CIT 23%, PIT 19% a 25%	0	283 015
Limitation of lump-sum allowance for the self-employed	0	17 588
Special PIT rate from revenues of selected constitutional officials	0	196
Limitation of spouse allowance (PIT)	0	5 670
Tax exemption of in-kind benefits of miners	0	-98
Tax exemption of local government revenues from sales of property	0	-10 260
Re-introduction of television/radio licence fee	0	73 881
Changes in taxation of bonds	0	-300
Taxation of retained profits from before 2004	0	4 000
Health insurance contributions paid from dividends	0	10 257
Increasing real estate tax	0	12 025
Increasing the waste disposal tax	0	3 694
Change in health insurance contributions paid by the state (on behalf of persons defined by law)	0	-72 207
Change in social insurance contributions paid by the state (on behalf of persons defined by law)	0	42 196
Social insurance contributions of armed forces	0	11 042
One-off revenues from dividends	185 970	12 296
Grant from JAVYS (state-owned nuclear decommissioning company)	0	30 000
Repayment of loan by Cargo (state-owned railway freight company)	-9 750	0
Changes in imputed social contributions	0	16 441
Social contributions relief for long-term unemployed	0	-1 043
Total	**469 189**	**1 688 023**
- y-o-y change	**-**	**1 218 834**

Source: CBR, MF SR

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