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Addendum to the Evaluation of the General Government Budget for 2016-2018

(Based on the amendments to the 2016-2018 General Government Budget adopted by the Parliament on 20 November 2015)

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This report presents the official positions of the Council for Budget Responsibility in line with its mandate laid down in Act No. 493/2011 on Fiscal Responsibility.

This publication is available at the CBR website (http://www.rozpoctovarada.sk).

Any suggestions or comments on the report are welcome at sekretariat@rrz.sk.

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Summary

The Council for Budget Responsibility (CBR) has updated its evaluation of the 2016-2018 general government budget in reaction to the State Budget Act approved by the parliament. The update also reflects the information released recently by the Ministry of Finance – a letter addressed to the European Commission, an updated forecast of the Tax Revenue Forecasting Committee and the approved 2016-2018 General Government Budget.

The recent changes have no impact on budgetary targets, nor do they change the structural balance estimate as presented in the budget proposal approved by the government. The most significant change entails an upward revision of the 2016-2018 tax revenue due to better-than-expected collection of taxes above the forecast approved by the Tax Revenue Forecasting Committee (annually by 0.3 % of GDP). Some of these funds (0.1 % of GDP annually) will be used to support major investment projects, while the remainder (0.2 % of GDP annually) is budgeted as a reserve for the coverage of unallocated expenditures. At the same time, the estimated impact of the reduced VAT rate on selected foodstuffs has been made more precise. The Ministry of Finance has specified some of the measures designed to reduce the operating expenditures of public administration and curb the expenditure growth in the healthcare sector, as well as the first steps towards evaluating the efficiency of public spending, which should become an integral part of the budgeting process.

The risks identified by the CBR in the budget proposal remain relevant also after the approval of the budget in the parliament. In comparison with the budget proposal, the risks for 2016 have increased, but they may be offset by the additionally specified measures[1]. The inclusion of the assumption of a higher tax revenue due to better tax collection in the budget and the allocation of a part of this additional revenue for specific purposes increase the risk of the deficit rising by 0.1 % of GDP if the additional revenue does not materialise. The CBR views positively the measures planned to reduce the operating expenditures of public administration and restrain expenditure growth in the healthcare sector. Nevertheless, the CBR is of the view that the savings expected by the Ministry of Finance in 2016 will not be fully achieved and the unspent funds will likely be used to cover other unbudgeted expenditures (a pay rise for nurses). Hence these measures should be viewed as a potential source of savings mainly in the following years. Also, the effects of the planned public expenditure review aimed at increasing their efficiency will be felt more in the medium than in the short term.

The CBR views negatively the fact that the parliament increased the budgeted revenues from taxes and social contributions and the Ministry of Finance reflected that increase in the three-year budget without the approval of the Tax Revenue Forecasting Committee, which compromises transparency of the process through which the general government budget is approved. Such additional increases in revenues and expenditures may create room for the circumvention of those fiscal rules which restrict the growth in budget expenditures. The way in which changes in the three-year budget[2] were introduced shows that

[1] In its evaluation of the government-approved budget proposal the CBR estimated the deficit, assuming that all quantified risks and sources for their coverage materialise, at 2.7 % of GDP in 2016 (without the impact of financial corrections).

[2] The parliament approved cash-based changes for the year 2016 and it was not clear what effects will they have under ESA2010 in 2016 to 2018. This uncertainty was dispelled when the Ministry of Finance incorporated the changes approved by the parliament into the budget. The CBR is of the view that such additional interventions into the government-approved budget by parliament should not be a standard procedure.

the current legislative framework regulating the budgetary procedure in the parliament is inadequate in transparency terms. The adoption by parliament of a cash-based budget for the next year in keeping with the historical tradition is no longer sufficient to capture all changes in public finances in compliance with the European standards defined in ESA2010. The CBR pointed out this issue also in its last year's evaluation of the budget[3].

[3] CBR , Addendum to the Evaluation of the General Government Budget for 2015-2017, p. 14.

1. Changes in the general government budget

The government approved the 2016-2018 General Government Budget Proposal on 7 October 2015 and the Council for Budget Responsibility published its evaluation[4] on 11 November 2015. Since the approval by the government, a number of changes have been made in the proposal, and the CBR has updated its evaluation accordingly. The changes include, in particular the approval of a revised tax revenue forecast by the Tax Revenue Forecasting Committee on 26 October 2015, publication of a letter dated 10 November 2015 by the Ministry of Finance addressed to the European Commission in connection with the latter's less favourable deficit estimate and the ensuing deviation from the rules of the Stability and Growth Pact[5] in 2016, and the adoption of the budget by the parliament on 20 November 2015 with a number of amendments. On 9 December 2015, the Ministry of Finance published the approved General Government Budget for 2016-2018 with additional adjustments related to the amendments in the parliament.

The amendments have not altered fiscal targets, nor have they changed the structural balance estimate presented in the government's proposal. Macroeconomic assumptions have not changed either. **According to the MPs who tabled the amendments, the changes which they introduced should have a neutral impact on the balance.**

At its extraordinary meeting on 26 October 2015 the Tax Revenue Forecasting Committee **approved the impact of the downward revision of its VAT revenue forecast due to the introduction of a reduced VAT rate on selected foodstuffs**. This change has not been reflected in the General Government Budget. On the other hand, the budget now contains a reserve on the expenditure side to cater for the impacts of legislative changes, including the anticipated impact of the reduced VAT rate. At the time when the budget proposal was prepared, the measure was expected to have a slightly more negative impact. By making the estimates more precise, the overall impact on the balance can be slightly positive.

In its letter[6] of 10 November 2015 addressed to the European Commission the Ministry of Finance **specified some of the measures it is planning to take to meet the budgetary objective**. The public administration reform (ESO) is set to continue, however, the measures which should save 0.1 % of GDP in 2016 have yet not been specified. In the healthcare sector the government intends to reduce expenditures on drugs by making the financial links between the pharmaceutical industry and healthcare professionals more transparent[7], by introducing a price-

4 CBR, Evaluation of the General Government Budget Proposal for 2016-2018. The full English version was published on 8 January 2016.

5 In its autumn forecast the European Commission estimated Slovakia's general government deficit at 2.4 % of GDP in 2016 (compared to the deficit target of 1.9 % of GDP). Based on the forecast it identified a risk of deviation from the rules of the Stability and Growth Pact (deviation from the structural balance and expenditure rule). After having taken into account the additional information contained in the MoF letter it concluded that the budgetary plan for 2016 was in line with the SGP rules.

6 The letter is published on the website of the Ministry of Finance: http://www.finance.gov.sk/Components/CategoryDocuments/s_LoadDocument.aspx?categoryId=10498&documentId=13915

7 The parliament approved amendment to Act No. 362/2011 on Drugs and Medical Devices on 25 November 2015. The obligation to publish data will enter into force on 1 January 2016. The potential positive impacts on public finances are not quantified in the 'budgetary impact clause'.

referencing system for medical devices[8] and by setting price ceilings for significant purchases of medical technologies in hospitals[9]; the cumulative impact of these measures in 2016 should reach 0.15 % of GDP. The Ministry of Finance is planning to review the efficiency of public spending (the analysis of public expenditure efficiency should become a standard part of the budgeting process) with the easiest-to-achieve cuts to be implemented in 2016. On the revenue side, the government expects higher tax revenue for 2015 (by 0.2 % of GDP) and the positive risk for 2016 is higher because of the unspecified additional measures to be taken to combat tax evasion.

During the debate on the government's budget proposal for 2016-2018, the **parliament approved three amendments**:

- The joint report of parliamentary committees introduced certain technical changes (updated numbering of the legislative act) and the incorporated conditions for the granting of subsidies to gas customers into the draft State Budget Act. These changes have no additional impact compared with the budget proposal approved by the government.

- The parliament voted to increase the 2016 budget cash tax revenues by EUR 250 million (EUR 200 million from VAT and EUR 50 million from excise taxes, without further specification) based on the assumption of better tax collection. On the other hand, the expenditure side of the budget now contains a reserve for better-than-expected tax collection (EUR 150 million), while the reserve for significant investments increased by EUR 100 million (from EUR 75.7 million to EUR 175.7 million). Provided that the increase in cash-based revenues will be the same also under the ESA2010 methodology[10], these changes will have a neutral impact on the balance.

- In its draft resolution on the budget, the parliament asked the government to guarantee that the funding of expenditures connected with the application of amended Act[11] No. 578/2004 on Healthcare Providers, Healthcare Professionals and Professional Organisations in the Healthcare Sector is provided within the expenditure ceilings of the 2016 budgetary chapter of the Ministry of Health, including the expenditures incurred in connection with the pay rise of other healthcare professionals (medical nurses including) to the tune of EUR 55 million a year[12]. Nevertheless, the revenues and expenditures in the state budget have not been revised along those lines.

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8 The annual positive impact of price-referencing is estimated by Institute for Financial Policy (available only in Slovak) between EUR 7 and 20 million. According to the Ministry of Health, due to the need to develop a data base, this measure will be effectively felt on the second half of 2016.

9 According to the Ministry of Health, the setting of purchase ceilings and the cost-benefit analysis should begin in the course of December 2015.

10 This assumption does not have to apply at all times. The CBR pointed out a similar problem also in the addendum to the Evaluation of the 2015-2017 General Government Budget when several types of tax revenues increased above the TRFC forecast.

11 The parliament approved the amendment on 25 November 2015.

12 The budgetary impact clause to this amendment quantifies the negative impacts on public finances at EUR 55.6 million in 2016, EUR 68.3 million in 2017 and EUR 87.7 million in 2018.

For the sake of being consistent in reflecting the assumption of a better tax collection in the three-year budget, the **Ministry of Finance** has made **additional adjustments**. The cash-based impact of the revised tax revenue assumption for 2016 as approved by the parliament has also been reflected in revenues under ESA2010. As far as excise taxes are concerned, the ministry has specified that the additional revenue will come from the excise tax on mineral oils. At the same time, the upward revision of tax revenues and of the reserves created in the budget have also been reflected in the years 2017 and 2018 in the same amounts.

Tab 1: Changes in the 2016-2018 General Government Budget (ESA2010, € million)

	2016	2017	2018
1. Joint report of parliamentary committees	**0**	**0**	**0**
2. Better collection of taxes:	**0**	**0**	**0**
- increase in VAT revenues	200	200	200
- increase in excise tax revenues from mineral oil	50	50	50
- reserve for better-than-expected tax collection (unallocated expenditures)	-150	-150	-150
- increase in the reserve for significant investments	-100	-100	-100
3. Guaranteeing expenditures on pay rise in healthcare	**0**	**0**	**0**
Total impact on the GG balance (1+2+3)	**0**	**0**	**0**
Updated estimated impact of the reduced VAT rate on selected foodstuff	**11**	**12**	**12**
- estimate approved by the TRFC	-66	-69	-72
- reserve incorporated in the budget proposal	-77	-81	-85

(+) positive impact, (-) negative impact on the GG balance *Source: NC SR, MF SR*

2. Assessment of changes and their impact on budgetary objectives

The changes in the budget have also been reflected in risk assessment. **In comparison with the budget proposal, the risks for 2016 increased** (Table 2)**, but they may be offset by additionally specified measures.**

The most significant **additional negative risk stems from the assumption of tax revenue being** EUR 250 million above the TRFC forecast in 2016 to 2018. This risk is partly offset by a reserve for unallocated expenditures in the amount of EUR 150 million a year. If the assumed revenue does not come in, **the negative impact on the balance may reach EUR 100 million a year**.

The 2016 reserve budgeted for significant investments increased by EUR 100 million to EUR 175.7 million. The reserve budgeted for the next years represents EUR 100 million a year. Since no further official information on the prepared Jaguar Land Rover investment, or any other significant investment, has been released, it is difficult to assess the extent to which these expenditures are realistic, i.e., whether this budget line will be unspent or overrun. Consequently, the **CBR is not quantifying the risk**.

The approved pay rise in the healthcare sector in 2016 will contribute towards increase in expenditures on an annual basis. On the other hand, **the measures adopted may lead to lower expenditures** from the budgets of health insurance companies and healthcare facilities. The question is to what degree the positive effects will be felt already in 2016, because these changes take time to implement (ongoing improvements in the methodology for the setting of price ceilings, development of a data base for medical devices price-referencing) and they also assume changes in the decision-making of patients who will be better informed. In comparison with its evaluation of the budget proposal, the CBR has not revised the overall impact of the risks in this sector since the estimate is based on the average rate of expenditure growth[13] in the past six years, while the expenditure growth rates in 2013 and 2014 stood above the average.

The lower impact on the reduced VAT rate on selected foodstuffs compared with the budget proposal may represent a potential source for risk coverage. The negative impacts approved by the TRFC are approximately EUR 11-12 million lower annually. If this assumption proves to be correct, the balance will improve by the above amount each year.

The continuation of the ESO project (streamlined public administration) may induce additional cuts in expenditures. However, specific measures have not yet been presented and thus their impact on 2016 remains questionable. Also unclear is their potential impact on the balance, mainly because the unrealised expenditures were used in the past to finance other priorities. Hence no change in terms of risk assessment.

[13] The CBR estimates the risks in the development of healthcare expenditures based on their development in the past years, without specifying individual risk items.

The intention to review the **efficiency of public expenditures** may help create resources for the coverage of existing risks. Since this is an ambitious project requiring meticulous preparation, its potential benefits may come about in the medium term only.

The other risks identified by the CBR in the budget proposal remain valid (their complete list is in Table 2).

Tab 2: Estimated risks and their coverage in 2016-2018 (€ million)

Budget risks with impact on the balance	2016	2017	2018	Risk coverage in 2016	
1. Overestimated non-tax revenues:	171	154	145		
- revenues from SPP and VSE dividends	119	115	117		
- revenues from the sale of CO_2 allowances	52	39	28		
- revenue from the levy for the operation of Units 3 and 4 of Mochovce nuclear power plant	0	no quantification			
2. Financial corrections to EU funds	no quantification			Potential saving in co-financing	max. 90
3. Underestimated healthcare expenditures	145	245	185		
- expenditures on healthcare provision and the financial performance of hospitals	120	220	160		
- discharge of liabilities payable to the shareholders of private health insurance companies	25	25	25		
4. Underestimated expenditures of local governments	0-100	no quantification			
5. Impact of potential expenditure cuts in 2015 (e.g., carryover of capital expenditures)	no quantification	-	-		
6. Impact of the potential carryover of expenditures originally budgeted for 2015 in connection with PPP project D4/R7	0-287	-	-	**reserve on better tax collection**	**150**
7. Expenditures on the construction of the national football stadium	26	26	-		
8. Accrual recording of cash expenditures in the defence sector	no quantification				
9. Expenditures of the National Nuclear Fund on the decommissioning of nuclear facilities	no quantification				
10. Recapitalisation of the traditionally loss-making state corporations	no quantification			**lower impact of reduced VAT rate on selected foodstuff**	**11**
11. Impact of the worse macroeconomic scenario as a consequence of consolidation	0	202	256		
12. Overestimated tax revenues	**250**	**250**	**250**		
13. Expenditures on significant investments	**no quantification**				
Risk from the net worth perspective without impact on the balance					
1. Impairment in the value of government assets due to restriction on capital expenditures	no quantification				

2. Use of the assets accrued from the levy paid by financial institutions to finance current expenditures, occurrence of new contingent liabilities	no quantification	

Note: changes compared to the assessment of the budget proposal are shown in bold *Source: CBR*

3. Budget transparency

The process through which the budget proposal was approved in the parliament was not fully transparent. The CBR views as negative that the parliament increased the budgeted revenue from taxes and social contributions without the approval of the **Tax Revenue Forecasting Committee (TRFC)** enshrined in the Fiscal Responsibility Act. This has happened for the second year in a row[14]. Budget revenues have been increased by EUR 316 million in 2016 (1.4 %), EUR 319 million in 2017 (1.3 %) and EUR 322 million in 2018 (1.3 %).

The CBR considers such a procedure non-transparent for the following reasons:

- It **circumvents the established principle whereby the macroeconomic and tax revenue forecasts for the budget are approved by independent committees**. From the CBR's perspective, the non-inclusion of the latest Committee forecasts and any additional increases above those forecasts lack credibility[15] (see Box 1 for more). By the way, the latest TRFC meeting[16] took place one month before the approval of the budget in the parliament. This principle is being circumvented at a time when the eurozone strengthens the principle of independent budget preparation[17].

- Moreover, rather than a one-off instance, **it has become a practice.** The CBR believes that tax revenue forecasts are not for politicians to decide on, but rather for a committee composed of independent experts to produce[18].

- **The reserve for unallocated expenditures falls short of fully covering the increase in revenues above the forecast level**. In other words, if these additional revenues do not come in, the government will have to find additional funds above and beyond those set aside in the reserve in order to meet the deficit target. This is because a part of the additional tax revenue is earmarked to increase the reserve for significant investments. The resulting impact on the balance will depend on the extent to which these expenditures are effected (in other word, the impact on the balance hinges on an event unrelated to whether or not the government indeed collects the additional tax revenue).

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14 For the third time on the whole, in the first year (September 2013) the Ministry of Finance increased the tax revenue forecast without the approval of the TRFC when the budget was sent to the cabinet for discussion.

15 Moreover, in the past, in the published versions of the general government budget the Ministry of Finance did not disclose changes in tax revenue forecasts. In the section describing tax revenues, the ministry would present the forecasts approved by the Tax Revenue Forecasting Committee along with their original assessment as 'being realistic'. Only one paragraph contained a note on their subsequent increase in the parliament. In the CBR's view, the budget documentation should present, in a transparent manner, the actual tax revenues approved by the parliament.

16 Meeting of the Tax Revenue Forecasting Committee dated on 26 October 2015 (documents available only in Slovak).

17 According to Regulation of the European Parliament and of the Council (EU) approved in 2013 (Regulation No. 473/2013, Chapter 3, Article 4 – part of the so-called two pack) the budget should be approved based on independent macroeconomic forecasts and should indicate whether the budgetary forecasts (including tax forecasts) have been produced or endorsed by an independent body.

18 Article 2(2) of the Statutes of the Tax Revenue Forecasting Committee (available only in Slovak) explicitly describes the competences of the Committee and the intention to sever professional aspects from political decisions.

- This creates an opportunity to **circumvent the fiscal rules** by softening the more stringent debt-brake sanctions (invoked when the debt limit of 55 % of GDP is overrun) and the rule whereby the increase in cash expenditures of the state budget must not exceed 1 %[19]. For example, if the government becomes obliged to block certain budget expenditures, the freeze may affect the reserve for better-than-expected tax collection without affecting the other government spending policies[20] any significantly; or, if the government becomes obliged to propose a budget based on a zero-increase in expenditures – there, the level of expenditures approved in the previous year's budget is taken as a reference[21]. On the other hand, in times when actual revenues exceed the budgeted level, it enables the government to use the extra revenue to finance expenditures without any limitation.

- **The way in which changes in the three-year budget[22] were introduced shows that the current legislative framework regulating the budgetary procedure in the parliament is inadequate in transparency terms.** The adoption by the parliament of a cash-based budget for the next year in keeping with the tradition is no longer sufficient to capture all changes in public finances in compliance with the European standards defined in ESA2010. Unlike the parliament, the government approves the budgetary objectives under ESA2010 for the entire general government sector. For this reason, any amendments to the proposed budget should include all changes affecting the general government budget presented in compliance with the applicable methodology for reporting[23].

The CBR views positively that the Ministry of Finance published the 2016-2018 General Government Budget within three weeks of its approval by the parliament. In the past, the approved budget would typically be published in late January/early February of the next year, hence its publication in the course of December should be viewed as a significant progress; making it a rule would be mostly desirable. The published budget contains the description of all tax revenues and distinguishes clearly between those approved by the Tax Revenue Forecasting Committee and those approved above the TRFC forecast. In terms of transparency, the CBR views negatively the fact that the documents published contain the position of the Tax Revenue Forecasting Committee only for a part of the tax and social contribution revenues while the assessment of additional revenues is missing.

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[19] The approved expenditures may be exceeded by a maximum of one percent without increasing the deficit. In other words, this rule is there to ensure that the additional revenues earned in good times are spent only up to a certain limit, the remainder should be used to improve the government balance.

[20] This occurred after the publication of the end-2013 debt amount in April 2014 when a significant portion of the mandatory blockage of expenditures (about 2/3) concerned the budgeted reserve for better VAT collection.

[21] If these expenditures contain the reserve for better tax collection, the obligation to block expenditures in the following year is less painful because the expenditures may increase by an amount equal to the amount of funds in the reserve.

[22] The parliament approved cash-based changes for the year 2016 and it was not clear what effects will these changes have under ESA2010 in 2016 to 2018. This uncertainty was dispelled when the Ministry of Finance incorporated the changes approved by the parliament into the budget. The question is whether such subsequent changes in the three-year budget, i.e. a document approved by the government and sent to the parliament, should be considered a standard procedure.

[23] The CBR pointed at this problem in its last year's evaluation of the approved General Government Budget for 2015 to 2017.

BOX 1: How realistic the tax revenue forecasts are

According to the TRFC rules[24], a tax revenue forecast by the Ministry of Finance is considered realistic if the individual Committee members' forecast **does not deviate from the presented forecast by more than one percent throughout the forecast horizon**. For the purpose of assessing the tax revenue forecast contained in the budget submitted to the parliament, deviation is calculated as a weighted average of deviations from forecasts for individual years, with the next year carrying 50 % of the weight. The weights for subsequent years are lower (25 % and 15 %). The comprehensive assessment of deviations in tax revenue forecasts for several years reflects the fact that the general government budget is compiled for three years.

If we apply this rule to compare the forecast built into the 2016-2018 General Government Budget against the official TRFC forecast[25], **the average deviation reaches 1.2 % and exceeds the one-percent threshold**.

Tab 3: Comparison of TRFC approved forecast (Oct.2015) and approved budget

(ESA2010, € million)	2015	2016	2017	2018
Tax forecast approved by the TRFC (26th October 2015)	22 360	22 995	23 983	25 190
Tax forecast in the budget approved by parliament (9th December 2015)	22 360	23 311	24 302	25 512
Difference (budget – TRFC):	0	316	319	322
- *better tax collection (MPs' budget amendment)*	0	250	0	0
- *not including impact of reduced VAT rate on selected foodstuff*	0	66	319	322
- *better tax collection (MoF's assumption)*	0	0	250	250
Difference in %	**0.0%**	**1.4%**	**1.3%**	**1.3%**
Weight of individual years according to TRFC statute	10%	50%	25%	15%
Weighted average of differences in % (art. 4 paragraph 9 of the TRFC statute)	**1.21%**			

Source: MF SR, NC SR

[24] Statutes of the Tax Revenue Forecasting Committee , Article 4(9)

[25] In order to correctly assess the extent to which the forecast approved by the parliament is realistic, as defined in the TRFC Statutes, it should be compared against the forecasts of individual TRFC members.

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