Summary

The Council for Budget Responsibility (CBR) views as positive that the government has declared its intention to achieve the medium-term objective by 2017. It is an important milestone which, together with lowering gross debt below the sanction thresholds, could significantly improve the position of Slovakia in the face of the risks emanating from potential crises and the negative impacts of demographic development.

According to the Ministry of Finance, the government's budgetary objectives and the ensuing consolidation are more ambitious than the level of consolidation required under the EU fiscal rules[1]. The likely failure to attain the budgetary objective in 2015 and the existence of additional risks which go beyond the estimate presented in the budget proposal represent a risk for the years to come. While the budget proposal is detailed in explaining those government steps which, for the most part, increase the deficit, it lacks a detailed explanation of consolidation measures. Moreover, not all the measures necessary to meet the 2017 and 2018 objectives have yet been specified. The meeting of these objectives may also be influenced by the fact that the budget implementation will be largely in the hands of the new government which will have to adopt sufficient measures in the medium term to attain a structurally balanced budget. According to the budget proposal, the debt level should dip just below the first sanction threshold in 2018. With the expected consolidation incorporated into the economic forecast, the CBR sees the gross debt at the end of 2018, even if the budgetary objectives are met, within the first sanction zone.

The purpose of the CBR's opinions is to offer an independent view on the budget and assess whether the fiscal policy setup is sufficient in terms of achieving the targets set and, at the same time, to identify potential risks which need to be eliminated through the adoption of additional measures. In line with its mandate, the CBR also points at whether the present budget provides sufficient margins for ensuring compliance with the national fiscal rules. With this objective in mind, the CBR points at the following potential risks:

- So far, **no sufficient measures needed to steer the debt outside the sanction zones** (as defined in the Fiscal Responsibility Act) **have been presented**. Fiscal policy should create sufficient room for manoeuvre mainly in the good times when the economy generates higher tax revenue and spends less. The government missed the opportunity to use numerous positive effects to step up consolidation; on the contrary, as part of its three-year budget updates the government would repeatedly revise the target values of budgeted deficits upwards. According to the CBR, the introduction of expenditure ceilings, as contemplated by the Fiscal Responsibility Act, could significantly facilitate consolidation in the good times.
- The sources of consolidation (apart from reduced drawing of EU funds) concentrate mostly around a considerable decrease in investments and intermediate consumption, as well as expenditure cuts in the healthcare sector. Reduced investments may enfeeble the growth potential of the economy and increase the government's investment gap. The explanation of the measures contained in the budget proposal is imbalanced. **While the deficit-increasing items are described and quantified in detail, the consolidation measures are presented only in general terms**. The efficacy of spending is just as important as the level of expenditure itself. From this perspective, it would be appropriate to accentuate the development of analytical capacities designed to measure the efficacy of spending (value for money).

1 The compliance of budgetary objectives with the EU fiscal rules is evaluated by the European Commission.

- **The risks in the budget proposal are mostly negative.** According to the CBR, the budget proposal overestimates non-tax revenues (insufficient explanation of higher revenues from dividends and from the sale of CO_2 allowances) and underestimates expenditures in the healthcare and local government sectors, without explaining the cost-saving measures. Likewise, the budget proposal does not factor in any corrections to EU funds. The consolidation strategy would more credible if the risks presented in the budget proposal were better balanced. **Assuming that all the risks materialise and taking into account the potential savings in co-financing, the general government deficit in 2016 might reach 2.7 % of GDP (without the impact of corrections)[2] and the gross debt might increase to 52.9 % of GDP by the end of 2016.** In order to meet the 2016 objective, the government will have to take new measures and/or make the existing measures more specific and, at the same time, eliminate all identified risks to the maximum extent possible.

Although the 2017 medium-term objective has not changed since 2013, the objectives for 2014 to 2016 were revised towards higher deficits in each update of the three-year budget. **Moreover, the 2014 deficit was, and the 2015 deficit is expected to be higher than planned in the approved budgets. These increases in deficit target values took place at a time when the government could have benefited from a number of positive effects, including the additional revenue from fight against tax evasion.** First and foremost, the accelerating economic growth generated higher tax revenues, the historically lowest interest rates reduced budget expenditures quite significantly, and the budget also benefited from additional revenues from openings of and the reduction of contribution rates to the fully-funded pillar of the pension system. The second significant factor includes the positive additional effects which occurred during the fiscal year and which could have, at least partly, been used to reduce the actual versus budgeted deficit and step up consolidation in the years to come. In this connection, it is necessary to appreciate the measures taken by the government to raise additional revenue by combating VAT evasion (with a secondary positive effect on revenues from corporate income tax) which represent a unique and non-recurring source for deficit reduction. The failure to use of these positive effects for deficit and debt reduction thus pushes the necessary consolidation behind the horizon of the upcoming fiscal year, i.e., into the year 2017.

In addition to the European fiscal rules, also the national rules constitute an important part of the national fiscal framework. Their objective is to set the boundaries the transgression of which poses significant risks for the long-term sustainability of public finances. For the constitutional debt limit, this means keeping the gross debt outside the sanction-triggering thresholds (which were overrun for the first time in 2012). The gross debt to GDP ratio began to decline after 2013, mainly under the influence of the one-off measures taken by the government (cash reserve reduction, receipts from privatisation, revenues from the opening of the fully-funded pension pillar, and extraordinary dividends paid by state corporations) which do not improve Slovakia's net worth. **The debt is expected to decline under the influence of permanent government measures for the first time only in 2016 as a consequence of planned deficit reductions and the acceleration of economic growth.** Despite the fact that the one-off revenues in 2014 and 2015 contributed towards the debt reduction, the meeting of the objectives set out by the government in the consolidation macroeconomic scenario of the Ministry of Finance[3] **is not sufficient to bring the debt below the sanction thresholds by 2018** when it is expected to reach 49.2 % of GDP.

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[2] European Commission estimates the 2016 general government deficit at 2.4 % of GDP.

[3] According to the scenario in Annex 5 Draft budgetary plan for 2016 (currently available only in Slovak) the CBR has estimated the amount of debt subject to meeting the objectives and incorporating the consolidation measures into the macroeconomic forecast.

The balanced-budget rule requires the government to gradually follow the path set to meet the medium-term objective. The present estimates suggest that, **after fiscal relaxation in 2014 and 2015, the risk of the government diverging significantly from the adjustment path towards the medium-term objective is increasing and that the 2017 medium-term objective will not be met.** The failure to use the positive effects to accelerate consolidation also comes as a consequence of the absence of an effective tool for operational budget management. The expenditure ceilings, whose introduction is foreseen by the Fiscal Responsibility Act, represent one of such tools. However, the **expenditure ceilings, as an operational tool of fiscal policy, have not yet been introduced in Slovakia[4].**

The 2016-2018 budget proposal is prepared based on the latest estimates of development in 2015. Compared with the budgeted deficit of 2.49 % of GDP the government has indicated deterioration to 2.74 % of GDP. Many of the risks which the CBR pointed out at the end of the last year have materialised (local governments, healthcare sector and corrections to EU funds), while the deficit was reduced thanks to higher taxes and social security contributions, lower transfers to the EU budget and a zero spending from the reserve for the worse-than-expected macroeconomic development). **The present estimate for structural deficit (CBR methodology) stands at 2.8 % of GDP, which is 0.4 % of GDP worse compared with the approved budget.** In the CBR's view, the development of the 2015 deficit will be exposed also to other risks than those identified in the budget proposal, particularly when it comes to local governments, revenues from dividends and the sale of CO_2 allowances, higher corrections to EU funds and the expenditures incurred in connection with the preparation of the D4/R7 PPP project. In its evaluation of the Medium-term Budget Outline for 2016-2018 the CBR estimated the 2015 deficit at 2.6-3.0 % of GDP. **Most of the indentified risks are likely to materialise and, unless the government adopts additional measures by the year-end, the deficit may near 3 % of GDP.**

According to the government, compared with the expected result of the 2015 budget implementation, the 2016 deficit will drop by 0.8 % of GDP to 1.93 %. In order to achieve that reduction, the government would need to adopt measures worth 0.6 % of GDP, since the deficit would have decreased automatically by 0.3 % of GDP under the influence of the existing mechanisms (particularly due to lower co-financing under the given macroeconomic scenario). **The magnitude of the deficit-reducing measures represents 1 % of GDP, whereas the deficit-increasing measures reach 0.5 % of GDP.** Apart from minor changes in taxes, a considerable part of expenditure cuts (0.4 % of GDP) is to be achieved through lower capital expenditures in the state budget and in the budgets of Slovak Railways and the National Motorway Company. With the exception of Slovak Railways, the two remaining budgets are expected to slash expenditures on goods and services (0.3 % of GDP). **The budget itself does not explain these cuts**, thus there is a risk that the expenditures are underestimated or their reduction will have to be offset by increases in the years to come. Similarly as in 2013, 2014 and 2015, also the 2016 budget foresees lower healthcare expenditures (0.2 % of GDP); however, the reduction is not sufficiently explained. The government is also planning higher revenues from dividends (0.2 % of GDP). On the other hand, the measures having a negative impact on the budget – such as the reduction in the VAT base rate on selected foodstuffs, the government's "social packages" and the growth in public sector wages above the private sector level – are quantified in detail.

[4] The expenditure ceilings, introduced as part of the implementation of the balanced-budget rule do not meet the purpose intended by the Fiscal Responsibility Act, because they represent a temporary tool the binding effect and enforceability of which are questionable. Their drawbacks are described in detail in a report prepared by the CBR on the evaluation of compliance with fiscal responsibility rules and transparency rules for the year 2013, August 2014, p. 20, Box 3 (available only in Slovak).

Both Committees[5] have evaluated the macroeconomic assumptions and tax revenue forecasts as being realistic. The largely negative risks from the external environment may be offset by the positive effects of the Jaguar Land Rover investment, which is currently in the pipeline. **However, contrary to expectations, the 2017-2018 macroeconomic scenario does not contain consolidation measures** which could, depending on the type of the measures involved, slightly deflate economic growth and tax revenues. As a consequence, if the defined objectives are to be met, the government will have to adopt additional measures above and beyond those presented in the budget proposal (by 0.2 % of GDP in 2017 and 0.3 % of GDP in 2018).

Some of the risks identified for 2015 spill over to 2016. The revenue from SPP and VSE dividends, which the government expects at a level above the previous year's profit from ordinary activities, constitutes a recurring risk. Also, the budget proposal does not reflect a change in the methodology for the recording of revenues from the sale of CO_2 allowances, overestimating them by EUR 52 million. Likewise, it does not contemplate any corrections to EU funds which, given the fact that their drawing from the second programming period is coming to a close, may exceed the present estimate for 2015. The CBR has quantified the risk in the healthcare sector at EUR 150 million, since the budget proposal contemplates only a minor increase in expenditures compared to previous years, without specifying any new measures. The risk of higher expenditures in the local government sector reaches EUR 100 million and is slightly lower compared with the 2015 budget. In order to secure sufficient coverage of the cost incurred in the construction of the national football stadium, the expenditure presented in the budget proposal should be EUR 26 million higher. The other risks include the unclearly budgeted expenditures for the procurement of military equipment and lower expenditures on the decommissioning of nuclear facilities compared with the approved strategy. The completion of the 3rd and 4th unit at the Mochovce Nuclear Power Plant in 2017 and 2018 represents a risk above the framework identified for 2016. The budget proposal also contains information on financial performance of 'state corporations', yet a number of them generate losses. It is questionable whether these corporations can operate on market principles. If not, their potential bailouts will have an impact on the government debt and deficit. The consolidation strategy would be more credible if the risks presented in the budget proposal were better balanced. **At this point, negative risks prevail fairly significantly**.

So far, the only identified source for the 2016 risks coverage is the **potential reduction in expenditures on co-financing due to the lower uptake of EU funds**, however, this may be partly offset by the less favourable macroeconomic development attributable to the slower uptake of EU funds. In terms of supporting economic growth, the drawing of funds from the third programming period should begin as soon as possible. Unlike in the last year's budget proposal, the government has not created a reserve for the worse-than-expected economic development and non-attainment of the budgetary objective.

From the perspective of long-term sustainability, the planned structural balance improvement and debt reduction in 2016 represent a better starting position. If these objectives are met, the long-term sustainability of public finances will improve compared with 2015. On the other hand, this improvement would only compensate for the deterioration of long-term sustainability[6] in 2014 and 2015 and thus **bring public finances back to the 2013 level.**

The budget proposal meets the statutory requirements for transparency. A more detailed explanation of some of the items would make the budget proposal clearer. In comparison with the 2015-2017 budget, the CBR appreciates the inclusion of additional information on court proceedings initiated during the year, as well as the estimate of implicit liabilities connected with planned PPP projects. There has been some progress in the budgeting of extra-budgetary revenues and expenditures of local governments, which, however, represents only a smaller part of all non-

5 Macroeconomic Forecasting Committee and Tax Revenue Forecasting Committee.
6 Measured through a change in the long-term sustainability indicator.

budgeted transactions. Although the budget proposal does contain an analysis of the estimated 2015 deficit, more detailed information is necessary to get a complete picture of the actual situation in public finances. The CBR views as negative that the proposed three-year budget does not contain all the measures necessary to meet the objectives, and only partially explains the measures proposed. There has been no improvement as far as the risks relating to the financial performance of corporations owned by the state and the National Property Fund are concerned.

The CBR's opinion is based on the 2016-2018 General Government Budget Proposal approved by the government on 7 October 2015 and on the Draft Budgetary Plan for 2016 which the government approved on 14 October 2015. Should additional measures be adopted in the course of the parliamentary procedure, the CBR will update its opinion accordingly.