CBR
COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of the General Government Budget Proposal for 2017-2019

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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.

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

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Summary

The government has presented the General government budget proposal for 2017-2019 aiming at achieving a medium-term budgetary objective by 2019. 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 negative impacts of demographic development. The government estimates the 2016 general government deficit at 1.97% of GDP, approximately at the level of the budgetary objective (a deficit of 1.93% of GDP). A gradual improvement in balance is expected in the subsequent years, with the balance reaching a surplus at a level of 0.2% of GDP in 2019, which according to the government estimates would lead to the meeting of the medium-term budgetary objective in 2018. In line with its budgetary objectives, the government also expects a reduction in the gross debt from 53.5% of GDP estimated for 2016 to the level of 49.1% of GDP by 2019.

In April 2016, the newly formed government decided to postpone the meeting of the medium-term objective from 2017 to 2019, failing thus to take advantage of positive effects, including a favourable economic development, to accelerate consolidation efforts and bring the gross debt below the sanction thresholds; the CBR views this as negative, in particular with respect to the purposes of the constitutional Fiscal Responsibility Act. The CBR appreciates that the budget proposal specifies a majority of measures included in the budget and that the fiscal framework for 2018 and 2019 is based on more realistic assumptions compared with the previous practice. Though the CBR has identified certain risks and concluded that additional measures need to be adopted to meet the budgetary objectives, meeting the medium-term objective of a structurally balanced budget in 2019 can be considered realistic. With the deadline for meeting the medium-term objective postponed, backed by a favourable economic development which will contribute the most to deficit reduction, room has been created for improving the deficit without the necessity to adopt any major consolidation measures. As estimated by both the budget proposal and the CBR, the gross debt should remain within the first sanction threshold by the end of 2019. Even though meeting the medium-term budgetary objective in 2019 is realistic, it would be desirable for the government to take further measures designed to bring the debt below the sanction thresholds and take advantage of potential unexpected positive effects to speed up consolidation.

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 compliance with the national fiscal rules. With this objective in mind, the CBR points at the following potential risks and positive aspects of the budget proposal:

- **The government failed to use the unexpected positive effects in the amount of 0.8% of GDP to speed up consolidation or eliminate all identified risks in 2016.** Many of the risks which the CBR warned of at the end of the previous year have materialised (local governments, healthcare sector and corrections to EU funds), while the deficit was reduced thanks to additional positive effects in the form of higher taxes and unspent reserves. According to the CBR, additional risks for the development of the 2016 deficit exist beyond the estimate included in the budget proposal, especially with respect

to revenues from dividends and emission allowances, expenditures in the state budget and healthcare spending. In its assessment of medium-term budgetary objectives for 2016-2019 (Stability Programme of April 2016), the CBR estimated the 2016 deficit at a level of 2.5% of GDP. **It seems that most of the identified risks are likely to materialise and, unless the government adopts additional measures by the year-end, the deficit may in an extreme case near 2.5% of GDP even under the CBR's current estimate.**

- **In the 2017-2019 budget proposal, negative risks outweigh the positive ones.** The CBR identified overestimated non-tax revenues (repeatedly, higher dividends and revenues from the sale of emission allowances are insufficiently explained) and a lower rate of growth in healthcare and local government spending, not backed by specifically explained cost-reduction measures. In healthcare, the measures are identified based on the Value for Money project, but in line with the plans presented by the government any potential savings will be used for additional spending in the healthcare sector, which will not result in a lower growth in overall healthcare expenditures. In addition, the budgeted wage expenditures do not include a wage increase in state administration and a further raise in wages in the educational sector envisaged for 2018 and 2019 in line with the Government Manifesto that may be covered from created reserves. The size of corrections to EU funds is also a source of uncertainty. Unclearly budgeted expenditures on the purchase of military equipment may also pose a budgetary risk. The budget proposal also contains information on financial performance of state-owned corporations, yet a number of them permanently generate losses. It is questionable whether these corporations can operate on market principles; if not, their bailouts will have an impact on the government debt and deficit. On the other hand, the budget proposal contains a large volume of reserves. Some of them are directly intended to cover particular risks, while others are not specified in more detail. Savings may also be expected on national co-financing to EU funds[1] and on social benefit payments. In order to meet the 2017 objective, the government will have to take additional measures and/or eliminate all identified risks to the maximum extent possible. If the government takes no new measures, all identified risks materialise and all potential sources of their coverage are used, the **general government deficit could reach 1.6% of GDP[2] in 2017 and the gross debt would amount to 52.8% of GDP[3] by the year-end.**
- **The CBR appreciates that the budget proposal for 2018 and 2019 is based on more realistic assumptions compared with the previous practice.** An overall risk for budget balance is within the range of 0.2 to 0.4% of GDP. If no significant deviation occurs in the excepted macroeconomic development, the CBR estimates that the medium-term objective of having a structurally balanced budget may be achieved without any further

[1] In contrast to the budget proposal, the CBR estimates a slower drawdown of EU funds, slightly below the level assumed in the MFC macroeconomic forecast of September 2016 (approximately by 6% a year). At this level, savings in expenditures on national co-financing would occur, while tax revenues under the budget proposal would also be lower. The risk of shortfall in tax revenues is offset by their better-than-expected collection in 2016.

[2] The European Commission estimates the 2017 general government deficit at 1.5% of GDP.

[3] Similarly to the European Commission, the CBR does not consider additional measures; therefore, the estimate is a conservative one.

measures in 2019, a year later than as currently estimated[4] by the government. Achieving this objective could be impaired by the fact that 2019 is a pre-election year, a period when governments tend to increase deficits.

- **Having postponed the deadline for meeting the medium-term objective, the government has created a margin to improve the deficit without the necessity to adopt any major consolidation measures.** The policy setup in 2016 and a favourable macroeconomic development are considerably contributing to deficit reduction and to achieving the medium-term objective. If the government did not adopt any new measures after 2016, the CBR estimates that the deficit would decrease to 2.1% of GDP by 2019, that is, only 0.1% of GDP below the set medium-term budgetary objective. The CBR estimates the contribution of government measures to an improved balance in the amount of 0.3% of GDP for all three years taken together. Compared to the CBR's estimate, the government envisages an even greater contribution of the no-policy change scenario to the improvement in budget balance. Under this scenario, the medium-term budgetary objective would be achieved as early as 2017, a year earlier than as envisaged in the budget proposal.
- **So far, no sufficient measures to steer the debt outside the sanction thresholds defined in the Fiscal Responsibility Act have been presented.** Fiscal policy should regain sufficient margins for manoeuvre mainly in good times when the economy generates higher tax revenue and spends less. The government did not take advantage of several positive effects to step up consolidation; to the contrary, the reduction in the gross-debt-to-GDP ratio was largely driven by one-off government measures in 2014 and 2015 (reduction in cash reserve, revenues from privatisation, revenues from the opening of the fully-funded pillar of the pension system and/or extraordinary dividend payments from state corporations) which do not improve the net worth of the Slovak Republic. The gross debt for 2016 is expected to grow mainly due to a budget deficit[5]. The debt is expected to decline under the influence of permanent government measures for the first time only in 2017 as a consequence of the planned improvement in structural deficit and the acceleration of economic growth.
- **The binding nature of the medium-term budgetary framework is weak,** which allowed to change the budgetary objectives in the past and deficits were revised upwards in each update of the three-year budget. Moreover, the 2014 and 2015 deficits were, and a risk exists that the 2016 deficit will be, higher than planned in the approved budgets. The budgetary objective set for 2017 was gradually revised upwards, from a deficit of 0.5% (Stability Programme for 2014-2017) to 1.3% of GDP (General Government Budget Proposal for 2017-2019), while tax revenues grew by 3.4% of GDP[6] over the same period. A failure to capitalise on this positive development in order to reduce the deficit and debt at a higher pace has resulted in postponing the reduction of debt below the sanction thresholds.

[4] Box 4 on page 19 in the Draft Budgetary Plan for 2017 states: "Compared to the Stability Programme, the cyclical component has been updated, creating room for an earlier accomplishment of MTO in 2018 while nominal targets remain unchanged."

[5] The overall year-on-year increase in gross debt estimated at 1 p.p. in 2016 consists of the contribution of the general government balance exclusive of one-off effects in the amount of 0.7 p.p., while the remaining 0.3 p.p. is attributable to one-off effects (a year-on-year increase in the cash reserves, partially offset by extraordinary dividend payouts).

[6] The higher tax revenues may partly result from a growth in expenditures in excess of the original assumptions presented in the 2014-2017 Stability Programme.

According to the CBR, the introduction of expenditure ceilings, as contemplated by the Fiscal Responsibility Act, could significantly facilitate consolidation in good times.

- If the risks identified by the CBR materialised, the **long-term sustainability** would deteriorate in 2016 when compared against 2015. The planned structural balance improvement and debt reduction in 2017 represent a better starting position. If these objectives are met, the long-term sustainability of public finances will improve in comparison to 2016.

- **The budget proposal basically meets the statutory requirements for transparency.** Data on the planned economic results covering all healthcare facilities with capital participation of the Ministry of Health of the Slovak Republic, necessary to assess risks stemming from economic performance of corporations directly owned by the state, or through MH Manažment, a.s., are missing. In some cases, the presented data are merely formal, without a clear link with the actual budget proposal (MH Invest). The incorporation of assumptions on the amount of unbudgeted revenues and expenditures in the case of local governments and the state budget needs to be appreciated. However, the unbudgeted revenues and expenditures of public tertiary schools still remain a problem[7]. The CBR appreciates that the government creates reserves for unexpected and/or emergency situations, being thus able to eliminate potential negative effects on the budgetary performance. On the other hand, the large volume of reserves impairs the parliamentary oversight over budget expenditures, especially if not specified in sufficient detail. At the same time, there are no transparent rules set on how and for what kind of expenditures these reserves can be used.
- Macroeconomic and tax revenue forecasts were approved by competent independent committees. **In order to reinforce transparency, it would be beneficial if the Tax Revenue Forecasting Committee assessed all the revenues that are considered taxes under the ESA2010 methodology.** This has become all the more important in light of the fact that the previously unbudgeted social contributions to special schemes of the armed forces and police corps are now included in the budget proposal.
- **For the first time ever, the budget proposal contains the results of the Value for Money (VfM) project.** Several measures were identified in the healthcare sector and their contribution was specifically quantified. It is a major improvement in the quality of information in this area compared to the previous practice. Stronger links between the budget and results obtained from the VfM project in other areas would considerably increase the transparency of adopted measures and improve the quality of discussion on government's priorities.

The CBR's opinion is based on the 2017-2019 General Government Budget Proposal approved by the government on 5 October 2016 and on the Draft Budgetary Plan for 2017 which the government approved on 12 October 2016. The opinion also contains information on legislative changes that were adopted or announced after a September meeting of the Tax Revenue Forecasting Committee whose effects, however, are not reflected in the identified risks. The CBR will update its evaluation once the budget is approved by the parliament.

7 The current estimate of fiscal performance of public tertiary schools for 2016 takes into account unbudgeted revenues and expenditures.

1 Government's budgetary objectives for 2016-2019

The General government budget proposal for 2017-2019 approved by the government and the Draft Budgetary Plan for 2017 prepared on its basis confirm the government's plans presented in the Stability Programme of April 2016. The following chapter contains a summary of the basic objectives under the budget proposal in terms of general government balance and debt, and measures designed to achieve them.

1.1 General government balance and gross debt

The objectives declared by the government are based on the latest estimate of the 2016 general government deficit at 1.97 % of GDP[8]. The deficit is expected to gradually decline in subsequent year, with the **medium-term budgetary objective** (structural deficit below 0.5 % of GDP[9]) **to be achieved in 2018[10], according to the most recent calculations of the finance ministry**.

Tab 1: GG balance and gross debt objectives (ESA2010, % GDP)

	2015	2016E	2017P	2018P	2019P
1. GG balance (GGB 2016-2018)	-2.49	-1.93	-0.42	0.00	
2. GG balance (SP 2016-2019)	-2.97	-2.13	-1.29	-0.44	0.16
3. GG balance (GGBP 2017-2019)	**-2.73**	**-1.97**	**-1.29**	**-0.44**	**0.16**
4. change in objective (GG balance) compared to GGB 2016-2018 (1-3)	*0.24*	*0.04*	*0.87*	*0.44*	
5. change in objective (GG balance) compared to SP (2-3)	*-0.24*	*-0.16*	*0.00*	*0.00*	*0.00*
1. GG gross debt (GGB 2016-2018)	52.8	52.1	51.3	48.9	
2. GG gross debt (SP 2016-2019)	52.9	52.9	52.2	49.8	47.3
3. GG gross debt (GGBP 2017-2019)	**52.9**	**53.5**	**52.7**	**51.4**	**49.1**
4. change in debt forecast compared to GGB 2016-2018 (1-3)	*-0.1*	*-1.4*	*-1.4*	*-2.5*	
5. change in debt forecast compared to SP (2-3)	*0.0*	*-0.6*	*-0.6*	*-1.6*	*-1.8*

p.m.1: According to Eurostat notification released on 21 October, 2016 the GG deficit reached 2.71 % GDP and GG debt 52.5 % GDP in 2015. *Source: MF SR*

p.m.2: SP – Stability Programme, GGB – General government budget, GGBP – General government budget proposal, E – estimate, P - budgeted value (in GGBP).

The objectives are based on the rules of the preventive arm of the Stability and Growth Pact (SGP) and the common EU methodology for structural balance calculation. Compared to the approved 2016-2018 General government budget, the **targets are less ambitious**. The deficit is expected to reach 1.3 % of GDP in 2017 and 0.4 % of GDP in 2018, corresponding to a loosening

8 The meeting of the deficit target (1.93 % of GDP) requires an additional improvement by 0.04 % of GDP (approx. EUR 32.2 million), but the General Government Budget Proposal for 2017-2019 does not specify in more detail the measures through which this will be achieved.

9 The meeting of this target, apart from compliance with the rule of the preventive arm of the Stability and Growth Pact, would also mean achieving 'balanced budget' defined in the national legislation (implementation of the so-called Fiscal Compact) even under a different methodology for estimating the cyclical component and one-off effects.

10 With the unchanged nominal target of 0.16 % of GDP due to the update of the cyclical component.

of the original objective by 0.9 and 0.4 % of GDP, respectively. The government plans to have a budget surplus of 0.2 % of GDP in 2019.

Having relaxed its fiscal targets[11], the government postponed the deadline for meeting the **medium-term budgetary objective by two years, i.e., to 2019** (the original deadline was set for 2017)**.** Based on an update on the cyclical component, the medium-term budgetary objective could be achieved as early as in 2018, according to the finance ministry's calculations (Table 2). According to the European Commission[12], the revised fiscal targets would in general be in line with the EU fiscal rules.

Tab 2: Structural balance according to MF SR (ESA2010, % GDP)

	2015	2016E	2017P	2018P	2019P
1. General government balance	-2.73	-1.97	-1.29	-0.44	0.16
2. Cyclical component (MF SR)	-0.48	-0.34	-0.34	-0.08	0.37
3. One-off measures (MF SR)	-0.35	0.09	0.00	0.00	0.00
4. Structural balance (1-2-3)	**-1.89**	**-1.72**	**-0.95**	**-0.36**	**-0.21**
Change in structural balance (Δ4)	**0.15**	**0.17**	**0.77**	**0.59**	**0.16**
*p.m. fiscal effort required according to EC**	0.0	0.25	0.5	0.5	

** According to Council recommendation of May 18, 2016 required fiscal effort should reach 0.25 % GDP in 2016 and 0.5 % GDP in 2017. In 2018 according the EC fiscal adjustment matrix the fiscal effort should reach 0.5 % GDP.*

Source: MF SR

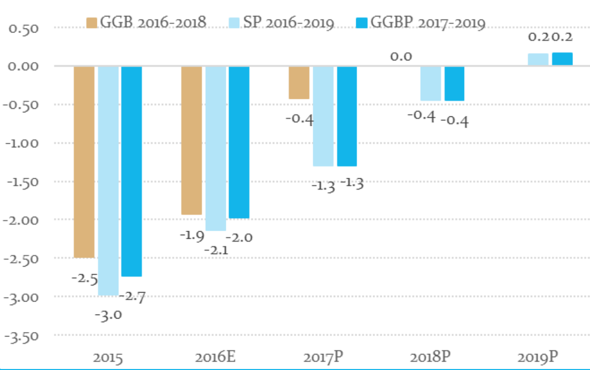
The accomplishment of the budgetary objectives set would lead to a gradual decline in the gross debt from the 2015 level of 52.9 % of GDP[13] to 49.1 % of GDP in 2019. In the medium term, the debt should therefore decrease by 3.8 p.p. The fiscal framework does not contemplate any windfall revenues. Compared to the approved 2016-2018 budget, a moderate increase in the debt forecast would occur (Figure 2), attributable to a raise in the level of cash reserve in 2016 in particular, and, partially, also to the relaxed budgetary objectives set for 2017 and 2018. If the cash reserve stayed in 2016-2019 at the level assumed in the approved 2016-2018 budget, the gross debt forecast under the budget proposal would be by 1.6 percentage points lower at the end of 2019.

[11] The Manifesto of the Government of the Slovak Republic for 2016-2020 (available only in Slovak) of April 2016 under which the government pledged to achieve a balanced general government budget by 2020.

[12] According to the Council recommendation of 18 May 2016, a risk of deviation from the MTO adjustment path exists in 2016. In the following year, the structural balance should improve in accordance with Commission recommendations: The Commission: "Based on its assessment of the Stability Programme and taking into account the Commission 2016 spring forecast, the Council is of the opinion that Slovakia is expected to broadly comply with the provisions of the Stability and Growth Pact." The Commission will update its assessment in November 2016 based on the presented Draft Budgetary Plan for 2017.

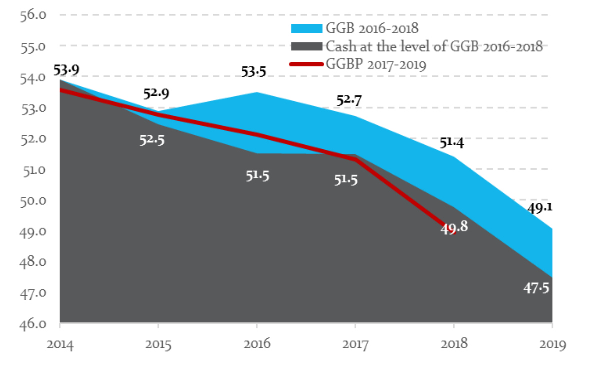
[13] The General government budget proposal for 2017-2019 did not contain the revised data on the gross-debt-to-GDP ratio at the end of 2015 which, according to a Eurostat notification published on 21 October 2016, stood at 52.5 % of GDP.

Figure 1: Government objectives comparison - GG balance (% GDP)



Source: MF SR

Figure 2: Change in gross debt forecast (% GDP)

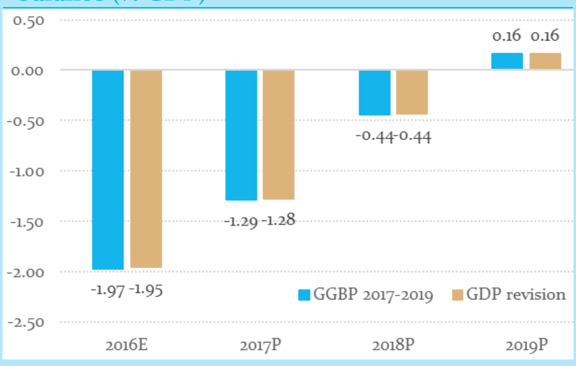


Source: MF SR, CBR

Box 1: Government's objectives after incorporation of revised nominal GDP[14]

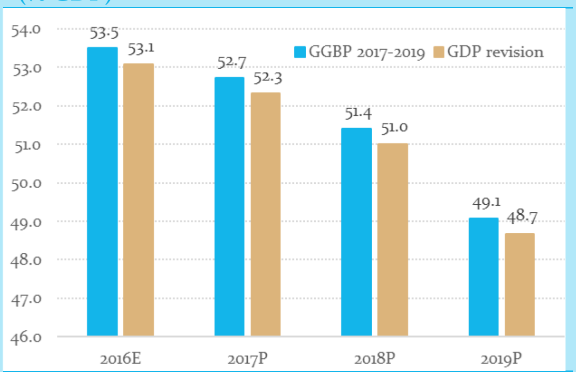
The regular revision of national accounts performed by the Statistical Office of the Slovak Republic resulted in an increase in the nominal level of GDP for the previous years. The revision has not been incorporated in the official macroeconomic forecasts used in the preparation of the budget proposal. Due this, the general government deficit would decrease by 0.02 % GDP in 2016 and 0.01 % GDP in 2017. The revision should have no significant impact of the general government balance set in subsequent years. In light of the GDP revision, the general government gross debt forecast could decrease by 0.4 p.p. every year, bringing the gross-debt-to-GDP ratio to 48.7 % of GDP by the end of 2019. **The revised GDP published by the Statistical Office of the Slovak Republic therefore represents a positive risk for the future development of public finances.**

Figure 3: Impact of GDP revision on the GG balance (% GDP)



Source: MF SR, SO SR

Figure 4: Impact of GDP revision on gross debt (% GDP)



Source: MF SR, SO SR

[14] The calculations are based on the revised GDP data published in the Draft Budgetary Plan of the Slovak Republic for 2017, Box 6.

1.2 Measures to meet the budgetary objective

The Ministry Finance´s no-policy change scenario is based on a general government deficit estimate of 1.97 % of GDP in 2016. Assuming that no new measures are taken after 2016, that public finances develop in line with existing legislation and that the budget items are determined solely by macroeconomic development, **the general government deficit could decline to 0.3 % of GDP in 2017, while an almost balanced budget could be reached in 2018. A surplus at a level of 0.6 % of GDP could be achieved in 2019**.

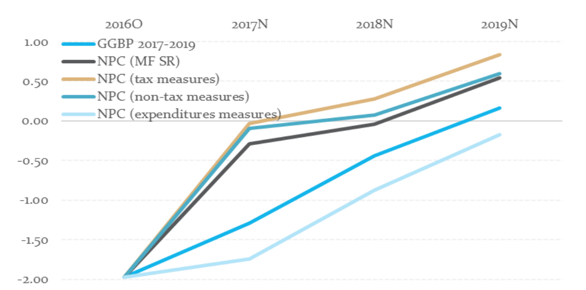
Tab 3: Measures required to achieve budgetary objectives (ESA2010, % GDP)

	2016E	2017P	2018P	2019P
1. GGBP 2017-2019	**-1.97**	**-1.29**	**-0.44**	**0.16**
2. Fiscal framework according to NPC (MF SR)	-1.97	-0.29	-0.04	0.55
3. Measures required to achieve objectives (1-2)	-	**-1.00**	**-0.40**	**-0.39**
(measures required to achieve objectives in mil. eur)	-	*-839*	*-355*	*-364*
y-o-y (3)	-	-1.0	0.6	0.0

Source: MF SR

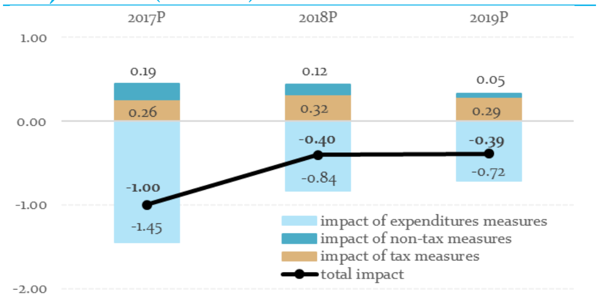
The budget proposal contains measures that worsen the balance compared to the NPC scenario, pushing the general government deficit up by **1 % of GDP in 2017 and 0.4 % of GDP in subsequent years.** Provided that permanent measures are adopted in 2017, **consolidation efforts amounting to 0.6 % of GDP would be necessary to meet the objectives subsequent years.**

Figure 5: GG budgetary objectives comparison to NPC scenario (% GDP)



Source: MF SR

Figure 6: Measures to achieve budgetary objectives (% GDP)



Source: MF SR,

Revenue measures primarily include changes in the legislation on taxes and health insurance, with their positive effect quantified at the level of 0.2 % of GDP in each year. A raise in revenues from the obligatory fee for the management of emergency oil and oil product stocks[15] will increase the revenues of the Emergency Oil Stocks Agency nearly by 0.1 % of GDP over the 2017-2019 period. **Tax measures included in the budget proposal will improve the general government balance by 0.3 % of GDP a year on average.**

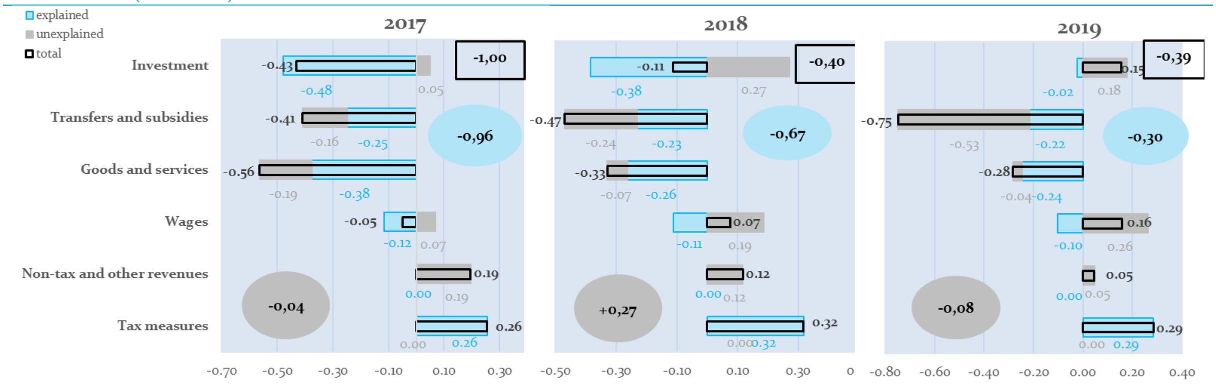
[15] Tax revenue under ESA2010.

Non-tax revenues are expected to grow by **0.2 % of GDP in 2017 and 0.1 % of GDP thereafter,** yet the relevant measures are not further explained.

Expenditure measures will affect compensations of employees (wages for teachers and pedagogical employees in regional and tertiary schools increased from 1 September 2016). Higher subsidies are also planned for farmers and, albeit in a lesser extent, in the transport sector, as well. Current transfers include pension indexation of 2 % in 2017, as well as higher benefits paid to persons with severe disability. Capital investments on replacement of car fleets of public transport companies from own funds, as well as reconstruction of the Slovak National Gallery and construction of a national football stadium have been announced; higher expenditures also contemplated for the defence sector. Reserves have been created in the budget proposal to cover possible accelerated spending on EU-funded projects and potential corrections, developments in 2017, solution of emergency situations and major investments. **Expenditure measures increase the general government deficit by 1.45 % of GDP in 2017, by 0.84 % of GDP in 2018, and by 0.72 % of GDP in 2019.**

The following figure shows the planned measures to meet the budgetary objectives. Revenue and expenditure measures are distinguished by the level of detail they are described with. The budget proposal contains explanations for a majority of measures (data shown in blue colour). The revenue side lacks descriptions of measures which would lead to higher non-tax revenues. Also, savings within compensations and cuts in investments are not explained. Higher, non-specified expenditures are to be spent on intermediate consumption and current transfers.

Figure 7: Measures to achieve budgetary objectives - comparison of GGBP 2017-2019 to NPC scenario (% GDP)



Source: MF SR, CBR

2 Evaluation of the likelihood of meeting the budgetary objectives in 2016 to 2018

In this chapter, the CBR assesses the credibility of the presented objectives by identifying concrete risks in the budget and possible sources for their coverage. As the first step, the CBR assesses how realistic the macroeconomic and tax forecasts, based on which the overall fiscal framework is formulated, are. Next, an update is made with respect to the estimate of budget development in 2016 which serves as a baseline year for the preparation of the budget proposal. Any slippages from the government's expectations may be carried over to the following years, likely creating additional risks in the medium term. The risks and potential sources for their coverage for 2017-2019 are identified by analysing the government's measures based on a comparison between the budget proposal and the no-policy change scenario.

2.1 Macroeconomic assumptions

The budget proposal is built on assumptions concerning the domestic and foreign development discussed and consensually adopted by the Macroeconomic Forecasting Committee (MFC) in September 2016[16]. Given the fact that a macroeconomic forecast depends on the existing fiscal policy setup, the evaluation of budgetary risks considers alternative scenarios of macroeconomic forecast assuming no change in the fiscal policy since the baseline year and a scenario following the implementation of fiscal measures.

The most recent MFC forecast estimates the Slovak economy to grow at 3.6% in 2016, up by 0.5 percentage points against the last year's expectations (Table 4). The forecasts prepared by domestic and international institutions reflect a gradual year-on-year deceleration in growth of foreign partners, which takes into account the negative effects of Brexit. A stable consumer demand amidst a better-than-expected development on the labour market and an increase in automotive sector production capacities are a positive impulse for domestic economy.

Tab 4: Forecast of the MFC and international institutions

GDP real growth in %	Actual*	Forecast				Change from previous year			
Institution	2015	2016	2017	2018	2019	2016	2017	2018	2019
MFC (September 2016 vs. 2015)	3.8	3.6	3.5	3.9	4.4	+0.5	-0.1	+0.3	-
IMF (October 2016 vs. 2015)	3.8	3.4	3.3	3.7	3.8	-0.2	-0.3	+0.4	+0.7
EC (November 2016 vs. 2015)	3.8	3.4	3.2	3.8	-	+0.5	-0.1	-	-
OECD (June 2016 vs. 2015)	3.8	3.1	3.2	-	-	-0.3	-0.3	-	-

** Revised figures (SO SR - October 2016)* *Source: MF SR, IMF, OECD, EC, CBR*

Risks in the development of external and internal environment

The external assumptions of the MFC forecast reflect negative effects of the Brexit, taking into account the fact that UK along with Germany has been since 2010 the largest contributor to the EU's growth (Figure 8). However, these effects are currently limited to deterioration of

[16] The forecast prepared by the Ministry of Finance has been evaluated as realistic by all the members of the Macroeconomic Forecasting Committee (NBS, ČSOB, Infostat, SLSP, Tatrabanka, Unicredit, VÚB, Sberbank and SAV).

expectations about the future growth of Slovak trading partners. Nevertheless, a growth in global trade is expected to resume in 2017, although the balance of risks stemming from the German economic indicators does not show a clear trend (Figure 9). In contrast with the anticipated tightening of the US monetary policy, the positive effects of the quantitative easing have so far did not show in the euro area, but some can be expected in exports if euro will continue to weaken against the US dollar. The stability of Europe's banking sector also represents a risk; several banking institutions have no sufficient capital reserves in place to serve as a buffer in case of possible shocks, while the loss of confidence in some financial institutions may ultimately result in lower liquidity of the entire banking sector.

Figure 8: Contributions to EU growth since 2010 in p.p.

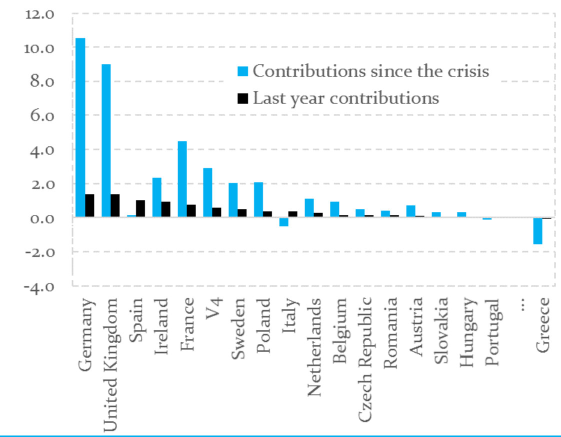
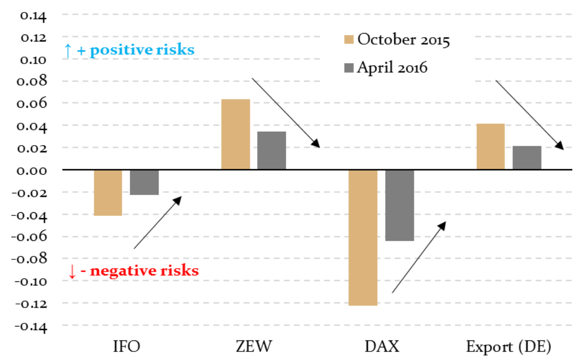


Figure 9: Changes in risk during the year*



** Change in the skewness coefficient of the time series distribution since 1993.*

Source: IFO, ZEW, BF, Destatis, CBR calculations

In the internal environment, the budget proposal reflects a year-on-year decline in EU funding, offset by private investments (Volkswagen) in 2016, while sizeable contributions from investments under the Jaguar Land Rover (JLR) project and construction of D4/D7 motorway can be expected from 2017 onwards. Exports will continue to considerably contribute to the economic growth throughout the entire forecast period; the balanced growth structure will be driven by stable contributions from domestic demand backed by a positive development on the labour market and consumer spending.

- Postponed Brexit and effects of the ongoing quantitative easing on the private sector constitute a positive risk for internal development.
- The risk for domestic economic growth lies in the uncertainty surrounding the planned fiscal measures and those actually implemented. The budget proposal expects slightly different dynamics in general government expenditures than as presented in the approved MFC forecast. Depending on the expenditure dynamics under the Ministry of Finance's no-policy change scenario and under a scenario with fiscal measures[17], the greatest risk lies in the effect of the measures on GDP in 2017, indicating GDP growth within the 2.8-3.2% interval (Table 5, Figure 10). The CBR's baseline fiscal scenario

[17] On top of said risks contained in the budget proposal, a negative impact on the achievement of budgetary objectives may be expected from measures that were not specified in the budget proposal (0.5% of GDP in 2018).

reflects the measures approved in the budget, however, the CBR considers the expenditure side underestimated in comparison to figures contained in the budget, with the GDP growth oscillating around the level of the MFC forecast from September 2016 (Figure 11). In particular, the fiscal scenario of the MFC shows a faster development in compensations in the general government sector with a positive effect on a growth in average wages and household consumption but with a negative impact on the deficit and debt, on the other hand. On the contrary, the CBR expects the growth in 2018 to be 0.2 p.p. slower than as assumed in the budget and by the MFC.

- In view of the more prominent changes in the GDP structure stemming from the revision published by the Slovak Statistical Office after the macroeconomic forecast was updated, its effect on the dynamics in 2016 and, subsequently, on the forecast has become an objective risk. Based on the historical effects of the revisions, no prominent risk for the forecast is expected. A change in the GDP dynamics may reach ±0.2 percentage points in 2016 (with 60% probability). The impact of the National Accounts revision (a raise in GDP level) was incorporated in all macroeconomic scenarios prepared by the CBR, assuming a zero effect on the change in the dynamics of variables against the original forecasts (Box 2).

Tab 5: GDP growth forecast and fiscal scenarios (in %)

	2015*	2016	2017	2018	2019
Forecast of the MFC	3.8	3.6	3.5	3.9	4.4
No-policy scenario of the GGBP	3.8	3.6	2.8	4.2	5.0
Policy scenario of the GGBP	3.8	3.6	3.2	3.9	4.6
No-policy scenario of the CBR	3.8	3.6	3.8	4.0	4.7
Policy scenario of the CBR	3.8	3.6	3.6	3.7	4.5

** Revised figures*

Source: MF SR, CBR

Figure 10: Fiscal scenarios of the GGBP and the impact on GDP growth in %

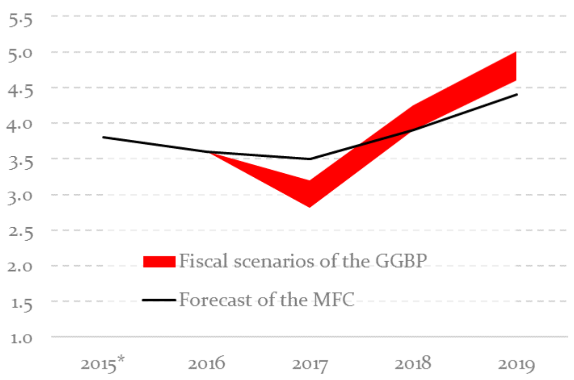
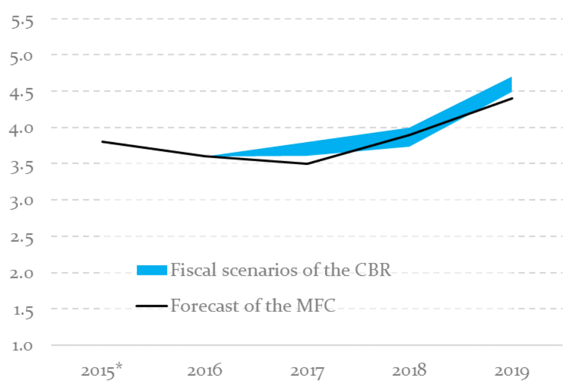


Figure 11: Fiscal scenarios of the CBR and the impact on GDP growth in %



Source: MF SR, CBR calculations

Box 2: National Accounts revision and forecast-related risks

Macroeconomic variables represent an estimate of actual developments. Therefore, they are permanently subject to revisions over time as new information is obtained and changes in methodology are adopted. These processes are standard and can be considered an objective risk for macroeconomic forecasts.

During the work on the General Government Budget Proposal for 2017-2019, the components of GDP were subject to revisions, either due to the reclassification of certain entities into the general government sector (different ways of accounting), updates to input data and/or regular revisions. This revision, however, could not be reflected in MFC forecasts for 2016-2019 at the time when the budget was compiled due to objective reasons. The new, revised data thus constitute an objective risk, mainly due to the magnitude of actual changes, for the development of macroeconomic variables on which the budget proposal is based.

According to the Statistical Office data, the new, revised structure of GDP was primarily affected by the change in the GDP level caused by the reclassification of general government institutions since 2015 (Figure 12). After the revision, GDP grew 0.2 p.p. faster in 2015 than originally presented, with the GDP level increasing by 0.7% in the forecasting period (Table 6).

Tab 6: GDP revision and the forecast of MFC

	2012	2013	2014	2015	2016	2017	2018	2019
Revised nominal GDP + MFC forecast (bill. euro)	72.7	74.2	75.9	78.7	*81.2*	*84.7*	*89.2*	*95.0*
Nom. GDP before revision + MFC forecast (bill. euro)	72.4	73.8	75.6	78.1	*80.5*	*84.0*	*88.5*	*94.2*
difference in p.p.	+ 0.3	+ 0.3	+ 0.4	+ 0.6	+ 0.6	+ 0.7	+ 0.7	+ 0.7
Revised real GDP growth + MFC forecast (%)	1.7	1.5	2.6	3.8	*3.6*	*3.5*	*3.9*	*4.4*
difference in p.p.	+ 0.1	+ 0.1	+ 0.0	+ 0.2	-	-	-	-

Source: MF SR, SO SR, CBR

Following an objective assessment of the GDP revision in terms of historical deviations in year-on-year growths from the most recent data (OECD database), the risk of future changes can be quantified at a level of their probability. With 80% probability, the future changes in the GDP growth caused by the revisions will move within the interval of ± 0.5 p.p. (Figure 13). Considering the past revisions of GDP growth for two consecutive years only, the 2016 GDP growth may be, with 80% probability, within the interval of ± 0.2 p.p. compared to the original assumptions (this effect is illustrated on the GDP growth currently projected by the MFC at a level of 3.6%).

Figure 12: Change in the composition of GDP after revisions by the SO SR (current prices)

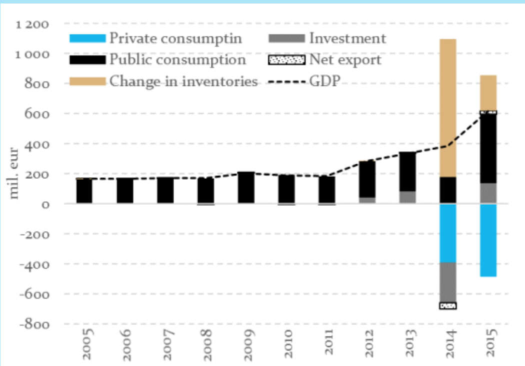
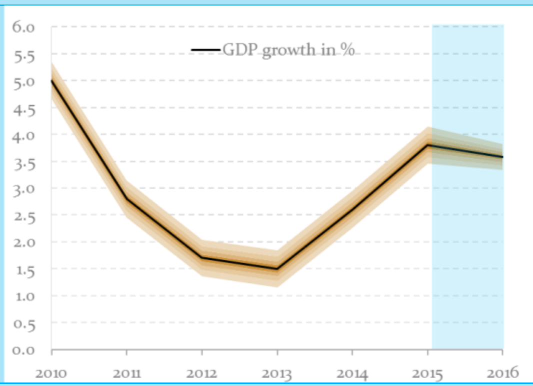


Figure 13: GDP revisions - past v. forecast



Source: SO SR, OECD, CBR calculations

Objective evaluation of the forecast risks

A great deal of uncertainty surrounds the macroeconomic forecast which serves as the basis for the preparation of budgetary revenues and expenditures. In its last year's evaluation of the budget, the CBR identified more prominent systemic forecast deviations in the general government consumption component which depends on the setup of the current fiscal targets and the structure of expenditures. Therefore, the evaluation also contains an alternative macroeconomic scenario without changes in policies, as well as fiscal scenario incorporating assumptions for the achievement of fiscal objectives.

On top of summarising the current risks in the development of both internal and external economic environment and identifying systemic deviations, the CBR also monitors potential objective deviations of the MFC forecasts from actual values. In addition to the revision-related uncertainty (Box 2), these may also be attributed to the uncertainty of incorporating the most recent information on internal and/or external economic development, or on unexpected shocks from various sources.

Slovakia as a small, open economy, is largely influenced by external developments. If we assess the effect of unexpected external developments on the domestic forecasts, a strong correlation is proved between the errors in foreign institutions' forecasts of the euro area growth and the forecast error of Slovakia's GDP growth (Figure 14). An unexpected change in the euro area's growth around 1 percentage point is, on average, reflected more than proportionally in the forecast error of the Slovak GDP.

If we apply the objective risk of the MFC forecast error concerning the growth of domestic economy (based on an average deviation of MFC forecasts from actual values over the 2009-2015 period) onto the current forecasting period, the GDP will grow, with 60% probability, between 3.2 and 3.9% in 2016, with the forecast uncertainty raising in the subsequent years (Figure 15).

Figure 14: Unexpected development in foreign environment and the impact on the forecast error of the MFC

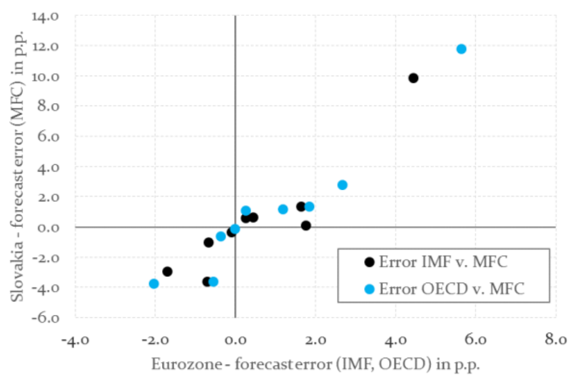
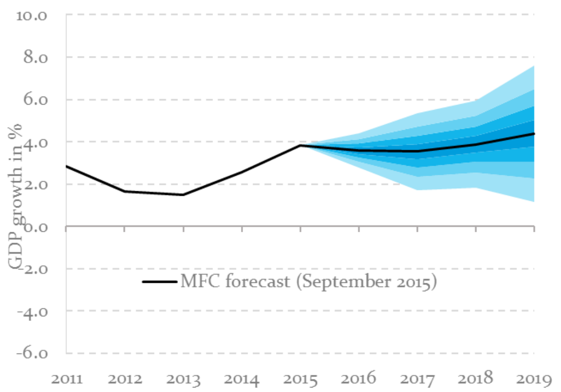


Figure 15: GDP forecast by the MFC and the risk based on the past forecast errors



Source: IMF, OECD, MF SR, CBR calculations

2.2 Forecast of revenues from taxes and social contributions

The forecasts of revenues from taxes and social security contributions ("tax revenue forecasts") were assessed and approved by the Tax Revenue Forecasting Committee (TRFC) in September

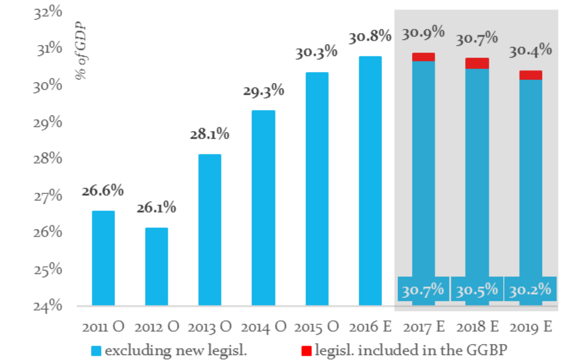
2016. The Secretariat of the Council for Budget Responsibility, as a regular TRFC member, assessed the tax revenue forecast as realistic[18], based on the common macroeconomic forecasts by the Macroeconomic Forecasting Committee. All legislative changes contained in the budget proposal were included in the forecast discussed by the committee.

The budget proposal does not contain some legislative measures that were approved by the parliament after the TRFC's September meeting and/or those measures that are expected to be approved by the end of the year. Fiscal implications of these measures should be discussed at an extraordinary TRFC meeting and will subsequently be included in tax revenue forecasts contained in the budget[19].

Legislative changes on taxes included in the budget proposal

The tax revenue forecast contains several new legislative measures which increase **the general government tax revenues by EUR 166-215 million over the 2017-2019 period (0.2% of GDP).**

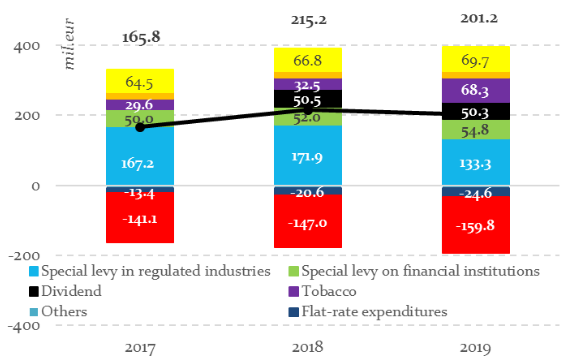
Figure 16: Tax revenues with the impact of new legislation (ESA2010, % of GDP)



Note: O – outcome, E – CBR estimate

Source: SO SR, MF SR, CBR

Figure 17: Impact of legislative changes incorporated within the budget (ESA2010, mil. eur)



**EOSA – Emergency Oil Stocks Agency*

Source: CBR MF SR

1. Changes in the **income tax** legislation primarily affect legal persons and natural persons-entrepreneurs.

   a. **The corporate income tax rate is lowered from 22% to 21%** for tax periods after 2017 (inclusive).

   b. The budgetary revenues will also be negatively affected by **an increase in flat-rate expenditures in the case of personal income tax** (income tax paid by sole traders)

[18] According to the TRFC Statute, a Ministry of Finance forecast is considered realistic if a deviation in a TRFC member's forecast from the ministry's forecast is below one percent. If a simple majority of TRFC members evaluates the ministry's forecast as realistic, the forecast becomes an approved TRFC forecast.

[19] An extraordinary TRFC meeting was held ("per rollam") on 9 November 2016 to assess, among other things, the measure to increase the maximum assessment base for social insurance contributions.

from 40% to 60% of revenues, with an increase of their upper limit from EUR 5,040 to EUR 20,000 a year at the same time.

c. The method and rate of **taxation of paid shares in profit (dividends)** have changed. Dividends paid on the profit made after 2017 (inclusive) to resident natural persons will be subject to income tax at a rate of 7%. The existing payments of health insurance contributions from dividends is, therefore, cancelled, but will continue to apply to the dividends paid from the profits generated in 2011-2016.

2. **The special levy on business operations in regulated industries**, originally adopted as a temporary measure[20], will change into a permanent one with effect from 2017. At the same time, the category of company's subject to the levy has been broadened and its rate doubled (from 2019 onwards, the rate should gradually decrease back to its current level).

3. In the case of the **special levy on selected financial institutions**, the mechanism for an automatic reduction in its rate depending on the volume of the levy collected has been cancelled. Hence, starting from 2017, the same rate should apply as in 2016 (the rate will not decrease as originally contemplated).

4. Tax rates on **tobacco products** will gradually increase over a multiannual period, starting from 2017, in line with a published calendar.

5. The budget proposal contemplates a raise in **revenues from the obligatory fee for the management of emergency oil and oil product stocks** with effect from 2017, which will increase the revenues of the Emergency Oil Stocks Agency by some 0.1% of GDP a year.

The amendments to the Income Tax Act and to the Act on Special Levy on Business Operations in Regulated Industries (see measures 1 and 2) were yet not approved by the parliament at the time of preparation of this report; therefore, a possibility exists that some legislative adjustments could have been made.

Legislative changes on taxes not included in the budget proposal

The tax revenue forecasts do not include three legislative changes that had yet not been approved at the time of the TRFC's September meeting[21].

1. An **increase in the maximum assessment base for social insurance** from the fivefold to sevenfold of the average wage was approved by the parliament in October 2016 as part of an amendment to the Social Insurance Act which also adjusted pension indexation for 2017.

[20] Introduced in 2012, the special levy was originally supposed to apply until 31 December 2013 only. Its application was later extended until 31 December 2016.

[21] According to its statutes, the tax revenue forecasts prepared by the Tax Revenue Forecasting Committee may only include legislation which has already been approved by the government or, at least, has passed into the second reading in the parliament.

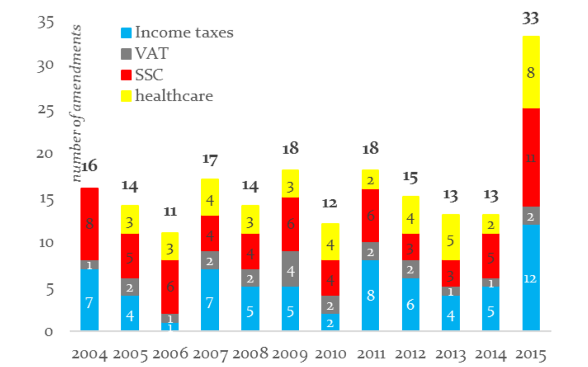
2. In connection with the change in the maximum assessment base for social insurance contributions, the **cancellation of maximum assessment bases for health insurance** payments was also announced. No legislative framework for this measure has been specified so far.
3. **The abolishment of tax licences for the corporate income tax** is included in the government's manifesto, with the relevant legislation expected to be passed in 2016[22].

Taken together, these measures would increase government's tax revenues by **EUR 130 million in 2017**; from 2018 onwards, their positive effect would fall to EUR 35 million **due to the abolishment of tax licences.**

Uncertainty of tax revenue forecast

In addition to developments in the macroeconomic environment, the uncertainty surrounding the tax revenue forecast is driven by numerous (and often concurrent) changes in the legislation governing taxes and social insurance contributions. For example, the income tax alone was amended twelve times in 2015 (Figure 18), while the corporate income tax rate changed three times between 2012 and 2016 due to new legislation.

Figure 18: Number of amendments* in tax law between 2004-2015



the chart incorporates even amendments affecting not only the revenue side of the budget (e.g. SSC)

Such frequent legislative changes affect the motivation and behaviour of **taxpayers, increasing the uncertainty in making forecasts.** The most recent example is the introduction of tax licences which caused a relatively large part of taxpayers to optimise their zero or very low tax liability to match the value of the tax licence. However, there are a lot of other measures which cannot be assessed, not even ex post, in terms of how they changed taxpayers' behaviour in the short and long term (changes in depreciation, amortisation of losses, reverse VAT charge regime in the construction sector, and many more).

The **increase in flat-rate expenditures for sole traders** is a similar legislative change among the recently proposed measures. The principle behind the flat-rate expenditure regime is that

22 A group of coalition MPs proposed their abolishment by an amendment to the Income Tax Act at the end of September 2016, but withdrew the proposal later.

entrepreneurs may choose whether they will calculate their income tax base from their actual expenditures or whether they apply the flat rate defined by the law as a percentage of their revenues (up to EUR 5,040 a year). According to the data for 2014[23], the **flat-rate expenditure regime is used by more than 180,000 taxpayers-entrepreneurs, that is, 45%** (Figure 19).

Figure 19: Distribution of taxpayers according to expenditures to income share in 2014 - real vs. flat-rate expenditures

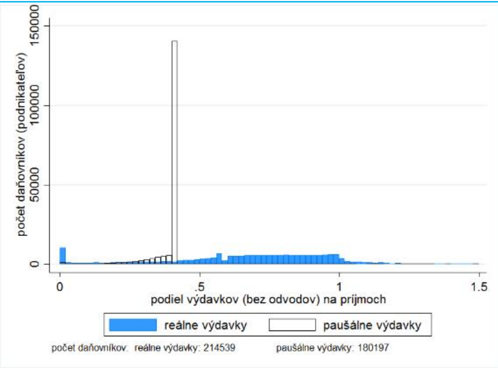
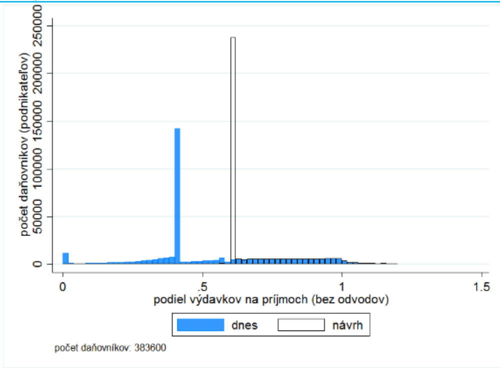


Figure 20: Distribution of taxpayers according to expenditures to income share in 2014 – impact of an increase in flat-rate (60 %)



Source: CBR, MF SR

The Ministry of Finance estimates that the introduction of higher flat-rate expenditures of 60% (and the higher ceiling set to EUR 20,000) **will decrease the general government's tax revenues by EUR 20 million, while assuming that a portion of taxpayers will not apply the new, higher flat-rate.** Under an alternative scenario which assumes that all taxpayers (eligible by law[24]) will take advantage of the increased flat-rate expenditures in order to optimise their income tax and social contributions as much as possible (Chart 20), **the negative effect on the budget could amount to as much as EUR 70 million.**

Box 3: Optimisation of taxes and social contributions by sole traders

The data collected from income tax returns prove **that a large number of entrepreneurs are already actively optimising their tax and social contribution liability.** In order to avoid the payment of social contributions[25] (Chart 22), they only report revenues up to the limit of the minimum assessment base (Chart 21). This applies to no-VAT payers in particular, regardless of whether they apply actual or flat-rate expenditures (VAT payers tend to optimise more on the expenditure side).

23 Type B individual income tax returns for the 2014 tax period.

24 Including those who are not VAT payers and apply actual expenditures at a level below the new flat-rate expenditures.

25 Pursuant to §14(1)(b) of Act No. 461/2003 Coll. on social insurance, the self-employed persons are not required to pay social contributions if their business income is less than twelve times the minimum assessment base.

Figure 21: Distribution of taxpayers according to income in 2014

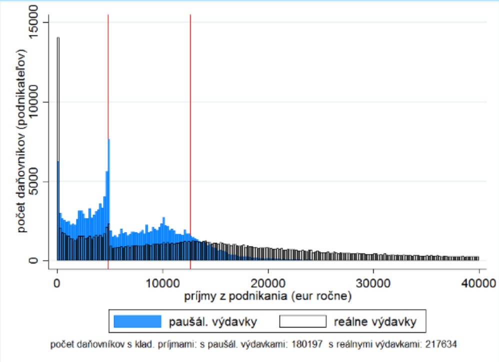
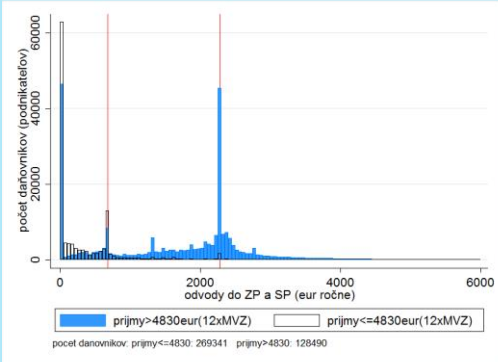


Figure 22: Distribution of taxpayers according to SSC paid in 2014



Source: FSSR (tax returns on PIT, type B, 2014)

Such avoidance of contribution payments is likely to **step up pressure on the public finances in the future** in the form of increased spending on material need benefits and/or minimum pensions. A large group of individuals who are now self-employed will achieve the retirement age in the future **and will not be entitled to receive an old-age pension** (they are failing their social insurance liability for at least 15 years, since they do not pay any social contributions at all), **or will be entitled to a very low pension (of those self-employed persons who pay social contributions, over 80% only pay the minimum amount in the long run).**

In addition to the uncertainty resulting from a potentially greater negative effect of the increase in the flat-rate expenditures in the amount of EUR 50 million, the CBR identified a risk amounting to EUR 20 million a year stemming from an assumption of higher EU fund spending included in the macroeconomic forecast in contrast to the estimate made by the CBR. However, these uncertainties are only marginal in the context of the overall tax revenue forecast and historical deviations. Moreover, based on the most recent data on the fulfilment of monthly accrual tax revenues, the 2016 tax and social contribution revenues can be expected to reach a slightly higher volume than as estimated by the TRFC. Given the nature of the taxes, this positive effect will also be felt in the subsequent years, which offset the aforementioned risks.

2.3 Budget development and risk assessment

The estimate of risks and their coverage is based on the information published in the General Government Budget Proposal for 2017-2019, the Draft Budgetary Plan for 2017, and on the data and information additionally requested from the Ministry of Finance[26] that helped better quantify the risks.

The risks and sources for their coverage are separately described in terms of their impact on the balance, general government gross debt and net worth. Their estimated impact represents the most likely estimate of the CBR using the currently available information, thus enabling to estimate the development in deficit and gross debt in the medium term. **The estimate is based on an assumption that no further additional**

[26] Additional questions and answers by the Ministry of Finance, except for sensitive information, were published together with this document (available only in Slovak).

measures will be adopted and constitutes a starting point for the CBR to evaluate the general government budget proposal.

2.3.1 Impacts on general government balance

The CBR quantified the risks and possible sources for their coverage with an impact on the general government balance in 2016 in comparison against an estimate prepared by the government[27]; for the years 2017-2019, the estimate is made in comparison against the revenues and expenditures presented in the three-year budget proposal.

Tab 7: Overview of budgetary risks and their coverage in 2016 - 2019 (ESA2010, € million)

	2016	2017	2018	2019
GG balance in the 2017-2019 GGB proposal (€ million)*	**-1 587**	**-1 084**	**-390**	**151**
GG balance in the 2017-2019 GGB proposal (in % of GDP)*	**-2,0**	**-1,3**	**-0,4**	**0,2**
Risks - total:	**-595**	**-855**	**-954**	**-1 043**
1. Overestimated non-tax revenues:	-198	-193	-174	-178
- revenues from dividends	-168	-115	-117	-123
- revenues from the sale of CO_2 allowances	-30	-61	-57	-55
- revenues from administrative fees	-	-17	-	-
2. Financial corrections to EU funds	0	-186	-145	-145
3. Underestimated state budget expenditures	-283	-101	-356	-575
- increased wages in state administration and education sector	0	-100	-280	-494
- expenditures on goods and services	-175	-1	-58	-36
- capital expenditures	-108	0	-18	-45
4. Underestimated healthcare expenditures	-102	-236	-177	-94
- healthcare expend. and financial performance of hospitals	-98	-209	-149	-66
- payout of retained profits by private health insurance comp.	-4	-27	-27	-27
5. Impact of higher expenditures of municipalities	-12	-137	-102	-51
6. Impact of EU funds on other GG entities (exc. the state budget)	no quantification			
7. Defence expenditures under secrecy	no quantification			
8. Recapitalisation of the traditionally loss-making state corp.	no quantification			
Coverage - total:	**114**	**622**	**628**	**896**
1. Savings in co-financing	50	106	194	145
2. Savings in state social benefits	10	23	14	10
3. Risk coverage from reserves:	20	493	420	740
- reserve on the coverage of new legislative initiatives	5	22	23	19
- reserve on 2017	-	100	-	-
- reserve on EU funds drawdown and financial corrections	-	186	145	145
- reserve on financial performance of hospitals	15	24	27	27
- non-specified reserves	-	161	226	550
4. Accrual contributions to the National Resolution Fund	34	-	-	-
Overall impact on the GG balance:	**-481**	**-233**	**-326**	**-147**
GG balance - CBR estimate (€ million)	**-2 068**	**-1 316**	**-715**	**4**
GG balance - CBR estimate (in % of GDP)	**-2,5**	**-1,6**	**-0,8**	**0,0**

Note: (+) means positive and (-) negative impact on the GG balance *Source: CBR*
** In 2016, the differences are shown vis-à-vis the government estimate published in the 2017-2019 GG budget proposal.*

[27] The government's estimate is included in the General Government Budget Proposal for 2017-2019.

The budget proposal **overestimates certain non-tax revenues, which poses a negative risk of EUR 198 million in 2016. In the subsequent year, the magnitude of the risk is between EUR 174 and 193 million.** They specifically include:

- The CBR believes that the expected **revenues from dividend payments from gas supplier SPP and electricity distributor Východoslovenská energetika (VSE) are overestimated.** Based on the actual economic results of the two companies in 2015 (constituting the basis for dividend payments in 2016), the risk is quantified at EUR 187 million for 2016. Equally, the volume of dividends estimated to be paid out in 2017-2019 is, according to the CBR, based on optimistic profit assumptions for both companies. If the profits generated by the two companies (and their subsidiaries[28]) from their ordinary business do not change against their 2015 level, the risk is quantified at nearly EUR 120 million a year for the 2017-2019 period. The assumed year-on-year growth in the profitability of both companies, which the budget proposal implicitly counts on, is not explained.
- By contrast, the dividend payouts from **national electricity grid operator SEPS** are expected to have a positive effect on the 2016 balance in the amount of EUR 19 million compared to the government's estimate. The difference stems from the fact that a decision on the amount of the dividends to be paid out was made after the budget proposal had been approved by the government.
- The revenues from the **sale of emission allowances** are also overestimated. The risk ranging between EUR 30 and 61 million a year stems mainly from the fact that the budgeted revenues are not quantified in accordance with the ESA2010 methodology[29].
- The CBR identified a risk amounting to EUR 17 million in the **revenues of national railway operator ŽSR from administrative fees** in 2017. The Ministry of Finance provides it is a one-off payment, giving no further explanation.

The financial corrections payable for irregularities in the use of EU funds represent another potential risk. Between 2013 and 2015, the corrections related to the 2nd programming period amounted to EUR 227 million a year on average. The government expects to see a similar amount in 2016, as well, and, given the need to draw a large amount of EU funds in the course of 2015, total corrections for the 2nd programming period are likely to be even higher. It is impossible at this point to estimate their potential impact and the time at which they will negatively affect the deficit. The CBR appreciates that the government has created a cash reserve in the budget proposal to cover future corrections, too. In its estimate, the CBR assumes that the corrections in 2017-2019 match the amount of the case reserve (**EUR 145-186 million a year**).

[28] When quantifying dividends payable by state corporations under the ESA2010 methodology, the Statistical Office examines the source of profits (i.e., whether generated from their ordinary or extraordinary business operations) also in the case of subsidiaries. Only dividends generated from ordinary business are considered general government revenues under the ESA2010 methodology. The Statistical Office applied this procedure for the first for a spring Eurostat notification in April 2016.

[29] Even though the changed methodology for reporting revenues from the sale of emission allowances was first applied by the Slovak Statistical Office in October 2015, the 2017-2019 budget proposal does not reflect this new approach.

The CBR identified risks in the **state budget**, as well. Based on the development in expenditures over the first nine months of 2016, and in comparison to their development throughout 2013-2015, the CBR quantifies a risk in the **expenditures on goods and services at EUR 175 million and in capital expenditures at EUR 108 million in 2016**. The actual development in these categories may be considerably different because by making changes in state budget expenditures the government may, at the end of the year, respond to an adverse development in the public finances. If this is the case, the impact of such changes in subsequent years will need to be examined, i.e., whether the cuts in spending did not postpone the necessary expenditures to future years.

The higher expenditures on goods and services estimated for 2016 will partially reflect in subsequent years, too: the risk is quantified at EUR 58 million and 36 million in 2018 and 2019, respectively. Given the one-off nature of capital expenditures, the CBR estimates the expenditures at a level of their long-term average (0.6% of GDP). The risk in 2018 and 2019 is respectively quantified at EUR 18 million and EUR 45 million.

Moreover, the CBR's estimate also contains a growth in **wage expenditures,** since the budget proposal contemplates a zero indexation from 2017. As far as the educational sector is concerned, the CBR assumes the wages will increase as presented in the government's manifesto, i.e., by 6% from 1 January 2018 and by the same percentage a year later. For other employees financed from the state budget the CBR expects, including in view of the published information on the ongoing collective bargaining, a growth in wages copying the expected growth in wages in the private sector. This may lead to an aggregate increase in state budget expenditures **between EUR 100 and 494 million** over the 2017-2019 period.

The government estimates that the expenditures of **health insurance companies on healthcare provision** in 2016 will grow 4.3% year-on-year, while their development over the first nine months of 2016 in comparison with the 2015 situation indicates that the increase could be even higher than expected (5.7%). Having considered this development, the CBR expects an additional risk in the amount of EUR 98 million for 2016. For subsequent years, the CBR estimates a growth in expenditures at a rate of its long-term average (3.4% a year). The reason is that despite several measures identified under the Value for Money project that are likely to generate considerable cuts in healthcare spending, the government plans to spend the potential savings in the healthcare sector. For 2017-2019, the risk quantified by the **CBR ranges from EUR 66 to 209 million.** These negative risks may increase the expenditures of health insurance companies or, if health insurance companies stick to their budgeted means, negatively affect the budgets of hospitals.

The budget proposal foresees the payout of **retained profits of private health insurance companies** at EUR 23 million annually, which represents the already known expenditure on the instalments of a loan taken in the past by Dôvera health insurance company to discharge its liabilities towards the company's shareholders. The retained profits of this particular insurance company represent approximately EUR 220 million (at the end of 2015), which may result, similarly as in 2016, to further payouts in 2017-2019 in excess of regular loan instalments. The CBR estimates the additional risk at **EUR 27 million annually**.

With respect to the fiscal performance of **local governments,** the CBR has quantified the 2016 risk at EUR 12 million above the most recent government's estimate. The risk stems from the grant provided by SPP to the City of Bratislava to cover the costs related to Slovakia's EU presidency[30]. As explained by the Ministry of Finance, SPP provided these funds from its retained profits from previous years which, according to the CBR, should not be reported as general government revenue under the ESA2010 methodology[31].

The evaluation of the fiscal performance at the level of local governments is complicated by the fact that the revenues from EU funds reported for the first half of 2016 considerably exceed expenditures (improving the balance by some EUR 75 million), but more detailed information about the causes of such development are not available[32]. On the one hand, this may be the result of the drawing of funds still available under the 2nd programming period along with a slower-than-expected start-up curve in the drawing of EU funds under the new programming period, but also of incorrect recording of relevant data. The latter could distort the conclusions presented in the evaluation, with a possible negative effect on the balance.

The 2017-2019 budget proposal for local governments assumes higher surpluses compared to the 2016 estimate, attributable to the significant annual increase in their revenues from taxes, assuming their limited growth of operating expenditures (mainly for municipalities) and a low level of capital expenditures financed from their budgets. The CBR considers this assumption optimistic, as the high growth in revenues, low debt burden, and large balances on the accounts of local governments create conditions for an accelerated growth in expenditures. Taking into account the development in operating expenditures in 2016 and an accelerated growth in capital expenditures which have long been kept at a low level, the fiscal performance of local governments in 2017 may be **EUR 137 million** worse than expected. **In the next two years, the risk declines to EUR 102 and 51 million.**

In 2014 and 2015, the **ministry of defence** signed agreements on the purchase of multi-purpose helicopters and transport aircrafts. Since these procurement transactions are classified, the CBR does not have the information necessary to assess the potential risks associated with them.

Some **companies fully controlled by the state** (for example, Slovenský vodohospodársky podnik, Bratislava Airport, Hydromeliorácie) have been making losses constantly since 2010 and even their business plans until 2019 do not foresee any change in this trend. Such a situation is not sustainable in the long run. If the state wants to keep them afloat, they will

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30 SPP and the City of Bratislava signed the donation agreement (available only in Slovak) on 29 January 2016.

31 The Slovak Statistical Office will assess the compliance of this transaction with the ESA2010 methodology in the spring of 2017 as part of the 2016 deficit and debt notification.

32 Under the methodology approved by Eurostat, the effect of transfers from the EU budget on the balance is zeroed at the level of paying units in the state budget. At the next level, i.e., when these funds are transferred from the state budget to other general government entities, the effects on the balance of that entity are not monitored. This may give rise to a situation when the funds from the EU budget have a non-zero effect on the general government balance in a given year, but their overall effect over the entire programming period should be zero. However, this assumption could not be confirmed in the case of local governments, because they regularly report (as seen throughout the 2009-2015 period) surpluses stemming from a difference in revenues and expenditures from the EU budget, which is probably caused by an incorrect recording of the funds, or by the fact that the reports are not retroactively adjusted at the time when a decision on the reimbursement of a particular project from EU funds is made.

have to be recapitalised in the future. This is a long-term risk which will not necessarily materialise during the 2017-2019 period.

The 2016-2019 risks may potentially be covered by **savings in the expenditures on co-financing, estimated by the CBR at EUR 50 million in 2016 and at EUR 106-194 million in the subsequent years**[33]. This is due to the fact that the budget proposal expects that the startup curve in the drawing of EU funds under the third programming period will be much steeper than it was in the previous programming period. This assumption is partly substantiated by the experience gained so far, as well as by the implementation of certain infrastructure projects which have been divided into two phases and are funded from both programming periods. On the other hand, the progress made in the drawing of EU funds over the first ten months of 2016 indicates even a slower onset of the new programming period, probably also due to the strain which the closure of the second programming period (end of 2015) put on the administrative capacities.

Another potential source of savings are expenditures on **state social benefits,** with a major portion of such savings attributable to the lower spending on material need benefits which have been dynamically falling in the recent years. This is due to a marked decline in the number of beneficiaries as a consequence of the positive development on the labour market (lower unemployment) and legislative changes. The CBR estimates savings in expenditures to **range between EUR 10 and 23 million** in 2016-2019.

The CBR did not identify any risks with respect to **old-age and disability pensions**, nor any potential sources for the coverage of other risks.

The budget proposal contains several types of **reserves** that may cover identified risks to a large extent. They include, for example, a reserve for EU funds and transfers to the EU budget, a reserve for worse-than-expected fiscal performance of healthcare facilities, a reserve for new legislative arrangements, a reserve for 2017, and other unspecified reserves. **The total amount of these reserves ranges between EUR 420 and 740 million in the 2017-2019 period.**

The recording of transfers from the **National Resolution Fund** will have a positive effect in 2016 exceeding the government's estimate **by EUR 34 million.** By a Eurostat decision, the financial resources which the National Resolution Fund transferred to the Single Resolution Fund at the beginning of 2016 were recorded in 2015 (since financial institutions made their contributions in 2015). This change worsened the 2015 balance. In contrast to the government's estimate, the 2016 balance will improve by the same amount.

33 In contrast to the budget proposal, the CBR estimates a slower drawdown of EU funds, slightly below the level assumed in the MFC macroeconomic forecast of September 2016 (approximately by 6 % a year). At this level, savings in expenditures on national co-financing would occur, while tax revenues under the budget proposal would annually be EUR 20 million lower on average. After considering other factors (more in section 2.2), the CBR identified no risk for overall tax revenues.

Tab 8: Risks related to meeting the budgetary objectives (ESA2010, € million)

	2016	2017	2018	2019
1. Budgetary objectives*	-1 557	-1 084	-390	151
- in % of GDP	**-1.9**	**-1.3**	**-0.4**	**0.2**
2. Size of quantified risks	-625	-855	-954	-1 043
3. Size of potential sources of coverage	114	622	628	896
4. GG balance adjusted for risks and their coverage (1+2+3)	-2 068	-1 316	-715	4
- in % of GDP	**-2.5**	**-1.6**	**-0.8**	**0.0**
5. Need for additional measures (1-4)**	499	224	323	148
- in % of GDP	**0.6**	**0.3**	**0.4**	**0.2**

** In 2016, it is the government estimate.* *Source: MF SR, CBR*

*** Revision of the nominal GDP was also taken into account.*

Taking into account the quantified risks, the possible sources for their coverage, and assuming that no additional measures are adopted by the end of the year, the CBR estimates that the deficit may near 2.5% of GDP in an extreme case. Meeting the budgetary objective will require additional measures in a total amount of 0.6% of GDP. Since the risks will partially reflect in the subsequent years, too, the CBR estimates the 2017 deficit at 1.6% of GDP and its further decline towards a balanced budget in 2019.

2.3.2 Impacts on general government gross debt

A worse-than-expected estimate of general government balance for 2016-2019 compared against the government's objectives presented in the budget proposal will also be reflected in the estimate of gross debt development. The quantified risks will annually contribute an additional EUR 119 to 514 million to the gross debt (assuming that the size of the cash reserve remains the same as in the government's forecast). On the other hand, the effect of dividends from extraordinary profits of the SPP and VSE companies will be the opposite. After including additional interest payments[34], the debt at the end of 2019 would be more than EUR 500 million higher than as projected in the government's forecast. When taking into account the impact of GDP revision in 2015, the debt-to-GDP ratio would increase against the budget proposal by 0.2 p.p. to 49.3 % at the end of 2019.

Tab 9: Assumptions on the GG gross debt development (€ million)

	2014	2015	2016	2017	2018	2019
1. Gross GG debt forecast (government forecast)	40 725	41 293	43 089	44 284	45 502	46 223
- in % of GDP	**53.9**	**52.9**	**53.5**	**52.7**	**51.4**	**49.1**
2. Additional change in debt:			327	69	179	-4
- risks and sources of their coverage affecting the GG balance*			514	182	296	119
- dividends from extraordinary profits			-187	-115	-117	-123
- additional cash interest expenditures			0	2	0	1

34 Additional interest payments reflect a higher deficit estimate by the CBR compared to the budget proposal and revenues from extraordinary dividends while applying an anticipated interest rate on 10-year bonds in a given year.

3. Gross GG debt adjusted for risks and their coverage	40 725	41 293	43 416	44 680	46 077	46 794
- in % GDP	**53.9**	**52.9**	**53.9**	**53.2**	**52.1**	**49.7**
- impact of GDP revision (p.p.)		-0.4	-0.4	-0.4	-0.4	-0.4
- gross GG debt in % of revised GDP		**52.5**	**53.5**	**52.8**	**51.6**	**49.3**
p.m. 10-year government bond yield (MFC, Sept. 2016)		*0.82*	*0.48*	*0.75*	*1.09*	*1.35*

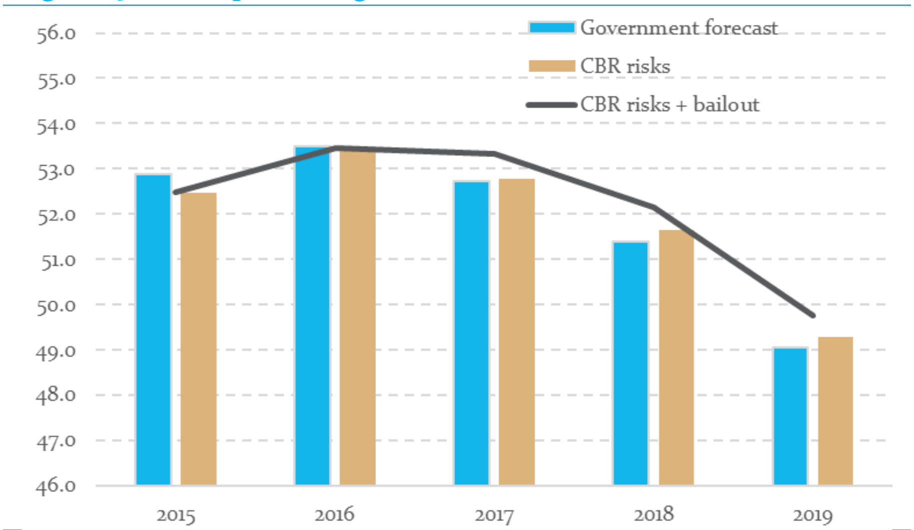
** For the sake of gross debt estimate, cash impacts of risks were taken in account (revenues of National Resolution Fund and revenues from the sales of CO2 emission quotas was not taken into account).*

Source: SO SR, MF SR, CBR

In addition to the risks affecting the general government balance, the size of debt may also be influenced by the **bailout of healthcare facilities**. No details of this plan are known at his point; therefore, the CBR presents this step as a scenario based on an assumption of the state taking over all overdue liabilities of central and local healthcare facilities in 2017. Their liabilities were almost EUR 550 million at the end of 2015 and, considering the growth rate estimated by the government in the budget proposal, they would amount to EUR 670 million at the end of 2016. Since a portion of these liabilities is owed to general government entities, such as the Social Insurance Agency, there is a lesser need to obtain funds on financial markets. The full repayment of overdue liabilities to the private sector would require additional funds in an approximate amount of EUR 480 million. If the debt of hospitals recorded under the Maastricht debt[35] is also reduced, the net contribution to an increase in debt would amount to some EUR 456 million (0.5% of GDP).

In terms of eliminating the negative impacts on the balance and debt in the future, it is important that such a bailout be also accompanied by measures which will prevent the healthcare facilities from creating new debts.

Figure 23: Development of gross debt - scenarios (% of GDP)



Source: MF SR, CBR

35 The consolidated Maastricht debt of hospitals stood at EUR 24 million at the end of 2015. There is no information available at this point on whether this debt also includes overdue liabilities. However, a majority of overdue liabilities are trade receivables that are not part of the Maastricht debt.

2.3.3 Impacts on net worth

A long-term view through the prism of net worth can identify such items of the budget where the medium-term development is different from the long-term development.

The first group covers **items having a positive impact on general government balance in the medium term, although their impact on net worth in the long term should be roughly neutral if set correctly**. This includes the nuclear decommissioning scheme and a special levy payable by selected financial institutions.

- In the current period, the balance of the **National Nuclear Fund** revenues and expenditures has been positive every year, and the accumulated funds are expected to be used for the payment of costs associated with the decommissioning of nuclear facilities in the future.
- The net worth approach offers a different view on revenues from the **special levy payable by selected financial institutions**. If we assume that these funds should be used to cover the future risks in the financial sector, the levies set in an actuarially fair manner have a zero impact on the net worth, even though they improve the current balance of public finances[36].

The second group covers those **items which may have a positive or neutral impact on general government balance in the medium term, but their negative impacts on the budget balance and debt will be observed in the long run**. This includes, for instance, the continued operation of state corporations that have been making losses for a long time, and the approval of a new PPP project.

- Some companies **fully controlled by the state** (for example, Slovenský vodohospodársky podnik, Bratislava Airport, Hydromeliorácie) have been making losses constantly since 2010 and even their business plans until 2019 do not foresee any change in this trend. Such a situation is not sustainable in the long run. If the state wants to keep them afloat, they will have to be recapitalised in the future.
- As a result of approving the **D4/R7 PPP project**, there will also be, in addition to initial costs associated with its preparation (purchase of land, in particular), higher expenditures earmarked for instalments to be paid by the state **during the 30-year period**. The first availability payment should be made in 2020[37]. By 2019, neither the budget balance nor the debt will be affected by the investment (construction), as opposed to a situation where the investment would be directly carried out by the state. For the purposes of quantifying the impact on net worth, it is therefore necessary to take into account all financial flows related to the PPP project, including the transfer of

[36] One side records the assets, the other records the potential liability if the funds need to be used in the future. At present, there is no clear quantification of potential risks in the financial sector available. What is also unclear is whether the liability is contingent or implicit.

[37] Impact assessment regarding the Proposal for the conclusion of a concession contract under the public procurement for the design, construction, funding, operation and maintenance of the D4 Jarovce – Rača motorway section and the R7 Bratislava Prievoz – Holice expressway (available only in Slovak), approved by the government on 17 February 2016.

the asset (the motorway that will be built) into the ownership of the state following its repayment. The final impact on net worth is therefore neutral (or slightly negative[38]).

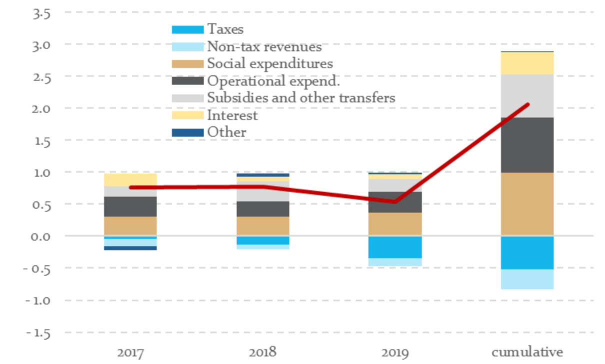
Also other net worth components are affected by public finances, such as the environmental debt or natural wealth. Due to the absence of data and methodology for their quantification, the CBR's evaluation does not include these components.

2.4 Consolidation measures

The size of measures included in the general government budget proposal for 2017-2019 can be assessed against the no-policy change scenario (NPC scenario) prepared by the CBR. The NPC scenario is based around the general government deficit estimate for 2016 at 2.5% of GDP which exceeds the government's estimate by 0.5% of GDP[39].

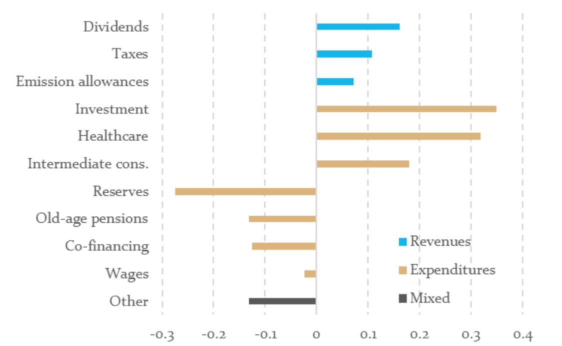
Assuming that no new measures are taken after 2016, that public finances develop based on the existing legislation and that the budget items are determined solely by macroeconomic development, the deficit would gradually decline by 2.1 p.p. to 0.5% of GDP in 2019. The deficit would be reduced in particular due to savings in social expenditures (contributing to a reduction by 1.0 p.p.), operating expenditures (0.9 p.p.) and subsidies and other transfers (0.7 p.p.). On the other hand, there would be a negative contribution of tax and non-tax revenues by 2019 (amounting to 0.8 p.p.).

Figure 24: Contributions to the y-o-y change in GG balance in the NPC scenario (p. p.)



Source: CBR

Figure 25: Impact of measures in the 2017 budget proposal (% of GDP)



Note: (+) improves, (-) worsens the GG balance

Source: CBR

Meeting of the budgetary objectives between 2017 and 2019 will require measures quantified at 0.6% of GDP per year on average. In 2017, the size of measures reaches 0.5% of GDP, focusing in particular on the expenditure side. The cuts in investments, healthcare and intermediate consumption are expected to have the most significant effect. As regards revenues, the budget proposal counts on an increase in the revenues from dividends and taxes. Not all of the measures are sufficiently explained. These include, in particular, the revenues from dividends, emission allowances, cuts in capital expenditures outside the state budget and

[38] Depending on the total financial cost of the PPP project, based on a combination of potential savings resulting from effective construction and of more expensive financing in comparison with a situation where the investment is directly carried out by the state.

[39] The NPC scenario prepared by the Ministry of Finance is based on an estimate of the general government deficit at 1.97 % of GDP in 2016.

cuts in the healthcare sector and intermediate consumption, all of which come with risks. On the other hand, the budget proposal contains several unspecified reserves which may partially offset these risks.

Tab 10: Size of measures in the budget proposal (% of GDP)

	2016	2017	2018	2019
1. GG balance - NPC scenario	-2.5	-1.8	-1.0	-0.5
2. GG budget proposal	-2.0	-1.3	-0.4	0.2
3. Size of measures (2-1)	**0.6**	**0.5**	**0.6**	**0.6**
- of which: risks identified by the CBR	**0.6**	**0.3**	**0.4**	**0.2**

Note: in 2016, the CBR estimate is compared to the government estimate. The NPC scenario is based on the estimate of 2016. Differences in row 3 might stem from rounding. *Source: CBR, MF SR*

As regards the development of gross debt, the no-policy change scenario is based on the CBR's estimate amounting to 53.5% of GDP at the end of 2016[40]. If no new measures are adopted after 2016, the gross debt relative to GDP would decline gradually in the years ahead to 50.8% of GDP at the end of 2019. In comparison with the forecast in the budget proposal, the debt would therefore be higher by 1.7% of GDP.

The debt decline projected by the government is mostly attributable to the measures incorporated into the 2017-2019 budget proposal (with a cumulative impact of 2.1% of GDP). The other factors, such as change in financial assets and differences between cash-based and accrual flows[41] will increase the debt in the medium term by a total of 0.4% of GDP.

Figure 26: Debt development under the CBR´s NPC scenario (% of GDP)

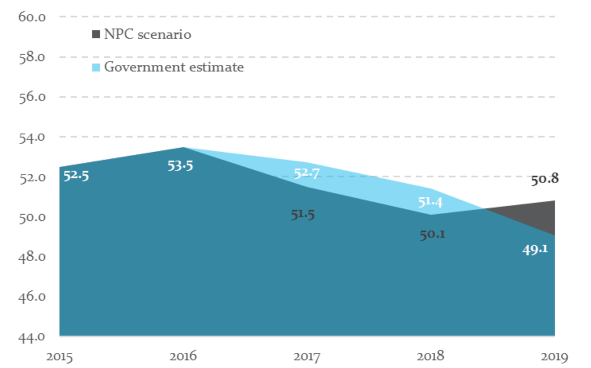


Figure 27: Contributions to change in debt in the government forecast (p. p.)

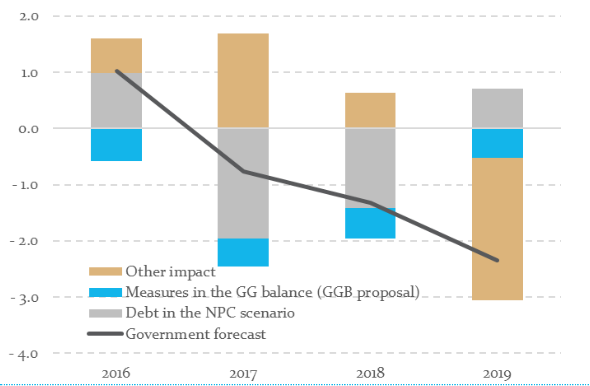


***Figure 26:** Debt development in the NPC scenario depends on the general government balance in the NPC scenario and beginning from 2017 on the assumption of cash reserve covering liabilities (redemption of government bonds, treasury bills and loans, and financing the state budget deficit) in the following 4 months. The growth of gross debt at the end of 2019 reflects also the need to hold higher cash reserve (compared to the debt forecast) to cover liabilities*

40 The basic assumption for the no-policy-change scenario regarding the debt development is such an amount of the cash reserve that covers the liabilities for the next four months. Had this assumption been used in the debt estimate at the end of 2016, the gross debt relative to GDP would be at 55.7%. In its debt estimate at the end of 2016, the CBR took into account the cash reserve envisaged by the government in its forecast, which represented a one-off decrease in the gross debt level by 2.2% of GDP.

41 While general government deficit is expressed in accrual methodology, gross debt is defined in cash-based methodology. From the perspective of debt development, cash flows in public finances are therefore of key importance. The differences between the cash-based and accrual flows thus explain the different debt development in a given year in comparison with the amount of the deficit.

in the first 4 months of 2020.
Figure 27*: Figure shows the contributions to a year-on-year change in debt in the government forecast. In 2017, significant decline in debt in the NPC scenario (compared to government forecast) is due to lower need of cash reserve to cover liabilities in following 4 months.*

Source: MF SR, CBR

3 Trends in the public finance development in Slovakia

The previous chapter discussed the identification of specific risks on the revenue or expenditure side of the general government budget and their resulting impact on the balance and debt. In terms of assessing the overall development of public finances, it is useful to know the main trends in the basic indicators. Their description does not typically facilitate direct quantification of potential risks; however, they may provide a broader context and an opportunity to evaluate the government's policies in qualitative terms at the least. The fiscal framework of the budget is confronted with the previous experience in terms of its fulfilment. Using the trends in the structure of budget revenues and expenditures, it is possible to illustrate what measures the government is using to attain its objectives compared to the past. An important aspect from the macroeconomic perspective is whether the budget contributes to a more stable economic development. And, last but not least, the budget proposal is assessed in terms of its effects on the long-term sustainability of public finances.

This report covers the basic information concerning the development of budgetary revenues and expenditures. In the future, the CBR intends to continue the analyses in order to provide alternative perspectives on the development of public finances.

3.1 Fiscal framework

In addition to quantifying the specific risks in revenues and expenditures, the credibility of the fiscal framework can also be examined from a number of perspectives: 1/ what is the historical experience with attaining the defined objectives; 2/ the binding nature of the three-year budgetary framework; 3/ how the government responds to deviations in the development of the budget; 4/ the size of fiscal adjustment necessary for attaining the objectives; 5/ how the fiscal rules can influence the attainment of objectives.

Since 2003, the deficit has been hovering close to 3 % of GDP

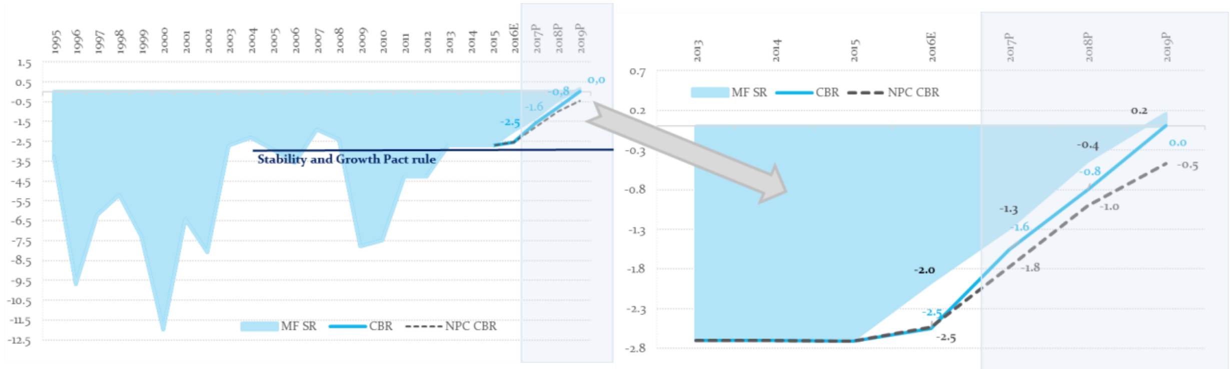
If the government's assumptions regarding budgetary performance in 2016 – a deficit at 2.0 % of GDP – are fulfilled, this figure would be the second lowest in the history of Slovakia. If the government does not adopt any new measures and the risks identified by the CBR materialise, the deficit might rise to 2.5 % of GDP, which is only slightly less than the level where the deficit had fluctuated in the period between 2013 and 2015.

The period since 2003 is characterised by deficits staying close to the three-percent threshold. The only exception was the period between 2009 and 2010 when the economic crisis brought the deficit to as high as 8 % of GDP. With the subsequent budgetary consolidation, the deficit was pushed back below 3 % of GDP in 2013. This threshold constitutes an important criterion under European fiscal rules and, therefore, the government seeks to comply with it.

On the other hand, the government's objective under the European and national rules should be to attain a nearly balanced budget. Because of insufficient enforcement of this rule at the EU level, the governments were less motivated to meet this objective and, as a result, the **reduction of the deficit has stopped slightly below the threshold of 3 % of GDP, with the attainment of a balanced budget being constantly deferred.**

The budget plans until 2019 envisage the attainment of a slight budgetary surplus. According to the CBR's estimate, a nearly balanced budget can be attained without significant consolidation measures, because the current setup of policies and macroeconomic development are geared towards bringing the deficit below 1 % of GDP in the years ahead.

Figure 28: GG balance in 1995-2019 (ESA2010, % GDP)



Source: Eurostat, MF SR, CBR

Revisions of budgetary objectives reduce the credibility of presented plans

Unlike the targets for 2013 and 2014, the deficit targets for 2015 through 2017 were revised upwards in the update of the three-year budget, deferring the consolidation necessary to meet the objective beyond the horizon of the next fiscal year. Moreover, without additional measures, the government expects the 2016 deficit to be slightly higher than planned in the approved budgets, as was the case with deficits between 2014 and 2015. These increases in deficit targets took place at a time when the government could have benefited from a number of positive effects, including the additional revenue from the fight against tax evasion. **The budgetary objective for 2017 has been revised five times in total. Compared to the figure published for the first time in the Stability Programme for 2014-2017, this objective has worsened by a total of 0.8 % of GDP. This has happened even in the absence of any unexpected negative impacts; quite the contrary, the tax revenues were higher by 3.4 % of GDP[42] compared to the first estimate of revenues for 2017** (taken from the Stability Programme for 2014-2017 in April 2014)**.**

Although the medium-term budget framework is approved by the government, the parliament approves (i.e., enacts) only the cash balance of the state budget for the forthcoming year. Hence, the government considers as binding only the budget for the nearest fiscal year. The binding nature of the medium-term objective could be strengthened if the parliament debated the entire general government budget under the ESA2010 methodology, thus enabling more effective control and a focus on compliance with potential fiscal rules, such as a binding expenditure ceiling.

[42] Higher tax revenues can partially be coming from an increase in expenditures compared to the original assumptions presented in the Stability Programme for 2014-2017.

Figure 29: Revision of fiscal objectives in 3-years budgetary framework (% GDP)

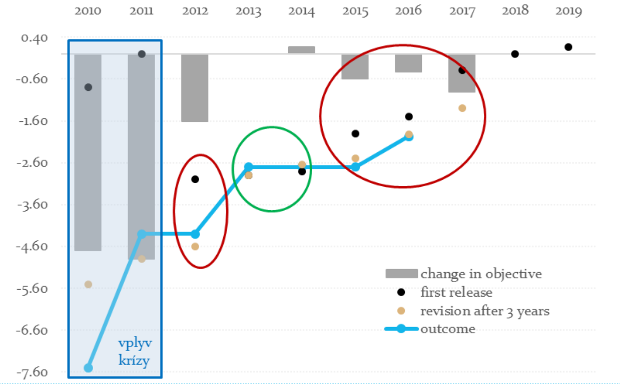


Figure 30: Change in GG balance objective in 2017

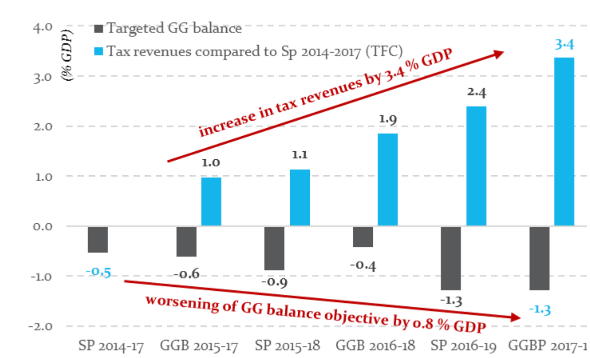


Figure 29: *Change in objective (bar chart) stands for a difference between the first announcement of targeted GG balance in the respective year and its revision after three years (three-years fiscal framework). For example, targeted deficit in 2015 was firstly set within the approved 2013-2015 GGB, revised under the 2015-2017 GGB by 0.6 % of GDP.*

Source: CBR

Between 2014 and 2017, the positive unexpected effects were not utilised to accelerate consolidation

The preparation of the budget for the entire general government is a relatively complex process and, in the course of budget execution, there may be unexpected deviations to which the government reacts. If the effects are positive, the government may use the additional revenue to reduce the debt and deficit (accelerated consolidation) or may take new measures which increase the deficit (through higher expenditures) and use to revenues to offset the risks. If, on the other hand, the unexpected effects are negative, the government may either take additional measures so as to meet the budgetary target or may reflect these effects in higher deficit. In most cases, the result is a combination of reflecting the unexpected effects, risk coverage and government measures.

By making a distinction between those effects that are totally or partially beyond the government's control ("unexpected effects") and other effects, including discretionary measures, the following information can be gained: 1/ the government's ability to eliminate negative unexpected effects, 2/ the manner in which positive unexpected effects are utilised, 3/ whether and to what extent the prepared budget is realistic (reflecting the risks). Understanding the reasons for deviation is also important for the assessment of compliance with the national fiscal rules, mainly the progress achieved in bringing the debt below sanction thresholds.

Within the individual years between 2010 and 2017, the unexpected effects varied in size. Except for 2010, their impact on the budget balance remained positive. Between 2011 and 2013, their impact was quantified at 0.5 % of GDP on average and they fully or significantly contributed to the better-than-planned fiscal performance results. Between 2014 and 2017, the positive effects have accounted for more than 1.0 % of GDP per year. This increase is attributable to the better-than-budgeted tax collection as a result of improved economic development and higher efficiency in VAT collection. Higher tax revenues can partially be coming from an increase in expenditures compared to the original assumptions, and the impact on the economy may be more pronounced at zero percent interest rates. Had these positive unexpected effects been used in each of these years to improve the respective deficits (assuming no rollover of positive effects), the deficit could have been below 1 % of GDP in 2014 and in a slight surplus in 2017[43]. **These positive effects were not used to step up consolidation because of the significant risks built into the budgets, which the CBR identified and pointed out, and also due to the fact that the government had implemented additional measures which these positive effects enabled it to take.**

Figure 31: Impact of unexpected effects and other items on the GG balance (% GDP, ESA2010)

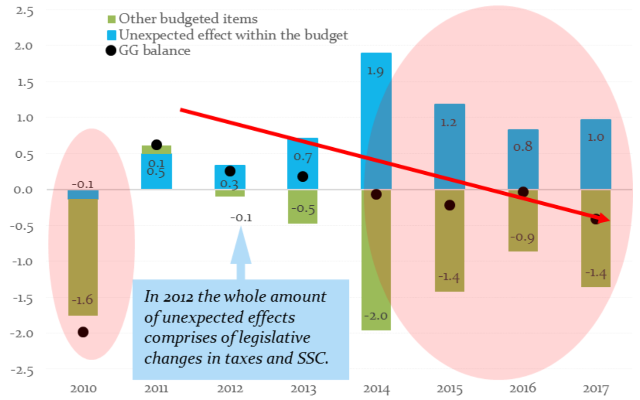


Figure 32: Potential GG balance taking into account unexpected effects (% GDP, ESA2010)

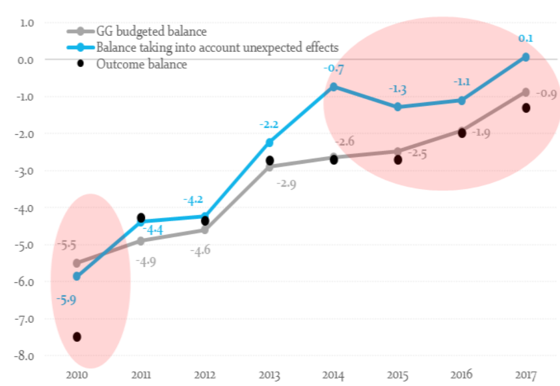


Figure 31: *Unexpected effects in the budget represent the difference between the budget and the outcome of budgetary items including: performance of local governments (years 2010-2016, in 2017 change in balance stands for a more realistic estimate of budget), tax revenues and social contributions, co-financing and induced investment, EU financial corrections (only in 2013, in further years these could be expected), contribution to EU budget, interest payments. Legislative changes incorporate those, which were adopted during the year or which had a different impact compared to the budget. Concerning the year 2017, the 2016-2018 GGB (deficit 0.9 % of GDP) is compared to the current 2017-2019 GGBP (1.3 % of GDP).*

Figure 32: *In 2010 approved budget was amended, reasoned by unrealistic figures of the initial budget. The balance adjusted for unexpected effects is calculated only in respective year, i.e. unexpected effects in one year are not transferred to the next year.*

Source: SO SR, MF SR, CBR calculation

First and foremost, the accelerating economic growth generated additional tax revenues, the historically lowest interest rates reduced budget expenditures quite significantly, and additional revenues came from the opening 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 within 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 (Figure 31). 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 these positive effects for accelerating the deficit and debt reduction has thus been deferring the necessary consolidation, with a negative impact on the debt level.**

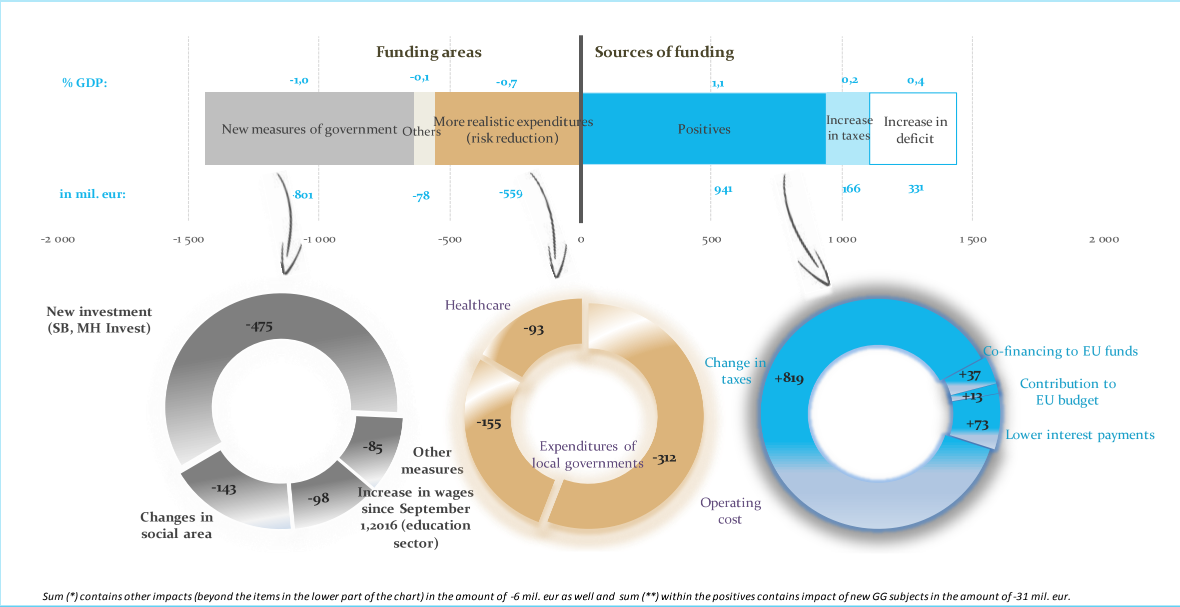
43 If the impact of expenditure policies on the increase of tax revenues is taken into account, the above balance values could be more accurate.

Box 4: Unexpected effects and their impact on the budget balance in 2017

The general government deficit target for 2017 has increased by 0.4 % of GDP compared to the 2016-2018 general government budget. The increase was not motivated by unexpected negative effects outside the government control, quite the contrary, the budget may benefit from a number of positive effects.

As shown by a comparison between the 2017 budget approved in 2015 as part of the general government budget for 2016-2018 and the current proposal for 2017, the unexpected effects mostly in the form of additional tax revenues (including better tax collection) accounted for 1.1 % of GDP. Coming in at 1.7 % of GDP in total, the negative factors include, in particular, more realistic expenditures in several areas, as well as additional measures of the government. With an increase in expenditures surpassing the positive factors, the resulting gap is compensated for by an increase in the budgeted deficit by 0.4 % of GDP and by a legislative tax raise by 0.2 %.

Figure 33: Budget for 2016 – factors contributing to a change in the deficit of the current budget proposal for 2016 against the 2016 budget within the 2015 – 2017 budget



Sum (*) contains other impacts (beyond the items in the lower part of the chart) in the amount of EUR -6 mil. and sum (**) within the positives contains impact of new GG subjects in the amount of EUR -31 mil. as well. *Source: MF SR, CBR*

The debt has stabilised at all-time highs due to one-off measures

Following the crisis, the debt relative to GDP remains at its all-time highs, and the debt level has stabilised over the past few years in particular due to one-off measures which might not necessarily occur again in the future.

Figure 34: GG gross debt development (% GDP)

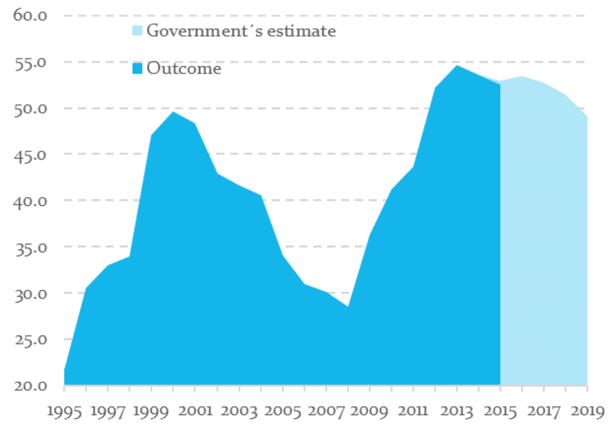


Figure 35: Change in gross debt (y-o-y, % GDP)

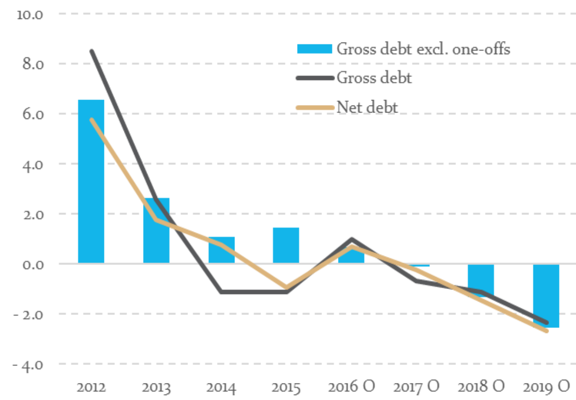


Figure 35: *When estimating the change in debt excl. one-offs, the impact on interest payments was not taken into account (higher level of debt in one year in comparison to the outcome would lead to an increase in interest payments as well).*

Source: MF SR, CBR

The gross debt-to-GDP ratio began to decline after 2013; however, the decline is largely attributable to one-off measures adopted by the government, which do not improve the net worth of Slovakia's public finances. This includes, for example, the one-off reduction in the cash reserve accumulated in the past, receipts from privatisation, income from private pension funds, and dividends from state corporations above their ordinary profits. Without taking these measures (non-recurring factors in the long run), the debt would be higher by 1.1 % of GDP in 2014 and by 1.4 % of GDP in 2015 year-on-year.

In 2016, the gross debt-to-GDP ratio is expected to increase again; when taking into account the one-off effects (a year-on-year increase in cash reserve partly offset by income from extraordinary dividends), it should rise by 0.7 % of GDP. **The moderate debt decline should become sustainable from 2017 onward as a consequence of the planned deficit reduction and economic growth acceleration.**

The government's consolidation effort will reach 0.2 % of GDP in 2017

The CBR estimates that the **general government deficit will decline from 2.5 % of GDP in 2016 to 0.0 % of GDP in 2019.** This development could imply that the structural deficit might improve by 2.4 % of GDP on a cumulative basis during the next four years, thus reaching 0.1 % of GDP in 2019 (Box 5 shows CBR's estimate compared with those of other institutions). According to CBR's calculations, the medium term budgetary objective will be attained in 2019.

In order to assess the extent to which the estimated structural balance improvement could be attributed to government measures or other external factors, it is necessary to compare its development with the no-policy-change scenario (the NPC scenario prepared by the CBR).

Tab 11: Change in GG structural balance in 2015-2019 according to CBR (ESA2010, % GDP)

	2015	2016E	2017P	2018P	2019P
1. General government balance	**-2.7**	**-2.5**	**-1.6**	**-0.8**	**0.0**
2. Cyclical component	-0.1	-0.1	0.0	0.0	0.1
3. One-off measures	-0.2	-0.1	0.0	0.0	0.0
4. Structural balance (1-2-3)	**-2.4**	**-2.4**	**-1.5**	**-0.8**	**-0.1**
5. Change in structural balance (Δ4)/ Fiscal Compact	**0.1**	**0.0**	**0.9**	**0.8**	**0.7**
6. General government balance - NPC scenario	**-2.7**	**-2.5**	**-1.8**	**-1.0**	**-0.5**
7. Structural balance - NPC scenario	-2.4	-2.4	-1.8	-1.0	-0.6
8. Change in structural balance - NPC scenario	-	**0.0**	**0.6**	**0.8**	**0.4**
9. Size of measures (1-6)		**0.0**	**0.2**	**0.2**	**0.5**
10. Change in size of measures (Δ9)			0.2	0.0	0.3
11. Consolidation effort of government (5-8)			**0.2**	**0.0**	**0.3**
12. Other factors:	0.1	0.2	0.5	0.0	0.1
- measures with no impact on long-term sustainability	-0.1	0.0	0.0	0.0	0.0
- PPP projects	0.0	0.0	0.3	-0.1	0.0
- interest payments	0.1	0.2	0.2	0.1	0.1
13. Government measures incl. impacts of other factors*			0.0	0.0	0.1
14. Change in structural balance taking into account impact of other factors (5-12)		**-0.3**	**0.4**	**0.8**	**0.6**
15. Government consolidation effort taking into account impact of other factors (11-13)			**0.2**	**-0.1**	**0.2**

** Including impact of increased levy of financial institutions, shift in term of completion of the 3rd and 4th unit of nuclear power plant Mochovce, change in interest payments due the consolidation.*

Source: CBR methodology

Without the government's interventions, the structural deficit will improve by a total of 1.8 % of GDP to 0.6 % of GDP by 2019, which is only 0.1 % of GDP away from the medium-term budgetary objective. This means that most of the projected structural balance improvement is attributable to the already existing setup of policies, macroeconomic development and a slower uptake of EU funds. **The net contribution of the government[44] to the permanent general government balance improvement is expected to reach, after taking into account the measures with an impact on other factors[45], a total of 0.3 % of GDP for three years.**

Box 5: Comparison of the general government balance and structural balance in 2015 to 2019

The following figures show the general government balance and estimates of the general government structural balance for 2015-2019 prepared by different institutions: the European Commission, OECD, IMF, CBR and the Ministry of Finance (Draft Budgetary Plan/DBP) The differences in the structural balance are due to different deficit estimates (the Commission bases itself on the NPC scenario),

44 The ‘government consolidation effort’ indicator is linked exclusively to the contribution of government measures towards a permanent change in fiscal position. A detailed description of this indicator is provided in the CBR discussion paper No. 02/2014: How to measure public finance consolidation.

45 These include factors with no impact on the long-term sustainability of public finances (the fully-funded pillar of the pension system, nuclear decommissioning scheme, a levy imposed on selected financial institutions), factors that are not directly related to the current development in public finances (debt interest payments) and factors reported outside the general government sector which will worsen the fiscal performance in the future (construction of motorways through PPP projects).

different estimates of the size of the cyclical component (output gap) and the one-off measures considered. The structural balance is expected to improve according to calculations by the CBR, Ministry of Finance and the Commission (as part of its autumn forecast published on 9 November 2016). Based on the Commission's estimate, the structural deficit should follow a downward trend in the upcoming period, reaching 1.4 % of GDP in 2017 and 0.7 % of GDP in the following year.

Figure 36: GG balance in 2015-2019 (ESA2010, % GDP)

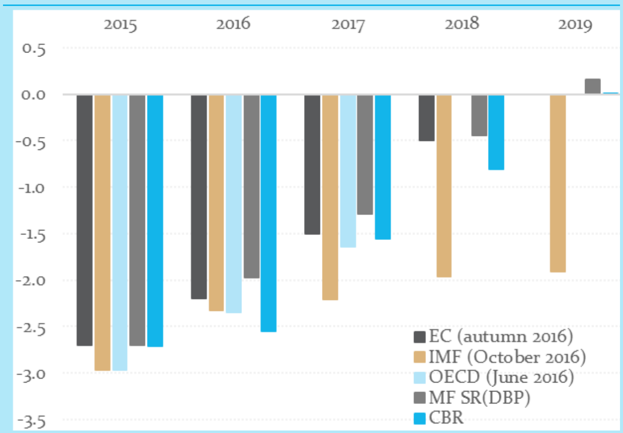
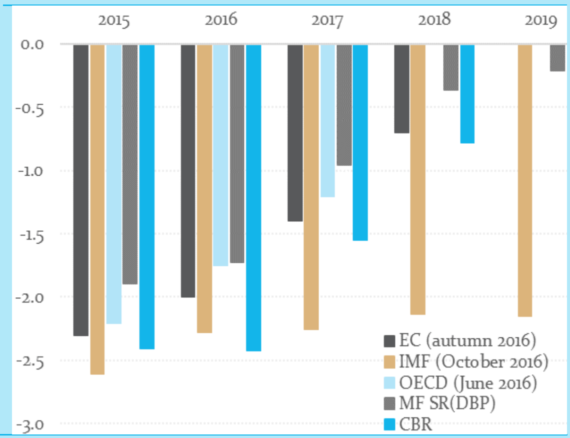


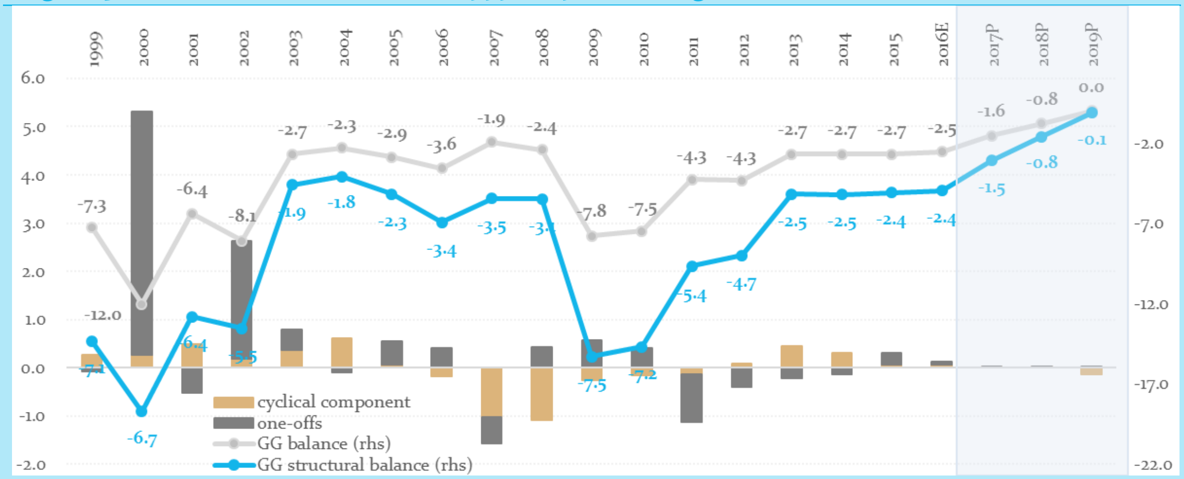
Figure 37: GG structural balance in 2015-2019 (ESA2010, % GDP)



*Estimates of IMF, CBR and MF SR are to disposal till 2019. EC autumn forecast covers period until 2018, OECD only until 2017.

Source: CBR, MF SR. OECD. IMF, EC *Source: CBR, MF SR. OECD. IMF, EC*

Figure 38: GG structural balance in 1999-2019 according to CBR (ESA2010, % GDP)



Source: CBR

Fiscal rules are expected to contribute to attaining a balanced budget

The relaxation of fiscal discipline in 2014 and 2015 has diluted the effect of robust consolidation in 2013. According to the CBR, while the 2014 deviation from the adjustment path towards meeting the originally defined medium-term objective by 2017 was only moderate (evaluated cumulatively), the deviation occurring in 2015 was significant. The significant deviation in 2015 was also confirmed by the expenditure benchmark as the adjusted expenditure growth was significantly higher than the growth derived from the required pace of consolidation. Under the existing rules, corrective measures leading to faster consolidation should have been adopted.

This national rule may complement the existing debt rule; although the application of the more stringent sanction mechanisms under the debt rule will be suspended for two years from the parliamentary vote of confidence in the new government, they will fully apply when the results for 2017[46] are evaluated. In a number of its previous reports[47] the CBR stated that the government failed to adopt sufficient measures to reduce the debt below the sanction thresholds despite the fact that the minister of finance and the government should have adopted them[48]. The budgetary targets presented in the current budget proposal for 2017-2019 are not such that would facilitate the reduction of the debt below the sanction thresholds by 2019. After 2018, the debt limits will be reduced by 1 p.p. every year, which implies that more ambitious budgetary targets must be set. For this reason, **respecting the currently applicable national fiscal rules, the budget consolidation should continue also in the years to come**.

European fiscal rules setting the annual minimum improvement of the structural balance and the expenditure growth rate also contribute to attaining a balanced budget. In order to meet the requirements of the preventive arm of the Stability and Growth Pact, it is necessary to continue reducing the structural balance while maintaining a reasonable growth of budgetary expenditures, all of which will facilitate a gradual reduction of the deficit. Compliance with these rules is evaluated by the European Commission.

3.2 Budget revenue and expenditure

The budget balance is affected by many factors, but not all of them are under the direct control of the government. One of the ways of looking at changes in the balance is to use the analytically adjusted balance and the government consolidation effort which takes into account the setup of policies in the past, one-off effects and the impact of the economic cycle. This approach is driven by the effort to quantify the budget balance which can be changed only by specific measures adopted by the government. On the other hand, a simpler approach not involving analytical adjustment provides a summary overview of all impacts on the budget, thus showing the basic trends as to whether the general government balance relative to GDP is changing due to changes in revenues expressed as a proportion of GDP or in expenditures expressed as a proportion of GDP or their combination[49].

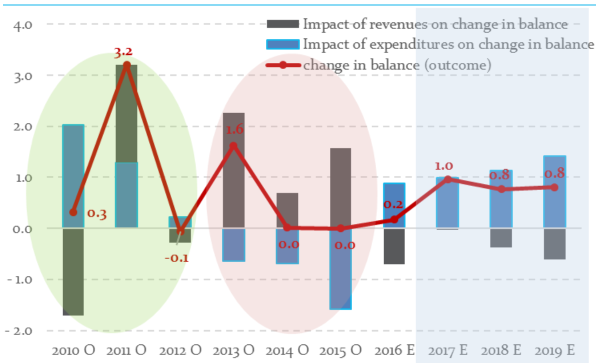
In comparison with 2010, the budget balance should improve by a total of 7.8 % of GDP by 2019, as the deficit is expected to drop from 7.8 % of GDP to a balance close to zero. The

46 The sanction mechanism applicable when the debt exceeds the level of 55 % of GDP will thus be triggered again after 26 April 2018 (because the vote of confidence in the government took place on 26 April 2016) when evaluating the debt for 2017.
47 Reports evaluating compliance with the fiscal responsibility rules and transparency rules for the years 2013 (August 2014), 2014 (August 2015) and 2015 (August 2016) – available only in Slovak.
48 The obligation to adopt measures arises when the first and second sanction thresholds are exceeded.
49 The changes exclude neutral transactions: revenues and expenditures from EU funds, imputed SSC paid and received.

reduced expenditure of the budget should contribute to this change by a total of 5.0 p.p. (65 % of the change) and the increase in revenues by a total of 2.8 p.p. (35 %).

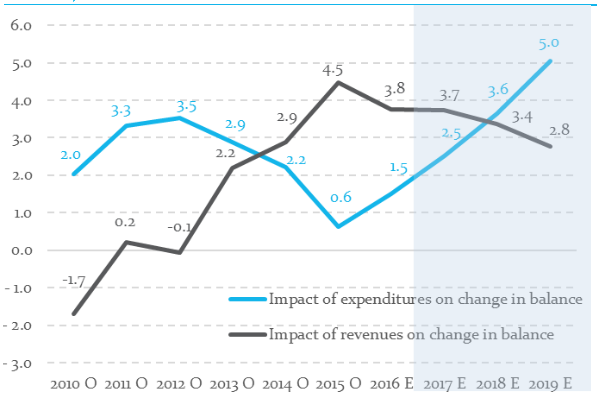
The entire period between 2010 and 2019 can be broken down into several different periods. Between 2010 and 2012, the deficit was reduced in particular through the reduction in expenditure combined with higher revenues. From 2013 to 2015, the deficit reduction was mostly the result of higher revenues which were used for increasing the expenditure in 2014 and 2015. In 2016, a decline in expenditure is expected to be offset by a decline in revenues. **In the 2017-2019 budgetary period, the deficit is likely to decline as a result of falling expenditures.**

Figure 39: Contributions of change in revenues and expenditures to change in balance (ESA 2010, % GDP)



Source: CBR, SO SR

Figure 40: Cumulative contributions of change in revenues and expenditures to change in balance (ESA 2010, % GDP, since 2010)



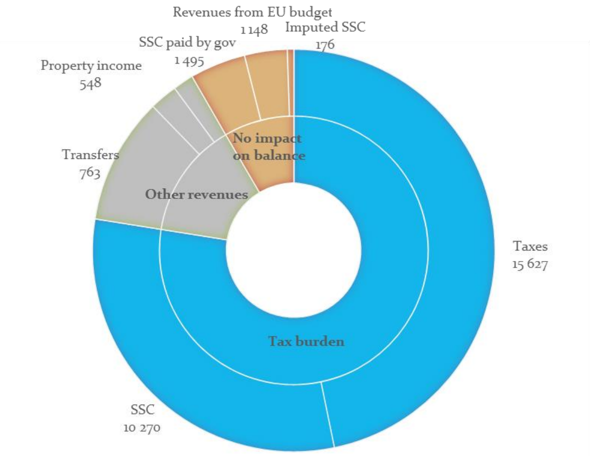
Source: CBR, SO SR

3.2.1 Structure of budget revenues

In 2017, according to the current estimates, nearly 80 % of all budgetary revenues will be coming from taxes and social contributions paid by citizens and companies, thus representing the main source of the budget. The remaining portion consists primarily of dividends from companies with capital participation of the state, various levies and funds from the EU. The revenues from the EU, as well as revenues from social contributions payable by the state for persons defined by law, are reflected in the budget expenditures in the same amount and, therefore, they have no impact on the resulting balance[50]. Taking into account these revenues, the share of taxes and contributions gradually grew from 81 % in 2009 to 86 % expected in 2019.

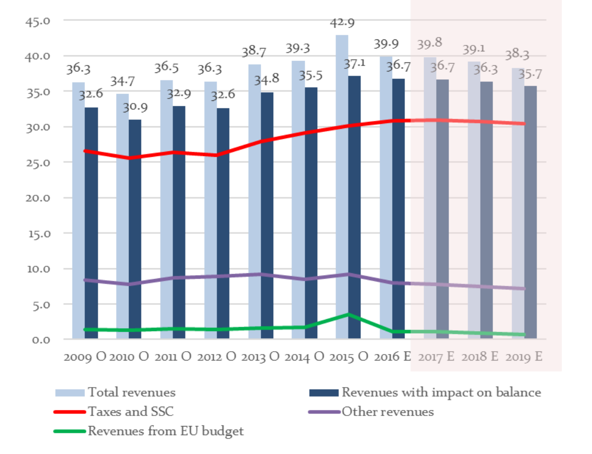
[50] In the case of social insurance contributions payable by the state, the impact on the balance is slightly negative because a part of social contributions goes to the pension asset management companies as a contribution to the fully-funded pillar of the pension system.

Figure 41: GG revenue structure in 2017 - CBR´s estimate (ESA2010, % GDP)



Source: CBR, MF SR

Figure 42: Change in revenues 2009-2019 (ESA2010, % GDP)



Source: CBR, MF SR

The budget proposal for 2017-2019 does not envisage any revenue-side measures that would increase the budget revenues above the expected nominal GDP growth. Quite the contrary, a slight decline in revenues relative to GDP is expected, which means that, **considering the current effort to reduce the deficit, the reduction of expenditures relative to GDP should be more significant in order to offset the negative impact of the decline in revenues.**

Figure 43: Impact of revenues on change in balance in single years – according to type of income (ESA 2010, % GDP)

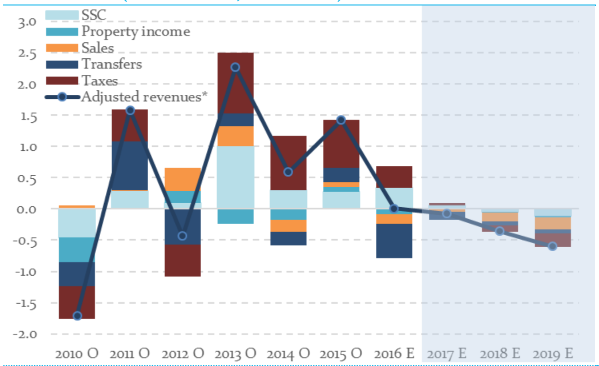


Figure 44: Cumulative impact of revenues on change in balance – according to type of income (ESA 2010, % GDP, since 2010)

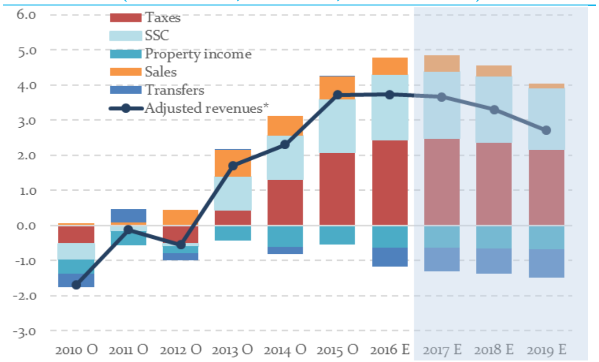


***Figure 43 and 44:** Figures illustrate contributions of single revenue items to a change in GG balance, whereas these are adjusted for impact of new unbudgeted GG subjects.*

Source: CBR, SO SR *Source: CBR, SO SR*

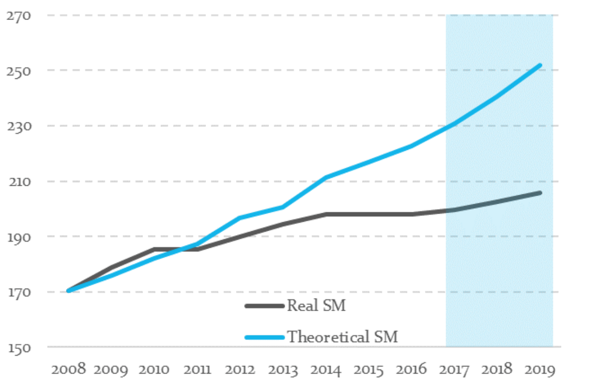
3.2.2 Taxation trends

The revenues from taxes and social contributions constitute the most significant portion of revenues and, therefore, any change in their proceeds has a great impact on the resulting fiscal performance. In the evaluations, the CBR and the government communicate new measures and their impact on the tax burden and the budget. The legislative framework in the tax system may involve automatic elements that are changing the effective tax burden even in the absence of legislative changes in the system of taxes and social contributions[51]. In Slovak tax system, this applies to the personal income tax.

A slow growth of tax allowances is "silently" increasing the taxation of income even without legislative changes

This is due to a difference in the growth dynamics of taxable income and tax allowances linked to the subsistence minimum. In such cases, we refer to the fiscal drag effect. Figure 45 shows the trends in actual subsistence minimum figures since 2008 as compared to a hypothetical situation where the fiscal drag effect would not be present if the subsistence minimum level had been growing at a pace equal to that of median wage. The tax burden has increased across the entire distribution of income, with the highest impact of 2.3 p.p. seen at the low income range (Figure 46). The reason is that the same change in tax paid translates, within the lower income range, into a higher increase in effective tax burden measured in percentage points. The tax burden declined only in 2009 and 2010 when subsistence minimum grew faster than the median wage. The widening gap due to the growth of tax allowances lagging behind the growth of income will also be seen in the budgeted period. Compared to 2016, the effective tax burden in relation to personal income tax is expected to increase by 0.5 p.p.

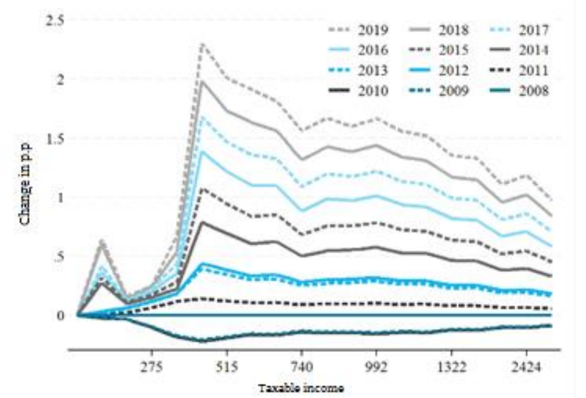
Figure 45: Trend of the real subsistence minimum and the theoretical subsistence minimum indexed by the median wage growth rate.



Note: Theoretical subsistence minimum is assumed to grow from 2008 by the median wage growth rate.

Source: CBR

Figure 46: Impact of the fiscal drag on the average tax rate (change from 2008 in p.p.)



Note.: Underlying dataset and legislation is fixed for 2016. Only the impact of the fiscal drag is depicted.

Source: CBR

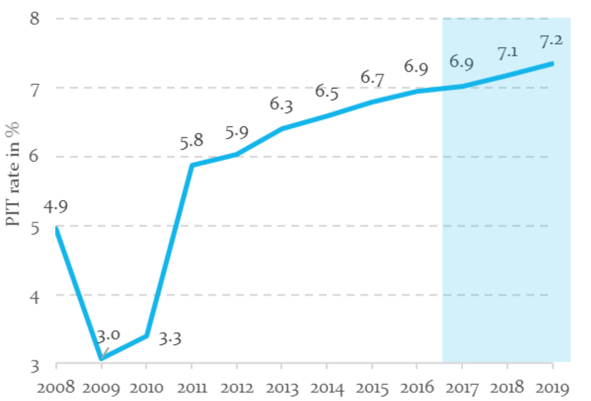
An increase in lump sum expenditures of self-employed in 2017 offsets the growing burden caused by the fiscal drag

The development of payroll tax burden between 2008 and 2019, including the legislative impacts, is shown in Figures 47 and 48 by means of effective income tax rate and tax the

[51] The impact on tax revenues is part of the no-policy change scenario (part of the TRFC forecast).

wedge[52] which includes, in addition to changes in personal income tax, also the changes in social and health insurance contributions, including contributions to the fully-funded pillar. The average effective tax rate represented 6.9% in 2016 and rose by 2 p.p. compared to 2008. (up 40%). Effective from 2017, an increase in lump sum expenditures of self-employed has temporarily stopped the increase in taxation. In comparison with 2016, the effective tax rate will increase by 0.3 p.p. by 2019. An increase in tax wedge against 2008 was less significant compared to the income tax, in particular due to the introduction of the payroll tax allowance in 2015. In 2016, it reaches 36%, up 0.9 p.p. compared to 2008. Between 2017 and 2019, the tax wedge is expected to increase only marginally by 0.1 p.p. while already reflecting the effect of increased lump sum expenditures of self-employed [53].

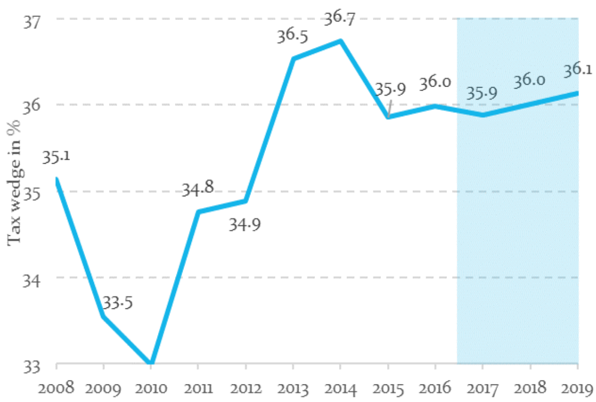
Figure 47: Effective tax rate on household level (in %)



Note: Effective tax rate is defined as the share of paid PIT on taxable income.

Source: CBR (SIMTASK)

Figure 48: Tax wedge on household level (in %)



Note: Tax wedge is defined as the share of paid PIT, social and health insurance contributions on total labour costs.

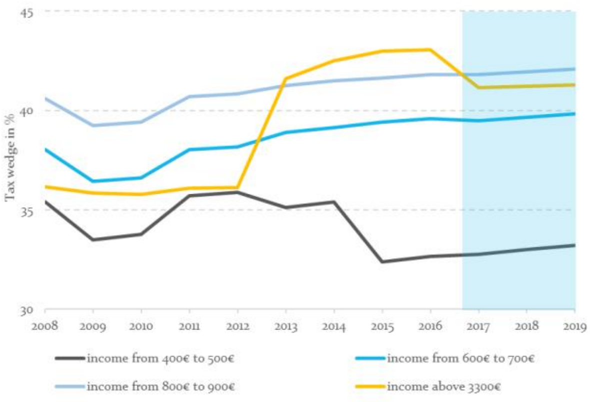
Source: CBR (SIMTASK)

The tax wedge has significantly dropped between 2009 and 2010 when the tax allowances were temporarily increased (returning back to their original levels in 2011). This legislative change did not affect high income groups. On the contrary, the payroll tax burden has increased for high income groups in 2013 when the maximum assessment bases were considerably raised from three- to five-fold of the average wage for health insurance payments and social contributions, while introducing the second income tax bracket at a rate of 25% in case the tax base exceeds the threshold of EUR 2,866. The introduction of the allowance on health insurance contributions in 2015 caused the payroll tax burden to drop significantly for low income groups. The tax wedge declined by three percentage points on average in the category of income between EUR 400 and 500. At the level of households, the effect of the health insurance allowance is also visible in higher income categories where this allowance is claimed by one of the partners. As of 2017, the tax wedge appears to be on a slight decline in particular for medium- and higher-income categories of individuals and households. The growing burden caused by the fiscal drag is offset by an increase in lump sum expenditures of self-employed in 2017.

[52] This analysis uses the legislation in the area of income tax, health insurance and social contributions as applicable in the relevant period, with the underlying data fixed for 2016.

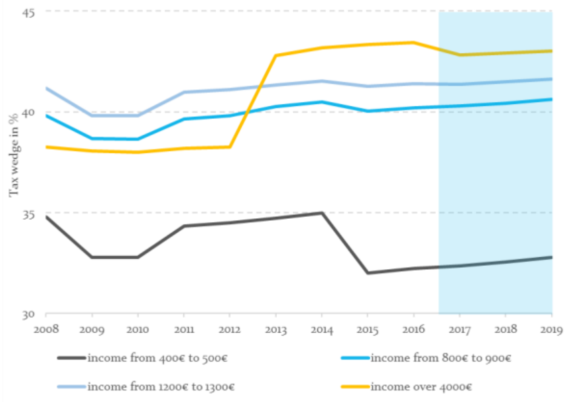
[53] Including social contributions to the fully-funded pillar. If the tax wedge is defined without the social contributions to the fully-funded pillar, the year-on-year increase in 2013 would be more pronounced.

Figure 49: Tax wedge on individual level by income groups (in %)



Source: CBR (SIMTASK)

Figure 50: Tax wedge on household level by income groups (in %)



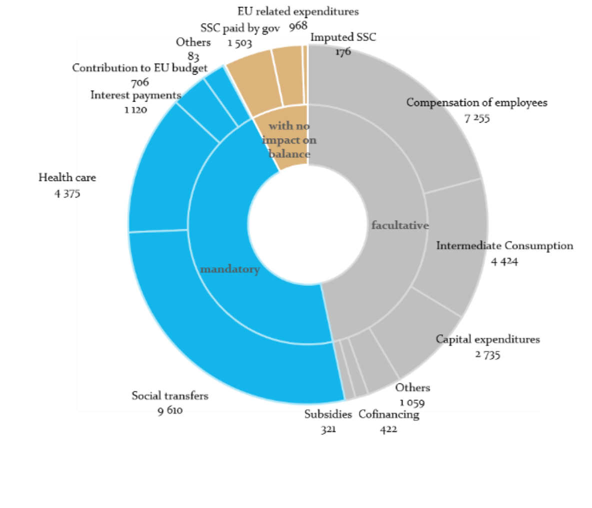
Source: CBR (SIMTASK)

3.2.3 Budget expenditures

The CBR estimates that the total expenditures of the budget will reach EUR 34.8 billion in 2017, up 1.6 % year-on-year. In terms of attaining the budgetary objectives, it is advisable to distinguish between facultative and mandatory expenditures. The decision on facultative expenditures is made by the government every year. These include expenditures on education, defence and security, or subsidies for companies. Expenditures associated with the administration and salaries of civil and public servants are not negligible either. In practice, this does not mean that the government decides on the total amount of expenditures, but rather on their year-on-year change[54]. Mandatory expenditures are defined by law and the government may not change them without amending the legislation. These include, in particular, expenditures on pensions, various benefits and healthcare. Even though the division line between them is not always clear, this breakdown provides information as to whether the structure of budget expenditures is changing. This is particularly important in a situation **where the proportion of mandatory expenditures is rising, thus narrowing down the government's flexibility in consolidating the budget.**

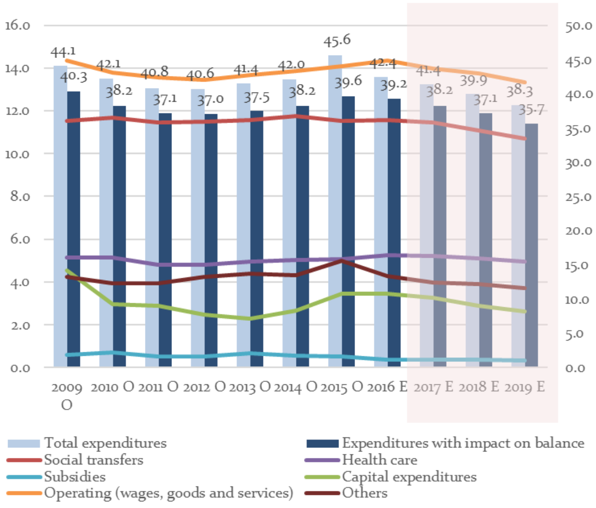
54 For instance, it cannot lower expenditure on salaries down to zero, but may considerably raise or lower such expenditure without having to change the legislation in the case of salaries where the government directly affects their development.

Figure 51: GG expenditures structure in 2017 - CBR´s estimate (ESA2010, % GDP)



Source: CBR, MF SR

Figure 52: GG expenditures in 2009-2019 (ESA2010, % GDP)



Source: CBR, SO SR

Between 2010 and 2016, the mandatory expenditures had a very slight impact on the budget balance. As their growth is based on rules set by legislation, these expenditures are rather perceived as the more stable portion of the budget in the medium term. On the contrary, **facultative expenditures increase the volatility of expenditures because they are decided upon by the government every year**. The CBR estimates that both types of expenditures would contribute to the improvement of the budget balance in the period between 2017 and 2019.

Figure 53: Impact of total expenditures on change in balance in single years – according to expenditures type (ESA2010, % GDP)

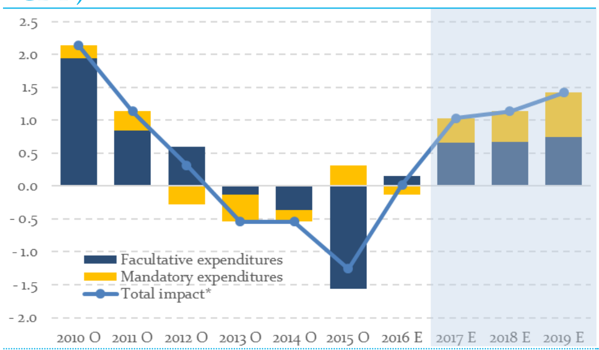


Figure 54: Cumulative impact of expenditures on change in balance – according to expenditures type (ESA2010, % GDP, since 2010)

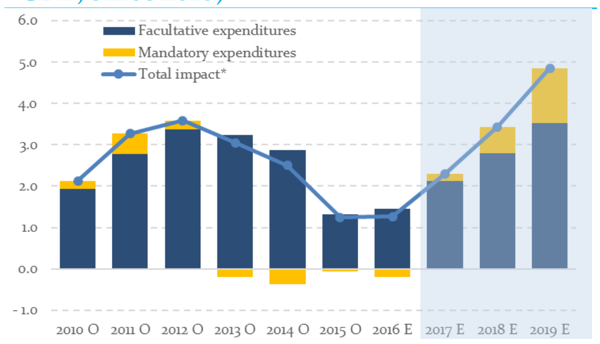
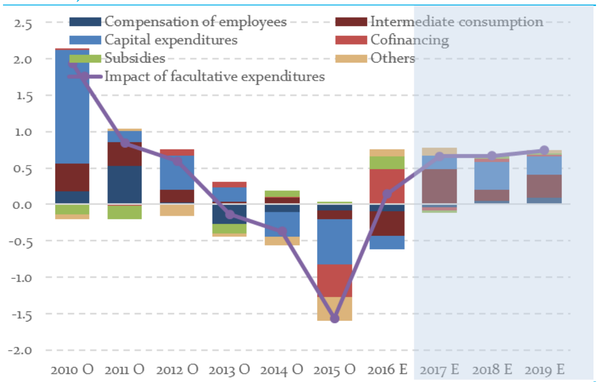


Figure 53 and 54: *Figures illustrate contributions of single expenditures revenue items to a change in GG balance, whereas these are adjusted for impact of new unbudgeted GG subjects.*

Source: CBR, SO SR *Source: CBR, SO SR*

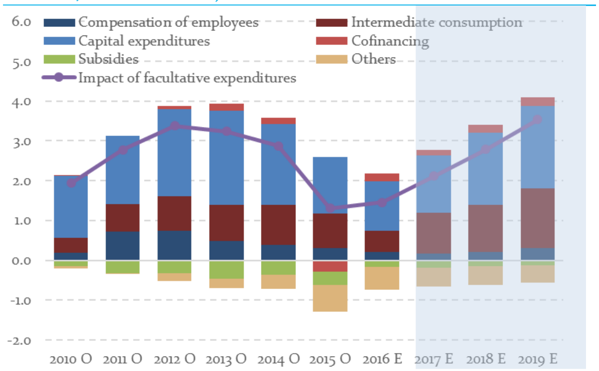
In terms of facultative expenditures, the balance is expected to improve between 2017 and 2019 due to a slower growth of expenditures on goods and services, as well investments. The average contribution to the budget improvement is quantified at some 0.7 % of GDP.

Figure 55: Impact of facultative expenditures on change in balance in single years – according to expenditures type (ESA2010, % GDP)



Source: CBR, SO SR

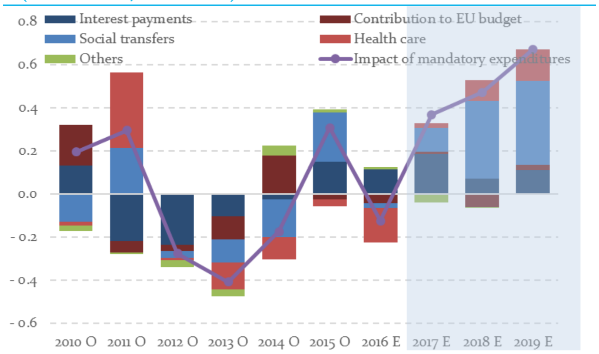
Figure 56: Cumulative impact of facultative expenditures on change in balance – according to expenditures type (ESA2010, % GDP, since 2010)



Source: CBR, SO SR

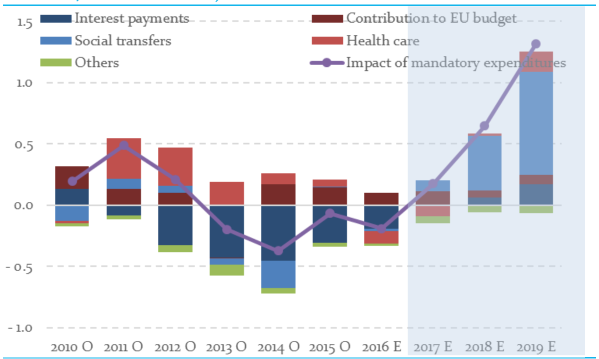
As part of mandatory expenditures, the balance is expected to improve between 2017 and 2019 due to a slower growth in expenditures on social transfers. Their slower growth compared to the nominal GDP growth is, on the one hand, caused by legislative rules (indexation of benefits to take account of inflation, an increase in pensionable age) and, on the other hand, by favourable developments in the labour market where the number of beneficiaries receiving social transfers (with the exception of pensions) is falling. In 2019, the high economic growth is also leading to a positive contribution of the healthcare sector and interest payments.

Figure 57: Impact of mandatory expenditures on change in balance in single years – according to expenditures type (ESA2010, % GDP)



Source: CBR, SO SR

Figure 58: Cumulative impact of mandatory expenditures on change in balance – according to expenditures type (ESA2010, % GDP, since 2010)



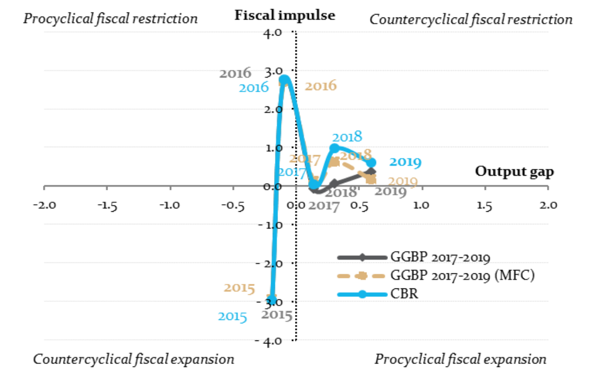
Source: CBR, SO SR

3.3 Impact of fiscal policy on the economic cycle

Apart from the fiscal performance of the government and its budgetary objectives, also the assumptions concerning the drawing of EU funds are important from the viewpoint of potential impacts on economic growth. These funds originate abroad and, adjusted for Slovakia's contribution to the EU budget, represent a net impact to the change in domestic demand.

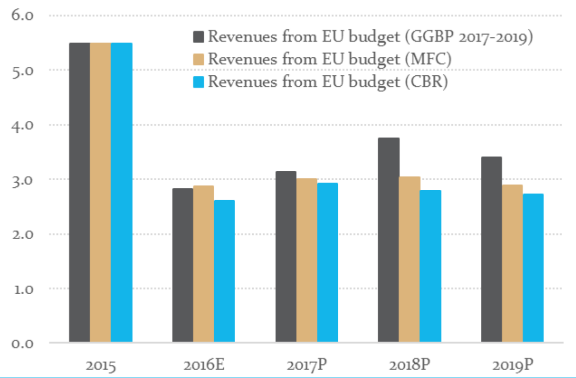
In 2016, the drawing of funds from the EU budget will temporarily slow down to levels seen in 2013 and 2014. With the gradual contracting of projects under the new programming period, the use of EU funds should regain momentum and thus accelerate economic growth. A more favourable macroeconomic environment expected in the upcoming period should give more room for fiscal policy tightening[55].

Figure 59: Fiscal impulse in 2015-2019 (% GDP)



Source: CBR methodology

Figure 60: Anticipated drawn of EU funds in GGBP (2017-2019) (% GDP)



Source: MF SR, CBR

3.4 Impacts on the long-term sustainability of public finances

The long-term sustainability of public finances is affected by the development of **the general government balance, existing debt and future liabilities**[56], in particular under the influence of population ageing.

The CBR evaluates long-term sustainability twice a year. In the spring, the Report on the Long-term Sustainability of Public Finances provides a detailed long-term sustainability quantification based on the actual fiscal performance and adopted measures **for the previous year**. In the autumn, as part of the evaluation of the budget proposal, the expected impact **on the upcoming year** is stated in a qualitative manner, taking into account the targets and measures proposed.

As stated by the CBR in its long-term sustainability report from April, there were no significant changes in the long-term sustainability of public finances **in 2015**. The worsened fiscal performance of the government in 2015 was offset by a better estimate of the development of public finances in the medium term under the assumption of no changes in policies. The contribution of future liabilities to the long-term sustainability has remained largely unchanged year-on-year.

In assessing the budget proposal for 2016 issued in November last year, the CBR expected an improvement in the long-term sustainability mainly due to better fiscal performance of the

55 The intensity of fiscal restriction will also depend on the amount of absorbed EU funds.
56 Mainly through increased expenditures on pensions and health care.

general government. As was the case with 2014 and 2015, the budgetary objective set by the government will not be met unless additional measures are adopted. The CBR estimates that the **primary structural deficit** could deepen to **0.9% of GDP** by 2016, with **general government debt reaching 53.5% of GDP.** In terms of future liabilities, the one-off allowance to the Christmas bonus[57] was approved again in 2016. The legislation describes the allowance as a one-off measure[58], however, this is a third measure of this kind over the past three years. For this reason, the CBR considers annual increases in the Christmas bonus as a permanent measure which slightly worsens the sustainability of public finances through higher expenditures of the pension system. Based on both of the above factors, the long-term sustainability is expected to worsen in 2016. The CBR will publish a detailed quantification in its Sustainability Report in April 2017.

Tab 12: Government objectives with impact on long-term sustainability (% GDP, ESA2010)

	2014	2015	2016	2017	2018	2019
GG structural primary balance	-0.6	-0.7	-0.9	-0.2	0.5	1.0
GG gross debt	0.0	52.5	53.5	52.8	51.7	49.3

Source: CBR

In 2017, the long-term sustainability of public finances is likely to improve year-on-year. This improvement is attributable, for the most part, to the primary structural deficit dropping **from 0.9% of GDP in 2016 to 0.2% of GDP in 2017,** while the decline in general government debt from 53.5% of GDP to 52.8% of GDP will have a smaller positive impact. In terms of future liabilities, the long-term sustainability will be affected in particular by changes in the general pension system.

The introduction of the **minimum indexation percentage threshold,** by which a fixed amount is set for increasing the pensions in 2017, will have a slightly negative impact on sustainability. The indexation percentage as laid down in the original legislation[59], which has reached the level of 0.3%, will be **brought by means of a one-off measure to 2% in 2017 under the new legislation**. Although the pensions are increased above the level set by the original indexation mechanism in a single year, the impact of higher pensions will be carried over to the subsequent periods because the expenditures of the pension system will remain increased for the duration of the lives of pensioners affected by such indexation.

Based on the above factors it is possible to say that 2017 will see an improvement in the long term sustainability as compared to 2015. This improvement is attributable to the expected better fiscal performance of the general government in 2017 which will compensate for the worsened sustainability in 2016.

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57 In the amount of EUR 12.74 for pensions not exceeding twice the subsistence minimum amount. The overall expenditures associated with the Christmas bonus will reach EUR 81.3 million, with the impact of allowance quantified at some EUR 10 million.

58 In terms of legislation, the one-off allowance is stipulated in transitional provisions.

59 The indexation percentage in 2017 was originally calculated as the weighted average of the year-on-year increase in consumer prices (CPI) and the average nominal wage as reported by the Statistical Office of the Slovak Republic for the first half of 2016. In the weighted average formula, the weight of consumer prices was set to 0.9 and the weight of the average nominal wage to 0.1.

Identification of risks resulting from the shortcomings in the legislative setup is part of the assessment of the pension system's impact on the long-term sustainability of public finances. Their potential adjustment may be reflected in the long term with a potentially negative impact on the long-term sustainability. The CBR has identified two problematic parameters in the current system[60].

First of all, for those people who worked less than 12 months in any year of their career, this shortened period will be taken into account twice in the calculation of their pensions: firstly, in the shorter qualifying period of their career and, secondly, in the lower value of their personal wage point expressing the amount of income in the given year. The second problematic parameter is related to an increase in pensionable age and applies to women who raised 2 or more children[61]. Within the next ten years, the transitory period will gradually expire for these women, which means that in the subsequent year, the pensionable age will see a step increase to the level of general pensionable age.

In the current setup, both cases bring savings in the pension system expenditures. On the other hand, these savings are coming from an unreasonable difference in the treatment of specific groups of insured persons – future pensioners.

60 In terms of legislation, this issue is regulated by Act No. 461/2003 Coll. on social insurance.

61 In this context, the legislation defines 3 categories: women with two children, women with 3 or 4 children and women with 5 or more children.

4 Evaluation of the budget in terms of fiscal rules

The general government budget should respect national rules, as well as those applicable to all euro area members. The most important national legislation includes the **Fiscal Responsibility Act** and the **balanced budget rule** which implements the international Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. At the EU level, compliance with the requirements of the **Stability and Growth Pact** and the related regulations is of particular importance.

The Fiscal Responsibility Act contains a **rule on the gross debt-to-GDP ratio** and defines the sanctions which are activated when specific thresholds are exceeded. Based on the Eurostat autumn notification on 21 October 2016, **general government gross debt reached 52.5 % of GDP in 2015** and stayed within the first sanction zone of the debt brake defined by the Fiscal Responsibility Act. The sanctions attaching to the first sanction zone oblige the Ministry of Finance to substantiate the debt amount in the national parliament and propose measures for debt reduction. The sanctions continue to apply until the debt falls below the first threshold, i.e., 50 % of GDP[62].

The CBR estimates that, after taking into account the risks within the budget, the debt will fall to 49.3 % of GDP[63] at the end of 2019 (if the bailout of healthcare facilities is included, the debt could reach 49.8 % of GDP). This means that the debt would continue to stay within the first sanction bracket. **The measures incorporated in the budget proposal are therefore not sufficient for steering the debt outside the sanction brackets.**

The act also contains a **debt rule for local governments** effective from 2015, and its breach triggers sanctions[64]. The rule is more stringent than the debt limit for general government (with the same upper threshold of 60 %) because it is assessed in proportion to local governments' current revenues rather than to their economic performance. The CBR published the results for 2015 at the end of August[65]. While the debts of all self-governing regions stood below the statutory limit, overrunning of the debt limit has been reported by 140 municipalities that are not subject to any exemption under the Act[66]. The Ministry of Finance will impose the fines after completing the ongoing verification of data.

Another important national rule is the **balanced budget rule**, according to which Slovakia should be moving towards a balanced budget in the medium term. In April 2016, the

62 The approval of the new Government Manifesto is without prejudice to the application of the first- and second-zone sanctions; while the application of sanctions starting from the third-sanction zone is suspended (a debt of at least 55 % of GDP).

63 If the GDP is revised, it may decline to 48.7 % of GDP.

64 If the total amount of debt of a municipality or self-governing region reaches or exceeds 60 % of its actual current revenues in the previous fiscal year, the municipality or self-governing region concerned shall pay a penalty imposed by the Ministry of Finance amounting to 5 % of the difference between the total debt amount and 60 % of its actual current revenues in the previous fiscal year.

65 The evaluation was part of the Report on Compliance with the Fiscal Responsibility and Fiscal Transparency Rules for 2015 (available only in Slovak).

66 The overrunning of the debt limit was reported by 69 additional municipalities. However, 67 municipalities are subject to a temporary exemption which applies upon the appointment of newly-elected mayors after the municipal election. The remaining two municipalities are under receivership which constitutes a permanent exemption from the fine.

government decided to postpone the deadline for attaining this objective until 2019, even though the initial deadline was set to 2017. The objective of structural deficit reaching 0.5 % of GDP remains unchanged. In its most recent calculations the Ministry of Finance assumes that the objective will be met already in 2018, but the CBR estimates its attainment in 2019. The Ministry of Finance and the CBR evaluate compliance with this rule on the basis of actual data[67]. Assuming that the risks identified by the CBR materialise in 2016 and the government does not adopt any additional measures, there might be a deviation[68] from the defined adjustment path based on the developments in the structural balance and the expenditure benchmark.

When it comes to the **application of EU fiscal rules**, the **fiscal policy is governed by the preventive arm of the Stability and Growth Pact** based on which Slovakia should be on the path towards meeting its MTO. The General Government Budget Proposal for 2017-2019, as well as the Draft Budget Plan of the Slovak Republic for 2017, declares compliance with these rules. Since the CBR does not quantify the change in structural balance strictly according to the methodology defined by the Commission, it does not evaluate the budgetary objectives in the budget proposal in terms of their compliance with the rules under the Stability and Growth Pact.

67 In July 2016, the CBR concluded in its evaluation that the 2015 deviation from the adjustment path was significant and that it would be necessary to trigger the correction mechanism.

68 Attaining the medium-term budgetary objective in 2019 requires a yearly improvement at a rate of 0.4 % of GDP starting in 2016. The CBR estimates that, without adopting additional measures in 2016, the change in the structural deficit will be zero, which means a deviation from the given rule. A similar deviation (0.3 % of GDP) is also implied by the expenditure benchmark.

5 Fiscal transparency rules

The preparation of the budget, as well as the approved documents, should respect the transparency rules defined in the Fiscal Responsibility Act. The Act requires independent assessment of macroeconomic assumptions and the tax revenue forecast as a prerequisite for making the fiscal framework realistic. The requirements concerning the publication of data should ensure better information about the overall situation in the budget and the policies that are being implemented.

The Macroeconomic Forecasting Committee and the Tax Revenue Forecasting Committee are responsible for ensuring the macroeconomic and tax revenue assumptions are realistic. The two committees operate independently. **In 2016, the committees held three sessions and published their forecasts in compliance with the constitutional Act.**

Tab 13: Draw up of the macroeconomic and tax forecasts by the Committee in 2016

		1. Mandatory term till 15.2.	*2. Mandatory term till 30.6.*	*3.*
Macroeconomic Forecasting Committee	session of the MFC	3.2.2016	15.6.2016	14.9.2016
	release of the forecast	**4.2.2016**	**21.6.2016**	19.9.2016
Tax Revenue Forecasting Committee	session of the TRFC	11.2.2016	23.6.2016	22.9.2016
	release of the forecast	**15.2.2016**	**30.6.2016**	29.9.2016

Source: MF SR

The General Government Budget Proposal for 2017-2019 **contained** all the data defined in the Act; however, **in terms of content, the information presented was not sufficiently explained and justified, which makes the evaluation and identification of potential risks more difficult**. The CBR requested access to a more detailed data and answers to additional questions. The Ministry of Finance accommodated the request and certain topics were discussed in depth.

The document provides information on the **latest estimate of the general government deficit for 2016.** The most important positive and negative factors in the fiscal performance of the general government in 2016 are presented in a summary table which is accompanied by a more detailed table containing the differences between the budget and the latest estimate, including a brief textual description. However, a better understanding and evaluation of the 2016 development in public finances requires additional information. The budget proposal contains a more detailed description of measures geared towards attaining the objectives. **Above the framework of the existing implicit liabilities**, the document also contains estimated impacts of the planned PPP projects (motorway bypass D4/R7 and the R1 expressway). The table of contingent liabilities monitors the situation as at the end of 2015 and the text part of the document provides information also on **new liabilities which arose in the course of 2016** (MH Invest – preparation and construction of the Nitra – Mlynárce industrial park). The risks associated with the **financial performance of corporations in the portfolio of the state or the MH Manažment, a.s.** cannot be evaluated due to the absence of performance results for all healthcare facilities with capital participation of the Ministry of Health of the Slovak Republic, with a brief commentary for all companies absenting as well. In some cases the data are presented only formally, without being clearly consistent with the budget proposal itself (MH Invest). Concerning local governments and the state budget, their balances incorporates the assumptions regarding their unbudgeted revenues and expenditures, what could be viewed positively. However, **unbudgeted revenues and expenditures of public universities**[69] remain a problem. The CBR appreciates that the government is building up **reserves for unexpected or crisis situations** allowing it to eliminate the potentially negative impacts on the fiscal performance of the general government**.** In terms of transparency, the **large volume of reserves reduces the parliament's control over the budget expenditures**, even more so when they are not specified in sufficient detail. At the same time, however, no transparent rules have been set as regards the manner and expenditures for which these reserves can be used.

[69] Unbudgeted revenues and expenditures are taken into account in the latest estimate of the public universities' fiscal performance for 2016.

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