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COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of Compliance with the Balanced Budget Rule in 2016

Summary

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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. 523/2005 on the general government budgetary rules and Act No. 493/2011 on fiscal responsibility.

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

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

Evaluation of Compliance with the Balanced Budget rule in 2016

The balanced budget rule[1] is based on the medium–term objective – a structural balance that Slovakia's public finances should attain or quickly approach. The evaluation of compliance falls under the responsibility of the Ministry of Finance ("Ministry") which publishes its reports biannually, by 30 June and 30 November. Subsequently, the Council for Budget Responsibility ("CBR") provides an independent evaluation. According to the principles published by the European Commission[2], the Ministry publishes its position on CBR evaluation.

The CBR prepared its final evaluation of compliance with the balanced budget rule for 2016 based on the data contained in the October deficit and debt notification by Eurostat. It also contains CBR's response to the evaluation published by the Ministry on 30 November 2017. The methodology of evaluation has not changed. The evaluation reflects the fact that, in 2016, the government decided[3] to postpone its ambition to meet the medium-term budgetary objective from 2017 to 2019. Consequently, 2015 was taken as the baseline year of the evaluation[4].

The 2016 general government structural deficit reached 1.89 % of GDP, which means that medium–term objective of having a close to balanced budget (structural deficit up to 0.5 % of GDP – Figure 1) was not met. With additional factors taken into account, the development of both the structural balance and adjusted expenditures showed a deviation of up to 0.5 % of GDP[5]. Since none of the indicators exceeded the deviation margin set by the balanced budget rule, the CBR holds that the deviation was not significant and the correction mechanism does not have to be triggered.

In 2016 the structural balance improved by 0.68 % of GDP y-o-y, 0.16 % of GDP above the required improvement at 0.52 % of GDP necessary to meet the MTO by 2019 (Figure 2). **In its overall evaluation the CBR also took into account the effects of other factors which reduced the annual improvement in structural balance to 0.34 % of GDP, veering 0.17 % of GDP off by from the adjustment path**. These factors include, in particular, windfall revenues at 0.25 % of GDP and the reduction in debt interest payments by 0.1 % of GDP, since these factors do not depend solely on the present fiscal policy.

The 2016 adjusted expenditures overran the expenditure benchmark ceiling by 1.09 p.p. y-o-y, (Figure 3) with negative effect on the balance at 0.42 % of GDP (Figure 4). The evaluation of compliance with the expenditure benchmark rule reflects the lower national co-financing of EU projects, causing lower tax revenues, and increased effectiveness of VAT collection, which can be considered a government measure. **These additional factors reduced the negative impact of the adjusted expenditures's deviation on the balance to 0.32 % of GDP.**

The main reason behind the difference between the two indicators lies in lower government investments. While the increase in adjusted expenditures had a negative impact of 0.14 % of GDP

1 Transposed into Slovak law based on an obligation arising from the international Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The first evaluation was presented in 2014 (for 2013).

2 Communication from the Commission: Common principles on national fiscal correction mechanisms of 20 June 2012 (/* COM/2012/0342 final */). The 'comply or explain' principle.

3 The new government formed after the 2016 general elections decided to postpone the meeting of the medium-term budgetary objective by two years. The government reasoned the postponement arguing that the new government objectives were in line with the rules of the Stability and Growth Pact and, as such, enabled the government to finance its investment priorities. In its evaluation of the 2015 results the CBR noted the existence of a significant deviation and suggested the activation of the correction mechanism, namely the setting of a mandatory expenditure limit at the level planned and presented in the 2017-2019 general government budget, which had already assumed postponement in meeting the MTO.

4 The year for which, at the time when the decision to postpone the meeting of the MTO was taken, the real figures for the general government's fiscal performance were available.

5 The threshold of significant deviation. A deviation becomes significant from 0.5 % of GDP upwards.

due to the use of multi-annual average in the evaluation, their contribution to structural balance improvement reached 0.3 % of GDP. **Since the development of investments may fluctuate quite considerably in time, the adjusted expenditure indicator can better capture the development in public finances in 2016 given the potentially negative impact of declining investments on the future economic growth.**

Apart from evaluating these two indicators, the CBR also took into account the impact of the likely financial corrections payable due to the irregularities identified in the drawing of EU funds towards the end of the 2nd programming period. Moreover, the CBR also took into account the fact that the debt level continues to remain within the sanction zones set by the Fiscal Responsibility Act[6], yet no additional measures have been adopted[7] to reduce the debt.

In spite of the deviations identified for both indicators, the 2016 structural balance was closer to the MTO than what the adjustment path required. The deviation should thus be interpreted as a reason to step up consolidation because the structural balance improvement was mainly due to windfall revenues (0.25 p.p.) and lower investments (0.3 p.p.). **The 2016 development created preconditions for meeting medium-term objective ahead of 2019**[8].

The meeting of the budgetary objectives set in the draft 2018-2020 General Government Budget would, according to the CBR, lead to meeting the MTO in 2019. On the other hand, the 2016 deviation from the adjustment path, and the risks of not meeting the 2017 and 2018 budgetary objectives, increase the risk of the deviation turning significant in the years to come.

The conclusions by both the Ministry and CBR are identical. Neither of them concluded that the conditions for the activation of the correction mechanism were met. The Ministry published its evaluation of compliance with the balanced budget rule for 2016 on 30.11.2017, stating that the 2016 structural balance followed the adjustment path and that deviation from the expenditure benchmark was not significant. With additional factors taken into account, the structural balance did not change and the expenditure benchmark deviation became significant, although the Ministry did not explain in explicit terms why the two indicators differed. Given the application of the Stability and Growth Pact matrix in its overall evaluation[9], the Ministry did not propose to activate the correction mechanism. The CBR's evaluation is less favourable when it comes to the structural balance, since the CBR does not view the deviation significant, and more favourable as regards the expenditure benchmark, since the CBR only identified a deviation.

The differences between the two evaluations stem mainly from the way in which they reflect the additional factors and one-off effects. The Ministry did not take into account additional revenues, lower debt interest payments, and measures neutral to long-term sustainability, nor did it assume any additional financial corrections beyond 2017 which, according to the CBR, may affect the structural balance. On the other hand, the Ministry assumed a more adverse impact of co-financing expenditures on the development of adjusted expenditures, which makes the evaluation of the expenditure benchmark rule more stringent. In the category of one-off effects, the Ministry did not assume a one-off reduction in government receivables from a cartel penalty imposed in the construction sector.

6 The Fiscal Responsibility Act (Constitutional Act No. 493/2011).

7 CBR, Evaluation of the Draft General Government Budget for 2018-2020, November 2017 (only summary available in English version).

8 Windfall revenues/expenditure shortfalls should be reflected in the evaluation of compliance with the requirement for structural balance improvements towards the medium-term budget objective within the preventive arm of the Stability and Growth Pact (Article 5, paragraph 1 of Council Regulation No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, as amended).

9 Under the rules of the Stability and Growth Pact, a significant deviation leading to the triggering of the correction mechanism may only occur if at least one of the indicators in the basic evaluation (i.e., without including additional factors) meets the criteria of a significant deviation.

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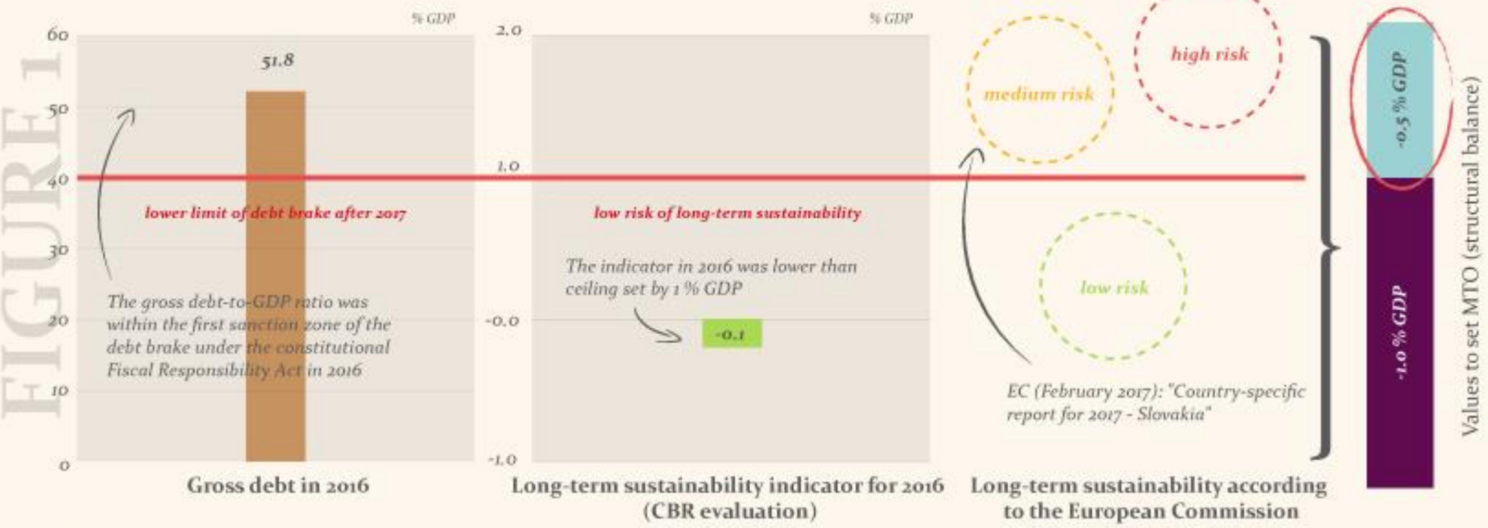
Structural balance

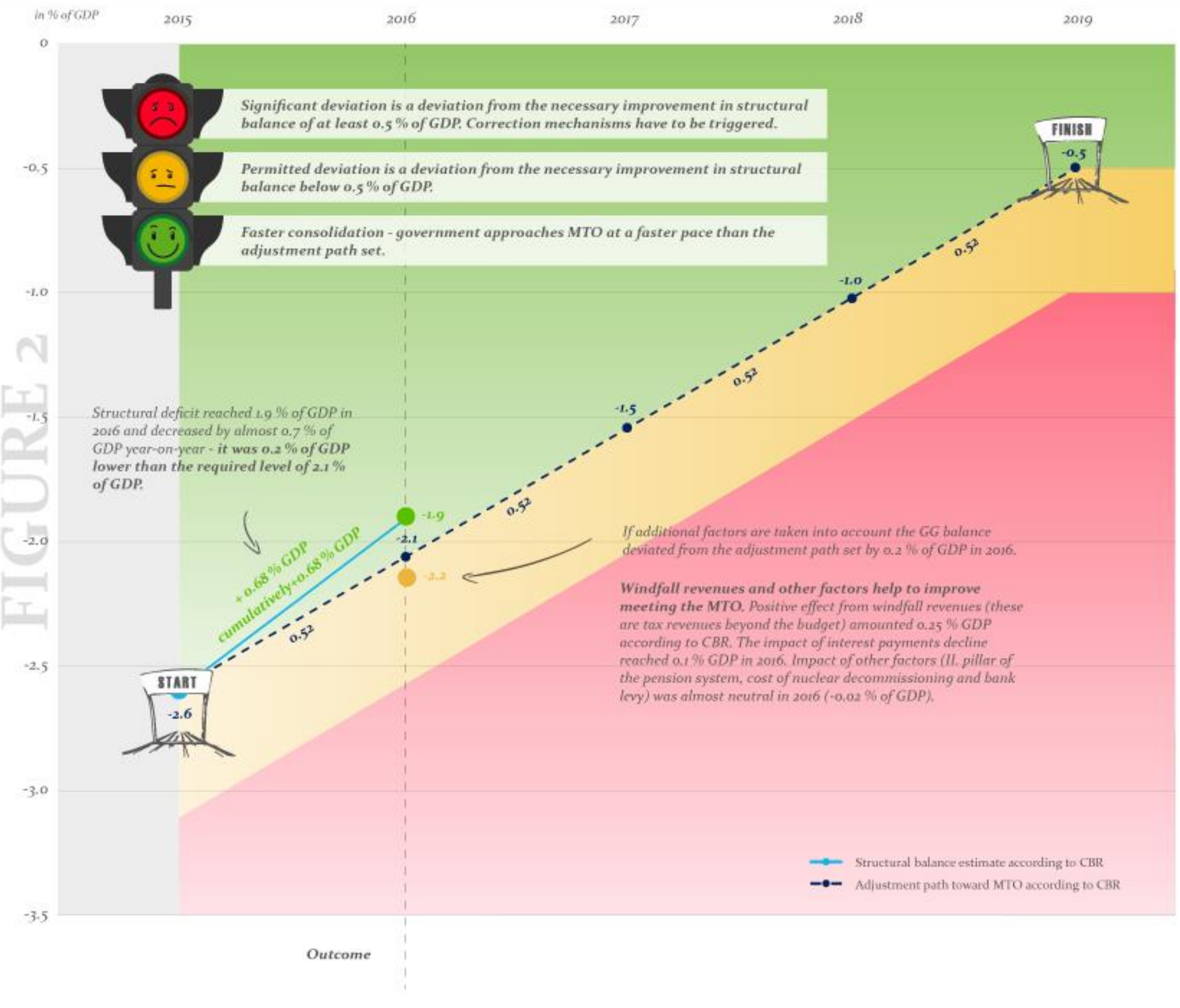
Given the level of the debt and long-term risks, a more stringent MTO has been set - structural deficit of 0.5 % of GDP.

FIGURE 1



The general government structural deficit stood at 1.9 % GDP in 2016, i.e. the medium-term objective of attaining a close to balanced budget (structural deficit up to 0.5 % of GDP) was not achieved.

FIGURE 2



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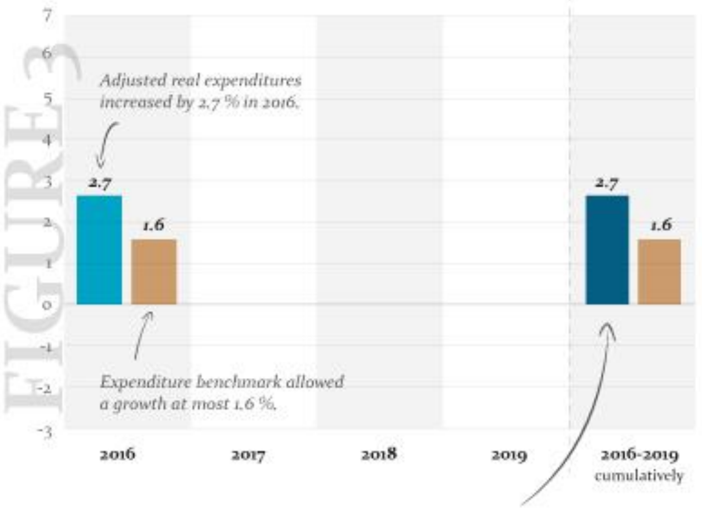
Expenditure benchmark: The growth in expenditures in 2016 was 1.09 p.p. higher than the growth given by the rule with a negative impact on the balance at the level of 0.42 % of GDP.

FIGURE 3

Expenditure growth in %

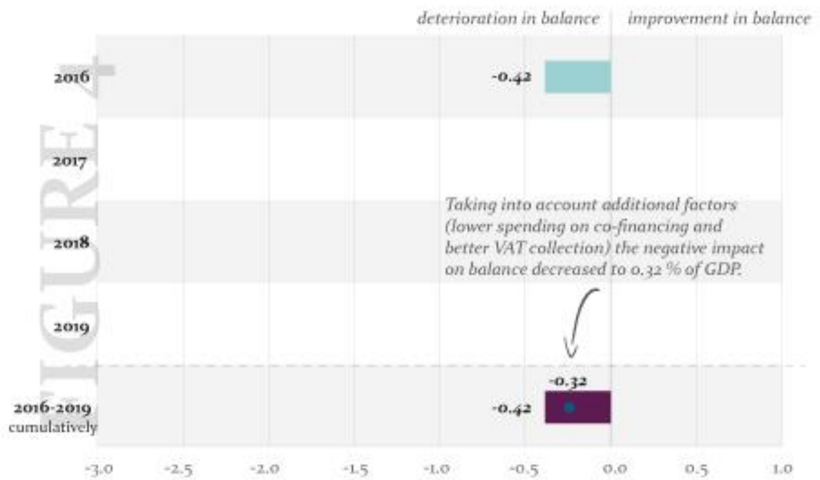


Adjusted real expenditures increased by 2.7 % in 2016, whereas the benchmark expected their growth at most 1.6 %.

Actual pace of expenditures growth — *Expenditure benchmark (permitted growth in expenditures)*

FIGURE 4

Impact on the balance (% GDP)



If the expenditures growth was in line with the expenditure benchmark, the deficit would be 0.42 % HDP lower in 2016, totalling 1.8 % GDP (the deficit reached 2.2 % GDP).

Taking into account additional factors the CBR´s as well as MF´s evaluation worsened

FIGURE 5

	CBR	Ministerstvo financií Slovenskej republiky
Change in structural balance	fulfilled	fulfilled
Expenditure benchmark	deviation	deviation
Additional factors	worsened the evaluation	worsened the evaluation
Change in structural balance	deviation	fulfilled
Expenditure benchmark	deviation	significant deviation
Change in fully-funded pension pillar	without impact	not assessed
Cost of nuclear decommissioning	without impact	not assessed
Extended bank levy	without impact	not assessed
Interest payments	−	not assessed
Windfall revenues	−	not assessed
Debt within "debt brake" sanction thresholds	−	not assessed
Lower expenditures on co-financing	−	−
More effective VAT collection	+	+
Time-consistent recording of correction to EU funds	without impact	+
Final evaluation	no significant deviation	no significant deviation

The main cause of dissimilar results of both of the indicators stem from y-o-y decline in investment of the general government in 2016. The impact of investment in the adjusted expenditures growth was negative amounting 0.14 % of GDP (due the multi-annual averaging of the investment), whereas contribution to the improvement in the structural balance reached 0.3 % of GDP.

The interest payment decline contributed to the structural balance improvement by 0.1 % GDP in 2016.

Windfall revenues improved the structural balance by 0.3 % GDP in 2016. The structural balance should thus improve more significant against the adjustment path set.

Lower EU funds withdrawing associated with lower cost on co-financing decreases tax revenues. The impact on structural balance is thus almost neutral. The expenditure benchmark reflects only a decline in expenditures on co-financing. To ensure a neutral impact on the balance an assumption of a tax revenue reduction in the amount of 0.22 % of GDP was considered within the additional factors.

Due to the lack of complete information about shifts in present corrections (reducing the deviation) and the missing estimate of future corrections (increasing the deviation), the CBR considered the actual level of corrections under ESA2010. According to the CBR, this level gives a more precise picture of the expected effect of corrections on structural balance in 2015 and 2016. The Ministry only considered the time in shift in present corrections which reduce the deviation.

Taking into account additional factors a deviation was identified in case of both indicators. As the deviation is not considered as significant according to CBR, there is no need to trigger the correction mechanism.

− + *effects increasing/decreasing deviation in structural balance or expenditure benchmark*

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