COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of the General Government Budget Proposal for 2018-2020

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. 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.

Summary

The Slovak government has submitted the General Government Budget Proposal for 2018-2020 in which it declared, in line with its Manifesto, the intention to achieve a balanced budget by 2020. In 2017, the government estimates the general government deficit at 1.63 % of GDP, which is above the level of the budgetary objective at 1.29 % of GDP. In the subsequent years, the deficit is expected to gradually decline towards a balanced budget which, according to the calculations of the Ministry of Finance, should lead to meeting the medium-term budgetary objective as well. In line with the declared objectives, the government also expects the debt to fall from the estimated level of 51.1 % of GDP in 2017 to 45.5 % of GDP[1] by 2020, thus bringing the debt outside the debt sanction zones in 2019 even despite the gradual lowering of debt limit boundaries as of 2018. Compared to the approved general government budget for 2017-2019 the debt forecast improved by 1.46 % of GDP in 2018 and by 1.23 % of GDP in 2019, provided that the balance targets are met. The targets for the budget balance for 2018 and 2019 have worsened by 0.39 % of GDP and, 0.26 % of GDP respectively. If the government does not adopt any new measures after 2017, the no-policy-change scenario[2] indicates that the medium-term budgetary objective would be attained already in 2018, i.e., two years earlier than what is assumed in the budget proposal and, in 2020, the public finances would reach a surplus of 0.56 % of GDP. The budget proposal contains mostly measures on the expenditure side, the aggregate effect of which, according to the Ministry of Finance, deteriorates the general government balance in comparison with the no-policy-change scenario. The measures included in the budget proposal are not sufficient for meeting the targets set. In 2019 and 2020, the deficit is budgeted at some 0.3 % of GDP[3] and, in order to achieve the medium-term budgetary objective, additional measures of equal amount will have to be adopted, according to the government.

As regards meeting the objectives under the Fiscal Responsibility Act, the government's budget proposal fails to sufficiently capitalise on the favourable economic conditions to accelerate consolidation. The weak binding nature of the medium-term budgetary framework has allowed the government to submit a budget proposal that worsens the budget balance targets again and necessitates the adoption of additional measures to meet the medium-term budgetary objective in 2020. The budgetary objectives are threatened by risks amounting to 0.6 to 0.8 % of GDP a year and, in case these risks materialise while taking into account the current macroeconomic assumptions, a balanced budget can only be attained within the timeframe of the budget if more profound consolidation measures are adopted. The CBR estimates that, having considered the risks of the budget proposal, the debt would decline to 47.5 % of GDP at the end of 2020, thus staying within the first sanction

1 This means the debt level if the targets declared by the government are met. Neither the budget proposal nor the Draft Budgetary Plan for 2018 contains the debt forecast at the budgeted balances. After taking into account the need for additional measures – expected by the government and not incorporated in the budget proposal – aimed at attaining the objectives, the debt would reach a level of 46.0% of GDP in 2020.

2 Based on the no-policy change scenario prepared by the Ministry of Finance of the Slovak Republic and incorporated in the Draft Budgetary Plan for 2018. According to the Ministry of Finance, the no-policy-change scenario, defined as the development in public finances assuming unchanged legislation and updated estimate of macroeconomic development, quantifies the size of measures necessary for the attainment of budgetary objectives.

3 In 2019, the deficit is at 0.32 % of GDP and at 0.27 % of GDP in 2020.

zone. The expected worsening of the deficit in 2017 and negative impacts of measures in the pension system are slightly deteriorating the long-term sustainability of public finances. In order to preserve the long-term sustainability of public finances, it is inevitable to meet the objectives declared by the government which are aimed at achieving a balanced budget by 2020. Transparency has improved with the provision of more detailed information in those areas where expenditures were subjected to review under the Value for Money project. In terms of comprehensively communicating the individual measures and the manner in which the budgetary objectives are to be achieved, the budget proposal is considered as less transparent.

The purpose of the CBR's opinions is to offer an independent view on the budget and assess whether the current 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 subsequently 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 maintaining the long-term sustainability of public finances[4] and for complying with the national fiscal rules. With this objective in mind, the CBR is pointing at the following potential risks and positive aspects of the budget proposal:

- **In 2017, the government has not yet adopted sufficient measures to eliminate all identified risks.** Many of the risks, which the CBR warned of at the end of the last year, appear to be materialising also on the basis of estimates by the Ministry of Finance (expenditures of local governments, the healthcare sector and financial corrections to EU funds), while the deficit was reduced thanks to positive additional effects in the form of lower co-financing expenditures and zero spending from reserves. According to the CBR, additional risks for the development of the 2017 deficit exist beyond the estimate referred to in the budget proposal, especially with respect to revenues from dividends and emission allowances, expenditures in the state budget and also in the healthcare sector and local governments. In its evaluation of the medium-term budgetary objectives for 2017-2020 (Stability Programme of April 2017), the CBR estimated the 2017 deficit at 1.5 % of GDP. **Unless additional measures are adopted by the end of the year, the deficit may approach 1.7 % of GDP under the CBR's current estimate.**

- **In the 2018-2020 budget proposal, negative risks outweigh the potential sources for the coverage of risks.** The CBR has identified overestimated non-tax revenues (this again involves insufficiently explained higher dividends and revenues from the sale of emission allowances, unspecified revenue from the sale of assets as well as an increase in the fee for the management of emergency oil stocks which has not been approved yet) and, compared to the past, a low level of local governments' current expenditure in particular. The risks in the healthcare sector have been reduced compared to the previous evaluations and, with a gradual acceleration of budgeted expenditures in this area, the CBR has noted a more pronounced risk only in 2018. Additional risks have been identified by the CBR in operating costs of the Social Insurance Agency, the Železničná spoločnosť Slovensko (a railway company) and in non-budgeted expenditures for the replenishment of emergency oil stocks. In addition, the budgeted wage expenditures of ministries and other budgetary chapters do not include a wage increase in state administration and a

[4] In the Report on the Long-term Sustainability of Public Finances for 2016 (April 2017), the CBR noted that public finances would be sustainable in the long term if the no-policy-change scenario (baseline scenario) is met.

further raise in wages in the educational sector envisaged for 2019 and 2020 in line with the Government Manifesto that may be predominantly covered from created reserves[5]. The amount of financial corrections to EU funds and the absorption of EU funds, which may lead to higher expenditures on national co-financing in 2018, remain a source of uncertainty as well. Unclear expenditures on the purchase of military equipment due to the classified nature of these transactions may also pose a risk. 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. In order to meet the 2018 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 1.4 % of GDP[6] in 2018 and the gross debt would amount to 50.7 % of GDP[7] by the end of 2017.

- **In the medium term, there are additional risks going beyond the scope of quantified risks which may pose a threat to the adjustment path and the meeting of the medium-term objective until 2020.** Over the recent years, the deficit has declined also due to lower capital expenditures of the state budget and of municipalities (excluding European funds and national co-financing), while the budget proposal does not assume any significant increase in their amount in the future even though their level is not sufficient for the renewal of the existing assets, thus contributing to the reduction of the net worth of the Slovak Republic. The budget proposal assumes a saving of more than 1 % of GDP in social transfers in the medium term. Because most of them are linked to inflation or a government decision/change in legislation and, over the recent years, these benefits have not been adjusted significantly, there is a risk of their revision with a negative impact on the state budget[8]. The budget proposal also contains information on financial performance of state-owned corporations, many of which have been generating losses in the long term, and any potential support received from the state will have an impact on the general government deficit and debt.

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5 According to the Ministry of Finance, the VPS chapter (General Treasury Administration) includes indexation of wages of employees in the civil and public service sector by 4 % as of 1 January 2018 and a 2 % increase in remuneration through bonuses from 1 September 2018 to 31 December 2018 in accordance with a memorandum constituting an annex to higher level collective agreements for 2017, and indexation of wages of pedagogical and professional personnel and university teachers by 6 % from 1 January 2019 and by a further 6 % from 1 January 2020 in accordance with the Manifesto of the Government of the Slovak Republic. In the budget proposal, the Ministry of Finance does not indicate the expected amount for the indexation of wages in the civil and public service sector in 2019 and 2020.

6 The European Commission estimates the 2018 general government deficit at 1.0 % of GDP.

7 Similarly, to the European Commission, the CBR does not consider additional measures; therefore, the estimate is considered as conservative one.

8 The budget proposal includes, for instance, an increase in allowance provided in connection with the care for severely disabled persons. On the contrary, the budget proposal does not reflect an increase in benefits for people in material need by 5 % from 1 January 2019, which was submitted to the government on 3 November 2017 (a bill amending Act No. 417/2013 Coll. on assistance in material need and on amendments to certain acts as amended and amending Act No. 453/2003 Coll. on state administration bodies in the field of social affairs, family and employment services and on amendments to certain acts as amended; document No. UV-47919/2017).

- **Should the risks identified by the CBR materialise, additional measures would have to be adopted to reduce the debt to a level outside the sanction brackets specified in the Fiscal Responsibility Act.** Fiscal policy should regain sufficient margins for manoeuvre mainly in good times when the economy generates higher tax revenue and spends less. The reduction in the gross-debt-to-GDP ratio was largely driven by one-off government measures between 2014 and 2016 (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 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.

- **By postponing the deadline for attaining a balanced budget, the size of measures necessary for improving the deficit is reduced.** The policy setup in 2017 and a favourable macroeconomic development are considerably contributing to deficit reduction and to achieving the medium-term objective. If the government does not adopt any new measures after 2017, the CBR estimates that the deficit would decrease by 1.3 % of GDP by 2020. After taking into account all of the risks identified, the CBR estimates the contribution of government measures to the worsening of the balance at 0.3 % of GDP for all three years taken together.

- **In comparison with the Budget Proposal for 2017-2019, the transparency of the budget is lower in some areas.** The CBR assessed the transparency of the budget from three angles: compliance with the requirements of the Fiscal Responsibility Act, the application of the ESA2010 methodology and the comprehensibility of communicated objectives and individual measures. The budget proposal in principle complies with the formal requirements of the law. In comparison with the budget proposal for 2017-2019, several identified shortcomings have not been remedied (missing information on financial performance of the companies with equity participation of the MH Manažment, healthcare facilities with equity participation of the Ministry of Health of the Slovak Republic, and part of revenues and expenditures of public universities are not covered by the budget[9]). In terms of transparency, applying the ESA2010 methodology consistently with how data is reported by the Statistical Office of the Slovak Republic after verification by Eurostat is important as well. The CBR has been repeatedly pointing to the fact that the budget proposal is not compiled in line with the ESA2010 methodology in the case of several items (emission allowances, debt interest payments), as also confirmed by actual data notified by Eurostat. As regards overall comprehensibility of the fiscal framework, the budget proposal does not sufficiently clarify the manner in which the declared objectives related to the budget balance are to be achieved. All of the most important information, including the structural balance development, compliance with European rules and the development of debt, rely on the declared objectives rather than taking the budgeted balance into account. Several measures incorporated in the budget proposal have not been sufficiently explained and presented while a considerable portion of their impacts was included in a large volume of unspecified reserves. The volume of measures still awaiting

[9] Unbudgeted revenues and expenditures are taken into account in the latest estimate of the public universities' fiscal performance for 2017.

approval has increased as well, yet the final shape of the measures and their impacts was not known at the time when the budget proposal was approved by the government (social contributions relief for pensioners, introduction of the 13th and 14th salary, impacts of the minimum wage, taxation of gambling, excise tax on insurance premiums, higher fee for the storage of emergency oil stocks). A high volume of reserves reduces the transparency of the budget due to the absence of rules setting out the manner in which those reserves can be spent, while their actual use is not published.

- **Measures identified under the Value for Money (VfM) project have not been included in the budget proposal.** Under the project, several additional areas have been assessed: education, labour and social affairs and the environment. The identified measures are described in the text part of the budget, thus contributing to the improvement of information in this area, but are not incorporated in the budget proposal. The only area of the revision which has been more thoroughly incorporated in the budget (already in the 2017-2019 budget) involves measures in the healthcare sector. A stronger link between the budget and the results from the VfM project in other areas would significantly contribute to a more effective spending of public funds.

- **The binding nature of the medium-term budgetary framework is weak**, which makes it possible to change the budgetary objectives while the planned deficits are being revised upwards in each annual update of the three-year budget. Moreover, the deficits between 2014 and 2016 were higher than planned in the approved budgets and there is a risk that this will be the case with the 2017 deficit as well. The budgetary objective set for 2018 was gradually revised upwards, from a deficit of 0.5 % (Stability Programme for 2015-2018) to 0.8 % of GDP (General Government Budget Proposal for 2018-2020), while tax revenues grew by 2.3 % of GDP[10] 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. According to the CBR, the introduction of expenditure ceilings, as contemplated by the Fiscal Responsibility Act, could significantly facilitate consolidation in good times.

- **The budget proposal also contains tax-related measures that have not been discussed by independent Committees** (introduction of the 13th and 14th salary, social contributions relief for pensioners, excise tax on insurance premiums)[11]**.** The macroeconomic and tax forecasts approved by the respective independent committees reflect only those measures that were approved by the government or the parliament at that time. In terms of assessing the fiscal policy, it would be advisable that the Macroeconomic Forecasting Committee also focuses on the output gap estimate which is only an optional indicator now. For the sake of increasing transparency, the Tax Revenue Forecasting Committee should be assessing all revenues that are treated as taxes under the ESA2010 methodology.

[10] An increase in expenditures in comparison with the original assumptions in the Stability Programme for 2015-2018 might have indirectly led to higher tax revenues.

[11] In accordance with the Statutes of the Tax Revenue Forecasting Committee, its Chairman informed the individual members, by letter of 16 October 2017, about additional measures that are affecting accrual tax revenues incorporated in the budget proposal beyond the Committee's approved forecast.

- **In order to preserve the long-term sustainability of public finances, it is necessary to meet those objectives declared by the government to achieve a balanced budget by 2020.** In the Report on the Long-term Sustainability of Public Finances for 2016 (April 2017), the CBR noted that public finances would be sustainable in the long term if the no-policy-change scenario (baseline scenario) is met. In comparison with the baseline scenario, the budget proposal expects higher deficits for all years of the period covered by the budget which, provided that they materialise, would contribute the most to the worsening of the long-term sustainability. In addition, there were two measures approved in connection with the pension system which have a very slight negative impact on the long-term sustainability.

The CBR's opinion is based on the 2018-2020 General Government Budget Proposal and the Draft Budgetary Plan for 2018 approved by the government approved on 11 October 2017. The CBR will update its evaluation once the budget is approved by the parliament.

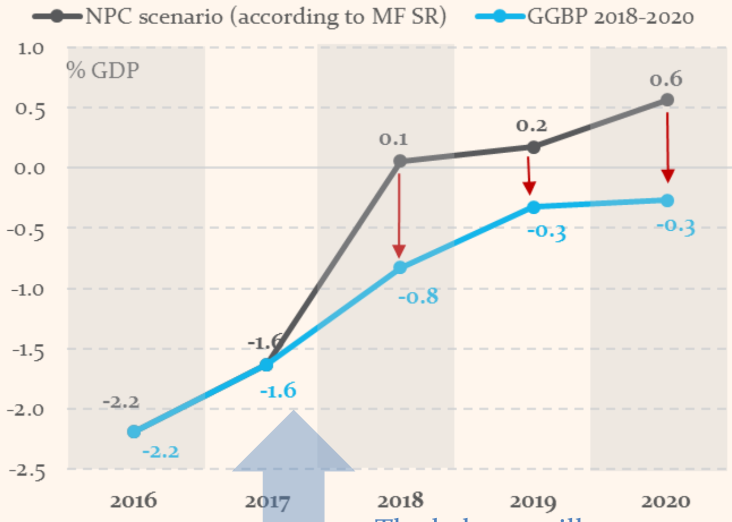
Evaluation of the General Government Budget Proposal for 2018-2020

CBR COUNCIL FOR BUDGET RESPONSIBILITY

What the General Government Budget Proposal for 2018-2020 says

According to the MF SR, the overall effect of the measures contained in the Stability Programme worsens the balance compared to the NPC scenario.

Figure 1



NPC – no-policy-change scenario

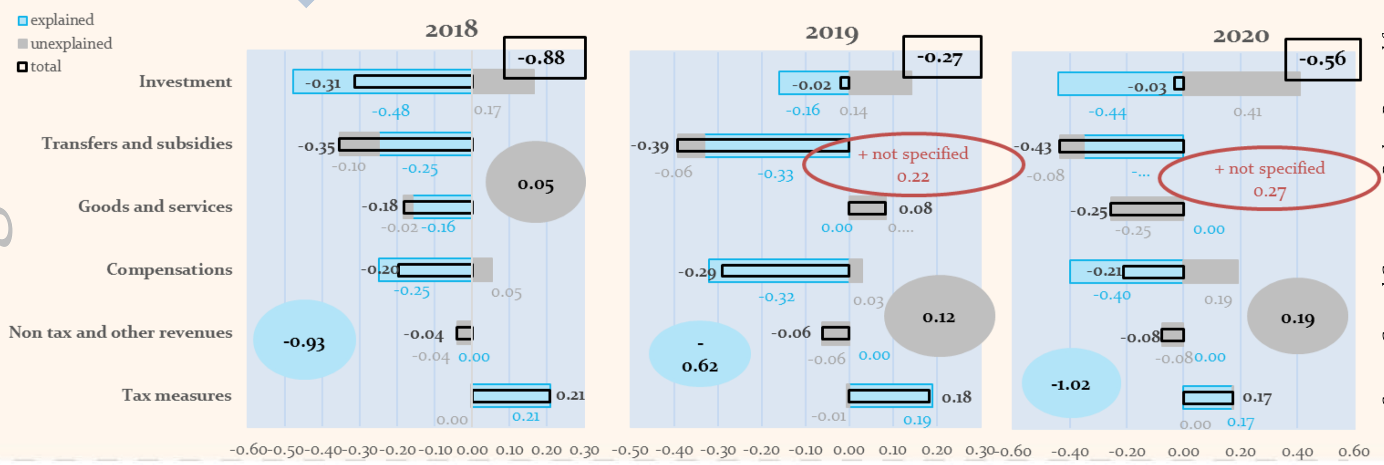
If the government took no new measures and public finances developed within the present legislative framework and macroeconomic assumptions, the MF SR expects a surplus of 0.6 % of GDP in 2020.

- The budget proposal contains measures, the aggregate effect of which, according to the MF SR, deteriorates the general government balance.

Source: General Government Budget Proposal for 2018-2020

The balance will worsen under the influence of lower non-tax revenues and higher expenditures (wages, investments in the defence and transport sectors, increase in pensions). The tax measures will have the opposite impact. **In comparison with the budget proposal, there is an absence of additional measures in the amount of 0.22 % of GDP in 2019 or 0.27 % of GDP in 2020, according to the government.**

Figure 2



Source: General Government Budget Proposal for 2018-2020, CBR

CBR's evaluation and comparisons

In terms of attaining the objectives, the CBR has identified several negative risks which, even with the positive effects taken into account, necessitate the adoption of additional measures for the objectives to be met.

Figure 3

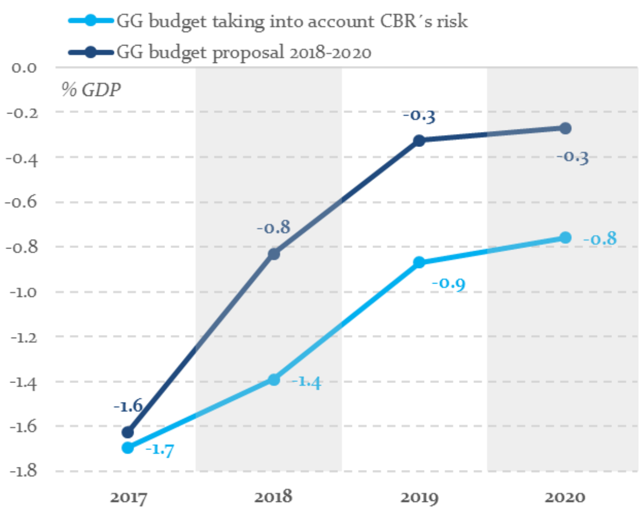
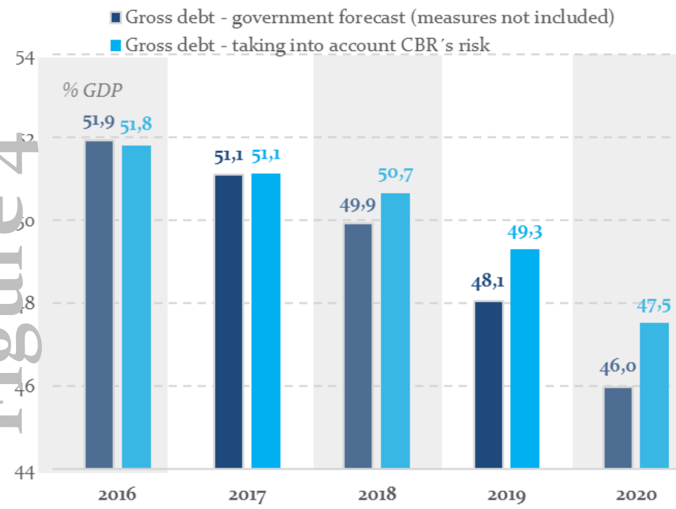


Figure 4



Source: General Government Budget Proposal for 2018-2020, CBR

Evaluation of the General Government Budget Proposal for 2018-2020

What the CBR's evaluation says

Similarly to the MF SR, the CBR has also calculated that the measures adopted by the government worsen the overall fiscal position.

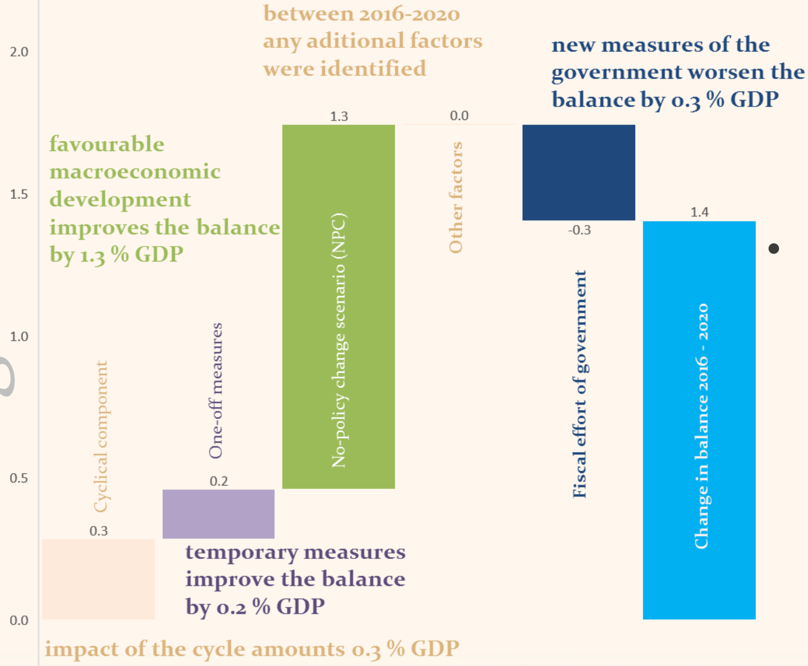
Figure 5

Source: General Government Budget Proposal for 2018-2020, CBR

NPC – no-policy-change scenario

- According to the CBR, the meeting of the 2018-2020 budgetary objectives will require the adoption of consolidation measures worth 0.6 % of GDP in 2018-2019 and 0.4 % of GDP in 2020. Similarly to the MF SR, the CBR has calculated that the measures adopted by the government in 2020 worsen the overall fiscal position.
- If the government's medium-term objectives are met, the public finances will be sustainable in the long term.

Figure 6

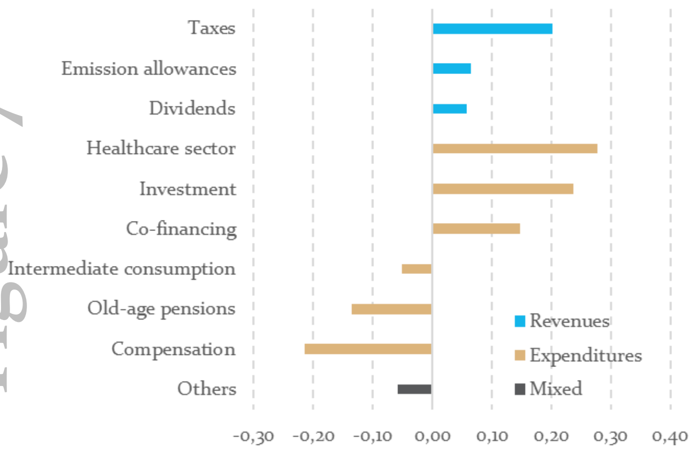


Source: General Government Budget Proposal for 2018-2020, CBR

- While the expected favourable macroeconomic development by 2020 will improve structural balance by 1.3 % of GDP, the net contribution of government measures will worsen it by 0.3 % of GDP when taking into account the risks identified by the CBR.

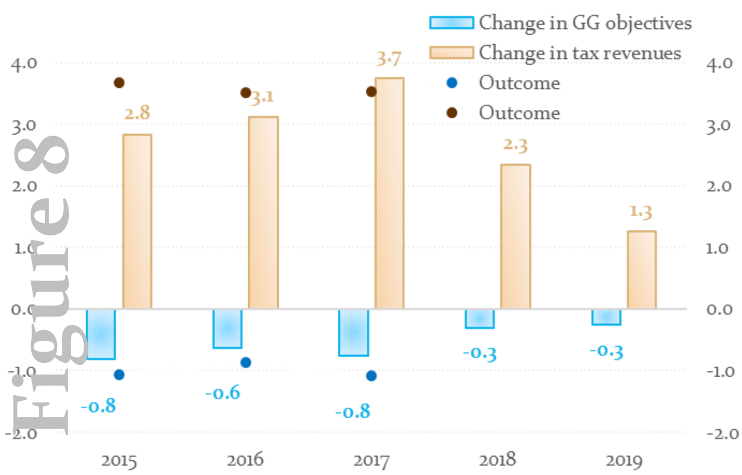
Measures for 2018 contained in the budget proposal will worsen the general government balance by 0.5 % of GDP

Figure 7



The budgetary objectives are worsening despite better collection of taxes

Figure 8



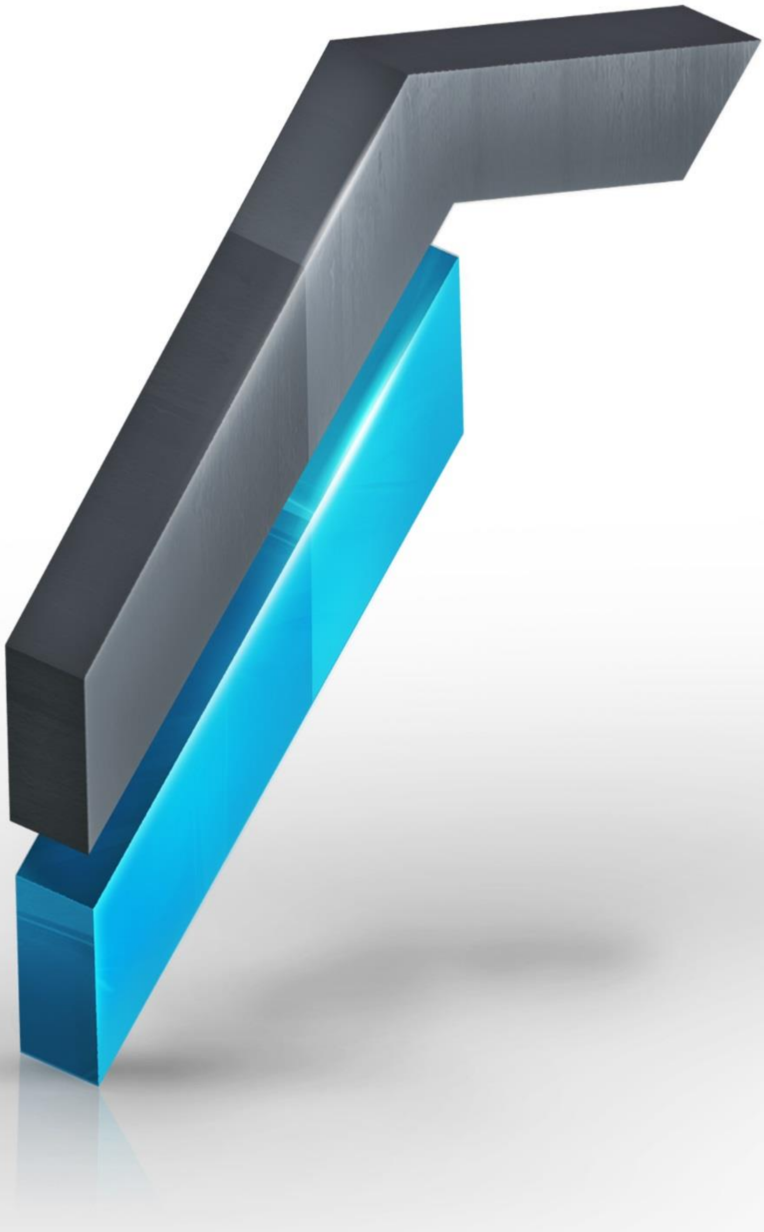
Source: General Government Budget Proposal for 2018-2020, CBR

Tab 1: Overview of budgetary risks and their coverage in 2017-2020 (ESA2010, € million)

	2017*	2018	2019	2020
Budget balance in the 2018-2020 GGB proposal, € million*	**-1 376**	**-743**	**-309**	**-273**
Budget balance under the 2018-2020 GGB proposal, in % of GDP)*	**-1.6**	**-0.8**	**-0.3**	**-0.3**
Risks - total:	**-393**	**-1 078**	**-1 342**	**-1 508**
- in % of GDP	**-0.5**	**-1.2**	**-1.4**	**-1.5**
1. Overestimated non-tax revenues (dividends, CO_2 allowances, revenues from the sale of assets, fee for oil stocks)	-93	-183	-177	-172
2. Financial corrections to EU funds	0	-80	-80	-80
3. Underestimated state budget expenditures	-33	-443	-790	-1 045
- wage expenditures in the state budget (incl. education)	-13	-89	-291	-521
- social package	0	-107	-195	-196
- other current expenditures (goods and services, transfers)	42	-29	-117	-119
- road infrastructure preparation – strategic park in Nitra	-64	-126	0	0
- investment aid for Jaguar Land Rover (JLR)	0	-32	-45	-45
- other capital expenditures	2	-60	-143	-163
4. Underestimated healthcare expenditures	-81	-135	-67	35
5. Impact of higher expenditures of municipalities	-69	-133	-78	-41
6. Underestimated expenditures of other GG entities (ŽSSK, Social Insurance Agency, storage of emergency oil stocks)	-15	-66	-59	-69
7. Tax revenues	-11	-38	-91	-136
8. Settlement of the cyclotron centre facilities	-91	0	0	0
9. Revenue-side measures not incorporated in legislation	no quantification			
10. Defence expenditures under secrecy	no quantification			
11. Recapitalisation of the traditionally loss-making state corp.	no quantification			
Coverage - total:	**332**	**574**	**821**	**1 012**
- in % of GDP	**0.4**	**0.6**	**0.9**	**1.0**
1. Savings in co-financing	1	-133	98	132
2. Savings in state social benefits	25	10	10	10
3. Coverage of risks from the state budget reserves	243	697	713	870
4. Savings in the transfer to the EU budget	63	0	0	0
5. Bailout in the healthcare sector	no quantification			
Change in interest expenditure due to risks and sources of coverage	**5**	**-2**	**-11**	**-22**
Overall impact of risks on the GG balance:	**-56**	**-506**	**-531**	**-518**
Budget balance reflecting the risks noted by CBR (€ million)	**-1 431**	**-1 249**	**-841**	**-791**
Budget balance reflecting the risks noted by CBR (in % of GDP)	**-1.7**	**-1.4**	**-0.9**	**-0.8**

Note: (+) means positive and (-) negative impact on the GG balance *Source: CBR*

** In 2017, the differences are shown vis-à-vis the government estimate published in the 2018-2020 General Government Budget Proposal*



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