Evaluation of Compliance with the Balanced Budget Rule for 2017

Summary

December 2018

This report presents the official opinions of the Council for Budget Responsibility in line with its mandate laid down in Act No. 523/2004 on the General Government Budgetary Rules and Act No. 493/2011 on Fiscal Responsibility.

This publication is available on 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 for 2017

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

The CBR prepared its final evaluation of compliance with the balanced budget rule for the year 2017 based on the data contained in the October deficit and debt notification by Eurostat. It also contains the response to the evaluation published by the Ministry on 30 November 2018. The methodology of evaluation has not changed. The year 2015[3] remained the baseline year for evaluation.

The 2017 general government's structural deficit reached 1.02 % of GDP, which means that the medium–term objective of having a close to balanced budget (structural deficit of not more than 0.5 % of GDP – Chart 1) was not met so far. As identified by the CBR in the primary assessment, the structural balance improvement was 0.42 % of GDP higher than required by the rule, whereas for the expenditure benchmark, the deviation amounted to 0.18 % of GDP. With the additional factors taken into account (lower interest payments and windfall revenues), the structural balance deviation reached 0.20 % of GDP, i.e., below the threshold of 0.5 % of GDP[4]. On the contrary, the additional factors (lower co-financing expenditures and increased efficiency of VAT collection) improved the development of adjusted expenditures, by which the rule was met by 0.05 % of GDP[5]. Convergence towards the medium-term objective was not sufficiently fast when taking into account additional factors. At the same time, however, the deviation permitted by the rule was not exceeded; and as the deviation identified was not considered as significant according to the CBR, there is no need to trigger the correction mechanism.

In 2017, compared to 2015, the structural balance improved by 1.35 % of GDP, which is 0.42 % of GDP above the required improvement at 0.94 % of GDP necessary to meet the medium-term objective by 2019 (Chart 2). **In its overall assessment, the CBR also took into account the impacts of other factors which reduced the year-on-year structural balance improvement to 0.74 % of GDP and brought the deviation to 0.20 % of GDP.** These factors include, in particular, lower interest payments by 0.35 % of GDP, since these do not depend solely on the present fiscal policy, and the positive impact of windfall revenues[6] at 0.33 % of GDP.

Compared to 2015, adjusted budgetary expenditures in 2017 increased by 0.45 p.p. (Chart 3) above the expenditure benchmark, with a negative impact on the balance at 0.18 % of GDP

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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 year for which the data on the general government's fiscal performance were available at the time of the decision (April 2016) on the postponement of the deadline for meeting the medium-term budgetary objective to 2019.

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

5 The rule implicitly contemplates a higher rate of revenue growth than was actually achieved. Compliance with the expenditure rule would not, in such a case, lead to compliance with the medium-term objective.

6 Windfall revenues/revenue shortfalls should be reflected in the evaluation of compliance with the requirement for structural balance improvements towards the medium-term budgetary objective within the preventive arm of the Stability and Growth Pact (Article 5, paragraph 1 of the Council Regulation 1466/97).

(Chart 4). The evaluation of compliance with the expenditure benchmark also reflects the lower national co-financing of EU projects, causing lower tax revenues, and increased efficiency of VAT collection, which can be considered a government measure. **Taking these additional factors into account, the negative impact of the adjusted expenditures' growth changed to positive on the level of 0.05 % of GDP.**

Despite the deviation identified in the structural balance, this balance was closer to the medium-term objective in 2017 as required by the trajectory. The rule identifies a deviation also in circumstances which have significantly and without direct government intervention improved the structural balance or reduced the pace of growth in expenditures. In that case, full compliance with the rule (without deviation) may lead to meeting the medium-term objective before the deadline set by the government. **Based on the CBR's current evaluation, achieving full compliance with the rule would also mean meeting the medium-term objective in 2018.** Achieving a structural deficit of 0.5 % of GDP already in 2018 would imply the need to improve the structural balance year-on-year by 0.52 % of GDP, which is less than the requirement ensuing from the assumption of removing the currently identified deviation in the structural balance (on the level of 0.67 % GDP[7]).

The overall conclusions by both the Ministry and the CBR are identical. Neither of them concluded that the conditions for the activation of the correction mechanism were met. In its evaluation, the Ministry noted that Slovakia was approaching a balanced budget at an adequate pace without a deviation from the required trajectory. The Ministry, having identified in the primary assessment that both indicators (structural balance and expenditure benchmark) were met, did not carry out an overall assessment as a result of this approach. The CBR's evaluation is less favourable. In the primary assessment, the change in the structural balance is in line with the rule; a deviation has been found in the expenditure benchmark. After taking into account the additional factors, a deviation occurred in the change of the structural balance, which is not significant and the expenditure benchmark is met. **The differences between the primary assessment of the Ministry and the CBR stem mainly from how discretionary revenue measures are taken into account in the expenditure benchmark, based on which it was not necessary, according to the Ministry's opinion, to assess additional factors[8], which, according to the CBR, mostly worsened the evaluation[9].**

The method applied by both institutions in evaluating the structural balance is identical. The one-off effects of the Ministry and the CBR are fully identical. There are slight differences in the structural balance (and the required rate of expenditures growth) between institutions based on the fact that the CBR, when estimating the potential output, takes into account, in addition to the forecast by the Ministry, the forecasts of other institutions as well.

Differences exist in case of development of adjusted expenditures. This is mainly due to the fact that, as in its preliminary evaluation of June 2018, the Ministry included the

7 It involves the impact of savings in interest payments and windfall revenues in 2016 and 2017 of 0.20 % GDP and the necessary improvement in the structural balance in 2018, according to the trajectory set by 0.47 % of GDP.

8 Had the Ministry applied the same approach in drawing up the list of discretionary revenue measures as was the case with its previous years' evaluations or, as done by the CBR, a deviation would occur in the expenditure benchmark, thus necessitating an overall assessment.

9 In its previous evaluations, the Ministry took into account, as part of additional factors, only the impact of the decline in co-financing expenditures on the rate of growth in adjusted expenditures. The impacts of interest payments and windfall revenues on the structural balance, as well as the impact of measures not affecting the long-term sustainability, were not taken into account.

estimated impact of improved VAT collection in discretionary revenue measures[10]**.** The CBR due to the persistence of high uncertainty of estimation and simplified approach to quantification takes into account the impact of better VAT collection within the additional factors[11].

[10] Without this difference, the Ministry's evaluation would contain a deviation in the expenditure benchmark with a cumulative two-year negative effect of 0.07 % of GDP, which is close to the result of the CBR's evaluation. Such a result would require further analysis through an overall assessment.

[11] In evaluating the balanced budget rule before 2017, the Ministry proceeded in the same way as the CBR. The Ministry substantiated its changed approach by the fact that "...these measures are of the same budgetary nature as the other legislative revenue measures that are included in the primary evaluation." (MF SR, opinion of the Ministry of Finance of the SR on the CBR evaluation, August 2018). At the same time, the Ministry presented an example of the Czech Republic which quantified the measure to improve tax collection in its Convergence Program (April 2018), while it is not clear from the available information to what extent these estimates were taken into account by the European Commission in its evaluation.

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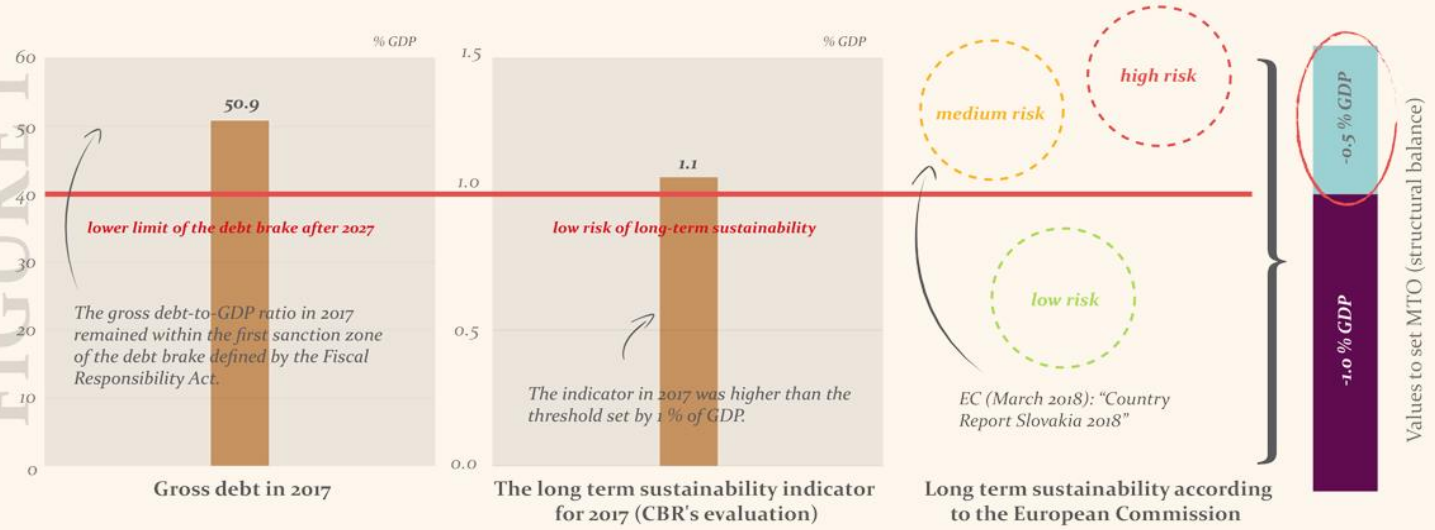
Structural balance

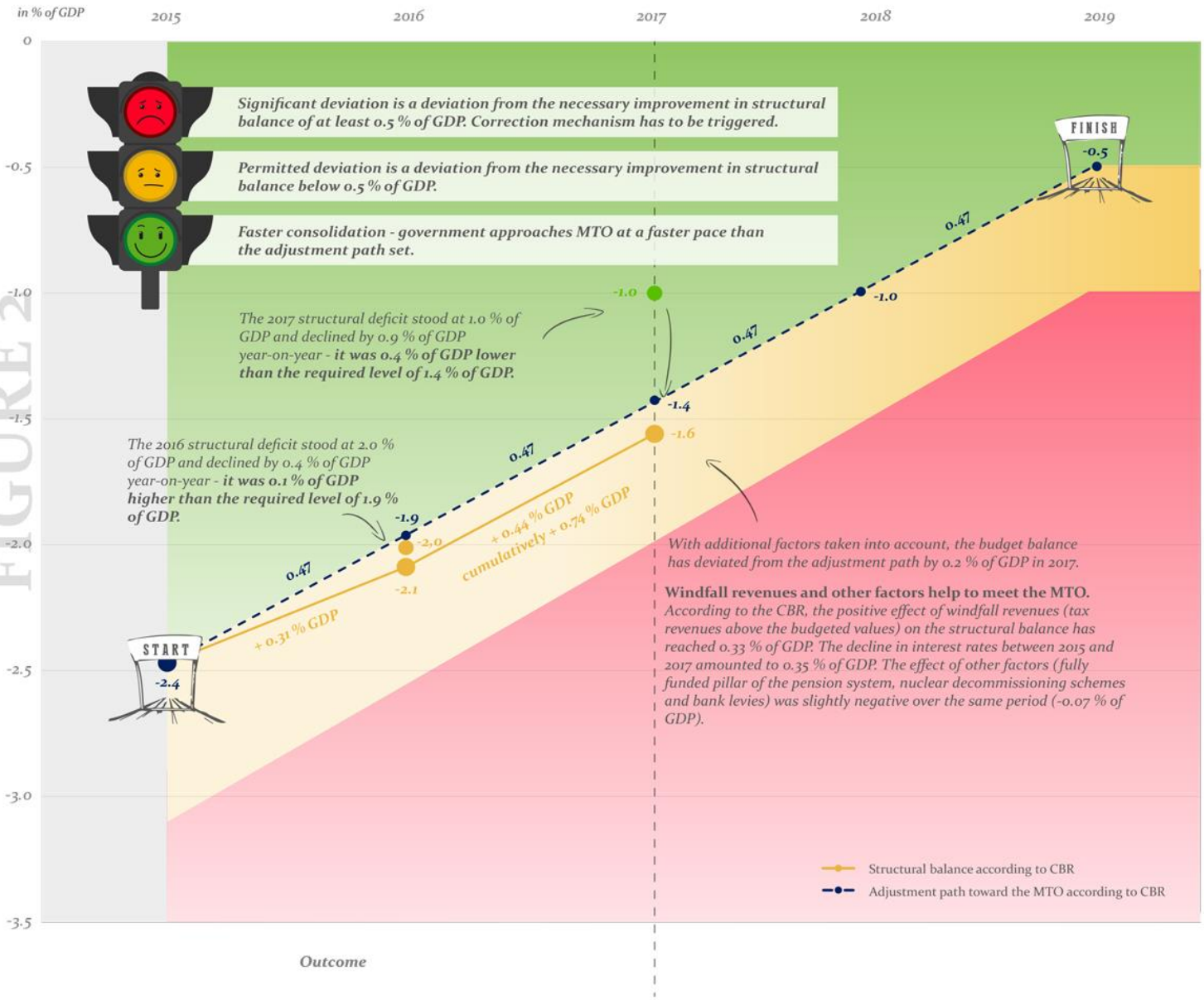
Considering the debt level and long-term risks, a more stringent medium-term objective (MTO) – a structural deficit of 0.5 % GDP – has been defined.

FIGURE 1



The 2017 general government's structural deficit reached 1.0 % of GDP, which means that the medium–term objective of having a close to balanced budget (structural deficit of not more than 0.5 % of GDP) was not met so far.

FIGURE 2



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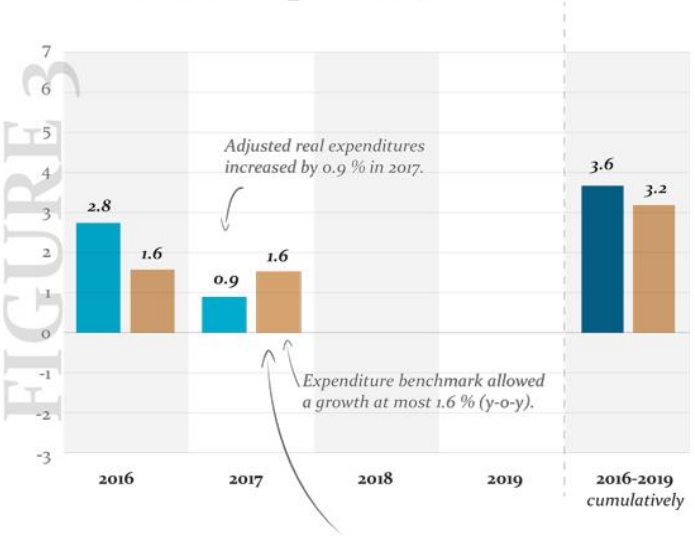
Expenditure benchmark: compared to 2015, adjusted budgetary expenditure increased by 0.4 p.p. above the expenditure benchmark, with a negative impact on the balance at 0.18 % of GDP.

FIGURE 3

Increase in expenditures, in %



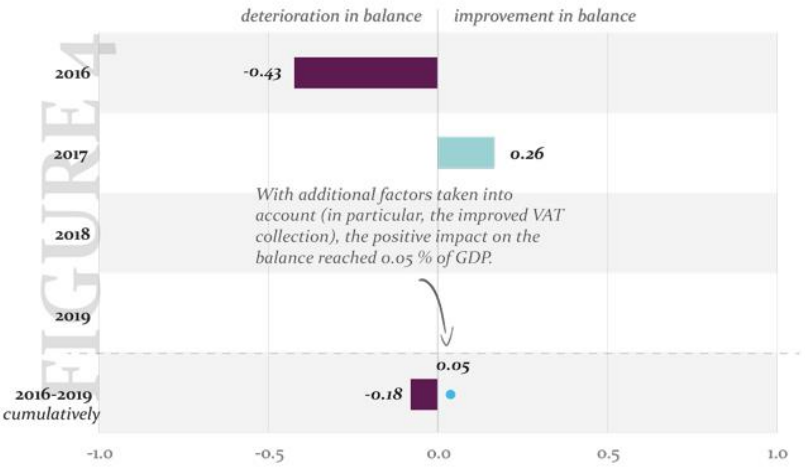
Adjusted real expenditures of the budget grew 0.7 p.p. slower than the expenditure benchmark.

The real increase in expenditures

Expenditure benchmark (permitted expenditure growth)

FIGURE 4

Impact on the balance (% GDP)



Had the permitted rate of growth in expenditures been adhered to in 2016 and 2017, the budget deficit in 2017 would be 0.18 % of GDP lower, standing at 0.6 % of GDP (the actual deficit was at 0.78 % of GDP).

FIGURE 5

Taking into account additional factors, the CBR's assessment has worsened, whereas the Ministry did not assess additional factors.

	CBR	MINISTERSTVO FINANCIÍ SLOVENSKEJ REPUBLIKY
Change in structural balance	fulfilled	fulfilled
Expenditure benchmark	deviation	fulfilled
Additional factors	**worsened evaluation**	**not assessed**
Change in structural balance	deviation	
Expenditure benchmark	fulfilled	
Changes in the fully-funded pillar of the pension system	+	
Nuclear decommissioning costs	no impact	
Bank levies	no impact	
Interest payments	−	
Windfall revenues	−	
Lower expenditures on co-financing	−	
More effective VAT collection	+	covered within the primary assessment
Time-consistent recording of correction to EU funds	−	
Debt within the sanction brackets of the "debt brake"	−	
Overall assessment	**no significant deviation**	**in line with fiscal rules**

Differences between the Ministry's and CBR's primary assessment stem mainly from how discretionary revenue measures are taken into account (in particular the impact of improved VAT collection) as a result of which the Ministry deemed the assessment of additional factors unnecessary.

Since 2015, debt interest payments dropped by 0.35 % of GDP, thus improving the structural balance.

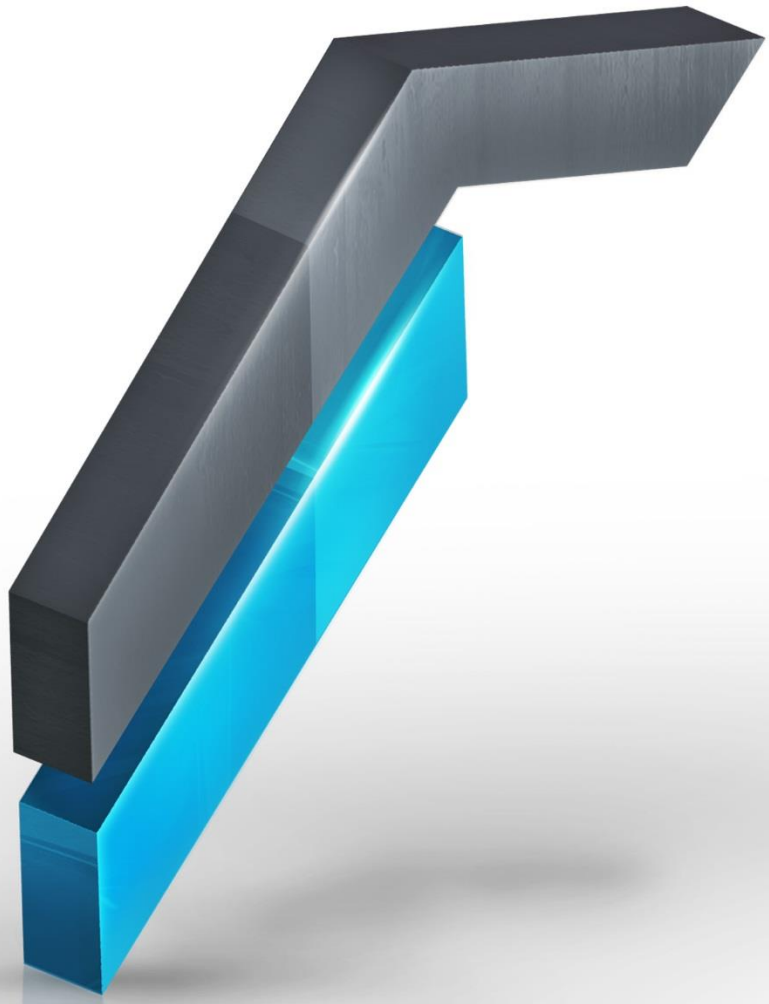
Since 2015, windfall revenues have contributed to improving the balance by 0.33 % of GDP. The structural balance should thus improve more significantly in comparison with the adjustment path set.

Tax revenues of the budget are decreasing with the lower absorption of EU funds and the related lower co-financing. There is an approximately zero impact on the structural balance. The expenditure benchmark only reflects a decline in co-financing expenditures; in order to ensure a neutral impact on the balance, an assumed reduction in tax revenues by 0.29 % of GDP since 2015 has been reflected in additional factors.

The Ministry took into account the impact of improved VAT collection already in its primary assessment. However, both the Ministry and the CBR, took this impact into account as a part of additional factors in their previous assessments (years 2013 through 2016), due to a high uncertainty of estimate and a simpler approach. Because, since the last assessment, no qualitative changes have occurred in the method of estimation, the CBR has not changed its current approach.

When taking into account additional factors CBR has identified a deviation. As the deviation is not considered to be significant according to CBR, there is no need to trigger the correction mechanism.

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



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