COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of Compliance with the Balanced Budget Rule in 2017

Summary

July 2018

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

Evaluation of Compliance with the Balanced Budget Rule in 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 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 then publishes its position on CBR evaluation.

The CBR prepared its initial evaluation of compliance with the balanced budget rule for the year 2017 based on the data contained in the April deficit and debt notification by Eurostat. It also contains the CBR's response to the evaluation published by the Ministry on 27 June 2018. The methodology of evaluation has not changed. The CBR revised its estimate of windfall revenues and incorporated the impacts of changes in national accounts that were made by the Statistical Office of the Slovak Republic. The year 2015[3] remained the baseline year for evaluation.

The 2017 general government's structural deficit reached 1.18 % 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 – Figure 1) was not met so far. As identified by the CBR in the primary assessment, the structural balance improvement was 0.36 % of GDP higher than required by the rule, whereas for the expenditure benchmark, the deviation amounted to 0.35 % of GDP. With the additional factors taken into account, the structural balance deviation reached 0.17 % of GDP, i.e., below the threshold of 0.5 % of GDP[4]. A similar deviation, at 0.1 % of GDP, was also identified in evaluating the development in adjusted expenditures. Convergence towards the medium-term objective was not sufficiently fast when taking into account additional factors, as none of the indicators has been fulfilled following the overall assessment. 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 1.39 % of GDP, which is 0.36 % of GDP above the required improvement at 1.04 % of GDP necessary to meet the MTO by 2019 (Figure 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 0.87 % of GDP and brought the deviation to 0.17 % 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[5] at 0.25 % 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 was 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] 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 Council Regulation No. 1466/97).

Compared to 2015, adjusted budgetary expenditure in 2017 increased by 0.92 p.p. (Figure 3) above the expenditure benchmark, with a negative impact on the balance at 0.35 % of GDP (Figure 4). The evaluation of compliance with the expenditure benchmark 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' deviation on the balance to 0.1 % of GDP.**

If the conclusions of this evaluation are confirmed in its December update, the identified deviations will not jeopardise the meeting of the medium-term objective by 2019 based on the 2017 figures. 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 imply the need to improve the structural balance by 0.69 % of GDP in 2018,** which reflects the effect of savings in interest payments and windfall revenues in 2016 and 2017 (0.17 % of GDP) and the required structural balance improvement in 2018 in line with the defined adjustment path (0.52 % of GDP). **According to the rule, the structural deficit should reach 0.5 % of GDP[6] in 2018, i.e., at the level of the medium-term objective.**

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. In its evaluation, the Ministry noted that Slovakia was approaching a balanced budget at an adequate pace without a deviation from the desired adjustment path. 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; a deviation has been found in the expenditure benchmark under the primary assessment and, when taking additional factors into account, a deviation has occurred in both indicators. **The differences between the primary assessments of the Ministry and of the CBR stem mainly from how discretionary revenue measures are reflected in the expenditure benchmark**, **based on which it was not necessary, in the Ministry's opinion, to assess additional factors (overall assessment)[7] which, according to the CBR, worsened the evaluation[8] in most cases**.

The method applied by both institutions in evaluating the structural balance is identical. The one-off effects identified by the Ministry and the CBR are identical because the Ministry, as opposed to its previous evaluations, did not treat the financial corrections to the EU funds on an accrual basis in its current evaluation, nor did it include the revision of the amount of the transfer to the EU budget in 2016 among one-off effects. The Ministry did not

6 Possible windfall revenues and savings in interest payments in 2018 are not reflected in the calculation. Based on data from the June forecast of the Tax Revenue Forecasting Committee, the CBR estimates windfall revenues at 0.3 % of GDP. Interest payments might decline 0.1 % of GDP year-on-year.

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

8 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.

explain its approach in more detail. Therefore, it is not clear whether the future corrections[9] will be included among one-off effects again.

As regards developments in adjusted expenditures, the Ministry carried out several methodological changes which, as a result, have increased the differences between both institutions. Some of the changes (modifying the methodology for calculating the base for expenditures, incorporating an estimate of the cyclical component of pension expenditures, expanding the list of methodological impacts) have made the calculation more precise, thus bringing the Ministry's methodology closer to that of CBR. On the other hand, there were two changes in discretionary revenue measures which increased[10] the differences between the institutions. **Among the discretionary revenue measures, the Ministry included an estimate of the impact of improved VAT collection** which both institutions took into account as part of additional factors[11] in the previous evaluations due to the high uncertainty of estimation and a simple approach to quantification. The Ministry did not substantiate this change in the methodology. Since the last CBR's evaluation in December 2017, no qualitative changes have occurred in the estimate and, for this reason, the CBR has not changed its current approach. The second difference involves the **revenues from a higher fee for the management of emergency oil and oil product stocks** effective from 1 January 2017, which the Ministry of Finance did not include among the revenue measures.

9 In 2017, the impact of corrections on the general government balance was positive, amounting to EUR 3 million, in particular due to the revision of amounts reported for the previous years. For 2018, the Ministry estimates the financial corrections to EU funds at EUR 19 million (the Stability Programme of the Slovak Republic for 2018 – 2021, April 2018).

10 Without these changes, the Ministry's evaluation would contain a deviation in the expenditure benchmark with a cumulative two-year negative effect of 0.42 % of GDP, which is close to the result of the CBR's evaluation.

11 The Ministry substantiated its approach in the previous evaluations as follows: "Additional revenues from measures aimed at increasing the collection of taxes, which have been reported in the long term also as part of tax revenues, are not reflected in discretionary revenue measures due to the complexity of estimation." (Ministry of Finance of the Slovak Republic, Compliance with the Balanced Budget Rule for 2016, November 2017.). The CBR adopted the same approach.

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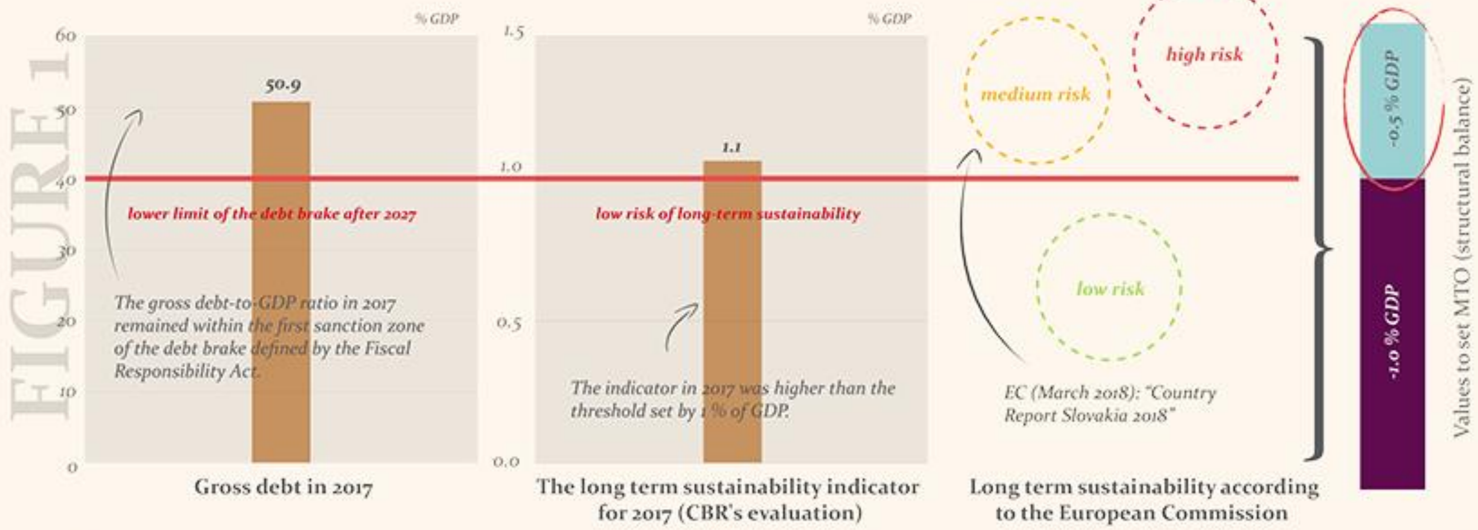
Structural balance

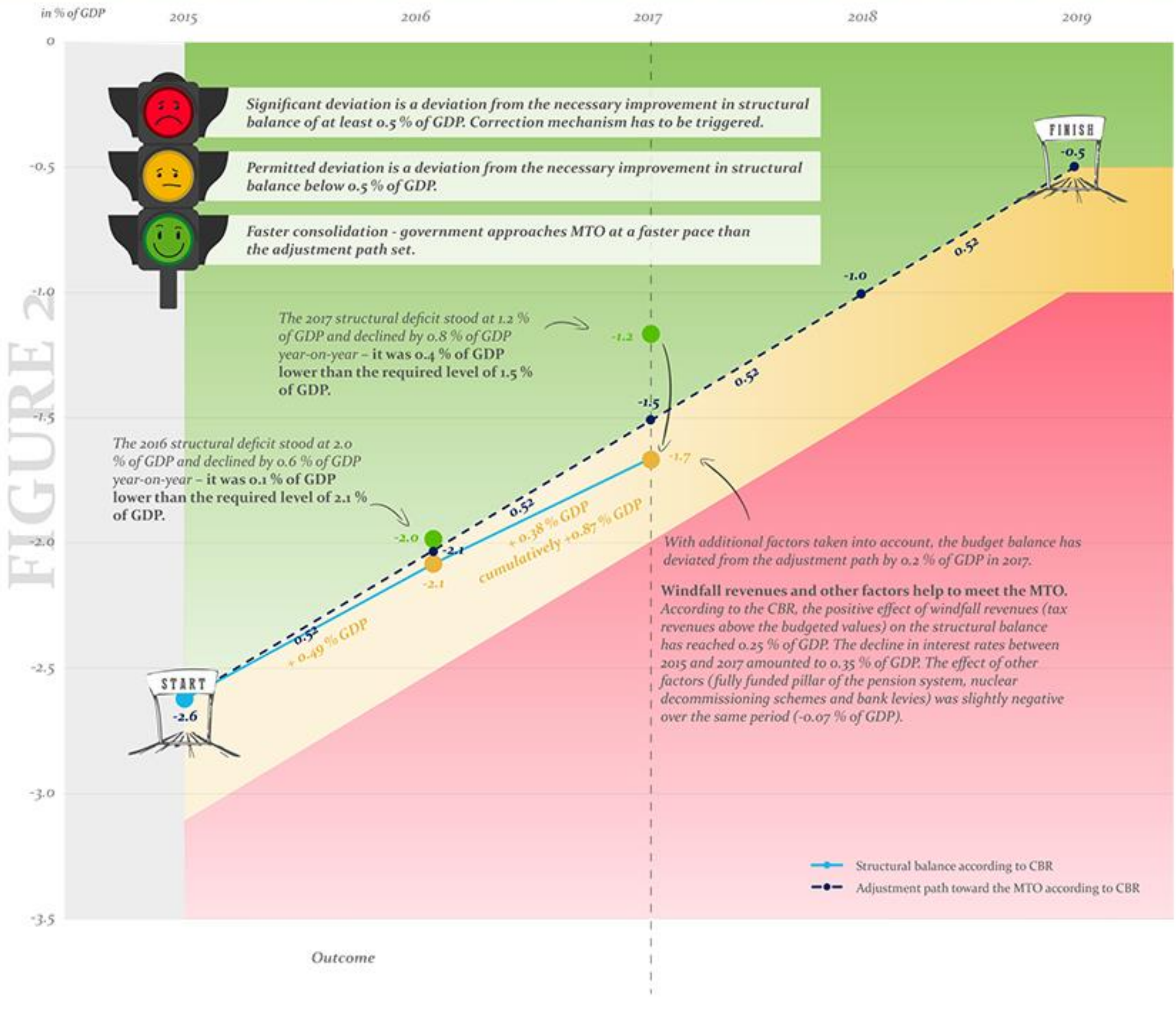
Considering the debt amount and long-term risks, a more stringent medium-term objective (MTO) – a structural deficit of 0.5 % GDP – has been defined.

FIGURE 1



The 2017 general government's structural deficit reached 1.2 % 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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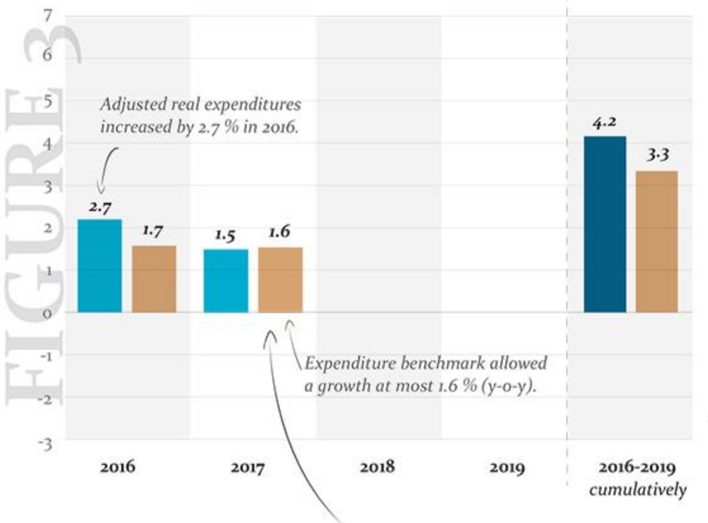
Expenditure benchmark: compared to 2015, adjusted budgetary expenditure increased by 0.9 p.p. above the expenditure benchmark, with a negative impact on the balance at 0.35 % of GDP.

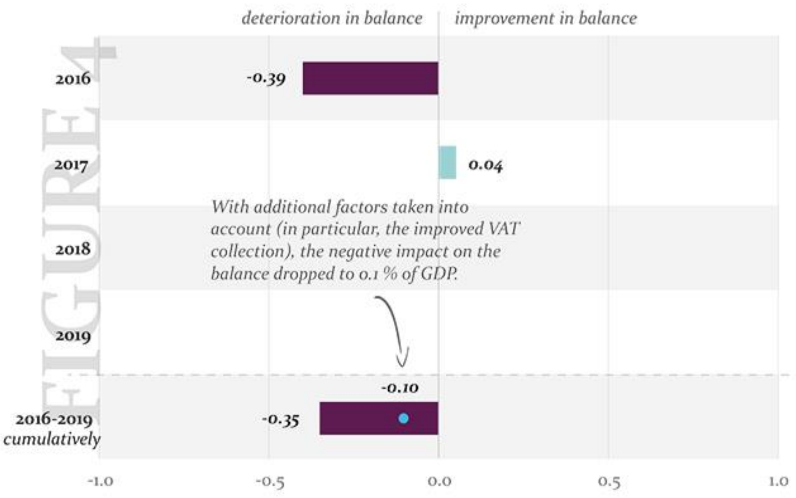
Increase in expenditures, in %



Adjusted real expenditures of the budget increased by 1.5 % in 2017, i.e., 0.1 p.p. below the expenditure benchmark.

The real increase in expenditures — *Expenditure benchmark (permitted expenditure growth)*

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 0.35 % of GDP lower, standing at 0.7 % of GDP (the actual deficit was at 1.04 % of GDP).

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

FIGURE 5

	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	deviation	
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	no significant deviation

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

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 0.25 % 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, without providing an explanation to this methodological change. In their previous evaluations, the Ministry and the CBR took this impact into account as part of additional factors due to 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, a deviation has been identified in both indicators. As the deviation is not considered to be significant according to CBR, there is no need to trigger the correction mechanism.

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