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COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of the correction mechanism proposal for 2020

Correcting the significant deviation in the fulfilment of the balanced budget rule in 2018

December 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. 523/2004 on the General Government Budgetary Rules and Act No. 493/2011 on Fiscal Responsibility

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

Evaluation of the Correction Mechanism Proposal for 2020

The Ministry of Finance of the Slovak Republic (the Ministry) published an evaluation of compliance with the balanced budget rule for 2018[1] on 29 November 2019, reporting a significant deviation from the required adjustment path towards the medium-term budgetary objective. The Council for Budget Responsibility (CBR) came to the same conclusion in its evaluation report published on 16 December 2019[2]. In line with the Act on the General Government Budgetary Rules, the Ministry is obliged to propose to the government triggering a correction mechanism to ensure that a structural deficit not exceeding 0.5 % of GDP is achieved in a sustainable manner by applying a binding expenditure ceiling.

On 12 December 2019, the Ministry published a correction mechanism proposal[3], recommending that the Slovak government approves an expenditure ceiling for 2020 at a level of the general government budget, which had already been approved by the parliament. According to the Ministry, the proposed limit should ensure that a structural deficit of 0.5 % of GDP is achieved.

Pursuant to the provisions of the Budgetary Rules Act, the CBR has an obligation to assess the proposal submitted by the Ministry before the government decides whether to trigger the correction mechanism. Equally, the CBR assesses the beginning and end of the duration of exceptional circumstances during which the correction mechanism needs not be applied. In compliance with the European Commission's provision, the CBR also evaluates the compliance with the correction mechanism throughout the period of its application.

Having assessed the submitted proposal, the CBR concluded the following:

- The correction mechanism proposal meets all formal requirements under the provisions of the Budgetary Rules Act. **Complying with the revenues and expenditures budgeted for 2020 while achieving the general government deficit of 0.49 % of GDP at the same time would result in meeting the medium-term objective in 2020.**
- **The planned expenditure growth rate is higher than that set under the expenditure benchmark, indicating that achieving the medium-term objective in 2020 might not be sustainable in the long term.** Meeting the budgetary objective is affected by items, which are not taken into account while assessing the adjustment path towards sustainable medium-term objective; those items are being adjusted for in the case of the expenditure benchmark. They include, in particular, a higher planned growth rate in revenues compared to the potential economic growth (arising from overestimated non-tax revenues), a neutral impact of additional revenues from the bank levy in terms of net worth, savings in debt interest payments, and a decline in investments below the four-year average level. In order to ensure the full compliance with the balanced budget rule, the aforementioned factors should be allowed for in the level of the overall ceiling or in the structure of expenditures within the set ceiling[4].

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1 Compliance with the Balanced Budget Rule for 2018 – final evaluation (November 2019) – available in Slovak only

2 Evaluation of compliance with the balanced budget rule for 2018 (December 2019)

3 Correction Mechanism Proposal for 2020 (December 2019) – available in Slovak only

4 According to the approved budget, the adjusted expenditures are to grow by 5.7 % on average in 2019 and 2020, whereas the expenditure benchmark allows a growth of 3.5 % of GDP. With the budgeted structure of expenditures, complying with the benchmark would require a EUR 1,558 million reduction in the overall

- In its evaluation report on the 2020-2022 budget proposal, the CBR notes that the budget proposal includes a balance-related risks amounting to EUR 1,290 million in 2020. Therefore, the CBR considers it necessary to point out **that additional measures will have to be implemented in order to comply with the overall expenditure ceiling, as well as to achieve the budgetary objective**. A significant share of the risks arises from the expenditures ensuing from the applicable legislation (for example, social benefits and transfers) and/or falls outside the government's direct control (e.g., local governments).
- In order to ensure compliance with the expenditure ceiling set, the CBR recommends that **the government should shortly re-evaluate the structure of expenditures** in the approved budget. For the purposes of the continuous monitoring of compliance with the expenditure benchmark and for adopting potential corrective measures, it would be advisable to ensure that the information about local governments' expenditures is available in regular monthly intervals the way such data are available for other general government entities.

expenditure ceiling to EUR 37,798 million. Alternatively, the specified expenditure ceiling could be fully met if the structure of expenditures is reassessed (e.g., to increase investments while cutting down the current expenditures at the same time).

Compliance with the provisions of the Budgetary Rules Act

The Budgetary Rules Act requires that the submitted **proposal takes into account the size of deviation**[5] **and respects the set medium-term objective.** The Ministry expects the medium-term objective to be achieved a year later than originally planned. It proposes to set the 2020 public expenditure ceiling corresponding to a structural deficit of 0.5% of GDP. In the CBR's opinion, this approach is in compliance with the applicable legislation[6].

Under the Budgetary Rules Act, the public expenditure ceiling means the **maximum amount of the total accrued general government expenditure.** The Ministry proposes that, based on the general government budget for 2020, the ceiling for consolidated general government expenditures be set at a level of EUR 39,326 million. Given the existing restrictions[7], the CBR considers this approach to be in compliance with the applicable legislation.

The proposed measures having an impact on municipalities and self-governing regions should be discussed with a country-wide associations of municipalities and representatives of higher territorial units **in advance.** The expenditure ceiling and proposed measures are based on the approved general government budget, the draft of which was discussed at the 14 October 2019 meeting of the Economic and Social Council of the Slovak Republic, of which the Association of Towns and Municipalities of Slovakia (ZMOS) is a member[8]. In addition to ZMOS, the relevant country-wide actors also include the Union of Towns of Slovakia and the Association of Self-governing Regions (SK8) with whom the Ministry usually holds bilateral talks during the preparation of a budget proposal. A meeting with ZMOS, the Union of Towns of Slovakia and SK8 regarding the 2020-2022 budget proposal was held at the Ministry on 2 October 2019.

While in the case of drafting a budget the Ministry considers the budgeting of local government revenues and expenditures indicative[9], in the case of approving the binding correction mechanism it should be in the government's interest to re-discuss the budgeted framework of expenditures of municipalities and self-governing regions in order to make sure they are aligned with the expenditure ceiling[10].

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5 The size of the deviation is measured through the changes in structural balance and in a growth rate of adjusted expenditures. The expenditure benchmark is used to monitor whether the adjustment path towards the medium-term objective is sustainable, i.e., it anticipates the revenues at a level of the potential economic growth and is adjusted for those expenditures that are volatile, have a neutral impact over a longer time horizon or are not under the government's full control.

6 The identified deviation for 2018 resulted in an increase in the general government debt level compared to a no-deviation situation. In order to eliminate the negative impact on the debt, the quantified deviation should be reflected in a temporary, more ambitious medium-term objective.

7 The restriction means not budgeting certain expenditures which the Ministry proposes to address when evaluating the compliance with the correction mechanism.

8 The Association of Towns and Municipalities of Slovakia disagrees with the general government budget proposal for 2020-2022 in the proposed wording.

9 According to the Ministry, the budgeting of local government expenditures is primarily designed to specify the balance and addresses a precise estimate of revenues and expenditures to a lesser degree: *"It is an estimate of the development in future revenues and expenditures of municipalities and self-governing regions primarily aimed at defining the expected balance of their fiscal performance within the overall general government budget balance."*

10 Regarding the local governments, the level of expenditures anticipated by the Ministry is also considered a measure, without any concrete measure being specified (e.g., against a no-policy change scenario).

Correction to achieve the medium-term objective

Complying with the revenues and expenditures budgeted for 2020 while achieving the general government deficit of 0.49 % of GDP at the same time should result in meeting the medium-term objective in 2020[11].

There are items that contribute to meeting the budgetary objective in 2020 that are assessed individually when evaluating the adjustment path towards a sustainable medium-term objective under the expenditure benchmark. Taking into account the size and structure of the revenues and expenditures planned in the 2020 budget and allowing for the fact that the expenditures of approximately EUR 1 billion are not budgeted, the adjusted expenditures would grow 5.7 % a year on average over the 2019-2020 period (annex 1). This value considerably exceeds the values recommended by the CBR (3.5 % a year[12]), having a cumulative negative impact on the balance amounting to 1.6 % of GDP in 2019 and 2020.

Since the aim of the expenditure benchmark is to make sure that the medium-term objective is achieved in a sustainable manner, **the Ministry should consider the effects of the following factors on the overall ceiling level or internal structure of the expenditures[13] in order to ensure the full compliance with the balanced budget rule**:

- **The revenue growth rate, adjusted for discretionary revenue measures, significantly exceeds the growth rate of the potential output** (chart 1). Under the expenditure benchmark, however, the revenues should grow approximately at the rate of the potential economic growth[14].
- **Meeting the medium-term objective is supported by the savings in debt interest payments** which are not fully under the control of the government since they depend on the government's past decisions - the amount of the accumulated debt and yields prevailing on the financial markets[15].
- **The government plans to achieve the objective by increasing the special levy on selected financial institutions** which is neutral in terms of net wealth in the long run. Meeting the medium-term budgetary objective should create conditions for a long-term sustainability of public finances, with the levy having a positive impact on the balance in the medium run, but a nearly neutral one in the long run due to the financing of future costs[16].

11 According to the CBR, the structural deficit would amount to 0.6 % of GDP due to a different estimate of the impact of the cyclical component. Given the proximity of the estimates and the uncertainty regarding the estimate of the cyclical component as such, the CBR does not consider it a significant difference at this stage of evaluation of the correction mechanism.

12 In order to achieve a balanced budget, i.e., a structural deficit of 0.5 % of GDP in 2020, a nominal year-on-year growth of adjusted expenditures in 2019 and 2020 should not exceed 3.5 % a year on average, according to the CBR.

13 Based on the CBR's current estimates, complying with the expenditure benchmark requires nearly a EUR 1.6 million cut in expenditures in 2020. When evaluating the compliance with the expenditure benchmark, the emphasis should be placed on a growth rate of adjusted expenditures as they are defined under the expenditure benchmark.

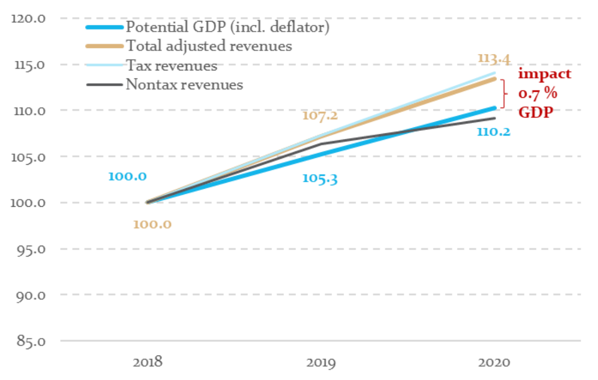
14 A higher growth rate of expenditures is associated with the risks the CBR identified with respect to the overestimated non-tax revenues.

15 The benchmark symmetrically reflects a possible increase in interest payments, as well.

16 The levy should serve to finance the future costs of resolving problems in the banking sector.

- **One of the measures included in the proposed expenditure ceiling is the decrease in capital expenditures by 1 % of GDP compared to 2018.** When assessing the deviation, the expenditure benchmark takes into account the average size of investments over the past four years. For 2020, the expenditure benchmark assumes a decline in investments by 0.4 % of GDP compared to 2018. The aim of this separate assessment of investments in the expenditure benchmark is to reduce the impact of the volatility of government´s investments on the evaluation of the sustainable achievement of the medium-term objective. The difference between both approaches amounting to 0.6 % of GDP represents a temporary decline in investments from the benchmark perspective which is not sustainable in the medium term. If no additional measures are taken, increasing the investments to the level of a multiyear average would thus again result in the worsening of the structural balance.

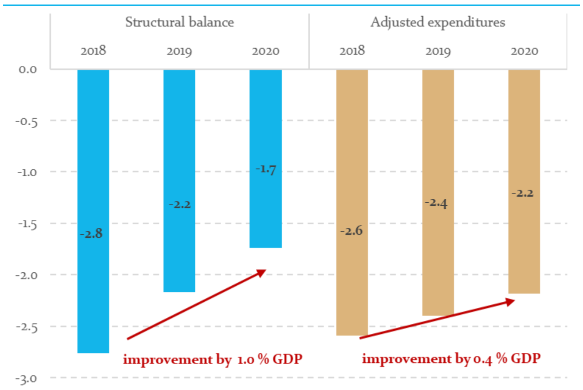
Chart 1: Development in individual components of general government revenues (index, 2018 = 100)



Year 2019 – the Ministry of Finance estimate included in the 2020-2022 general government budget proposal; year 2020 – approved budget

Source: CBR

Chart 2: Impact of the development in own investment on structural balance and adjusted expenditures* (ESA2010, % of GDP)



*Note: * the structural balance includes investments reported in a given year; the adjusted expenditures include the four-year average of investments*

Source: CBR

In the correction mechanism proposal, the Ministry identified a difference between the budgeting of expenditures and their official reporting by the Statistical Office of the Slovak Republic. This includes several items with a total value of approximately EUR 1 billion. **The CBR agrees with the proposed approach under which a possible overrun of the overall expenditure ceiling (with no effect on the balance) caused by the unbudgeted items specified by the Ministry[17] is not considered a failure to comply with the ceiling.**

With respect to the evaluation of the compliance with the expenditure ceiling, **the CBR equally agrees with the proposed approach that the assessment should take into consideration potential changes in the expenditures covered by the revenues from the EU budget.**

17 Since some of the unbudgeted items may have a non-zero effect on the balance, they should be factored in in the amount of recorded revenues when evaluating the ceiling. Any potential negative impacts of these items on the balance need then be offset by savings; this would ensure that the budgetary objective is met.

Impact of risks identified by the CBR on the expenditure ceiling and medium-term objective

The expenditure ceiling proposal submitted by the Ministry is based on the approved general government budget for 2020-2022. The correction mechanism specifies the expenditure ceiling for the whole of general government; it does not set specific ceilings to be observed by individual ministries or general government entities. The specific expenditure measures are left for the Slovak government to decide. However, the Ministry declares in the proposal that the internal allocation of the expenditures will, too, be based on the approved budget[18]. Therefore, the CBR considers it necessary to point out that **additional measures will have to be implemented by the government in order to comply with the overall expenditure ceiling, as well as to achieve budgetary objectives.** In its evaluation report, the CBR noted that the budget proposal includes a balance-related risks amounting to EUR 1,290 million in 2020.

- A portion of the risks was identified by the CBR in **non-tax revenues** which it considers overestimated by EUR 231 million. If non-tax revenues are lower than expected, **complying with the proposed expenditure ceiling may not be sufficient to achieve the medium-term budgetary objective.** Therefore, it is necessary that the continuous monitoring of compliance with expenditure ceiling also involves the revenue side of the budget and any identified revenue shortfall should be compensated through additional measures.

- Some of the risks on the side of the general government expenditures are **strongly linked to currently applicable legislation.** They mainly include the underestimation of budgeted expenditures on sickness benefits and unemployment benefits paid by the Social Insurance Agency. The approved budget assumes a year-on-year decline in benefit payments without presenting any specific measures, whereas additional expenditures may amount to EUR 136 million in 2020, given the development in the past years. **No proposals of legislative amendments are currently known which would enable eliminating this risk to the expenditure ceiling.**

- **The risks** that may impair compliance with the expenditure ceiling were also identified **in those parts of the budget that are outside the direct control of the government.** They are, for example, the expenditures of local governments, the Social Insurance Agency's Administrative Fund, and the ZSSK railway company. The CBR quantified the overall underestimation of these items in the amount of EUR 290 million. An increase in the expenditures by general government entities above their budgeted level will have to be compensated by the government through cuts in other expenditures .

- **The risks in the capital expenditures of the state budget** arise from the use of the funds carried over from the previous years; the CBR estimates a EUR 443 million increase in expenditures above the budgeted level. In the correction mechanism proposal, the Ministry says it will coordinate the use of the funds carried over from the previous years so that the ceiling is complied with. **The volume of carryovers envisaged by the Ministry is double the amount of funds budgeted for 2020 and included in the ceiling.** In order to offset additional spending, austerity measures may need to be adopted in other expenditure categories of the general government.

[18] Ministry of Finance: "The budgetary measures adopted under the approved budget, especially the approved cuts of expenditures in the state budget, will contribute to meeting the expenditure ceiling."

The beginning and end of exceptional circumstances[19]

No event **meeting the definition of exceptional circumstances** has been expected to occur in 2019 and 2020. The situation will again be reviewed during the evaluation of the compliance with the correction mechanism in 2021.

No events with a negative financial impact on the budget amounting at least to 3 % of GDP[20] are currently envisaged to have occurred/occur in 2019 or 2020, nor the occurrence of a severe economic downturn is anticipated. In 2019 and 2020, the Slovak economy is expected to grow at a rate exceeding 2 %[21] and should be slightly above its potential level (according to the CBR's estimate), which is well above the -3.0 % threshold. The economy of the euro area[22] should grow at a rate slightly above the 1 % level in both years, representing a moderately positive output gap.

[19] Evaluated in compliance with a manual published on the CBR's website (https://bit.ly/2swTzwm) - available in Slovak only.

[20] It involves the public expenditure incurred to restore the proper functioning of the banking sector affected by a financial crisis, public expenditure incurred to remedy the consequences of natural disasters and catastrophes in the Slovak Republic, and public expenditure incurred in connection with commitments arising from international treaties that have exceeded 3 % of GDP in a single year.

[21] Assumptions of the approved general government budget for 2020-2022, the Macroeconomic Forecasting Committee, September 2019.

[22] European Economic Forecast. Autumn 2019

Annex 1

Table 1: Structural balance (ESA2010, % of GDP)

	2018	2019	2020	cumulatively 2019-2020
1. Structural balance	-1.56	-1.09	-0.58	-
2. Change in structural balance		0.46	0.52	0.98
3. Required change in structural balance according to the CBR		0.53	0.53	1.06
4. Difference against the required adjustment path (2-3)		**-0.07**	**-0.01**	**-0.08**
5. Changes in measures with no impact on long-term sustainability		-0.08	0.07	-0.01
6. Changes in interest payments		0.05	0.13	0.18
7. Windfall revenues		0.00	0.00	0.00
8. Change in structural balance, including additional factors (2-5-6-7)		**0.49**	**0.32**	**0.81**
9. Difference against the required adjustment path taking into account additional factors (8-3)		**-0.04**	**-0.21**	**-0.25**

Note: Calculated based on the data from the approved budget (Year 2019 – the Ministry of Finance estimate included in the 2020-2022 general government budget proposal; year 2020 – approved budget) *Source: CBR*

Table 2: Expenditure benchmark (ESA2010, EUR million)

	2018	2019	2020
1. Total expenditure	37,521	38,380	39,326
2. Interest payments	1,207	1,135	1,057
3. Expenditures on EU programmes fully matched by EU funds revenue	956	940	547
- of that: capital expenditures on EU programmes	748	575	118
4. Gross fixed capital formation (net of EU expenditures)	2,605	2,151	1,713
5. Gross fixed capital formation *(net of EU expenditures, Ø for t-3 through t)*	2,502	2,354	2,220
6. Cyclical expenditures (unemployment benefits, pensions)	38	60	114
7. One-off expenditures	6	6	6
8. Primary expenditure aggregate (1-2-3-4+5-6-7)	**35,211**	**36,443**	**38,108**
9. Year-on-year Δ in primary expenditure aggregate *(8t-8t-1)*		1,233	1,665
10. Δ in revenues due to discretionary measures, unbudgeted items, and methodology of national account reporting		-999	-152
11. Nominal growth in expenditure aggregate net of Δ in revenues *((9t-10t)/8t-1)*		6.3	5.0
12. Year on year change in GDP deflator		*2.4*	*1.9*
13. Real growth in expenditure aggregate net of Δ in revenues *(11-12)*		**3.9**	**3.0**
14. Potential GDP growth rate		2.9	2.8
15. Decrease in expenditure growth (p.p.) CBR k.u./*(8(t-1)/GDP(t))*		1.4	1.4
16. Expenditure benchmark *(reference expenditure growth rate) (14-15)*		**1.4**	**1.3**
17. Deviation impact on the balance in a given year *(16t-13t)*8t-1/GDP$_t$*		-0.91	-0.63
18. Cumulative deviation			**-1.54**
19. Cumulative deviation, with additional factors taken into account			**-1.59**
p.m.1 Gross fixed capital formation	*3,353*	*2,726*	*1,831*
p.m.2 Required improvement in structural balance according to the CBR		0.53	0.53

** Year 2019 – the Ministry of Finance estimate included in the 2020-2022 general government budget proposal; year 2020 – approved budget* *Source: CBR, Ministry of Finance, Eurostat*

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