CBR
COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of compliance with the balanced budget rule for 2018

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. 523/2004 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 for 2018

Under the General Government Budgetary Rules Act, the general government budget needs to be balanced or in surplus. This balanced budget rule which Slovakia undertook to comply with by transposing an international treaty into its national legislation[1] is based on a 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. In line with 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 2018 based on the data contained in the October deficit and debt notification by Eurostat which also includes a wide-ranging revision of national accounts. It contains a response to the evaluation published by the Ministry on 29 November 2019. In the methodology of evaluation, there were two changes as regards the manner in which the long-term impacts on the public finances are taken into account[3]; however, the conclusions of the CBR's evaluation remained unaffected. The year 2015 remains the base year of the evaluation[4].

A balanced budget in the form of a structural deficit of up to 0.5 % of GDP (Chart 1) has not been achieved in 2018. According to the CBR, the structural deficit of the general government stood at 1.56 % of GDP in 2018. Following an assessment of the path towards the balanced budget, a significant deviation with the need to trigger the correction mechanism occurred in 2018. This confirmed the conclusions of the CBR's evaluation in July 2019.

Given the identified significant deviation, the government should approve a binding correction plan that would enable meeting the medium-term budgetary objective of having a structural deficit of 0.5 % of GDP within the shortest time possible. The need to take corrective action is also underlined by significant risks from the point of view of the development in the general government balance in 2019 and the approved general government budget for 2020[5]. The balanced budget rule should be complied

1 The rule was transposed into the national legislation on the basis of an obligation arising under 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 In determining the extent of risks associated with the long-term sustainability of public finances, the CBR will consider its own evaluation only (without taking into account the European Commission's assessment), as envisaged in the General Government Budgetary Rules Act. The second change follows up on the benchmark revision of national accounts, according to which the long-term impacts of nuclear decommissioning are already included in the general government balance as currently reported under the ESA2010 methodology. For this reason, they do not need to be reflected in additional factors. A detailed process of CBR evaluation is described in the manual published on the CBR's website.

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

5 Without the government adopting additional measures in November or December 2019, the general government deficit may amount to 1.3 % of GDP, according to the CBR's current estimate, corresponding to a structural deficit of 1.7 % of GDP. The 2020 budget assumes a structural deficit of 0.5 % of GDP, whereas the risks identified by the CBR in budget proposal approved by the government imply that the structural deficit might reach 1.9 % of GDP. In order to comply with the balanced budget rule, measures amounting to EUR 1,360 million (1.4 % of GDP) will be necessary.

with in 2020 at the latest. In order to meet this objective, a nominal year-on-year growth rate of adjusted expenditures should not exceed 3.5 % a year on average for 2019 and 2020[6].

This is the first time when the activation of the correction mechanism is also suggested by the Ministry. It is expected to take the form of public expenditure ceiling[7] for 2020 that would correspond to achieving a structural deficit of 0.5 % of GDP[8]. The Ministry also said it would publish the precise figure of the ceiling after the general government budget is approved by the Slovak parliament. Before the government decides on the application of the proposed correction mechanism, it will be assessed by the CBR as well.

According to the CBR, the reasons for triggering the correction mechanism have occurred for the second time since it started evaluating compliance with the balanced budget rule. As for the first time, when assessing the compliance with the balanced budget rule for 2015, in July 2016, the Ministry did not propose triggering the correction mechanism. The government relying on the interpretation of the European rules under the Stability and Growth Pact and ignoring the requirements under the national balanced budget rule, postponed the deadline for meeting the medium-term budgetary objective from 2017 to 2019. Since the purpose of the balanced budget rule is to prevent the moving-target syndrome[9] (i.e., repeatedly shifting the deadline for its compliance due to a failure to comply with the rule), the currently identified deviation makes the triggering of the correction mechanism all the more important.

The CBR's evaluation is based on the assessment of the structural balance development and growth in adjusted expenditures including additional factors:

- **In the primary assessment,** the deviation from the required adjustment path towards the structural balance necessary to meet the medium-term objective set by 2019 was at 0.56 % of GDP in 2018 (Chart 2). In real terms, the adjusted budget expenditures increased in 2018, compared to 2015, 4.9 p.p. (Chart 3) more in real terms than as stipulated under the expenditure benchmark, having a negative impact on the balance in the amount of 1.79 % of GDP (Chart 4).

- **With additional factors taken into account, the deviation in the development of the structural balance increased to 1.87 % of GDP.** This increase is mainly related to the CBR having excluded the positive effect of windfall revenues[10] in the amount

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6 These values apply under the assumption that the general government revenues would grow in accordance with the currently estimated growth rate of the potential output. In the case of a lower revenue growth rate, such as that which occurred, for example, in 2016 through 2018, the expenditure growth rate should be reduced so as to ensure the necessary improvement in the structural balance.

7 Pursuant to Section 30a of Act No. 523/2004 Coll. on General Government Budgetary Rules, this represents the maximum amount of the total accrued consolidated general government expenditure. It does not mean the expenditure ceiling in light of the objectives of Act No. 493/2011 Coll. on fiscal responsibility.

8 At the same time, this value represents a target along which the General Government Budget Proposal for 2020-2022 has been prepared.

9 Communication from the Commission: Common principles on national fiscal correction mechanisms of 20 June 2012 (/* COM/2012/0342 final */). Correction mechanisms are aimed at preventing the moving-target syndrome.

10 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(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).

of 1.01 % of GDP and of lower interest payments[11] by 0.43 % of GDP from the change in structural balance since they do not depend solely on the present fiscal policy of the government.

- In the case of the expenditure benchmark, the CBR also considered the lower expenditures on co-financing to EU funds that are associated with lower tax revenues, and the increased effectiveness of VAT collection which may be deemed a government measure. **These additional factors have slightly worsened the negative impact of the adjusted expenditure deviation to 1.83 % of GDP[12].**

- The significant deviations[13] under both indicators indicate that the **medium-term budgetary objective could have been attained already in 2018, that is, a year earlier than envisaged by the government, had the expenditure benchmark been complied with[14].** The reason is that the windfall tax revenues and the lower debt interest payments had created conditions for an accelerated fulfilment of the medium-term budgetary objective but the government failed to take advantage of such improved conditions.

The overall conclusions by both the Ministry and CBR are identical. Under the primary assessment, both institutions assessed the deviation in terms of the structural balance and expenditure benchmark as significant. While there are no numerical differences in the structural balance, the expenditure benchmark shows a difference of 0.7 % of GDP. The difference stems mainly from the way in which discretionary revenue measures[15] are taken into account, as well as from the different estimate of the potential economic growth between 2016 and 2018 because, in estimating the potential output, the CBR also considers the forecasts of other institutions in addition to the Ministry's forecast.

In its overall evaluation, the Ministry did not take into account the effect of debt interest payments and windfall revenues on the balance improvement; this deepened the differences in the evaluation of the structural balance. In the past, these factors have also been taken into account by the European Commission[16], while the windfall revenues are directly specified in the rules of the Stability and Growth Pact[17]. Despite the differences stated above, a significant deviation in both indicators has been identified by both institutions within the overall evaluation.

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11 The savings in interest payments in 2017 which had improved the structural balance were also noted by the European Commission in its assessment of the Slovak Stability Programme for 2018 to 2021: "However, the structural balance reading is positively impacted by interest savings and windfall revenues, accounting for which would substantially reduce – but still preserve – a positive margin on the structural balance pillar." (EC, Assessment of the 2018 Stability Programme for Slovakia, Commission staff working document, pg. 13).

12 The benchmark implicitly assumes a higher revenue growth rate than actually achieved. Complying with the expenditure benchmark would not lead to the fulfilment of the medium-term objective in that case.

13 A deviation becomes significant from 0.5 % of GDP upwards.

14 A full compliance with the benchmark in 2018 would result in a structural surplus of 0.3 % of GDP, that is, above the set medium-term budgetary objective.

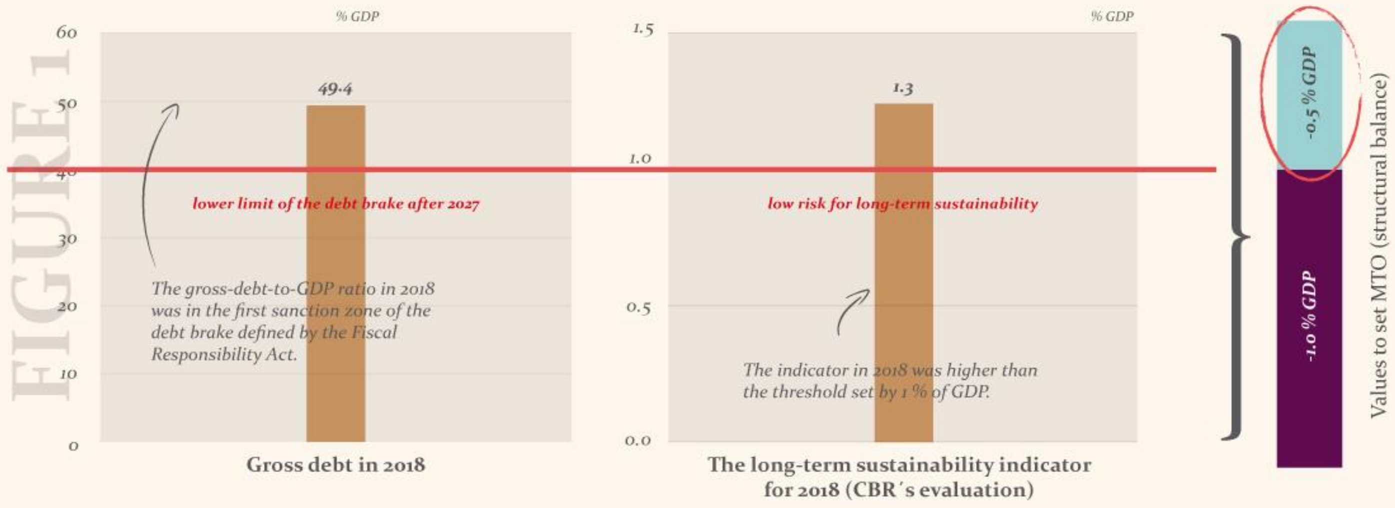
15 The Ministry of Finance included the estimate of the effect of improved VAT collection among the discretionary revenue measures (after taking into account the revision of national accounts, the estimate was reduced from 0.6 % of GDP to 0.3 % of GDP, according to the Ministry of Finance); however, due to the uncertainty associated with the estimate, the CBR takes it into account in additional factors only.

16 EC, Assessment of the 2018 Stability Programme for Slovakia, Commission staff working document, pg. 13

17 According to the rules of the Stability and Growth Pact, windfall revenues should also be taken into account in determining the year-on-year structural balance improvement and in its subsequent evaluation.

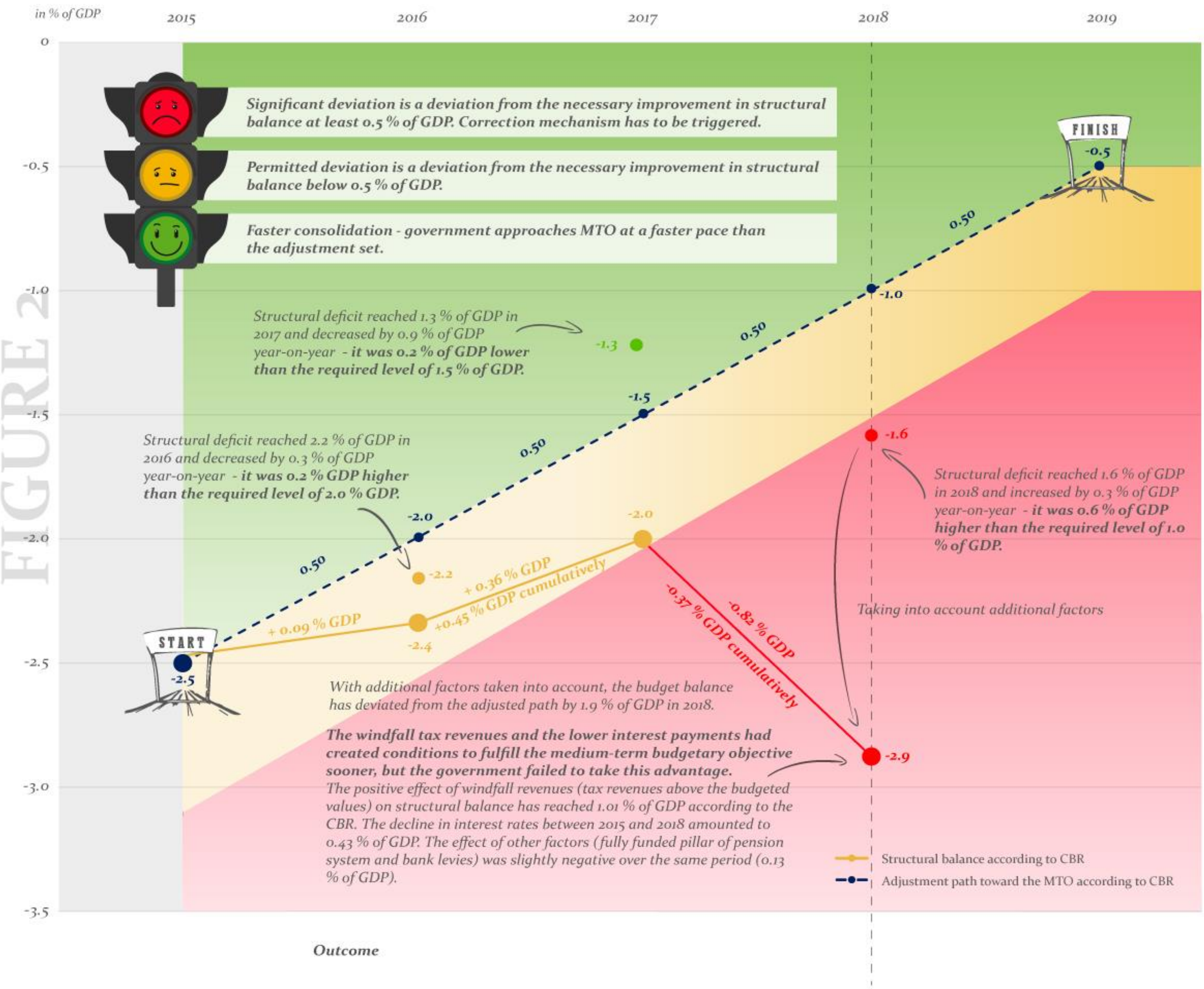
Structural balance

The medium-term budgetary objective (structural deficit of 0.5 % GDP) set by the government is in line with requirements of the balanced budget rule.



The 2018 general government's structural deficit reached 1.6 % 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.

Structural deficit in 2018 significantly deviated from the requirements of the balanced budget rule.



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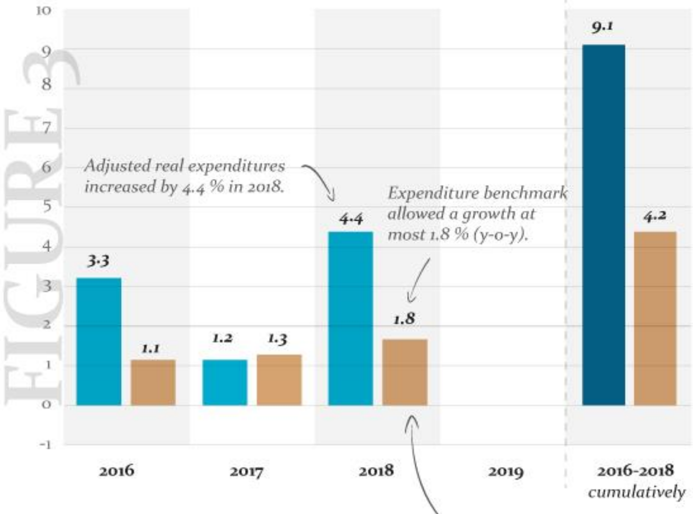
Expenditure benchmark: The adjusted expenditures grew 4.9 p.p. faster in 2016-2018 than allowed by the rule with a negative impact on the balance at the level of 1.8 % GDP.

Increase in expenditures, in %

FIGURE 3

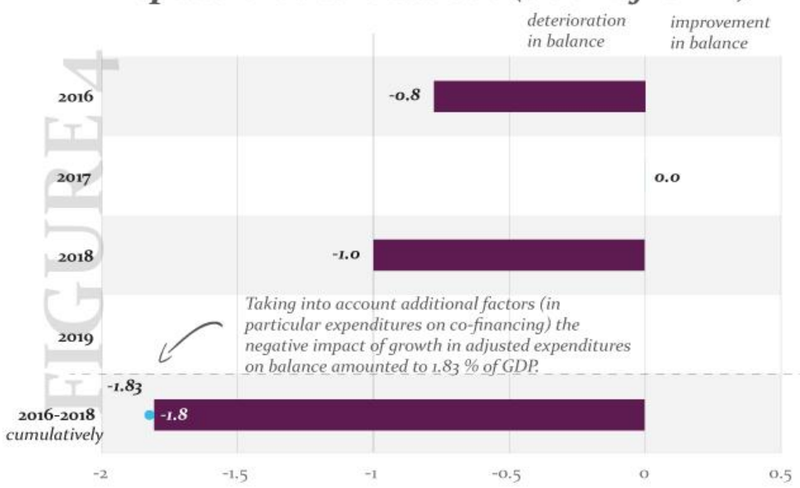


Adjusted real expenditures of the budget grew 2.6 p.p. faster than allowed by the expenditure benchmark in 2018.

Real increase in expenditures · *Expenditure benchmark (permitted expenditure growth)*

Impact on the balance (in % of GDP)

FIGURE 4



Had the permitted rate of growth in expenditures been adhered to between 2016 to 2018, the budget deficit in 2018 would be 1.8 % GDP lower, reaching the surplus of 0.7 % of GDP (the actual deficit amounted 1.1 % of GDP in 2018).

According to the CBR and the Ministry there is a significant deviation from the balanced budget rule in 2018. The Ministry suggested for the first time to trigger the correction mechanism.

FIGURE 5

Primary assessment	CBR	MINISTERSTVO FINANCIÍ SLOVENSKEJ REPUBLIKY
Change in structural balance	significant deviation	significant deviation
Expenditure benchmark	significant deviation	significant deviation
Overall assessment		
Additional factors	confirmed assessment	confirmed assessment
Change in structural balance	significant deviation	significant deviation
Expenditure benchmark	significant deviation	significant deviation
Change in fully-funded pillar of the pension system	+	not included
Bank levies	no impact	not included
Interest payments	−	not included
Windfall revenues	−	not included
Lower expenditures on co-financing	−	−
More effective VAT collection	+	covered within primary assessment
Final assessment	significant deviation	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 the discretionary revenue measures are taken into account (the impact of improved VAT collection) in the expenditure benchmark and a different estimate of the potential output in 2016-2018.

Since 2015, debt interest payments dropped by 0.43 % of GDP, thus improving the structural balance.

Windfall revenues improved the structural balance by 1.01 % GDP since 2015. 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 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 0.27 % of GDP since 2015 has been reflected in additional factors.

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

After taking into account additional factors, a significant deviation was identified in both indicators by the CBR and the Ministry. The Ministry suggested to trigger the correction mechanism.

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