Evaluation of compliance with the balanced budget rule in 2019

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.

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

Evaluation of compliance with the balanced budget rule in2019

The CBR prepared its final evaluation of compliance with the balanced budget rule for the year 2019 based on the data contained in the 2020 October deficit and debt notification by Eurostat. It also contains the CBR's response to the evaluation published by the Ministry of Finance of the Slovak Republic on 30 November 2020. No changes have been made in the methodology of evaluation[1]. Similarly to the Ministry of Finance, the CBR assessed the development in public finance over the years 2015 through 2019.

The government's medium-term budgetary objective was to achieve a balanced budget in the form of a structural deficit not exceeding 0.5 % of GDP by 2019. According to the CBR, as well as the Ministry of Finance[2], the objective was not achieved in 2019 and the government had deviated significantly from the adjustment path. Despite the decrease required under the balanced budget rule, the structural deficit increased both in 2018 and 2019, amounting to 2.3 % of GDP in 2019, according to the CBR. Between 2016 and 2019, the government missed the opportunity to use the additional windfall revenues and the reduction in interest payments to considerably move towards the balanced budget. **Expenditures for the period grew 10.2 p.p. above the level permitted by the expenditure benchmark, contributing to a rise in deficit by 3.6 % of GDP.**

The CBR had already identified a significant deviation from the balanced budget rule in its evaluation of the 2018 results and the non-compliance with the rule became even more prominent in 2019. In order to preserve the deviation at the 2018 level, a surplus of 0.1 % of GDP would have been needed in 2019 and removing the deviation accumulated over the previous years (2016 through 2018) would have required a surplus of 2.1 % of GDP in 2019.

Under standard economic conditions, the identification of a significant deviation should have triggered corrections as envisaged under the balanced budget rule[3]. The government activated the correction mechanism as late as in January 2020, only after the second evaluation of the 2018 results had been released. However, the Slovak economy was affected by the pandemic of coronavirus in 2020. **Upon the Ministry of Finance's proposal assessed by the CBR, the government declared, on 24 June 2020, the beginning of exceptional circumstances for the duration of which the correction mechanism under the balanced budget rule is not applied.**

An important prerequisite to waive the correction mechanism for the duration of exceptional circumstances is that it does not endanger fiscal sustainability in the medium term. The impacts of the pandemic and the measures adopted prior to the general elections[4] have significantly exacerbated the sustainability of public finances both in the medium and long term. The CBR estimates[5] the structural deficit to be at 4.9 % of GDP in 2020; if no additional consolidation measures are adopted, it will reach 5.0 % of GDP by 2023, a level that is unsustainable over the long term due to the related growth in debt. It is therefore important to **promptly activate the correction mechanism and define a binding path towards a balanced budget once the exceptional circumstances have ended.**

In its 2021-2023 general government budget proposal, the government has not anticipated fiscal consolidation for 2021; this is in line with the need to boost the economy enfeebled by the impacts of the pandemic. However, it lacks a reliable budgetary strategy beyond 2021, based on measures. **When evaluating the budget proposal, the CBR, therefore,**

1 CBR, Methodology for the Evaluation of the Balanced Budget Rule, version 1, December 2019.
2 The conclusions of the evaluations of both institutions match despite the continued differences in the quantification of the size of deviation in structural balance and development in adjusted expenditures.
3 §30a of Act No. 523/2004 on the General Government Budgetary Rules.
4 Especially, the setting of the retirement age ceiling, increase in minimum pensions, introduction of 13th pension payments and increase in wages in the public sector in 2020.
5 CBR, Evaluation of the General Government Budget Proposal for 2021-2023, November 2020.

recommended the government to prepare a medium-term strategy to reduce the structural deficit to the level of 3 % by the end of the current election term and, subsequently, achieve at least a balanced budget in structural terms . We deem it positive in this respect that the Ministry of Finance intends to present a new medium-term budgetary objective and adjustment path towards it not later than in the next year's stability programme[6].

Achieving the balanced budget is not sufficient in terms of the long-term sustainability of public finances. Without implementation of structural reforms in the areas sensitive to population aging (namely the pension system, healthcare and long-term care services) and without enhancing the competitiveness and productivity in other sectors of Slovakia's economy, a structural surplus in excess of 2% of GDP would now be necessary in order to achieve the long-term sustainability of public finances.

The evaluations of the compliance with the balanced budget rule made so far clearly show that its existing setting is ineffective:

- The rule was established with the aim of making use of the favourable economic conditions in order to accelerate the recovery of public finances and achieve a balanced fiscal performance. The balanced budget was not achieved during the favourable period of the economic cycle over the past few years.
- **Given the favourable economic conditions in the 2015-2018 period** (higher-than-forecast tax revenues, savings on interest payments)**, the medium-term budgetary objective could have been achieved as early as 2018 if the balanced budget rule had been complied with.**
- Contrary to the rule's intended objective and Slovakia's economic development, the government have postponed the deadline for the meeting of the medium-term budgetary objective several times. The original deadline scheduled for 2017 was first postponed until 2019 and then again until 2020. The delays were related to the ongoing non-compliance with the rule of which the CBR warned in its evaluations released in 2016 and 2019. The Ministry of Finance was of a different opinion based on the changes in an approach to the evaluation[7] in 2016 and in June 2019 and did not propose triggering the correction mechanism.
- It was not before January 2020 that the government approved a correction mechanism in the form of an expenditure ceiling, even though the CBR had already identified significant risks in the general government budget for 2020 which was supposed to ensure the necessary corrections. Compliance with the expenditure ceiling cannot be assessed due to the impact of the pandemic on the Slovak economy.

According to the CBR, in order to increase the effectiveness of the rule, the manner of its evaluation should particularly be reviewed, the responsibility for which is borne by the Ministry of Finance[8], while the activation of the correction mechanism is subject to a government's decision. Although the CBR had identified a significant deviation already when evaluating the results of fiscal performance for 2015 and, subsequently, in its first evaluation of the 2018 performance, the government, based on the Ministry of Finance's position, did not activate the correction mechanism. If triggered on time after accepting the CBR's opinions, the public finance would have been better prepared for the current situation affected

[6] Ministry of Finance, Compliance with the Balanced Budget Rule for 2019, November 2020, pg. 11 (available in Slovak only).

[7] The Ministry selectively factored in additional factors identified by the European Commission (but only those that improved the evaluation) in 2016, while since 2018 it has been improving the basic evaluation by means of additional factors (transferring the estimated improved VAT collection among discretionary revenue measures). Despite the reasons provided by the Ministry, the CBR did not go along with these changes in methodology in its evaluations.

[8] The first institution that evaluates the rule is the Ministry of Finance. The CBR then publishes its position to which the Ministry responds in line with the comply-or-explain principle.

by the pandemic. For example, if the correction mechanism had been triggered by a significant deviation in 2015 and the balanced budget rule had been met by the original deadline of 2017, the end of 2019 gross debt could have been at 43.6 % of GDP, that is almost 5 p.p. lower than it actually was. **Therefore, the compliance with the rule should be assessed by an independent institution, with the option of automatically triggering corrections in the event of a significant deviation[9]. In order to implement this change, the General Government Budgetary Rules Act would need to be amended accordingly.**

9 According to the report from the European Commission (EC (2017), The Fiscal Compact: Taking Stock, Communication from the Commission), on the implementation of the fiscal compact, in some countries (Belgium, Bulgaria, France), the correction mechanism is activated based on an assessment by an independent institutions, in other cases (Austria, Germany, Denmark, Spain, and Latvia), the automatic correction is ensured through the obligation to prepare and adopt a budget with the balance at the level of the medium-term budgetary objective irrespective of any previous deviation.

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Structural balance

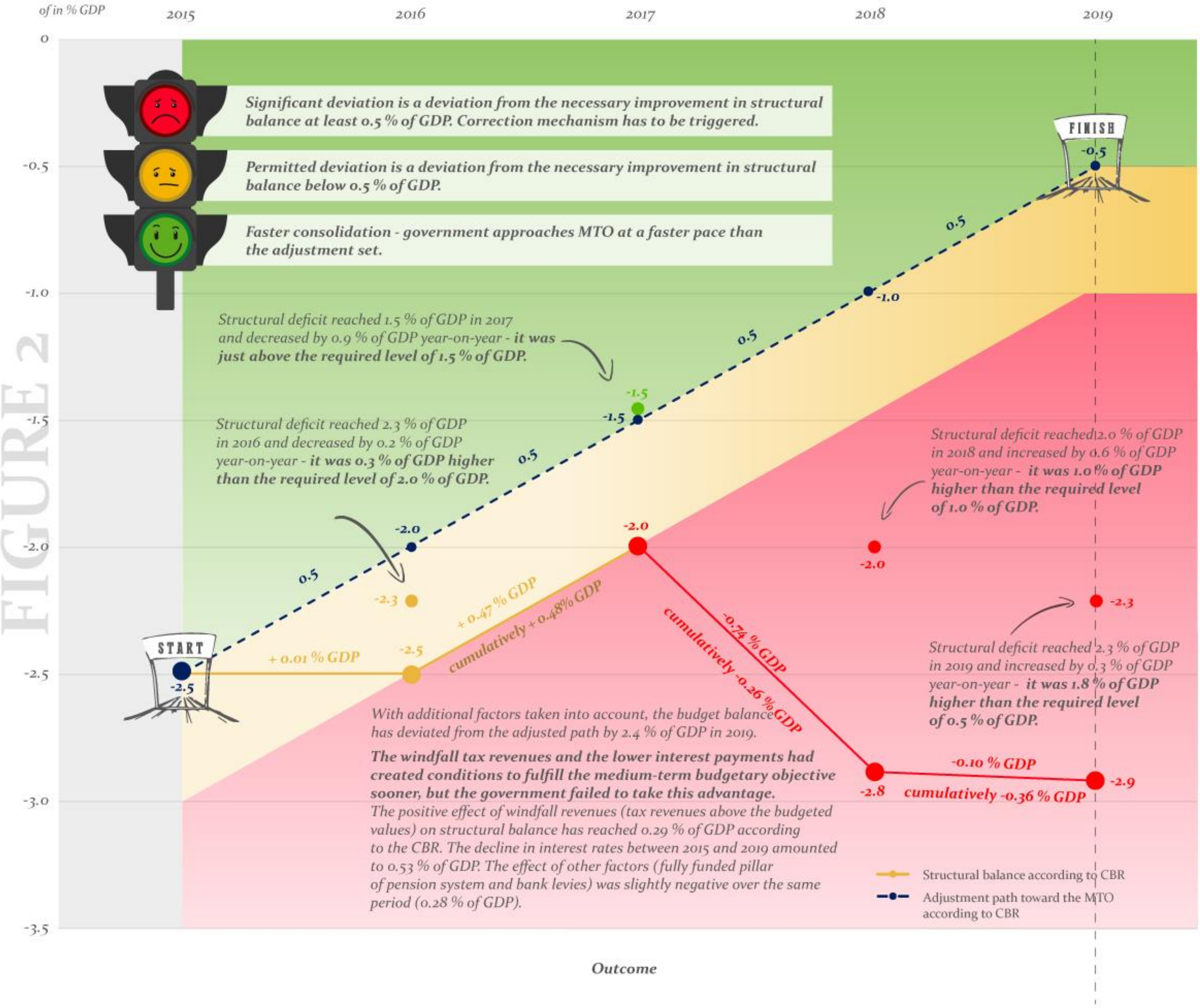
As the debt exceeds 40 % of GDP and the risks to long-term sustainability are not low, a structural deficit of a maximum of 0.5 % of GDP is required under the balanced budget rule. The government planned to achieve this goal in 2019.

FIGURE 1

The 2019 general government's structural deficit reached 2.3 % 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.

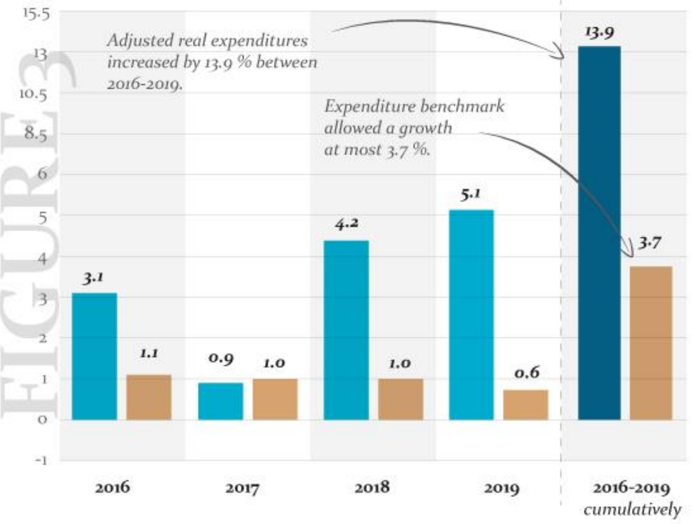
Structural deficit in 2019 significantly deviated from the requirements of the balanced budget rule

FIGURE 2



Expenditure benchmark: The adjusted expenditures grew 10.2 p.p. faster between 2016-2019 than allowed by the rule with a negative impact on the balance at the level of 3.6 % GDP.

Increase in expenditures, in %

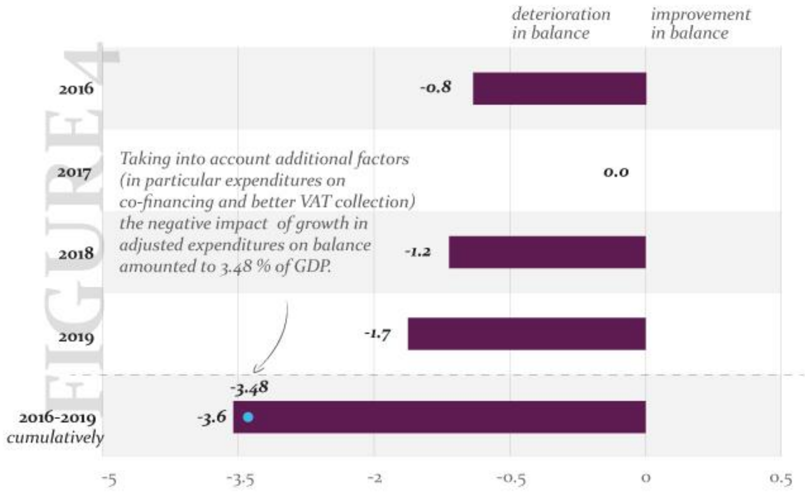


Adjusted real expenditures of the budget grew 10.2 p.p. faster than allowed by the expenditure benchmark between 2016- 2019.

Real increase in expenditures

Expenditure benchmark (permitted expenditure growth)

Impact on the balance (in % of GDP)



Had the permitted rate of growth in expenditures been adhered to between 2016 to 2019, the budget deficit in 2019 would be 3.5 % GDP lower, reaching the surplus of 2.1 % of GDP (the actual deficit amounted 1.4 % of GDP in 2019).

According to the CBR and the Ministry there is a significant deviation from the balanced budget rule in 2019. After termination of exceptional circumstances, the correction mechanism should be triggered.

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

Since 2015, debt interest payments dropped by 0.53 % of GDP, thus improving the structural balance.

Windfall revenues improved the structural balance by 0.29 % GDP since 2015. The structural balance should thus improve more significantly 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 0.34 % 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 through 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. As the government has announced on June 24, 2020 occurrence of exceptional circumstances, the Ministry of Finance did not trigger the correction mechanism. After termination of exceptional circumstances, the correction mechanism should be triggered.

− + *Effects increasing/decreasing the deviation in the structural balance or expenditure benchmark in the final assessment over the primary one.*

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