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Evaluation of compliance with the balanced budget rule for 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.

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 2019

The CBR prepared its first evaluation of compliance with the balanced budget rule for 2019 based on the data contained in the April 2020 deficit and debt notification released by Eurostat. It also contains the CBR's response to the evaluation published by the Ministry of Finance of the Slovak Republic on 30 June 2020. No change has been made in the methodology of evaluation[1]. Similarly to the Ministry of Finance, the CBR assessed the development in public finance over the period for 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 as the government had significantly deviated from the adjustment path. Despite the decrease required under the balanced budget rule, the structural deficit increased in 2018 and 2019, amounting to 2.1 % of GDP in 2019, according to the CBR. Between 2016 and 2019, the government missed the opportunity to use the windfall revenues and the reduction in interest payments to considerably move towards the balanced budget. **Expenditures for the period grew 10.8 p.p. above the level permitted by the expenditure benchmark, contributing to a rise in deficit by 3.8 % of GDP.** The CBR had already identified a significant deviation from the balanced budget rule in its evaluation based on the 2018 results and the non-compliance with the rule became even more prominent 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 in January 2020, only after the second evaluation of the 2018 results had been released. However, the Slovak economy has been impacted by the pandemic of coronavirus in 2020. **Therefore, on 24 June 2020, the government announced the beginning of exceptional circumstances, proposed by the Ministry of Finance and assessed by the CBR, during which the correction mechanism under the balanced budget rule does not apply.**

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 the structural deficit to reach 6.0 % of GDP in 2020, and if no additional measures are adopted, it is expected to move around the same level in the subsequent years, too[5]. Additionally, the changes in the pension system have contributed to a significant increase in the estimate of costs related to population ageing, translating into worsened prospects of public finance development over the long term. 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 this regard, it is necessary that the government introduce, by the end of 2020, a trustworthy, measure-based budgetary strategy for individual years of its office term and, once the exceptional circumstances end, be prepared to make substantial improvements in public finances.

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1 CBR, The Balanced Budget Rule Evaluation Methodology (available in Slovak only), 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 Medium-term Budgetary Objectives for 2020 through 2023, July 2020.

Achieving a balanced budget alone is not sufficient for the long-term sustainability of public finances. Without implementation of structural reforms in the areas sensitive to population ageing (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 of more than 2 % of GDP would be necessary in order to achieve the long-term sustainability of public finances.

The evaluations of the compliance with the balanced budget rule so far clearly show that its current setup 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 from 2015 to 2018 (higher-than-forecasted 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 and the economic development in Slovakia, 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 until 2020. The delays were related to the ongoing non-compliance with the rule. The CBR warned of this in its evaluations released in 2016 and 2019. The Ministry of Finance was of a different opinion based on the changes in the approach to the evaluation 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 evaluation is within competence of the Ministry of Finance[6], 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 opinion, did not activate the correction mechanism. If it had been triggered sooner, after accepting the CBR's opinion, the public finances would have been better prepared for the current situation affected by the pandemic. Therefore, the compliance with the balanced budget rule should be assessed by an independent institution, with the option to automatically activate corrections in the event of a significant deviation.[7]

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6 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.

7 According to the report from the 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 institution, 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.

Structural balance

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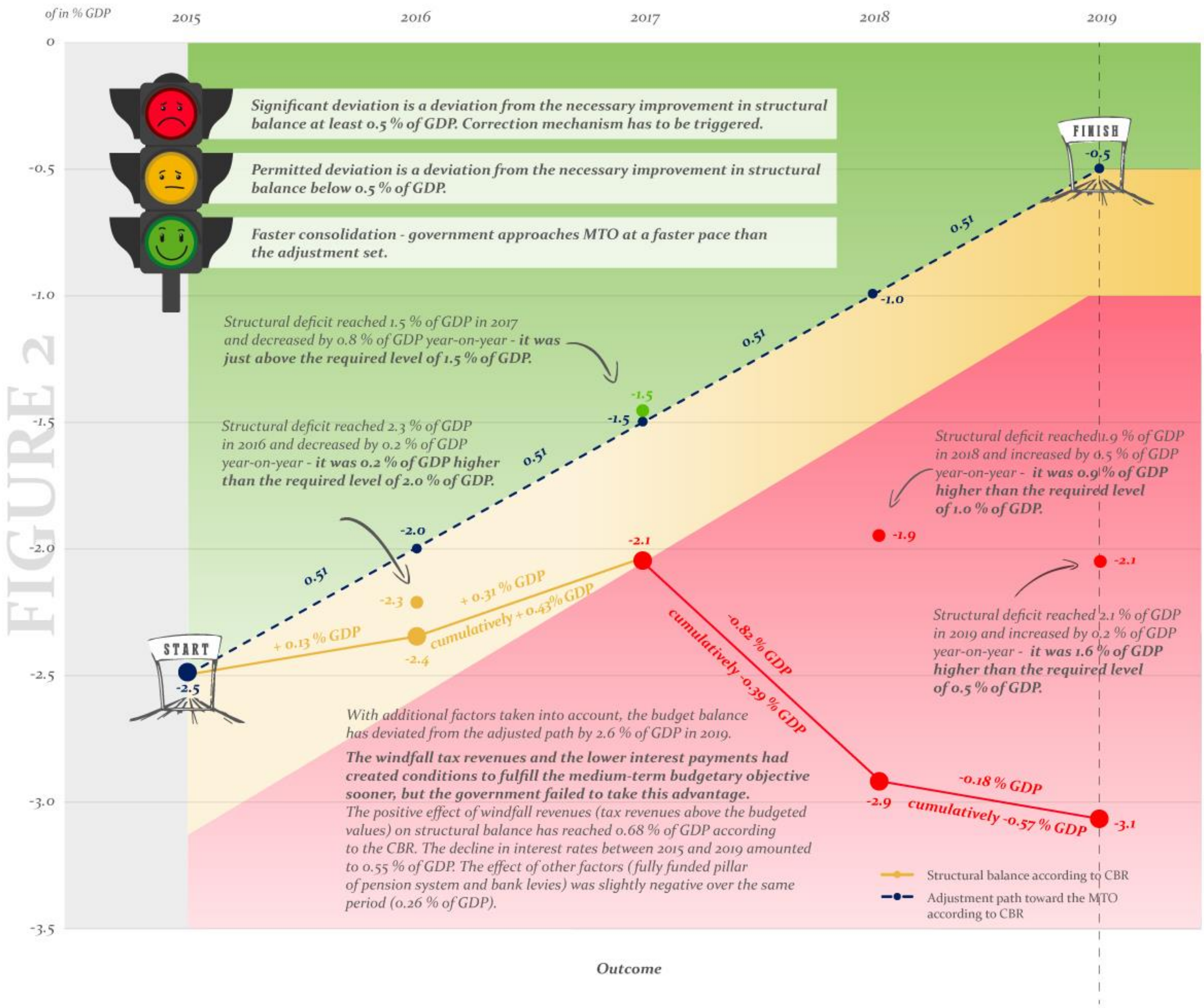
As the debt exceeds 40 % of GDP and the risks to long-term sustainability are not low, a structural deficit of a maximum of 0.5 % of GDP is required under the balanced budget rule. The government planned to achieve this goal in 2019.

FIGURE 1

The 2019 general government's structural deficit reached 2.1 % 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.

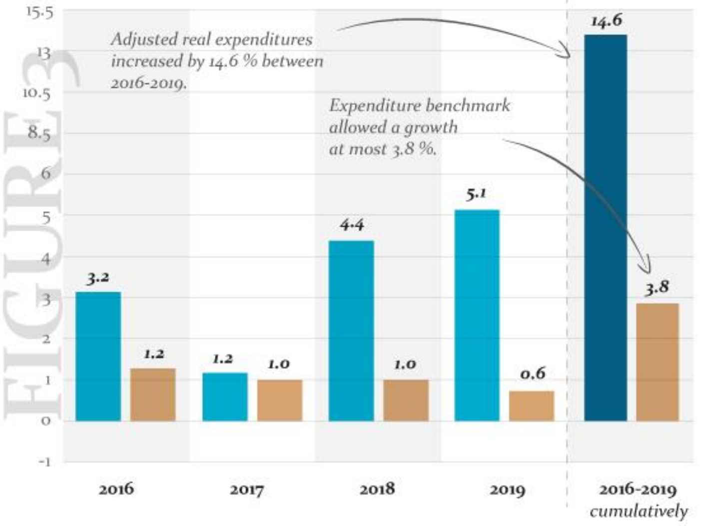
Structural deficit in 2019 significantly deviated from the requirements of the balanced budget rule

FIGURE 2

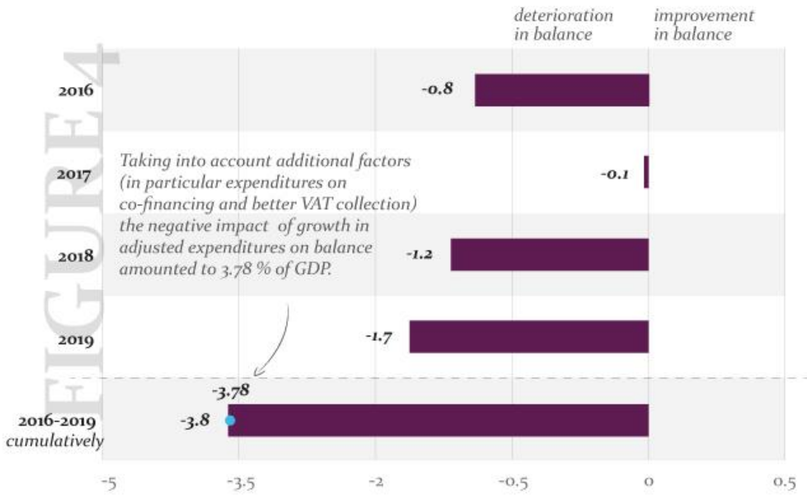


Expenditure benchmark: The adjusted expenditures grew 10.8 p.p. faster between 2016-2019 than allowed by the rule with a negative impact on the balance at the level of 3.8 % GDP.

Increase in expenditures, in %



Impact on the balance (in % of GDP)



Adjusted real expenditures of the budget grew 10.8 p.p. faster than allowed by the expenditure benchmark between 2016- 2019.

Real increase in expenditures

Expenditure benchmark (permitted expenditure growth)

Had the permitted rate of growth in expenditures been adhered to between 2016 to 2019, the budget deficit in 2019 would be 3.8 % GDP lower, reaching the surplus of 2.5 % of GDP (the actual deficit amounted 1.3 % 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 includedT
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 in the final assessment over the primary one.*

Since 2015, debt interest payments dropped by 0.55 % of GDP, thus improving the structural balance.

Windfall revenues improved the structural balance by 0.68 % 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.

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Council for Budget Responsibility

Imricha Karvaša 1
Bratislava 1
813 25
Slovakia

www.rozpoctovarada.sk