Evaluation of the General Government Budget Proposal for 2021-2023

Main conclusions and recommendations

November 2020

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Basic information about CBR's positions

In order to achieve long-term sustainability of Slovakia's economy, improve transparency and increase efficiency in public spending, as well as in an effort to support long-term competitiveness of the Slovak Republic while taking into account the requirement of economic and social justice and solidarity between the present and future generations, the Council for Budget Responsibility (CBR) was formed in 2012 as an independent body set up to monitor and evaluate the fiscal performance of the Slovak Republic. Its role is to provide professional, comprehensive and politically unbiased information to the public on the development of public finances.

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How the CBR assesses public finances

The Council for Budget Responsibility (hereinafter referred to as the "Council" or the CBR) evaluates the development of public finances in order to achieve their long-term sustainability. In addition to promoting transparency and efficiency of public finances, the Council supports the long-term competitiveness of the Slovak Republic while taking into account a fair distribution of costs between the present and future generations.

For the citizens and for the Council, it is crucial to judge the situation through the prism of long-term sustainability. If the debt is rising due to one-off anti-crisis measures without deteriorating the structural deficit, the impact on long-term sustainability is only temporary and very limited. On the contrary, long-term sustainability can be significantly influenced by legislative changes regarding pensions, health care or by other structural reforms that are improving the long-term economic growth. Therefore, the most important question is whether and how the intended fiscal policy outlined in the budget can improve our current high-risk status in terms of long-term sustainability.

The **budgetary policy** set out by the general government budget (GGB) is the **key source of long-term sustainability that is under government's control**. The plans outlined in the GGB do not necessarily provide an objective picture of the fiscal policy development in the medium-term horizon[1], therefore the Council regularly prepares a detailed evaluation of the government's General Government Budget Proposal before it is discussed in the Parliament.

At the same time, the Council evaluates the impact of intended legislative measures on the **long-term sustainability of public finances**. Considering that Slovakia's public finances are within the high-risk zone in terms of sustainability, it is necessary to take this situation into account especially in the process of approving the new budget.

Main conclusions from the evaluation of the GGB proposal for 2021-2023:

- **The Council considers the submitted budget proposal to be realistic,** the deficit estimates prepared by the CBR for the years 2021-2022 are slightly lower than those of the government.
- Given the need to support the economy weakened by the pandemic, the Council does not consider the absence of consolidation measures for 2021 to be a key problem**. Majority of additional measures, in particular the one-off measures to address the pandemic, have a minimum negative impact in terms of long-term sustainability of public finances.**
- **The consolidation effort in 2022 and 2023 should be much more ambitious. The Council recommends that a detailed consolidation path, by at least 1.5 % of GDP on a cumulative basis, should be prepared so that the structural deficit would be reduced to 3.6 % of GDP by 2023.** The need for consolidation is intensified by a high structural deficit and the ensuing high debt, as well as by the absence of a more specific and comprehensive pension reform, which could considerably strengthen the currently destabilised pension system. **During the inevitable consolidation, the resources from the EU recovery fund should serve as the source of a fiscal stimulus[2].**
- Slovakia's public finances were in a high-risk zone in terms of long-term sustainability

[1] For instance, out of the seven most recent budgets, the declared target has not been met in five cases.

[2] At the EU level, it is the Recovery and Resilience Facility, through which Slovakia, as a country, will be able to draw funds based on the Recovery and Resilience Plan.

already before the crisis. The Council regards as positive that the introduced measures regarding the 13th pension payments and the minimum pension have been amended, thus reducing their negative impact on the sustainability of public finances. The Council also welcomes a reform in the financing of public investments. **However, long-term sustainability will not improve without adopting additional measures and will instead remain within the high-risk zone even at the end of the budget horizon.**

- If this trend continues, the debt will remain above the upper limit of the debt brake and the distance from that limit will be increasing. **According to the Fiscal Responsibility Act, a new government is not subject to the most stringent sanctions of the debt brake during the first two years in office. In October, the government adopted a new proposal for the Fiscal Responsibility Act which adjusts certain rules of the debt brake. The type of debt brake rules – including expenditure ceilings – which are to be applied in the upcoming period will be known after the government's proposal is either approved or turned down by the parliament.**
- In the case of a better-than-expected economic development, for instance, as a result of spending financial resources from the EU recovery fund, **all positive aspects (including the unspent part of the reserve to address the impacts of the pandemic) need to be strictly reflected in the improvement of fiscal performance. The planned introduction of expenditure ceilings already during this election term should significantly contribute to achieving this objective.**

A more realistic budget

The GGB proposal is based on an estimate of the economic development as approved by the Macroeconomic Forecasting Committee. The Council evaluated this forecast as a realistic one. Unlike in the previous years, the submitted budget is correctly reflecting the estimates of revenues from taxes and social contributions as approved by the Tax Revenue Forecasting Committee. The tax forecast included in the budget proposal no longer contains items[3] not approved by the Committee, as used to be the case in the previous years.

Objective uncertainty in the macroeconomic development due to the pandemic can be considered the most significant risk of the budget proposal[4]. The Council assessed the overall risks in expenditures and revenues and, even though it perceives a risk of higher-than-budgeted spending in several expenditures, this risk is, as opposed to the previous years, sufficiently covered by a slightly conservative estimate of revenues from taxes and social contributions and by the expected non-spending of certain expenditures.

The real multiannual budgeting is still absent. The budget proposal is compiled in accordance with the budgetary objective only in 2021, but not in the years to follow. As regards 2023, even though the budgetary objective formally respects the legislation (the requirement of a balanced budget under the debt brake provision), it is described as unrealistic. **The budget proposal lacks a specific and realistic strategy which the government would follow beyond the horizon of 2021.**

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[3] The previous two budgets incorporated – beyond the scope approved by the Tax Revenue Forecasting Committee – a positive effect on tax revenues as a result of connecting electronic cash registers to the financial administration system online (eKasa) and of marking fuels by a special identifying substance (nanomarkers).

[4] The worsening trend of the pandemic over the recent period poses higher risks for macroeconomic development. In the analytical paper, the Council also presents an alternative scenario expecting a stronger second wave of the pandemic.

Table 1: A comparison between the expected balance and debt in the GGB proposal and the CBR's estimate (% of GDP)

	2019	2020	2021	2022	2023
Balance - government's objectives (upon budget approval)	0.0	-0.5	-7.4	-5.4	-
Balance of the GGB Proposal for 2021-2023 (MF SR)	-1.3	-9.7	-7.4	-6.2	-5.7
Budget balance according to CBR's estimate	-1.3	-7.7	-7.1	-6.1	-6.3
- **Difference**	**0.0**	**2.0**	**0.3**	**0.1**	**-0.6**
Gross debt under the GGB Proposal for 2021-2023 (MF SR)	48.5	62.2	65.0	68.1	69.4
Gross debt of the budget as per CBR's estimate	48.5	62.1	63.8	65.9	67.8
- **Difference**	**0.0**	**-0.1**	**-1.2**	**-2.2**	**-1.6**

Note: The crisis years are highlighted in grey. *Source: MF SR, CBR*

As far as the impacts on public finances are concerned, the Council also evaluated alternative development scenarios based on those of the Macroeconomic Forecasting Committee. While the risk scenario involving stronger impacts of the pandemic at the turn of 2020 and 2021 is significantly deteriorating the condition of public finances in every year, the scenario covering the expected startup curve in the drawing of financial resources from the EU recovery fund would positively manifest itself gradually as late as from 2022, with the spending of funds reaching a peak in 2024[5]. The scenario shows that, just like the **EU recovery fund might be able to significantly improve fiscal performance** in comparison with the baseline forecast, **it could be**, despite a certain delay, **a very robust instrument to counterbalance the stronger negative impacts of the pandemic.**

Figure 1: Development of GG balance in scenarios (% of GDP)

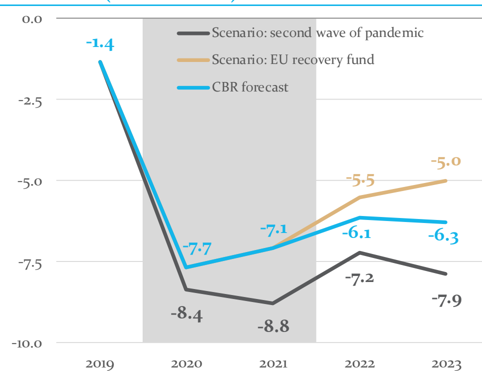
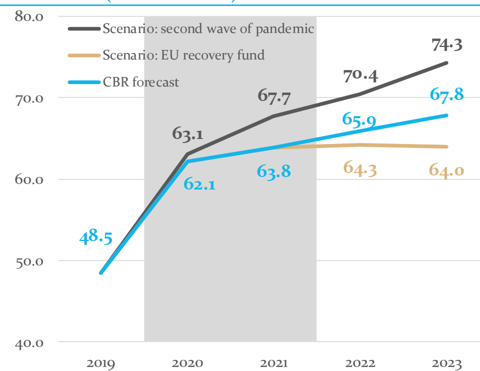


Figure 2: Development of GG debt in scenarios (% of GDP)



Note: The crisis years are highlighted in grey. *Source: Statistical Office, CBR*

Partial reforms in pensions and in the financing of investments are welcome, but mandatory current expenditures are rising

Public finances are going through a shock brought by the spread of the virus. In terms of intergenerational equity, the **crisis poses an unprecedented burden particularly on the young and middle generation**[6]. The years 2020 and 2021 are described as the crisis years when, on the part of the fiscal policy, it is necessary to stimulate the economy because of a

5 The scenario assumes drawing funds in a total amount of EUR 1.4 billion in 2022, EUR 2.1 billion in 2023 and EUR 2.3 billion in 2024.

6 Pastor L.: Will COVID-19 be followed by inflation? An inter-generational transfer perspective; Vox EU&CEPR, 12 June 2020; EC-EUROSTAT: COVID-19 labour effects across the income distribution; 27 October 2020

negative output gap[7]. For this reason, the year 2021 is not assessed with an emphasis on compliance with the existing fiscal rules[8].

In terms of a **stimulus** for the economy, what **is** actually **important is that public finances should not be burdened by such a stimulus in the long term.** Therefore, it should rather rely on targeted one-off anti-crisis measures or effective public investments, and not on recurring current expenditures. And as far as intergenerational equity is concerned, the new measures should ideally be aimed towards those population groups that suffer the most from the economic impact of the pandemic, i.e. the young and middle generations.

Table 2: Overview of basic indicators in budget proposal according to CBR (ESA2010, % of HDP)

	2019	2020	2021	2022	2023
Structural balance	-2.3	-4.9	-5.7	-5.3	-5.0
Government's consolidation effort*	-	-	-0.3	0.0	0.1
Gross general government debt	48.5	62.1	63.8	65.9	67.8
Net general government debt	*43.3*	*54.3*	*59.2*	*63.1*	*66.6*
Fiscal impulse (+ restriction, - expansion)	-0.4	-3.9	-0.5	1.4	-1.0
p.m. output gap	*2.8*	*-6.7*	*-3.0*	*-1.9*	*-0.8*

Note: The crisis years are highlighted in grey. *Source: CBR*

**Consolidation effort is defined as a year-on-year change in the structural balance beyond the scope of development under the no-policy-change scenario after taking into account the effect of abolishing the levy payable by financial institutions as from 2021.*

When disregarding the impact of the crisis (the pandemic brought the deficit up by EUR 3.6 billion), the **pre-crisis economic policy before 2020 was the key negative factor affecting the public finances**. We estimate that this was the reason behind the EUR 3.1 billion increase in the deficit as compared to the planned budget. The measures of the new government beyond the scope of the pandemic have been identified at EUR 0.2 billion.

Table 3: Factors affecting the fiscal performance of the general government in 2020

	Impact on nominal deficit		Impact on structural deficit	
	EUR million	% of GDP	EUR million	% of GDP
CBR's forecast – overall estimate	**-6,873**	**-7.7**	**-4,371**	**-4.9**
Economic policy of previous governments	-3,116	-3.5	-3,053	-3.4
Impact of the pandemic	-3,573	-4.0	-1,135	-1.3
Economic policy of the current government	-184	-0.2	-184	-0.2

Source: CBR, MF SR

As regards long-term sustainability and intergenerational equity, **the effort to reduce the burden posed by the "13th pension payments" can be perceived positively**. But in a situation where public finances have hardly any funds for the first 12 pension payments[9] and

7 EU has deactivated its fiscal rules for 2020 and 2021, whereas international institutions such as the IMF and the OECD call for promoting growth through fiscal policies. While the estimates of the output gap in Slovakia would suggest a higher stimulus, the most recent international comparisons of trends in household consumption and employment indicate a rather favourable situation in Slovakia so far.

8 In times like these, consolidation can become a destabilising factor for the economy and it is advisable to address long-term sustainability of public finances rather through legislative measures not having a short-term braking effect on the economy.

9 The amount of pension benefits in Slovakia, measured by the so-called net replacement rate, is average or above average in comparison with other countries (Pensions at a Glance, OECD 2019).

when the crisis poses an unprecedented burden on the younger generations, even the reduced 13th pension is in contract with the objectives of sustainability and fairness that the Council is expected to promote[10].

Because of the easing of budgetary discipline that is to take place in 2021 at a level 0.4% of GDP, the overall stimulus for the economy will go beyond the scope of the budgeted one-off anti-crisis reserve. Despite austerity measures in wages for 2021 it seems that they will not cover the entire increase in other mandatory expenditures that are unrelated to the crisis[11]. **The government should be adopting permanent compensatory measures to counteract the impacts of new permanent measures.** Otherwise the fiscal performance will be permanently worsening, which is very inappropriate in a situation characterised by a high debt.

The Council views positively the **reform in the financing of public investments** which requires that, in order for the funds to be paid from the state budget, the Value for Money criteria must be fulfilled. Theoretically, the reform may have a significant impact on the public spending efficiency[12]. **The revisions of expenditures are now interconnected with the budgetary process to a greater extent,** because measures identified by revisions also in areas other than health care have been incorporated in the budget proposal as well.

A credible consolidation path in 2022-2023 and a coherent pension reform are absent

The GGB proposal **does not include more detailed consolidation measures** for meeting the declared objectives. Without such measures, the government's economic policy would continue to show a **high structural deficit at a level of 5% of GDP**[13] at the end of 2023 and, therefore, it would not be sustainable in the long term. The expected general government debt would be gradually growing and could come in as high as **67.8% of GDP in 2023**. Such a debt level could be less disturbing in a situation where it would only be temporary and where a consolidation path towards reducing the long-term sustainability risk would be presented. In fact, in order to stabilise the debt, it is necessary to reduce the deficit down to a threshold of 3% of GDP.

Long-term sustainability of public finances has worsened significantly since 2018 and is now dwelling deep in the high-risk zone. In addition to the worse fiscal performance of the government and impacts of the pandemic, this is in particular attributable to legislative measures in the pension system that have reduced its financial resources and increased the need for expenditures by as much as some EUR 2 billion a year (2.1% of GDP). The Council

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[10] This is indirectly confirmed by the at-risk-of-poverty indicator, according to which the highest level of risk is experienced by households with three or more children (36.7), single parents with at least one child (36.7%) and individuals aged less than 65 years (23%). The lowest risk of poverty is reported for households with two adults where at least one of them is more than 65 years old (3.6%). Report on the Social Situation of the Slovak Population for 2019, the Ministry of Labour, Social Affairs and Family of the Slovak Republic, 2020

[11] Involving, in particular, the measures in social areas, such as the introduction of pregnancy benefits, increased compensation for persons with severe disability and maintenance payments, or the introduction of free-of-charge bus transport for selected groups of the population.

[12] The Council is not yet taking this positive effect on long-term sustainability into account due to insufficient data.

[13] Due to the capital expenditures of the armed forces, with the highest impact expected to occur in 2023, the actual structural deficit is lower than that which would have been calculated using the standard procedure. Purchases of this size will not be made every year, and we do not expect other investments to be crowded out.

views positively the measures designed to bring stability back into the payment of pension benefits by adjusting 13th pension payments and the minimum pension, which are quantified at some EUR 600 million a year (0.6% of GDP); however, due to the absence of consolidation in the general government budget, the long-term sustainability of public finances is not significantly improving and remains in the high-risk zone.

To date, a more detailed vision for a comprehensive pension reform, which is crucial for healthy public finances in the long term, has not been presented yet. The Council warns that, **despite the lacking details, the preliminarily presented principles of the constitutional Act on the Pension System might not be able to secure an improvement in the pension system's long-term sustainability by roughly the remaining EUR 1.4 billion a year (1.5% of GDP).**

Bringing the long-term sustainability safely from the high-risk zone to the medium-risk zone should be the main objective of the government for this election term[14]. Because the economy is still under-heated, it is advisable to attain this objective in a manner that would not pose a threat to the gradual recovery of the economy, but rather stabilise the debt level at the same time. For instance, this can be **achieved by implementing the pension reform**[15] **in combination with the consolidation of the budget by the end of the current election term:**

- In 2022, the outlined fiscal policy seems to have a restrictive impact[16] already, but due to the narrowing of the output gap (i.e. end of the crisis) and in particular due to the positive risk of spending financial resources from the EU recovery fund, **the Council recommends that additional consolidation measures amounting to at least 0.5% of GDP should be adopted for the year 2022.**

- Considering the acceleration of growth expected in 2023 along with more intensive spending from the EU recovery fund, the fiscal stimulus from the budget will no longer be necessary and, therefore, the **Council recommends that additional consolidation measures amounting to at least 1% of GDP**[17] **should be adopted for the year 2023.**

[14] Lowering the risk to the upper limit of the medium risk zone requires the adoption of additional measures amounting to 2.4% of GDP.

[15] The changes introduced in the pension system in 2019 and early 2020 (introduction of retirement age ceilings; increase in minimum pensions; reduced curtailment of pensions paid from the social insurance scheme to savers in the fully-funded pillar; introduction of the 13th pension payments in full amount) contributed some 2.1% of GDP to the worsening of the sustainability of public finances (ceteris paribus; i.e., not taking into account the worsened macroeconomic development caused by the effect of the decreased participation in the labour market on other ageing-related expenditures). If the correction measures in the amount of 0.6% of GDP are factored in (13th pension payment adjustment and freezing the minimum pension), the sustainability of public finances would have to improve by additional 1.5% of GDP if we wanted to revert the state of the pension system to the 2018 level from the sustainability perspective.

[16] The restrictive fiscal impulse is expected at a level of 1.5% of GDP.

[17] With higher spending from the EU Recovery and resilience facility, consolidation should be reaching higher levels as well.

Figure 3: GG structural balance development (excl. the EU Recovery and resilience facility, in % of GDP)

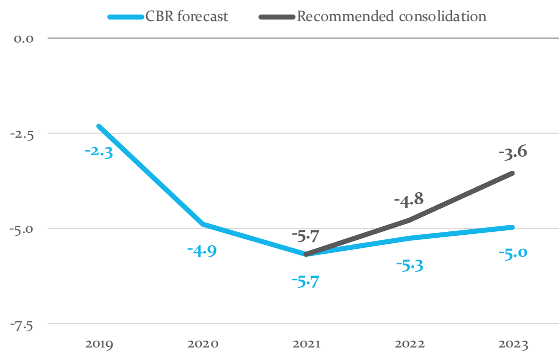
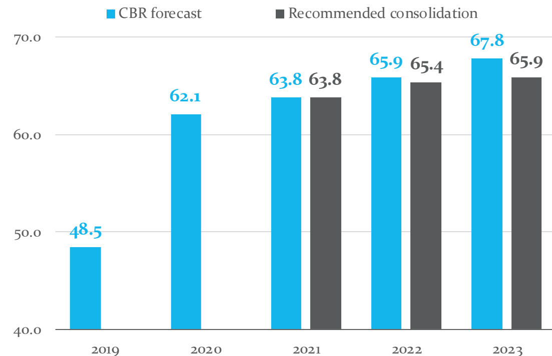


Figure 4: GG gross debt development (excl. the EU Recovery and resilience facility, in % of GDP)



Note: The crisis years are highlighted in grey.

Source: Statistical Office, CBR

It is advisable, according to the Council, to make use of all options and attempt to improve the financial stability of the pension system. **From this perspective, the Council considers the setup of the system, as seen in 2018, to be a suitable basis for comparison and, if achieved again, sustainability could improve by 1.5% of GDP.**

Figure 5: Development of long-term sustainability (the long-term sustainability indicator, in % of GDP, incl. the recommended scenario)

(*) Assuming that the planned comprehensive pension reform would revert the state of the pension system to the 2018 level.

Source: CBR

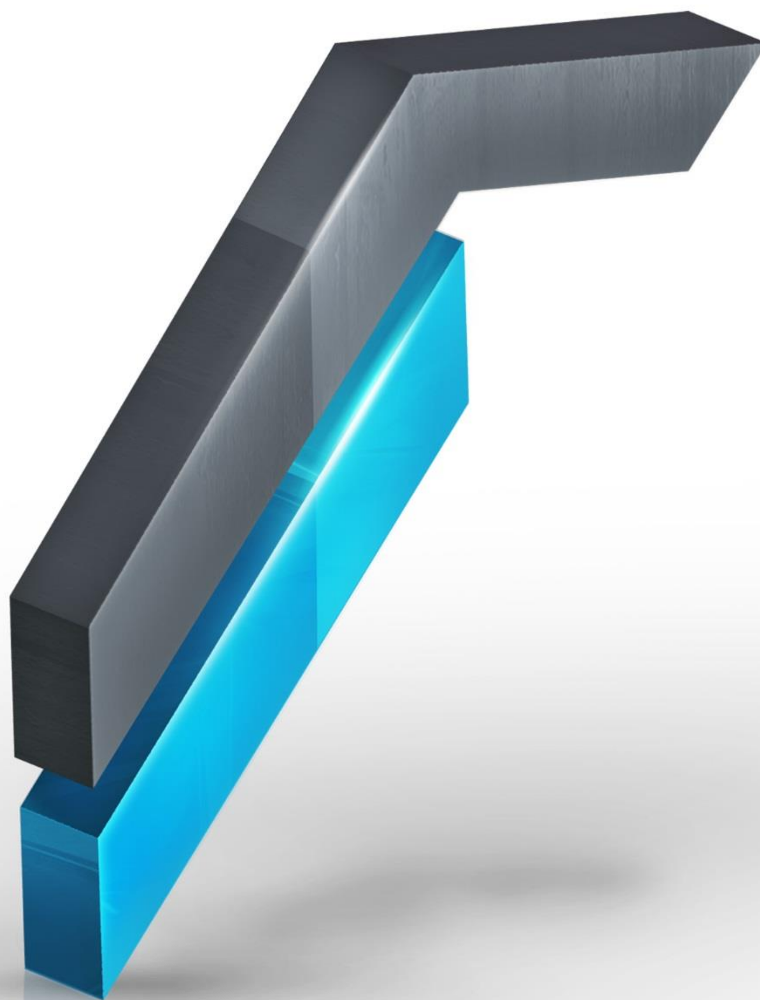
Deficit and debt rules suspended in 2020 and 2021

In 2020, the debt will rise above the upper limit of the debt brake sanction zones and will stay there between 2021 and 2023 as well. At the end of 2023, the debt would hover high above the upper limit of the sanction zones also in the case of two alternative scenarios (the risk scenario and the EU recovery fund scenario).

An **escape clause regarding compliance with more stringent debt brake sanctions** is activated for a period of 24 months upon the adoption of the government's Manifesto and the vote of confidence in the government. Based on the most recent estimate of GDP development, it seems that the economic crisis caused by the pandemic is not meeting any of the conditions for triggering a 36-month exemption from compliance with the more stringent sanctions. In 2023, the government would thus have to submit a no-deficit general government budget proposal without an increase in expenditures and ask the parliament for a vote of confidence.

The Council is aware that compliance with sanctions for the currently applicable debt limits would unreasonably and, from an economic point of view, inappropriately dampen economic growth while having an overly negative impact on the population's standard of living. This is not to say that the current debt level is not important in terms of achieving long-term sustainability; however, having a medium-term strategy for bringing the structural deficit down to a level of 3% of GDP by the end of the election term, including its subsequent reduction at least to a zero level, is more important at this moment. **The introduction of binding and independently evaluated multiannual expenditure ceilings to achieve this objective is an essential part of this strategy.**

In evaluating the balanced budget rule, the **Council is of the opinion that a significant deviation from the adjustment path towards the medium-term objective occurred in 2019**. As the government declared exceptional circumstances in June 2020, a correction mechanism is not being applied at present. Fiscal policy is not only bound by the national fiscal rules, but also by the European fiscal rules. In the present situation where the general government deficit is to exceed 3% of GDP, these rules would require the application of the corrective arm of the Stability and Growth Pact. But due to exceptional circumstances and the need for fiscal stimuli, the European Commission proposed the activation of the general escape clause, i.e., suspension of the rules, which will remain in effect also throughout 2021.



Council for Budget Responsibility

Imricha Karvaša 1
Bratislava 1
813 25
Slovakia