Evaluation of the General Government Budget Proposal for 2022-2024

Main conclusions and recommendations

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Basic information about CBR's positions

In order to achieve long-term sustainability of Slovakia's economy, enhance transparency and increase public spending efficiency and in an effort to promote 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 as regards the development of public finances.

Basic information about the budget assessment method

In order to realistically assess the budgetary policy, the Council will first of all estimate the budget balance for the current year. These estimates are based on updates of the Budgetary Traffic Lights. Subsequently, the CBR will determine the fiscal estimate for each year on the basis of the most recent estimate of macroeconomic development, as well as on the basis of a realistic estimate of measures introduced on the revenue and expenditure side. These estimates do not include measures that have not been specified. All of this will form the "CBR's scenario". The CBR's scenario therefore presents the likely impact of the budget on public finances, assuming that no additional measures are adopted.

The CBR's scenario is then compared against the no-policy-change scenario (NPC scenario). These two scenarios are subsequently used for calculating analytical indicators such as the government's consolidation effort and an overall analytical assessment of the budget.

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

How the CBR assesses public finances

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

The budgetary policy set out by the general government budget (GGB) is the key factor affecting the long-term sustainability under the government's control. Therefore, the most important question is whether and how the intended fiscal reform presented in the budget can improve the current high-risk level of long-term sustainability and meet the set budgetary objectives.

The plans outlined in the GGB do not necessarily provide an objective picture of the fiscal policy development in the medium term horizon. The Council regularly prepares a detailed evaluation of the government's General Government Budget Proposal before it is discussed by the Parliament.

Main conclusions from the evaluation of the GGB proposal for 2022-2024:

- **The Council considers the submitted budget proposal as realistic only for 2022**; its deficit estimate at 4.5% of GDP is lower than a comparable estimate of the government. No specific and credible measures that would lend themselves to meeting the objectives set by the government can be seen in 2023 and 2024. According to the Council's estimate, the specified measures would reduce the deficit only to 3.9% of GDP in 2023 and 2024, instead of 3.4%or 3.3% of GDP.
- **Next year, the continuing recovery is expected to bring the economy closer to its potential.** This means less need for a fiscal stimulus. **The overall effect of public funds on the dampening of economic recovery will be strengthened by the so-called fiscal cliff** (caused by a sudden halt in one-off Covid incentives amounting to 2.5% of GDP), which will be only partially offset by an increased influx of European funds (+1.3% of GDP). For this reason, the budgetary policy should remain cautious even in 2022.
- It is positive that a major part of the counter-cyclical policy aimed at protecting the economy in 2021 took place through one-off measures while the structural deficit has remained almost unchanged, according to CBR's estimate. As the CBR expects a significantly lower deficit (by 1.2% of GDP) in 2021 compared to the deficit envisaged by the Ministry of Finance and because this reduction is not sufficiently carried over to 2022, the CBR's estimate indicates that the **2022 budget alone** (disregarding fiscal reforms) **implies a slackening of the consolidation effort by 0.6% of GDP[1].** Naturally, this

[1] The CBR quantifies the "consolidation effort" by comparing the structural balance development against the NPC scenario. This gives a truer picture of the "size of measures" de facto adopted by the government through the budget. The Ministry of Finance, as well as the EC, calculate "consolidation" as a year-on-year change in the structural balance. Even though this approach is an internationally accepted standard, it is simplified in that it assumes no year-on-year changes in the structural balance, as long as the government adopts no additional measures. According to the Ministry of Finance, the structural balance will improve by 0.2% of GDP in 2022 (unchanged under the CBR's scenario). Historically, during regular economic times in Slovakia, the structural balance has been historically improving by some 0.2 p.p. of GDP year-on-year, provided that the government is not taking any active measures only on the basis of how the existing applicable legislation is set (such as

complicates the fulfilment of objectives for the subsequent years 2023 and 2024. **If an improved development of the budget is confirmed in 2021, the government is advised to consider, despite the dampening effect on the economy, an adequate reduction of such slackening and to focus in particular on how to accelerate the spending of European funds.**

- **The government is not making use of the expected favourable economic development in 2023** – supported by the drawing of European funds and resources under the Recovery and Resilience Plan – **for a more significant consolidation by specifying realistic and permanent measures**. In 2023, the economy is expected to free itself from the effects of the pandemic in general and there will be **optimal conditions for a more substantial consolidation, because the economy will be growing significantly and the negative demand-side effects of consolidation will be offset by the continued acceleration of the influx of European funds. This will therefore provide an opportunity for stabilising the economy (calming down its overheating), including the reduction of domestic inflationary pressures, and also for reducing the debt to a safer level.** Based on the presented and sufficiently specified measures, the Council estimates that the government's consolidation effort will be nearly zero between 2023-2024.
- **The deficit development, as estimated by the Council, will ensure the stabilisation of the debt, but not reduce it.** With such development, the debt will stabilise above the upper limit of the debt brake, close to the level of 60% of GDP, and its distance from the upper limit will be increasing. According to the constitutional Fiscal Responsibility Act, a new government is not subject to the most stringent debt brake sanctions during the first two years, therefore any potential sanctions will start applying during 2023. What these sanctions will look like also depends on whether and how the constitutional Fiscal Responsibility Act will be amended.
- **According to the CBR's scenario, the budget – along with the adoption of the pension reform as required by the Recovery and Resilience Plan – could reduce the currently high sustainability risk, but only down to somewhere between the medium- and high-risk level.** The Council points out that the general government budget alone impairs the long-term sustainability by 0.5% of GDP in 2022 and, over the entire budget horizon, by 0.6% of GDP.
- For achieving a credible and permanent reduction of the deficit below 3% of GDP and, simultaneously, for bringing the long-term sustainability safely into the medium-risk zone, the **Council deems it necessary that, in addition to adopting the pension reform under the Recovery and Resilience Plan, consolidation measures quantified roughly at 1-1.5% of GDP should be specified in a credible manner as well. In that case, the government's fiscal targets for 2023-2024 could be considered realistic.**

indexation of certain expenditure). The macroeconomic parameters expected for 2022 imply that the structural balance would improve by as much as 0.4% of GDP under the NPC scenario.

Budget is realistic only for 2022

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. This is the second year in a row that the submitted budget is correctly reflecting the estimates of revenues from taxes and social contributions as approved by the Tax Revenue Forecasting Committee. The Council also views it positively that, along with the objective of preparing the budget assumptions in a better and more transparent manner, the scope of independent assessment has also been extended to include selected non-tax revenues and selected expenditures[2].

Objective uncertainty in the macroeconomic development due to the pandemic and external environment, as well as the pace and effectiveness in spending the European funds and resources from the Recovery and Resilience Plan, can be considered the most significant risk of the budget proposal. However, the risks are now better balanced when compared with the previous year[3].

Multiannual budgeting is still absent. The budget proposal is compiled in accordance with the budgetary objective only for 2022, but not for the years to follow. The **Council** evaluated the overall risks in expenditure and revenue and **considers the budget for 2022 as realistic, because of expecting a deficit lower by 0.5% of GDP**. On the contrary, for 2023 and 2024, the Council estimates significant risks due to insufficient specification or non-specification of any measures[4] towards reaching the objectives set at a level of 1.3% of GDP.

The budget proposal is thus lacking a specific and realistic strategy supported by sufficiently specified measures which the government intends to follow in the recovery of public finances.

Table 1: Comparison of expected balance and debt in GGBP and CBR's estimate (% of GDP)

	202	2021	2022	2023	2024
Balance in 2022-2024 GGB Proposal (government's objectives)	-0.5	-7.4	-4.9	-2.7	-2.6*
1. Balance of the GG Budget Proposal for 2022-2024*	-5.5	-7.9	-4.9	-3.4	-3.3
2. GG Budget balance according to CBR's estimate	-5.5	-6.7	-4.5	-3.9	-3.9
difference (2-1)	**0.0**	**1.2**	**0.5**	**-0.5**	**-0.6**
3. Gross debt under GG Budget Proposal for 2022-2024**	59.7	61.5	61.5	58.6	58.7
4. Gross debt according to CBR's estimate	59.7	61.6	60.7	58.9	60.4
difference (4-3)	**0.0**	**0.1**	**-0.8**	**0.3**	**1.7**

Note.: Columns highlighted in grey represent the crisis years.

** The Draft Budgetary Plan for 2022 specifies two targets for 2024: 1) a balanced budget formally complying with the currently applicable sanctions of the constitutional Fiscal Responsibility Act and 2) a deficit of 2.6% of GDP which, according to the Ministry of Finance, assumes structural consolidation by 1% of GDP in line with the rules of the Stability and Growth Pact and is more realistic in terms of the required size of measures.*

*** The debt forecast under the budget proposal has been compiled based on the assumed compliance with the government's budgetary objectives.*

Source: Ministry of Finance, CBR

[2] Of the new items specified, the budget proposal does not include an estimate of income from dividends in an amount approved by the Tax Revenue Forecasting Committee (TRFC). Income from dividends has been decreased as a result of changes in the budget proposal and, therefore, the budgetary risks have not increased.

[3] In its analytical document (available only in Slovak), the Council's scenarios present the impact of better macroeconomic development also through a macroeconomic forecast of the National Bank of Slovakia, which would cause the balance to improve by 0.2% of GDP in 2023.

[4] In order to achieve its budgetary objectives, measures amounting to 0.7 % of GDP are missing in the years 2023 and 2024, according to the government. A higher level of necessary measures according to the CBR's estimate is based on the inclusion of the budget risks,.

The decision to link a part of the budgeted expenditure (0.5% of GDP) to the approval of significant reform-oriented fiscal intentions in the area of strengthening the budget management (expenditure ceilings), modernising the so-called debt brake or improving the financial stability of the pension system makes it more difficult to assess the government's fiscal policy. If the announced reforms are not adopted, in terms of long-term sustainability it is inevitable that the entire economic reserve of 0.5% of GDP be spared. Moreover, the target deficit in 2022 should decline, at a minimum, by an additional 0.5% of GDP to 4.0% of GDP in order to neutralize the impact of non-adoption of reforms on the long-term sustainability[5].

The deficits estimated by the Council in the CBR scenario are based on the assumption of using the greater part (2/3) of the reserve conditional on reforms, which also includes the adoption of the pension reform as assumed by the Recovery and Resilience Plan[6].

Table 2: Overview of basic indicators in the budget proposal according to CBR's scenario (ESA2010, % of GDP)

	2020	2021	2022	2023	2024
Structural balance	-3.2	-3.3	-3.3	-3.1	-3.1
Government consolidation effort*	-	-	-0.6	0.0	-0.1
General government gross debt	59.7	61.6	60.7	58.9	60.4
General government net debt	49.7	54.7	55.1	55.1	57.5
Fiscal impulse (+ indicates restriction, - expansion)	-2.7	-1.5	1.3	-1.0	2.6
output gap based on CBR's methodology	-2.9	-2.2	0.0	0.8	-1.0

Note: Columns highlighted in grey represent the crisis years. *Source: CBR*

***Consolidation effort of the government is defined as a year-on-year change in the structural balance beyond the scope of developments under the no-policy-change scenario after taking into account the impact of permanent support for short-time work (kurzarbeit) introduced as from 2022. This is a different indicator in comparison with consolidation effort used by the Ministry of Finance which only covers a change in structural balance.*

According to the CBR's estimate, the net contribution of consolidation measures adopted by the government towards a permanent change of the GG balance will be negative in the post-crisis year of 2022, reaching 0.6% of GDP. Based on the currently available information, the CBR expects – beyond the scope of development without the impact of government measures in 2022 – an additional increase in current expenditure at a level of 0.5% of GDP that is not compensated for in the subsequent years and has a negative impact on the balance. **This is, in particular, a consequence of the expected better development in 2021 in comparison with the government's estimate, by 1.2% of GDP, which has not been fully reflected in the budget for 2022**. In 2023 and 2024, the government's consolidation effort, as specified to date, is almost zero, despite the fact that the economy will be overheating in 2023 as a result of a significant influx of European funds. For a comparison, economic development would automatically cause, even without government's intervention, the fiscal performance to improve by 0.8% of GDP.

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5 Under the CBR's scenario, when the approval of two out of three reforms is technically expected, the two thirds of the economic reserve is spent. Despite that, in the case of changes in pensions, the long-term sustainability has improved by 0.4% of GDP, with the contribution of changes in pensions representing 0.9% of GDP. If the budget is to be compiled in a way so as to neutralise the unrealised positive impact of the pension reform on long-term sustainability, the deficit target in 2022 should be set at no more than 4.0% of GDP if no long-term reforms are adopted. The introduction of expenditure ceilings (or modernisation of the debt brake) could also contribute to better long-term sustainability of public finances, but it has not been quantified for the purposes of calculating the impact on the long-term sustainability indicator. The positive aspect would be based on a higher probability that Slovakia would be better prepared for any crises or shocks in the future.

6 The CBR assumes that two out of three reform intentions will be supported (expenditure ceilings, pension system reform), thus allowing to use two thirds of the allocated reserve.

The structural deficit will decline, according to the CBR, only very slightly at the budget horizon, from 3.3% of GDP in 2021 to 3.1% of GDP in 2024. However, without the impact of the government's measures, the structural deficit would improve from 3.3% of GDP to 2.5% of GDP (the so-called NPC scenario). In setting the consolidation strategy, the government would also have to address the fact that the share of revenue in proportion to GDP is decreasing because of a fast growing economy. Even if expenditure is growing slower than sustainable economic growth, its increase is higher than that assumed under the NPC scenario and, therefore, its trajectory does not sufficiently reflect the need for reducing the currently high structural debt level. From this perspective, it is necessary to consider how much faster will expenditure grow in 2022 in comparison with the no-measures scenario. At present, the difference is quantified at 0.5 % of GDP, as indeed illustrated by the government's additional expenditure measures in the given year.

Even though the overall impact of the budget set-up will be dampening the economic recovery, the fulfilment of objectives for the subsequent years of 2023 and 2024 will be more complicated due to the slackening of consolidation effort by 0.6% of GDP in the CBR's scenario. If the improved development of public finances in 2021 is confirmed, the government should consider an adequate reduction in the slackening of the consolidation effort.

Medium-term budget excluding the pension reform effect impairs long-term sustainability after considering the risks

Even though the adoption of the pension reform will eventually improve overall sustainability by 0.4% of GDP to 4.9% of GDP, the sustainability risk will still not be *safely* reduced down to the medium-risk zone. This would be the case only if the fiscal objectives set by the government are actually met.

Under the no-policy-change scenario, the long-term sustainability currently remains in the high-risk zone at a level of 5.3% of GDP. **The medium-term budget is in fact causing the long-term sustainability to worsen, because no consolidation measures have been specified.** If the **pension reform under the Recovery and Resilience Plan is approved**, sustainability under the CBR's scenario could improve by 0.9% of GDP (1.8% indicator S2) to 4.9% of GDP, which represents a boundary between the medium- and high-risk zone.

According to the Council, the **general government budget alone has a negative impact on the long-term sustainability of 0.6% of GDP** (with the year 2022 alone accounting for as much as 0.5% of GDP)**. Sustainability could thus be improved only through the contribution of an appropriate pension reform, by 0.9% of GDP**.

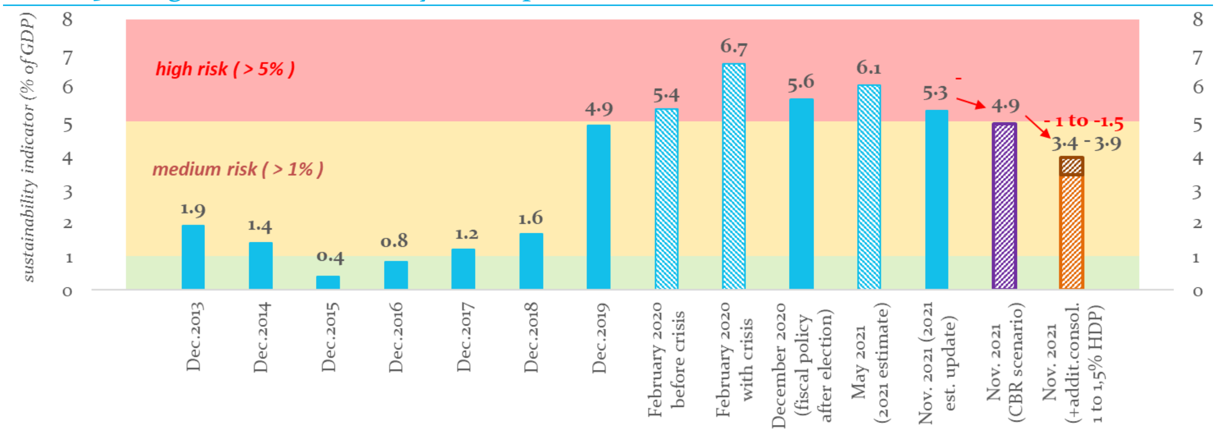
So far, the pension system reform has not been approved in the form of a specific legislative document. From the perspective of the pension reform, the **Council has been consistently recommending the adoption of such a pension reform that would bring the long-term financial stability of the pension system back to the condition seen in 2018**. In its assessment, the Council takes into account the adoption of a pension reform having a positive impact in accordance with the Recovery and Resilience Plan. This roughly represents **a half of the improvement** of sustainability against the recommended pension reform scenario;

the Council therefore recommends adopting a more ambitious pension reform through a constitutional act or by means of an amendment to the Slovak Constitution (in particular, by linking the retirement to average life expectancy again).

In the context of this budget, without adopting specific consolidation measures, sustainability can improve only through long-term reforms, such as the pension system reform. **Therefore, according to the CBR, it is absolutely crucial to adopt all of the three fiscal reforms discussed.**

For bringing the high-risk level of long-term sustainability safely into the medium-risk zone and for reducing the deficit below 3% of GDP by 2024, the Council deems it necessary that, in addition to adopting the pension reform under the Recovery and Resilience Plan, **additional consolidation measures quantified roughly at 1-1.5% of GDP should be specified** in a credible manner as well. At the same time, the adoption of measures improving the pension system balance in the long-term should not be accompanied by measures that are inadequately increasing the pension system expenditure. **In that case, the long-term sustainability indicator could be reduced to 3.4-3.9% of GDP, landing safely in the medium-risk zone.**

Table 3: Long-term sustainability development (% of GDP)



Source: CBR

The Council still[7] deems it important that, during this election term, the government focuses on reducing the deficit to a debt-stabilising level below 3% of GDP and on improving the long-term sustainability safely to the medium–risk zone. The Council considers this objective as attainable despite the pandemic, because it can be achieved even in a manner that would not put gradual recovery in peril. For instance, **implementation of the pension reform in combination with the meeting of fiscal objectives specified in the budget** seems to be the proper way to proceed:

- Even though the overall availability of public funds is dampening the economic recovery[8] in 2022 in comparison with the previous year due to the fiscal cliff, the economy will nonetheless be running close to its potential. In its opinion regarding the last year's budget and the most recent Stability Programme, the Council deemed it

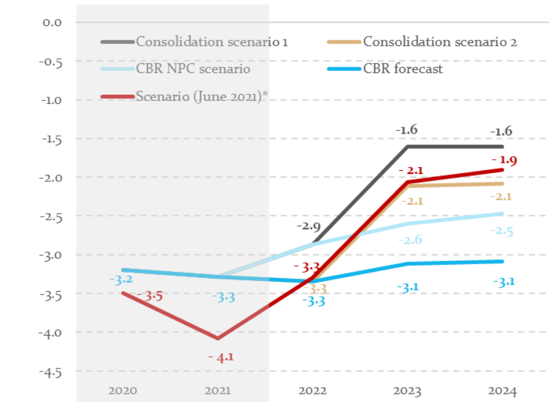
7 See the Evaluation of the General Government Budget Proposal for 2021-2023 (November 2020) and the Evaluation of Medium-term Budgetary Objectives for 2021-2024 (June 2021)

8 This involves the so-called demand fiscal impulse which also includes a year-on-year change in European funds. The restrictive fiscal impulse is estimated at 1.3% of GDP for 2022.

appropriate to consolidate at a pace of 0.5% of GDP already in 2022, because the economy was expected to start overheating. In the recent months, the expected output gap has worsened and, according to the latest forecasts, overheating of the economy is not expected for the time being. Despite that the deterioration is not so negative as to justify the estimated rate of fiscal easing at as much as 0.6% of GDP in the next year. **If the improved development of public finances in 2021 is confirmed, the government should consider an adequate reduction in the slackening of the consolidation effort which, if eliminated, the budgetary objective would improve by 0.6% of GDP (Consolidation Scenario 1)[9]. If the worsened pandemic situation persists, it is always possible to use one-off targeted measures that are not burdening the structural balance while attempting to start spending the European funds as soon as possible.**

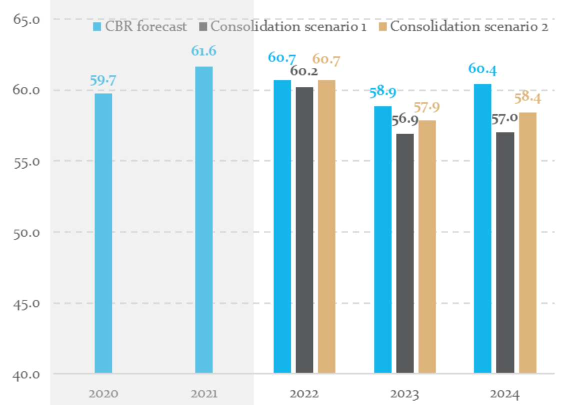
- Considering the expected acceleration in economic growth in 2023 as the pandemic fades away, as well as accelerated spending of the European funds, there will be no need for a fiscal stimulus from the budget and, therefore, the **Council recommends that consolidation measures amounting to at least 1% of GDP be adopted in that year**.

Figure 1: General government structural balance development (in % of GDP)



** This involves a recommended consolidation scenario of June 2021 (CBR, Evaluation of Medium-term Budgetary Objectives), provided that commitments under the Recovery Fund are complied with in the area of the pension reform (scenario comparable with the most recent consolidation scenarios).*

Figure 2: General government gross debt development (in % of GDP)



Note: Columns highlighted in grey represent the crisis years.
Source: SO SR, CBR

Deficit and debt rules suspended between 2020 and 2022

In 2020, the debt rose above the upper ceiling of the debt brake sanction zones and will stay there between 2021 and 2024 as well. Based on an estimate of the general government balance development, the CBR thinks the debt could reach 61.6% of GDP in 2021, hitting a new all-time high. In the years to follow, a slight decline to 60.4% of GDP at the end of 2024 is expected also thanks to the estimated economic recovery, spending of European funds and a gradual decrease in the cash reserve.

9 Consolidation Scenario 1 assumes additional consolidation against the CBR's baseline estimate in 2022 and in 2023 (totalling 1.5% of GDP); Consolidation Scenario 2 assumes additional consolidation only in 2023, by 1% of GDP.

At present, an escape clause about compliance with more stringent debt brake sanctions has been activated, because a period of 24 months since the approval of the government's Manifesto and the vote of confidence in the government has not expired yet. This escape clause will apply until May 4th of 2023, despite the fact that the government line-up has remained almost unchanged. Another downside to the current wording of the act seems to be that the economic crisis caused by the pandemic is not meeting any of the conditions triggering other escape clauses from compliance with the more stringent sanctions.

In 2023, the government would thus have to submit a deficit-free general government budget proposal for 2024 with no increase in expenditures and ask the parliament for a vote of confidence.

The Council is aware that **compliance with the sanctions associated with the currently applicable debt limits would cause a pro-cyclical dampening of the economic growth with a negative impact on the population's standard of living** based on the current assumptions. This is not to say that the current debt level is not important in terms of achieving long-term sustainability. At this moment, however, the government's active contribution towards creating the conditions for its **sustainable reduction** is more important. According to the Council's estimate, the debt level will stabilise in the medium-term horizon as the balance approaches 3% of GDP, however, its decline is not taking place because of the government's negative consolidation effort. It is therefore advisable that the government refrain from easing the fiscal policy; instead, credible consolidation measures towards meeting the set fiscal targets and a gradual decrease of the debt already in the medium-term horizon should be presented by the government. **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 considers 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, the correction mechanism does not apply at present. In addition to the national rules applicable to public finances, fiscal policy is also bound by the European budgetary rules. In the present situation where the general government deficit is to exceed 3% of GDP, the application of the corrective arm of the Stability and Growth Pact would be required. But due to the 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 2022.

The budget compilation process has somewhat improved

In addition to the aforementioned more transparent budgeting of tax and non-tax revenues, the Council views as positive that the effort to streamline public investments through the zero-based budgeting principle still continues. It is aimed at financing only projects that have already been prepared and are designed to deliver a sufficient return. Overtime, this will automatically imply creating a pool of prepared investment projects which could enhance the country's capacity to invest effectively.

A sufficiently large and flexible absorption capacity of the government for investments will indeed play the key role in the years ahead due to a high influx of resources for investments from the European funds. Their sufficient and timely use between 2022 and 2024 could help stabilise the economic environment even further, which can also come in handy in times of unexpected negative macroeconomic development.

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