COUNCIL FOR BUDGET RESPONSIBILITY

Evaluation of compliance with the balanced budget rule for 2018

Summary

July 2019

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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 2018

The general government budget shall be balanced or in surplus under the General Government Budgetary Rules Act. 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 with the rule falls under the responsibility of the Ministry of Finance ("the Ministry") which publishes its reports biannually, by 30 June and 30 November. Subsequently, the Council for Budget Responsibility ("CBR") provides its independent evaluation. In line with the principles published by the European Commission[2], the Ministry then publishes its position on the CBR's evaluation.

The CBR prepared its first evaluation of compliance with the balanced budget rule for the year 2018 based on the data contained in the April deficit and debt notification released by Eurostat. It also contains the CBR's response to the evaluation published by the Ministry on 12 July 2019[3]. No change has been made in the methodology of evaluation. The year 2015 remains the base year of the evaluation[4].

According to the CBR, the general government's structural deficit stood at 1.24 % of GDP in 2018; it means that the balanced budget (a structural deficit not exceeding 0.5 % of GDP – Figure 1) has not been achieved so far. Following an assessment of the path towards the balanced budget, a significant deviation with the need to trigger the correction mechanism occurred in 2018.

The achievement of the budgetary objective in 2019 would mean that the balanced budget rule was complied with. 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 adopt correction measures is also underlined by significant risks arising from the development in the general government balance in 2019[5]. If the correction measures do not result in meeting the medium-term budgetary objective in 2019, the MTO should be met in 2020 at the latest[6]. In order to meet this

[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] The Ministry published its evaluation on 28 June 2019, which was updated on 12 July 2019 to correct numerical errors.

[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 achieving the medium-term budgetary objective to 2019.

[5] The approved general government budget assumed that a zero balance should be attained in 2019. If the government does not adopt additional measures during 2019, the general government deficit may amount to 1.0 % of GDP, according to the CBR's estimates, corresponding to a structural deficit of 1.2 % of GDP. Reducing the structural deficit to 0.5 % of GDP in 2019, in accordance with the requirements under the balanced budget rule, will require the adoption of additional measures with a permanent effect in the amount of EUR 636 million (0.7 % of GDP).

[6] According to the CBR, it is the structural deficit of 0.5 % of GDP. In the Stability Programme (April 2019), the government approved the easement of the medium-term budgetary objective in the form of a structural deficit to 1.0 % of GDP in 2020 based on the minimum requirements under the Stability and Growth Pact. According to the CBR, however, the conditions for MTO easement as defined by the balanced budget rule in the General Government Budgetary Rules Act are currently not met.

objective, a nominal year-on-year growth rate of adjusted expenditures should not exceed 5.1 % on average for both years[7].

The CBR recommends triggering the correction mechanism for the second time since the balanced budget rule compliance was assessed for the first time. In July 2016, when assessing the compliance with the rule in 2015, the Ministry did not propose triggering the correction mechanism, but 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 the meeting of the medium-term budgetary objective from 2017 to 2019. Since the purpose of the balanced budget rule is to prevent the moving-target syndrome[8] (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 0.27 % of GDP in 2018 (Figure 2). Compared to 2015, the 2018 adjusted budget expenditures increased 3.4 p.p. (Figure 3) more than as stipulated under the expenditure benchmark, having a negative impact on the balance in the amount of 1.17 % of GDP (Figure 4).

- **With additional factors taken into account, the deviation in the development of the structural balance increased to 1.47 % of GDP.** This increase is mainly related to the positive effect of windfall revenues[9] in the amount of 0.92 % of GDP and of interest payments[10] lower by 0.44 % of GDP; those have been excluded from the change in structural balance calculated by the CBR, since they do not depend solely on the present fiscal policy.

- 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 as a result of government measures. **Taking the additional factors into account, the negative**

7 This applies under an assumption that the general government revenues would grow in accordance with a potential output growth rate. 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.

8 Communication from the Commission: Common principles on national fiscal correction mechanisms of 20 June 2012 (/* COM/2012/0342 final */). The correction mechanism should prevent the "moving-target syndrome".

9 Revenue windfalls and/or shortfalls should be taken into account when assessing the meeting of the requirement of improving the structural balance towards the medium-term budgetary objective under the preventive arm of the Stability and Growth Pact. (Article 5(1) of Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, as amended).

10 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 Stability Programme for Slovakia for 2018 to 2021: „However, the structural balance reading is positively impacted by interest savings and revenue windfalls, accounting for which would substantially reduce – but still preserve – a positive margin on the structural balance pillar." (European Commission: Assessment of the 2018 Stability Programme for Slovakia, Commission staff working document, pg. 13).

impact of the deviation in the adjusted expenditure was reduced to 0.94 % of GDP[11].

- The significant deviations[12] 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 rule been complied with**[13]. The reason is that the windfall tax revenues and the lower interest payments had created conditions to fulfil the medium-term budgetary objective sooner, but the government failed to take this advantage.

The Ministry's and the CBR's evaluations differ in their overall conclusions. According to the Ministry's evaluation, there was only an insignificant deviation from the balanced budget rule, therefore, it did not propose to trigger the correction mechanism. In the primary assessment, the Ministry identified insignificant deviations under both indicators. The deviation is just below the significant deviation threshold in the case of the expenditure benchmark; the deviation in the structural balance is negligible[14].

According to the CBR's opinion, the Ministry's evaluation contains inaccuracies stemming from the fact that it did not review the estimated effects of discretionary revenue measures prior to 2018[15]. The Ministry did not include the updated 2015-2017 macroeconomic indicators in its estimate of the improved VAT collection, thus having overvalued its positive effects. As regards the allowance in health insurance contributions, it did not apply the more precise procedure for its estimate consistently[16] in all years. **If these inaccuracies were removed, the significant deviation in the expenditure benchmark would occur even in the primary assessment. If that was the case, even the approach taken by the Ministry[17] could result in a significant deviation in the overall assessment with a recommendation to trigger the correction mechanism.**

Further differences between the two institutions' primary assessments are mainly caused by a different approach to considering the one-off effects in the structural balance and discretionary revenue measures in the expenditure benchmark. In its overall assessment, the Ministry did not take into account the effect of interest payments and windfall revenues on the balance improvement; this deepened the differences in the evaluation of the structural balance:

- The Ministry did not include the effect of the incorrect recording of wages on extra-budgetary accounts among the one-off effects but took it into consideration in additional

11 The rule 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.

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

13 A full compliance with the rule in 2018 would result in a structural surplus of 0.2 % of GDP, that is, above the medium-term budgetary objective set.

14 According to the Ministry, the expenditure benchmark deviation is 0.498 % of GDP, whereas the significant deviation threshold is set at 0.5 % of GDP. The deviation in the structural balance is 0.01 % of GDP.

15 According to the CBR, such approach is inconsistent and may lead to misrepresentations of the evaluation results when assessing the development in public finances cumulatively.

16 The more detailed procedure consists in that that neither the Ministry nor the CBR consider the effect of the fixed amount of the allowance in health insurance contributions which will lead to a gradual automatic reduction in the negative effect of the measure on the public finances over time to a be a discretionary measure.

17 The Ministry's evaluation applies the approach used by the European Commission to assess the rules under the Stability and Growth Pact. Under this approach, a significant deviation from the balanced budget rule may occur if a significant deviation has occurred in at least one of the indicators in the basic evaluation and this deviation is also confirmed by the overall assessment.

factors as a potential source of general government balance revision under the autumn notification.

- The Ministry included the estimate of the effect of the improved VAT collection among the discretionary revenue measures; this is the major difference in the expenditure benchmark under the primary assessment. Due to the ongoing high uncertainty and simplified approach, the CBR considers this effect among additional factors.

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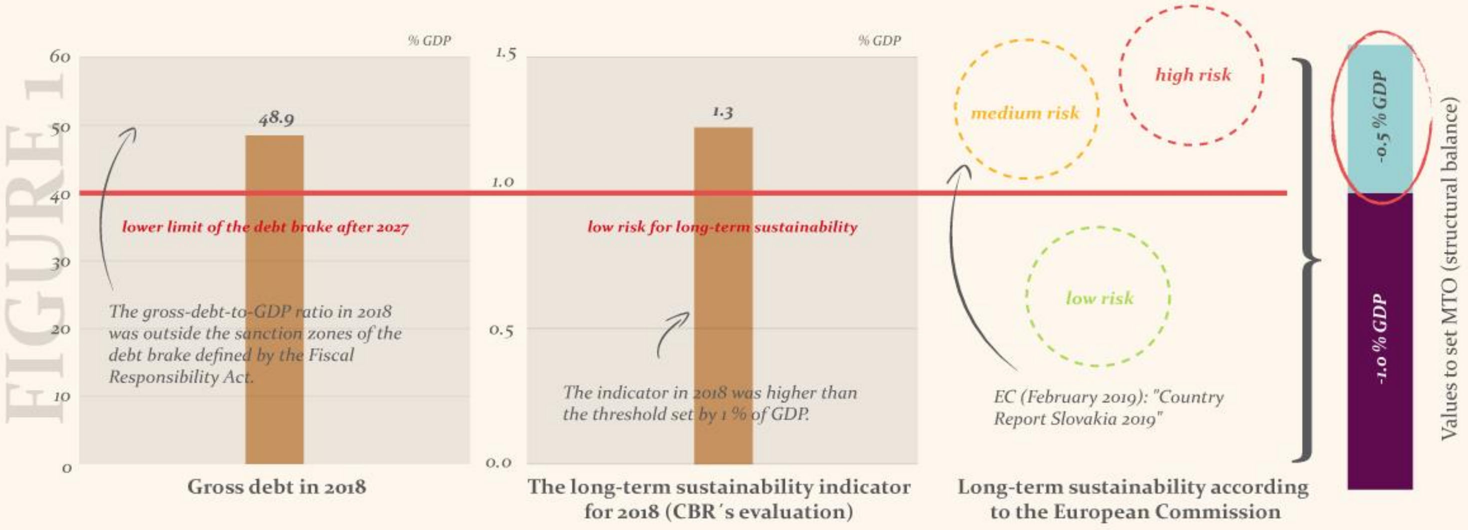
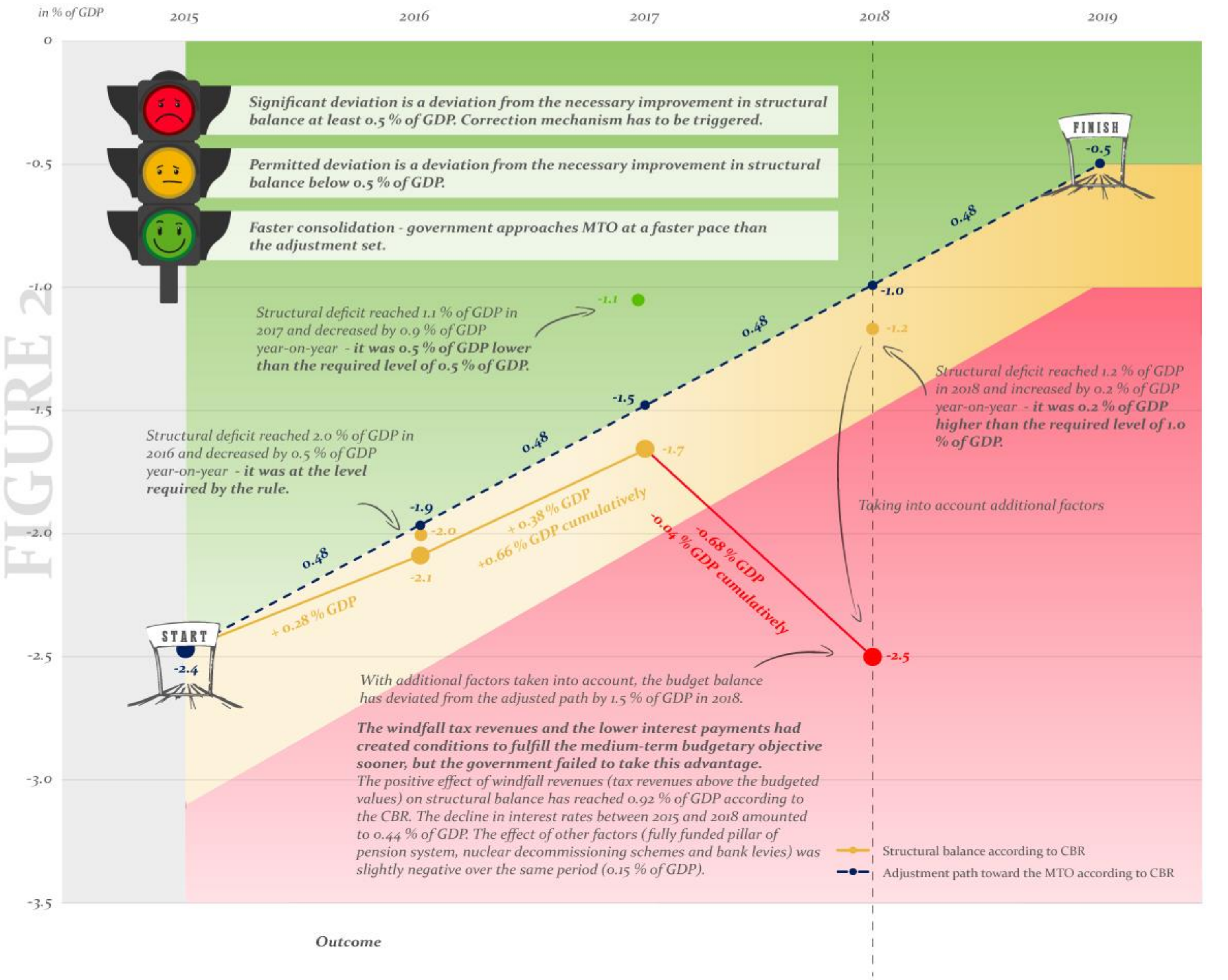
Structural balance

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.



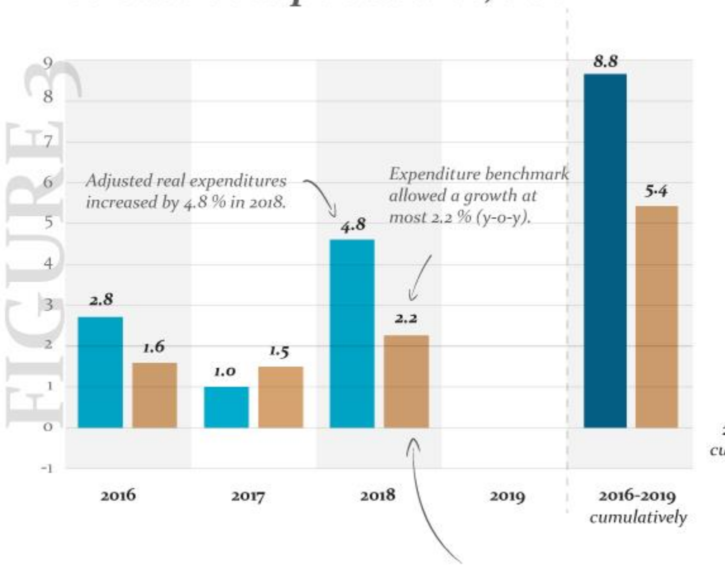
The 2018 general government's structural deficit reached 1.2 % of GDP, which means that the medium-term objective of having a close to balanced budget (structural deficit of not more than 0.5 % of GDP) was not met so far.

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



Expenditure benchmark: The growth in expenditures in 2018 over the 2015 was 3.4 p.p. higher than the growth given by the rule, with a negative impact on the balance at the level of 1.2 % of GDP.

Increase in expenditures, in %

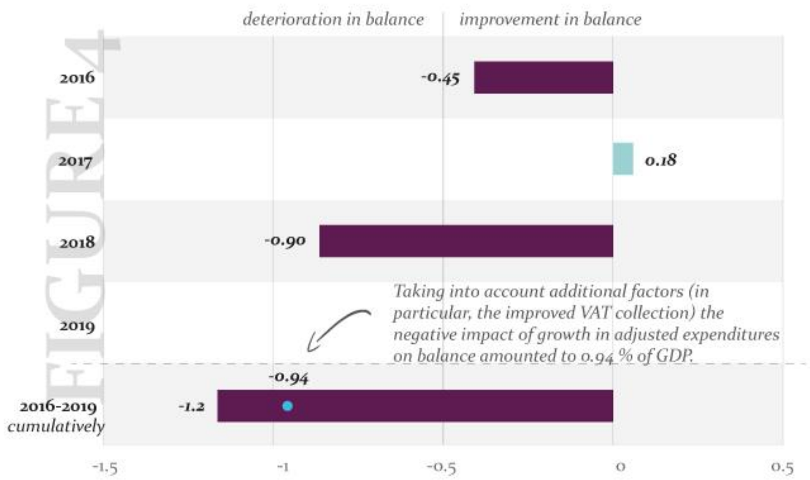


Adjusted real expenditures of the budget increased by 2.5 p.p. faster than allowed by the expenditure benchmark in 2018.

Real increase in expenditures

Expenditure benchmark (permitted expenditure growth)

Impact on the balance (in % of GDP)



Had the permitted rate of growth in expenditures been adhered to between 2016 to 2018, the budget deficit in 2018 would be 1.2 % GDP lower, reaching the surplus of 0.5 % of GDP (the actual deficit amounted 0.7 % of GDP in 2018).

Taking into account additional factors a significant deviation was confirmed by the CBR. According to MF SR there is an insignificant deviation from the balanced budget.

FIGURE 5

Primary assessment	CBR	Ministerstvo Financií Slovenskej republiky
Change in structural balance	deviation	deviation
Expenditure benchmark	singification deviation	deviation
Overall assessment		
Additional factors	worsened assessment	worsened assessment
Change in structural balance	significant deviation	deviation
Expenditure benchmark	significant deviation	significant deviation
Change in fully-funded pillar of the pension system	+	not included
Cost of nuclear decommissioning	no impact	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
Recording of wages on extra-budgetary accounts	covered within primary assessment	−
Final assessment	significant deviation	significant deviation

Differences between the Ministry's and CBR's primary assessment stem mainly from how one-offs in structural balance and discretionary revenue measures (in particular, the impact of improved VAT collection) in expenditure benchmark are taken into account.

Since 2015, debt interest payments dropped by 0.44 % of GDP, thus improving the structural balance.

Windfall revenues improved the structural balance by 0.92 % 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 in both indicators was identified by the CBR, hence there is a need to trigger the correction mechanism.

− + *Effects increasing/decreasing the deviation in the structural balance or expenditure benchmark.*

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