MINISTRY OF FINANCE
OF THE SLOVAK REPUBLIC

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Expenditure ceilings:

Operational tool to improve Slovak budget management

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Agenda

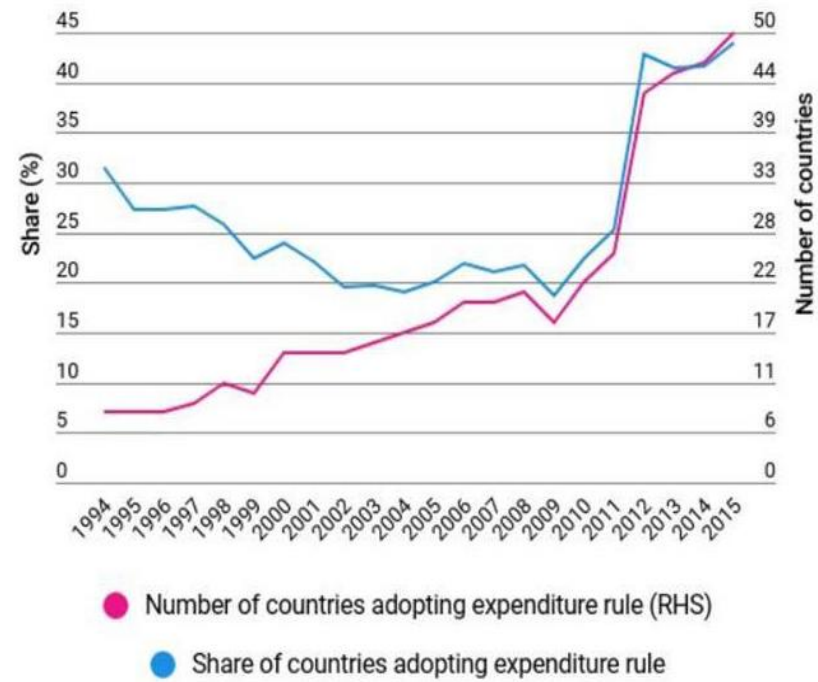
1. Why - what are the main benefits?
2. IFP proposal (main features)
3. Challenges for implementation

Road to expenditure ceilings

- ✓ 2012 - Adoption of Fiscal responsibility act (article 7 - exp. ceiling)
- ✓ 2018 - Preparatory work on expenditure ceilings announced
- ✓ 2018 - IFP Discussion study - proposal for the implementation of expenditure ceilings in Slovakia
- ✗ 2019 - Public consulations to choose specific variant/s of exp. ceilings
- ✗ 2019 - Preparation of internal budgetary processes
- ✗ 2020? - Launch of the test phase of expenditure ceilings

Almost everybody agrees on the need for expenditure ceilings

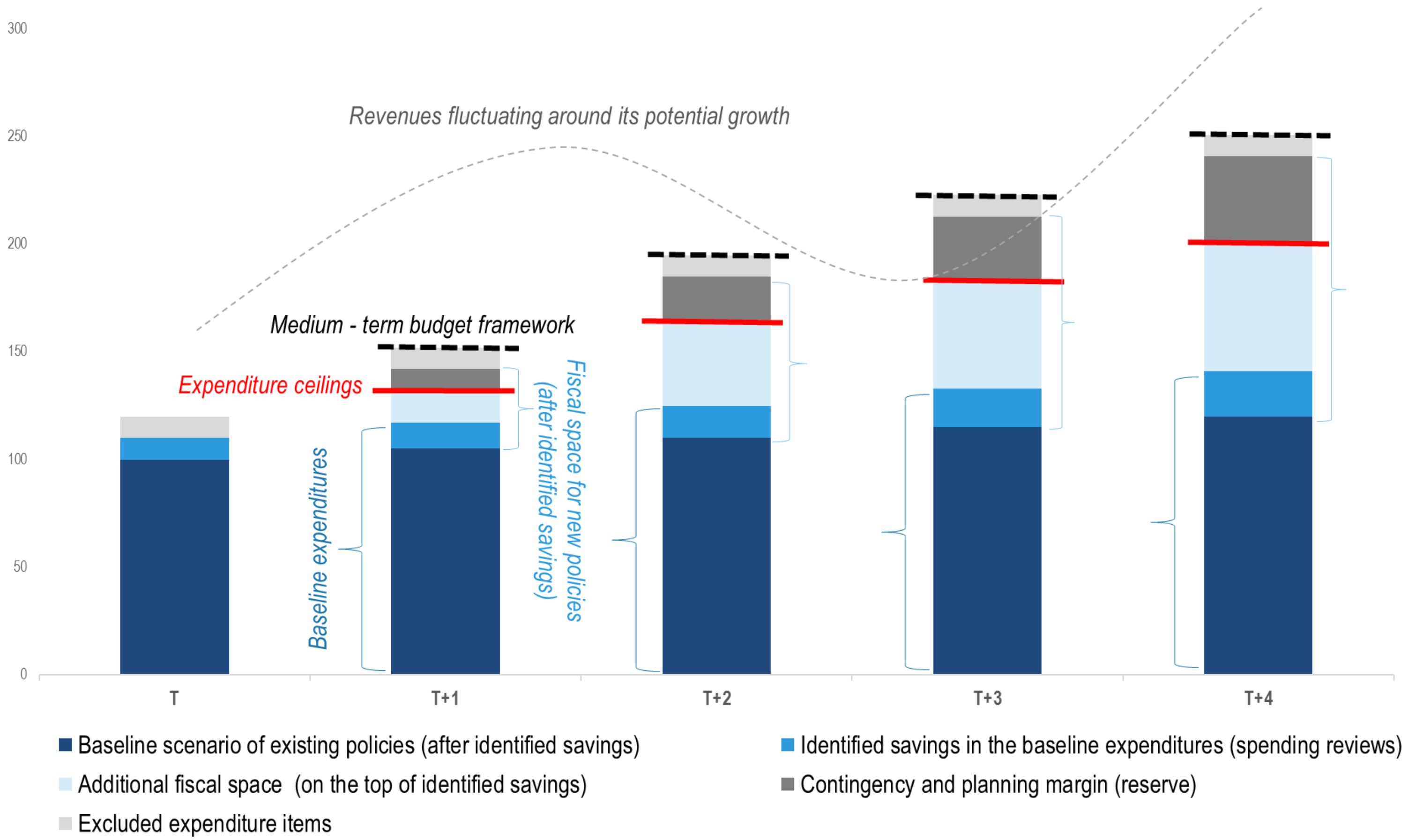
- **Support from academia and IOs**
  - All important international organisations recommend exp. rule as main operational budget rule (IMF, EC, OECD)
  - Even french and german economists agree (Carnot, 2014, Claeys et al, 2015; Bénassy-Quéré, et al, 2018, etc)
- **Brussels pushes for expenditure rules since 2012**
  - 6 – pack : Expenditure benchmark (2012)
  - Fiscal compact 2.0 (2017)
- **Strong trend of implementation in recent years**
  - Today almost 50 countries
  - Best practise (Netherlands, Sweden)



Source: IMF Fiscal Rule Dataset

What is an expenditure ceiling?

- **Hard aggregate ceiling on total government expenditures** at the start of the budget preparation process



Why is it a game changer? 4 main benefits

- **Anchoring the fiscal discipline**
  - Timeframe of **binding budgeting** is extended to medium-term
  - Streghtened control over expenditure side (main reason for „deficit bias“)
- **Prioritization and efficiency of public expenditures**
  - Hard top-down ceilings give **better incentives to reallocate resources**
- **More counter-cyclical fiscal policy**
  - **Reduced possibility to spend windfall cyclical revenues**
  - But also providing fiscal space to counter-act recessions
- **Increased budget control , accountability and transparency**
  - Constrained expenditure is **under control of government** (real policy changes)
  - Main operational tool for budget preparation and assesment

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IFP proposal

Main features of expenditure ceilings (3 areas)

- **Numerical formulation of the ceiling**
  - and link to the aggregate fiscal targets
- **Coverage and the level of detail of the ceiling**
  - by items and sectors and the level of detail (ministerial vs aggregate ceilings)
- **Flexibility instruments**
  - Uncertainities in the mid-term planning/forecast

How to calibrate expenditure ceilings in 3 steps - start with debt sustainibility analysis

Three - steps approach to link expenditure ceilings to fiscal targets

Long - term sustainibility analysis
(CBR)

Optimal debt level
-> current sustainibility gap

Medium - term budgetary objective
(CBR -> Government / Parliament)

Recommended medium - term budgetary objective (structural balance) consistent with no sustainibility gap
- > or planned trajectory of structural balance on the medium term horizon

Medium - term expenditure ceilings
(Government / CBR's opinion)

Calibration of expenditure ceilings

1. **Fiscal Anchor** -> *no long - term sustainibility gap* (based on not breaching gross debt ceiling of 50 % of GDP in the long-term in the baseline scenario)
2. **Medium - term objective (MTO)** (or trajectory to achieve it)

   -> *structural surplus 0.4 % of GDP* (prefund for population ageing)
3. **Expenditure ceilings** -> *nominal exp. ceilings (in EUR)* set consistently with the planned trajectory of structural balance towards targeted structural surplus

But what should be Slovak MTO? (different views by SGP, Fiscal compact and CBR)

SGP rules - Structural deficit of 1 % of GDP (updated every 4 years)
Assumptions:
- Debt thresholds of 60 % of GDP
- Weight of cost of ageing: 33%
- Horizon: up to 2070

Slovak budgetary act (transposition of Fiscal compact) – Structural deficit of 0.5 % of GDP (or 1 % of GDP if no long-term risks to sustanaibility of public finances and debt sufficiently below 60 % of GDP)
Assumptions:
- No link to any formula in the law, only reference to the CBR`s sustaibility GAP indicator

CBR (based on sustainibility gap indicator) - Structural surplus of 0.4 % of GDP (updated every year)
(Assumptions:
- Debt threshold of 50 % of GDP
- Weight of cost of ageing: 100%
- Horizon: next 50 years (now up to 2068)

Trajectory to reach MTO: decided by the government while respecting SGP rules

- The **government sets binding fiscal targets towards MTO**
  - for its whole term (4 years)
  - to reach (or get close to) the structural surplus target depending on the initial distance

- **How fast to reach the MTO**?
  - Need to balance sustainibility and stabilization objectives
  - **SGP Matrix - annual structural improvement of 0.5 % of GDP**
    - More in good times, less in bad times

Planning horizon: 4y fixed horizon (election term) provides stability in resource planning

- Rolling ceilings (e.g. year t+2 is always updated based on new macroeconomic assumptions)
  - More flexible, but not enough stability of resources

- Fixed ceilings (for the duration of the election term)
  - Provide clarity with regards to the resources during the whole term
  - Could also curb the excessive pre-election spending

Ceiling expressed as maximal level: transparent and substitutes for correction mechanism

- % annual growth (e.g. not breaching 4 % growth)
  - Flexible in terms of new entitites classified into the sector
  - Need to address fiscal slippages

- % of GDP (e.g. not breaching 40 % of GDP)
  - Potentially pro - cyclical (not recomended at all)

- Level (e.g. not breaching 40 mil. EUR)
  - Transparent, controllable
  - Substitutes for correction mechanism (in case of breach in year T, the original ceilings still binding in year T+1 and further)

Inflation adjustments: nominal ceilings improve transparency and counter - cyclicality

- Real terms
  - Flexible (accomodate structural shocks to inflation)
  - Not very transparent (need to calculate GDP deflators for GG)
  - Without clear reference point for medium - term planning

- Nominal terms
  - More rigid (but can be combined with contingency reserve)
  - Transparent, controllable, easier to communicate
  - Provides clear reference point for medium-term planning
  - Counter - cyclical in case of temporary shocks
    - Fiscal stimulus when below full employment (negative inflation shock)
    - Fiscal contraction when above full employment (positive inflation shock)

Recap: Expenditure ceilings calculation

Expenditure ceiling (5) =

- targeted (structural) balance of general government **(1)**

+ estimation of GG (structural) revenues (tax and non-tax) **(2)**

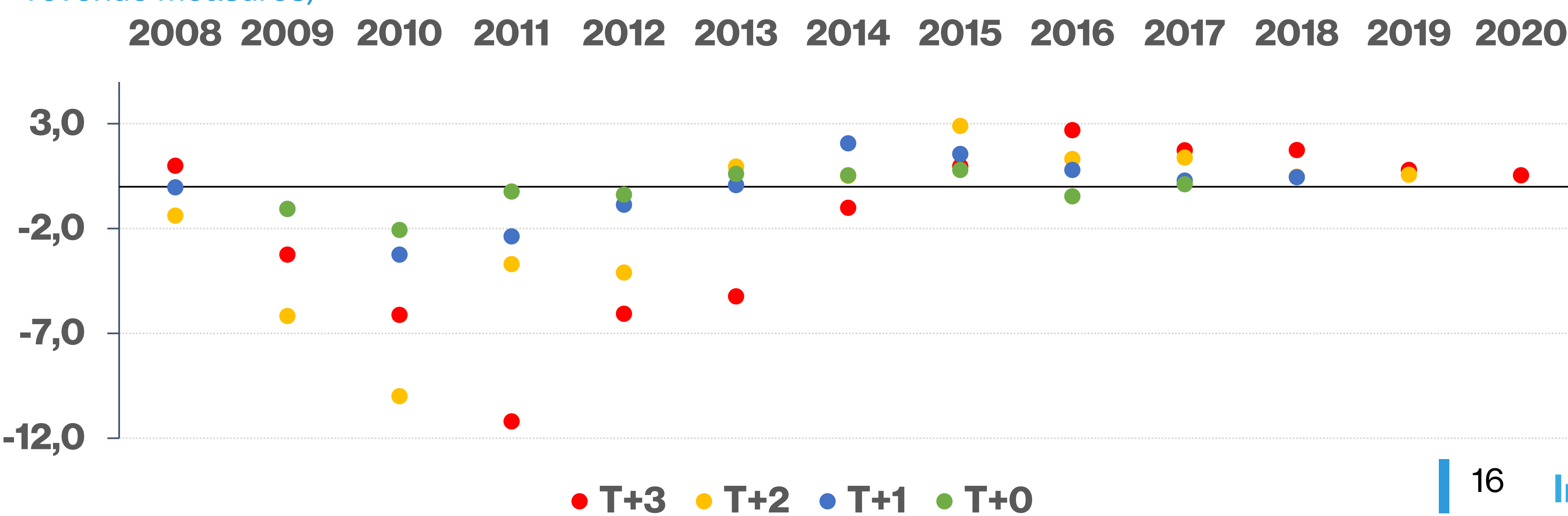
- items deducted from the expenditure ceiling **(3 and 4)**

(mil. eur)	2019	2020	2021	2022
1. Structural balance of general government (structural target)	**-679**	**-208**	**326**	**465**
(% of GDP; based on SGP matrix required consolidation effort)	*-0,7*	*-0,2*	*0,3*	*0,4*
of which: targeted structural balance of excluded entities	223	224	176	176
2. Structural revenue of general government (forecast) (a+b+c)	**34 971**	**37 530**	**38 836**	**40 625**
a. structural tax revenue and social contributions (net of cyclical component)	29 826	31 238	32 465	33 664
a1. tax revenue and social contribution	30 300	31 755	32 966	34 166
of which legislative measures (included tax allowances)	120	-122	-163	
a2. economic cycle	480	522	507	507
a3. one-off and teporarty measures	-6	-6	-6	-6
b. non-tax revenues of general government	4 182	4 331	4 423	4 511
c. revenues from grants and transfers	963	1 962	1 948	2 450
3. Excluded expenditure items (forecast) (a+b+c)	**2 355**	**3 168**	**3 125**	**3 823**
a. Expenditure related to EU budget	1 238	2 054	1 984	2 682
a1. expenditure covered by EU budget revenue	146	720	753	1 395
a2. co-financing of EU funds	252	463	359	415
a3. contribution to the EU budget	840	871	872	872
b. Cyclical component of selected social benefits (cyclical part of pension and unemployment benefits)	-7	19	30	30
c. state debt service costs	1 125	1 095	1 112	1 112
4. Excluded entities (forecast/target) (structural balance of excluded entities and its revenue)	**4 199**	**4 848**	**4 462**	**4 657**
5. Ependiture ceilling (-1+2-3-4)	**29 096**	**29 722**	**30 922**	**31 681**

...issue: strong reliance on tax forecast

- Level of expenditure ceilings is largely determined by the tax revenue forecast
  - Expenditure ceiling is linked to the projected total general government balance
- Looking ex-post, significant deviations have been identified on medium-term horizon
  - Up to 3 % of GDP on T+1 and even up to 11 % of GDP on T+3 ! (figure below)
- Hence, some mechanism to accomodate forecast errors (on top of the budget reserve) might be a key element for the credibility of the expenditure ceiling

Deviation of tax revenue and social contributions (forecast vs outturn in % of GDP; net of discretionary revenue measures)



Coverage by sectors: whole central gov'ment to strenghten link with fiscal targets

- Direct link to aggregate fiscal targets (structural balance) calls for as wide sector coverage as possible.

- However, it is a **good practise** to **exclude GG entities with own autonomy** and/or own fiscal rules **(local governments and independent entitites such as CBR, NKU, etc.)**

- **GG state enterprises (and other GG entities) should be constrained by the ceilings**
  - e.g. National highway company, National railway infrastructure and transport, but also health insurance system)
  - need to strenghten budgetary control over these entities

Coverage by items: 3 clear principles for exclusions

- **Principles for exclusion of items: a)** direct non-tax revenue couterpart, **b)** not under control of government, **c)** strongly counter-cyclical item

- Expenditure **items to be excluded**:
  - Interest payments **(b)**
  - Expenditures related to the EU budget
    - Expenditures matched by revenues from EU budget **(a)**
    - Co-financing of EU funds **(a,b)**
    - Contribution to the EU budget **(b)**
  - Cyclical component of some social spending (pensions, unempl. benefits) **(c)**

- To secure the link to aggregate balance targets, **macroeconomic forecast committee should estimate excluded items to set the exp. limit ex-ante**
  - reason: both structural and headline balance includes all items and their underestimation/overestimation in exp. limit would automatically lead to deviation against fiscal targets

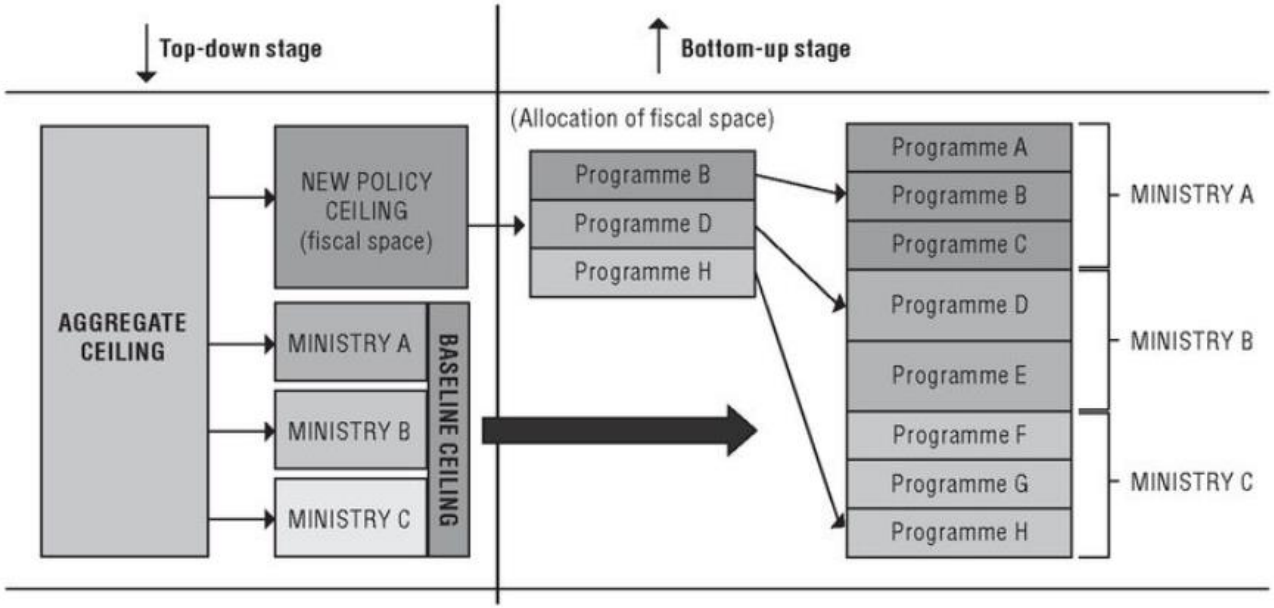
Ministerial sub - ceilings would anchor fiscal discipline even more

- <u>Aggregate</u> ceilings (only)
  - Higher flexibility
  - Lack of clear responsibility and budgetary certainty at line ministries
  - Lack of clarity of governmental priorities across public policies

- <u>Ministerial</u> subceilings
  - Budgetary negotiations need to control allocation across sectors (line ministries)
  - All ministers know ex-ante the fiscal space they have for priorities
  - Stronger incentive for identification of savings at line ministries, supporting implementation of spending reviews/VfM
  - Clear resposibility when it comes to budgetary results
  - Higher ownership

Ministerial subceilings

Figure 4. **Combining top-down discipline with allocative flexibility**



- It would also be **desirable to consolidate (centralize) budgetary chapters** into line ministries
  - Currently around 47 budgetary chapters
  - higher responsibility and easier budget negotiations

Contingency reserve as main absorption tool for standard shocks

- **Not all fiscal space under expenditure ceiling should be allocated ex-ante**
  - Need to provide fiscal space for uncertainities in forecast and planning
  - mainly real GDP and inflation forecast errors

- **Contingency reserve (within the nominal ceilings) should be created to absorb forecast revisions**
  - from 1 % of the exp. ceiling in T+1, up to 3 % in T+4 (approximately between 0.3 and 1 % of GDP)
  - the reserve can be dissolved step-by-step in case the baseline forecast materializes
    - Issue: how to proceed in case of large windfall revenues?

Carry - overs should be possible, but only to limited extent

- **Limited carry-overs between years should be allowed** for expenditure under ceilings (uncertainty in medium-term planning)
  - Carry-overs are implemented and monitored through a separated account

- **Carry-overs should not threaten compliance with fiscal targets**
  - Maximum allowed carry-over: **up to 1 % of expenditure limit (around 0.3 % of GDP)**

- **Process: requested by ministers and approved by government**
  - Based on type of expenditure and its nature (discretion over rules preferable)
  - Needs to be reconciled with current content of paragraph 8 (Act on budgetary rules)

Escape clauses for unusual/catastrophic events

- **In case of truly extraordinary events the expenditure limit can be changed**
  - Based on Fiscal responsibility act:
    - Deep recession like the one in 2008/2009 -> might be too strict
    - Bailout of banking sector or natural disasters

- **Need for oversight of independent institution**
  - Council for budget responsibility (CBR) approves triggering of escape clause

Implementation challenges

- **Legislation**
  - Amendment of relevant laws
  - Definition of specific roles for Government, Parliament, MoF, CBR
- **Budget management**
  - Amendment of budgetary negotiation process -> two-round process (ministerial level)
    - (1) No – policy change scenario (2) New priorities negotiations (both scrutinized by VfM)
  - Strengthening of budgetary control over state-owned enterprises
- **Macroeconomics**
  - Volatile economic cycle (real GDP, inflation)
  - How to allocate reserve (distinguishing between cyclical and structural shocks)
- **Public communication**
  - Selling points towards the public and politicians
    - Need to fine-tune the explanation of the expenditure ceiling features

Questions

Regarding the proposal:

- Good balance between flexibility and fiscal discipline?
- How to sort out the question on the right level of MTO
- Any ideas how to simplify to proposal?

Regarding the process:

- Suggestions/comments on the way forward (implementation action plan?)

Thank you for your attention