



**MINISTRY OF FINANCE  
OF THE SLOVAK REPUBLIC**

**institute for financial policy**

# I Expenditure ceilings:

*Operational tool to improve Slovak budget management*

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Workshop on implementation of expenditure ceilings in Slovakia, Bratislava, February 21, 2019

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# I 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 on proposal for the implementation of expenditure ceilings (built upon previous studies)

**2019** – Public consultations to choose specific variant/s of exp. ceilings

**2019** - Preparation of internal budgetary processes

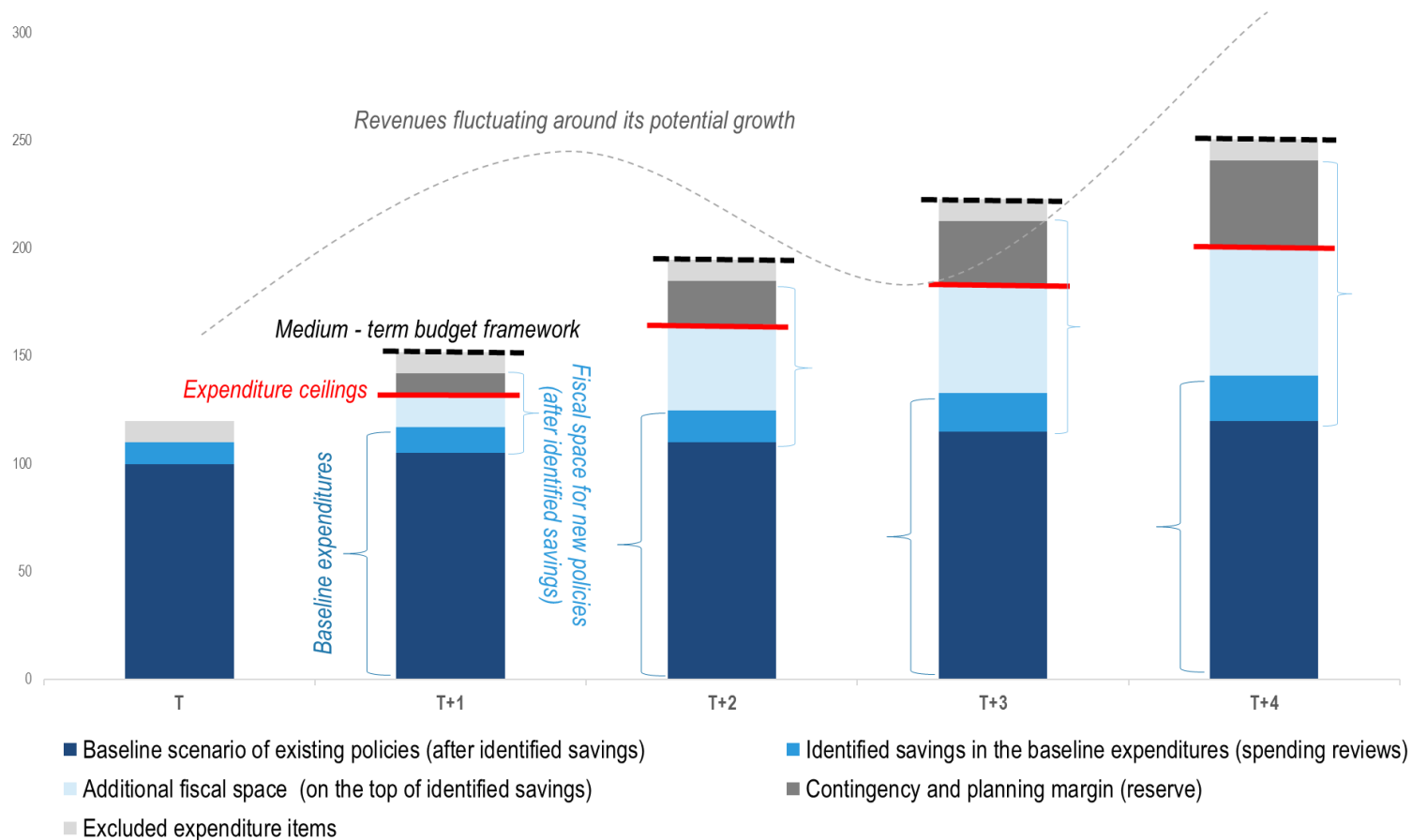
**2020, 2021?** – Launch of the test phase of expenditure ceilings





# I What is an expenditure ceiling?

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





# I Why is it a game changer? 4 main benefits

- **Anchoring the fiscal discipline**
  - Timeframe of **binding budgeting** is extended to medium-term
  - Strengthened 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 assessment





# Main features of expenditure ceilings (3 areas)

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





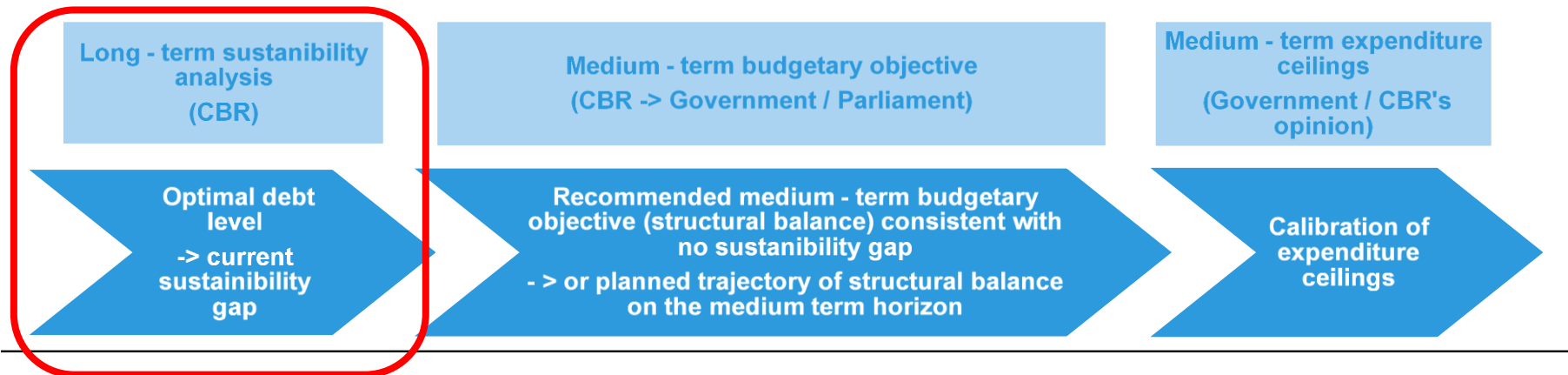
# Numerical formulation of the ceilings





# I How to calibrate expenditure ceilings in 3 steps - start with debt sustainability analysis

## Three - steps approach to link expenditure ceilings to fiscal targets



1. **Fiscal Anchor:** Not breaching *gross debt ceiling of 50-60 % of GDP* in the long-term in the baseline scenario
2. **Medium - term objective (MTO)** (or trajectory to achieve it):  
*structural balance of -1 % up to +0.4 % of GDP* (population ageing)
3. **Expenditure ceilings:** *nominal exp. ceilings (in EUR)* set consistently with the planned trajectory of structural balance towards targeted structural surplus





# I But what should be Slovak MTO - different views by SGP, Fiscal compact and CBR

## **Stability and growth pact - Structural deficit of 1 % of GDP (updated every 4 years)**

### **Main assumptions:**

- Debt threshold of 60 % of GDP
- **Weight of cost of ageing: 33%**
- Horizon: up to 2070
- Comment: Minimum MTO by SGP has 2 other criteria (ERM and safety margin w.r.t. to 3 % deficit)

## **Slovak budgetary act (transposition of Fiscal compact) – Structural deficit of 0.5 % of GDP (or 1 % of GDP if no long-term risks to sustainability of public finances and debt sufficiently below 60 % of GDP)**

### **Main assumptions:**

- No link to any formula in the law only reference to the CBR`s sustainability GAP indicator regarding risks assesment

## **Slovak Fiscal Council (based on sustainability gap indicator) - Structural surplus of 0.4 % of GDP (updated every year)**

### **Main assumptions:**

- Debt threshold of 50 % of GDP
- **Weight of cost of ageing: 100%**
- Horizon: next 50 years (now up to 2068)







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

- **The government sets binding fiscal targets towards MTO**
  - for its whole election term (4 years)
  - to reach (or get close to) MTO target depending on the distance
- **How fast to reach the MTO?**
  - Need to balance sustainability and stabilization objectives
  - **SGP Matrix - annual structural improvement of 0.5 % of GDP**
    - More in good times, less in bad times





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





- Fixed ceilings (for the duration of the election term)
  - Clarity with regards to the resources during the whole term ✓
  - But may be problematic in case of large macro and tax forecast errors (both in base year and forecast as well) ✗





# I Inflation adjustments: nominal ceilings improve transparency and counter - cyclicity

## ■ Nominal terms

- More rigid, especially if binding for longer term horizon 
  - 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)





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

- Level (e.g. not breaching 40 mil. EUR)
  - Transparent ✓
  - Controllable ✓
  - need to reconcile statistical changes (classifications into/outside sector) ✗





# I Recap: Expenditure rule definition

## Expenditure ceiling (5) =

- targeted (structural) balance of general government (1)
- + estimation of GG (structural) revenues (tax and non-tax) (2)
- general government items deducted from the expenditure ceiling (3 and 4)

Illustration of exp. ceiling calculation linked to GAP indicator (mil. of eur)	t+1	t+2	t+3	t+4
<b>1. Structural balance of general government (structural target)</b>	<b>-679</b>	<b>-208</b>	<b>326</b>	<b>465</b>
(% of GDP)	-0,7	-0,2	0,3	0,4
of which: targeted structural balance of excluded entities	223	224	176	176
<b>2. Structural revenue of general government (forecast) (a + b +c)</b>	<b>34 971</b>	<b>37 530</b>	<b>38 836</b>	<b>40 625</b>
a. structural tax revenue and social contribution	29 826	31 238	32 465	33 664
a1. tax revenue and social contribution	30 300	31 755	32 966	34 166
of which new legislative measures (included tax expenditures)	120	-122	-163	0
a2. impact of economic cycle	480	522	507	507
a3. one-off and temporary 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
<b>3. Excluded expenditure items (forecast) (a + b)</b>	<b>2 362</b>	<b>3 149</b>	<b>3 095</b>	<b>3 793</b>
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. state debt service costs	1 147	1 110	1 143	1 143
<b>4. Excluded entities (forecast/target) (structural balance of excluded entities and its revenue)</b>	<b>4 199</b>	<b>4 848</b>	<b>4 462</b>	<b>4 657</b>
<b>5. Expenditure ceiling (-1 + 2 - 3 - 4)</b>	<b>29 089</b>	<b>29 741</b>	<b>30 952</b>	<b>31 711</b>

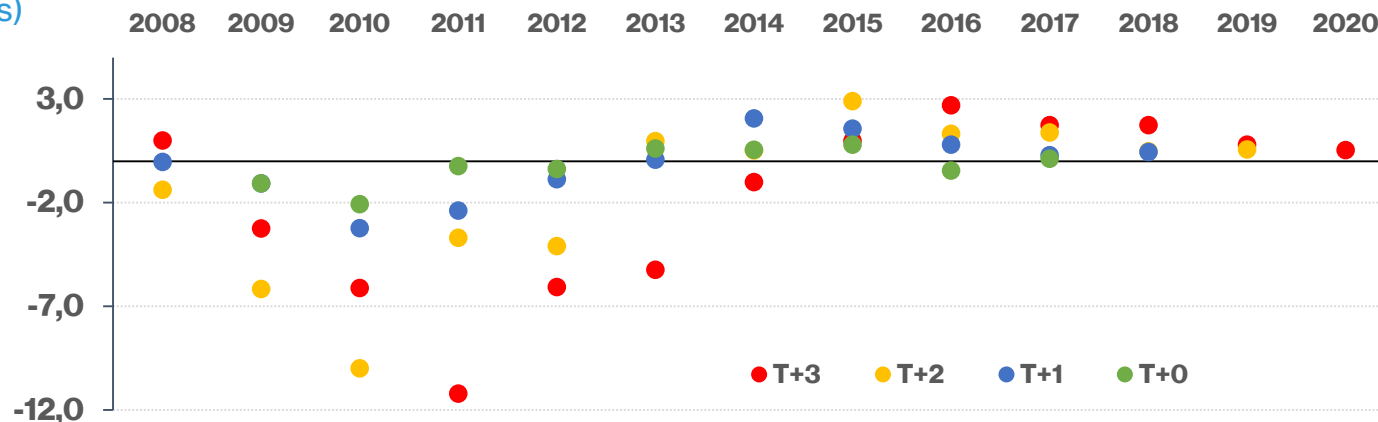




# I ...issue: strong reliance on tax forecast

- 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 (both positive and negative) 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 accommodate forecast errors (on top of the budget reserve) might be a key element for the credibility of the expenditure ceiling
  - Rolling of the ceilings
  - Ad - hoc correction mechanism (both positive and negative deviations in assumptions)
  - Less stringent escape clauses

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





# Scope of the ceilings/level of dissagregation



# I Coverage by sectors: whole central gov'tment to strenghten link with fiscal targets

- **Exclusion of GG entities with own autonomy and/or own fiscal rules (local governments and independent entitites such as Fiscal Council and National Audit office, 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 (coordination mechanisms/centralization of line ministries powers)







# Coverage by items: 3 clear principles for exclusions

- **Principles for exclusion of items: a)** direct non-tax revenue counterpart, **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





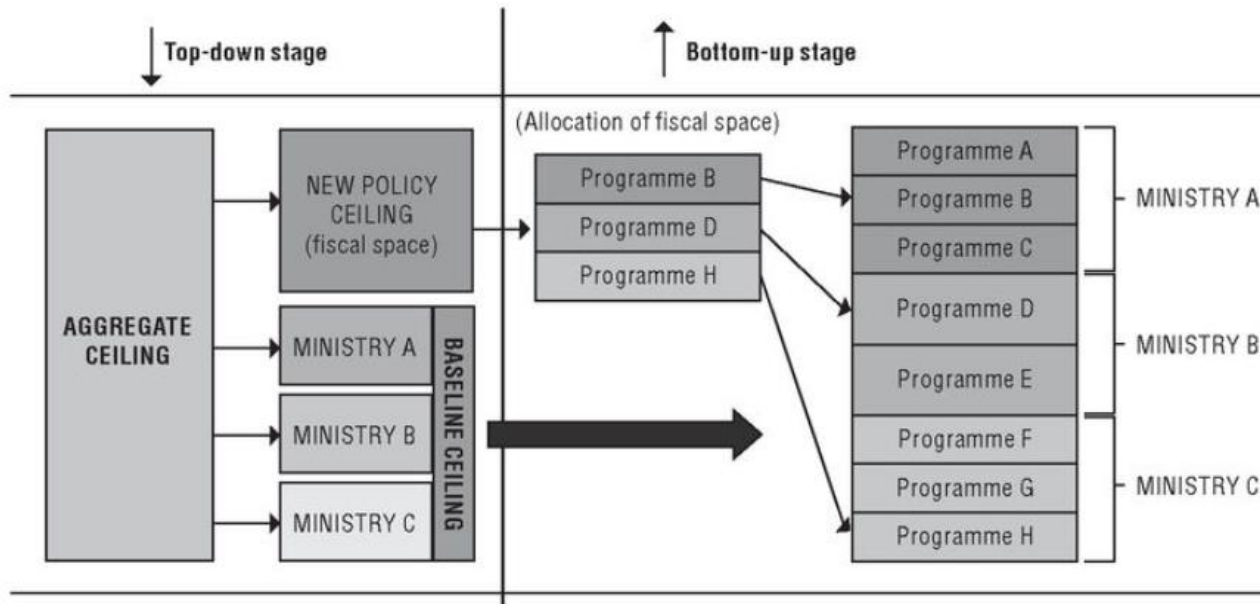
# Ministerial sub - ceilings would anchor fiscal discipline even more

- **Ministerial 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 responsibility 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



# Flexibility instruments (to manage uncertainty)



# 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 buffer for uncertainties in forecast and planning (especially if nominal ceiling is binding for 4 years)
  - 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 may be dissolved step-by-step in case the baseline forecast materializes
    - Issue: how to proceed in case of large windfall revenues?





# I 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 to be used for unusual/catastrophic events

- **In case of truly extraordinary events the expenditure limit can be changed in Parliament**
  - 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





# I 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 Value for money)
- 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/simplify the explanation of the expenditure ceiling features





# I Questions

- **How to strike the right balance between flexibility and fiscal discipline?**
  - Binding nature of the 4 - years nominal ceilings
  - Escape clauses (quite stringent)
  - Assymetrical approach in the reserve (only for negative surprises)
- **How to sort out the question on the right level of MTO?**
  - EU perspective (MTO by SGP) vs. more stringent national specifics (GAP indicator)
- **Any ideas how to simplify to proposal?**
  - The calibration is not easy to explain to the policy-makers and public





Thank you for your attention

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