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**Fiscal deficit in 2011 is expected to be 0.7% GDP lower than budgeted***Erik Bugyi, Michal Havlát*

The headline fiscal deficit is estimated at 4.8% of GDP in 2011. However, the number is a “victim” of some artificial methodology, namely the inclusion of older debts and well as a formal positive boost from VAT paid by the government concerning a large PPP project. Indeed, adjusted for these one-offs, the real deficit figure is 4.2% of GDP compared to a budget assumption of 4.9% of GDP, i.e. an improvement of 0.7% of GDP. Lower than expected financing of EU funds (0.4% of GDP), higher non-tax revenues from dividends and one-offs (0.4% of GDP) were pushing the deficit lower. They were partly offset by continuing inefficiencies in railways and hospitals (-0.5% of GDP). 2011 fiscal figure represents an annual fiscal tightening as large as 4% of GDP and a consolidation effort of 3.4% of GDP. The government sticks to its target of the deficit up to 4.6% of GDP in 2012.

This updated policy brief provides the latest estimate of general government deficit in 2011 based on the data available in mid-April 2012<sup>1</sup>. It contains an analytical description of the main factors driving its development compared to the budget and potential implications for 2012 general government balance.

The headline general government deficit in 2011 is formally estimated at 4.8% of GDP, which includes old debts in healthcare and railways created during 2004-2010 to the tune of 0.8%<sup>2</sup> of GDP. Eurostat’s approach is putting the old debts as a total to 2011 figure to prevent the revision of the old fiscal figures<sup>3</sup>. However, from economic point of view, spreading the debts into relevant years provides a better measure of government policies in that particular period. On the other hand, the figure benefits positively from the methodological treatment of PPP projects (concerning VAT payment) to the tune of 0.25% of GDP. Excluding these one-offs unrelated to current government policies, **the adjusted deficit is estimated to reach 4.2% of GDP compared to a fiscal target of 4.9% of GDP. On a comparable basis<sup>4</sup>, the fiscal deficit improved from 8.1% of GDP in 2010 to 4.2% of GDP in 2011, i.e. an improvement of 4% of GDP.** Table below provides a list of the main factors with their impacts compared to the budget (more detailed information can be found in annex).

The main factors explaining the difference compared to the budget can be divided into six groups:

- **Impact of macroeconomic development** - macroeconomic development had a slightly more negative impact than in the last revision (around 0.2 % GDP from less than 0.1 % of GDP) on the general government balance. It materialized into a shortfall of tax revenues (mainly personal income tax and excise taxes) and social contributions amounting to 0.3% of GDP, which was partially compensated with expenditure savings stemming from lower interest payments.
- **One-off revenues** had an overall positive impact amounting to 0.3% of GDP. Sales of telecommunication license fees were another source of one-off revenues. On the other hand, the planned sale of emission quotas was not realized in 2011 due to the failure on the part of the relevant ministry.
- **Transactions related to the EU budget** had one of the largest positive impacts amounting to 0.4% of GDP. Lower drawdown of EU funds led to lower needs of co-financing from the state budget with total savings reaching 0.3% of GDP. Savings were also achieved in transfers to the EU budget mainly due to a surplus of the 2010 EU budget which reduced the transfers needed from member states in 2011.

<sup>1</sup> Revised data is based on Eurostat April 2012 EDP notification.

<sup>2</sup> This value is calculated as the assumption of previous debt (0.92% of GDP) minus one-off tax revenues and social contribution (0.09% of GDP) stemming from the assumption. Debt bailout in healthcare resulted into additional revenues from social contributions (hospitals paid arrears on social contributions).

<sup>3</sup> Formally, this is in accordance with the time of recording of an event, based on official recognition of a liability and on exact determination of the amounts recognised.

<sup>4</sup> I.e. including old debts created in 2010 to the fiscal figure in 2010.

*The 2011 general government deficit estimate is better than budgeted by a hefty 0.7% of GDP*

<b>General government balance in 2011 (ESA 95)</b>		
	<b>EUR mill.</b>	<b>% of GDP</b>
<b>GENERAL GOVERNMENT BALANCE - BUDGET</b>	<b>-3 449</b>	<b>-4.91</b>
<b>Impact of macroeconomic development</b>	<b>-108</b>	<b>-0.16</b>
- core tax revenues and social contributions	-208	-0.30
- interest expenditures	100	0.14
<b>One-off revenues</b>	<b>206</b>	<b>0.30</b>
- unrealized sales of emission quotas	-100	-0.14
- telecommunication licence fees	89	0.13
- other revenues of the state budget and other GG entities	177	0.26
- contribution from Solidarity fund	20	0.03
- other	20	0.03
<b>Transactions related to the EU budget</b>	<b>307</b>	<b>0.44</b>
- co-financing for EU funds	227	0.33
- transfer to the EU budget	80	0.12
<b>Efficiency of state-owned enterprises</b>	<b>-242</b>	<b>-0.35</b>
- dividends	85	0.12
- assumption of debt (railways, hospitals) related to 2011	-327	-0.47
<b>Core expenditures and other factors</b>	<b>361</b>	<b>0.52</b>
- expenditures of local governments	123	0.18
- healthcare expenditures	116	0.17
- reserve on state debt interest expenditures	50	0.07
- expenditures of Social Insurance Agency	130	0.19
- other factors	-58	-0.08
<b>One-off factor artificially improving deficit - VAT from PPP project</b>	<b>174</b>	<b>0.25</b>
<b>One-off factor artificially increasing deficit - assumption of debt (railways, hospitals) related to previous years less its positive impact</b>	<b>-574</b>	<b>-0.83</b>
<b>Headline GENERAL GOVERNMENT BALANCE</b>	<b>-3 326</b>	<b>-4.82</b>
<b>Adjusted GG BALANCE - excl. on-offs (old debts + VAT from PPP project)</b>	<b>-2 926</b>	<b>-4.24</b>
of which: impact of updated nominal GDP forecast (p.p.)		-0.08

(+) indicates improvement and (-) deterioration of the general government balance

*Fiscal deficit was cut by 4% of GDP in 2011*

- **Efficiency of state-owned enterprises** can be approximated by revenues from dividends and debt created by these entities over and above their financing via the state budget. In 2011 they had an overall negative impact on deficit amounting to 0.4% of GDP. Higher revenues from dividends (mainly SPP) were more than offset with estimated debt accumulated in state railway companies and hospitals resulting from lack of reforms in these entities. Railways are now undergoing a major cost-cutting exercise with 2012 budget expected to cover all their needs.
- **Core expenditures and other factors** had by far the largest positive impact amounting to 0.5% of GDP. It can be attributed to several items (with relatively minor impacts). The major ones are lower expenditures of local governments as a reaction to lower tax revenues, lower expenditures of Social Insurance Agency (due to lower expenditures on old-age pensions and unemployment benefits).
- **One-off measure “artificially” improving deficit.** Budgeted VAT for PPP projects was formally excluded from core expenditures in 2011 and spread into relevant years according to the ESA95 rules<sup>5</sup> to the tune of 0.25% of GDP.
- **One-off measure “artificially” increasing deficit was assumption of debt related to previous years** - state railways and hospitals were in the period of years 2008-2010 accumulating liabilities stemming from the lack of reforms in these entities<sup>6</sup> which were not

<sup>5</sup> The budget assumed that transactions related to the VAT will have no impact on the deficit in ESA95. However, according to the ESA95 VAT paid from the budget should be included in the regular repayments for the PPP project, thus as an expenditure of the budget for the subsequent 30 years. Therefore the final impact on the deficit 2011 is positive but will have negative impact on the deficit in the future (imputed expenditures).

<sup>6</sup> State Railways were forced to take out loans that they could not repay as the government had not paid the promised fees to subsidise the rail passenger transport. Hospitals have been exempt from bankruptcy laws so that

This results in a consolidation effort of 3.4% of GDP in 2011, the second boldest in Slovak history

reported in general government accounts before. After identifying their actual value (amounting to 0.8% of GDP), Eurostat recommended to report all these debts into one year in 2011, even though they are not directly related to government policies in that year. In consolidation effort calculation, MinFin attributes these expenditures to the relevant years since it is more appropriate.

Adjusting the change in the fiscal balance for factors outside the direct control of the government (e.g. economic cycle, interest payments, etc.), **the consolidation effort reaches 3.4% of GDP in 2011**, which is the second highest figure in Slovak history (after 2003)<sup>7</sup>. Expected slowdown in the pace of consolidation in 2012 can be attributed to early elections and a further deterioration of macroeconomic outlook.

The fiscal impulse measures the contribution of public policy towards short-term growth, namely aggregate demand. It also includes the impact of EU funds on both public and private sectors. Slovakia managed to up the EU stimulus from 2.1% of GDP to 2.5% of GDP, less than expected. This decreased the impact of fiscal tightening by 0.4% of GDP. Hence, one can observe that **in 2011 the government was forced to pursue a restrictive and pro-cyclical fiscal policy in the order of 3% of GDP**. The hope is that this year, the fiscal policy would be broadly neutral towards short-term growth should the planned increased usage of EU funds materialise.

Public finances in Slovakia (ESA 95, % of GDP), consolidation and fiscal impulse (+ restriction)								
	2008	2009	2010	2011	2012B	2013T	2014T	2015T
Headline GG balance*	-2.1	-8.0	-7.7	-4.8	-4.6	-2.9	-2.3	-1.7
<b>Consolidation effort** (1)</b>	<b>0.0</b>	<b>-4.0</b>	<b>-0.7</b>	<b>3.4</b>	<b>0.8</b>	<b>2.0</b>	<b>0.5</b>	<b>0.5</b>
EU funds balance	0.6	1.2	2.1	2.5	3.5	3.3	2.5	1.9
<b>Additional EU stimulus (2)</b>	<b>0.2</b>	<b>0.5</b>	<b>0.9</b>	<b>0.4</b>	<b>1</b>	<b>-0.2</b>	<b>-0.8</b>	<b>-0.6</b>
<b>Fiscal impulse** (1-2)</b>	<b>-0.2</b>	<b>-4.5</b>	<b>-1.6</b>	<b>3.0</b>	<b>-0.2</b>	<b>2.2</b>	<b>1.3</b>	<b>1.1</b>

\* For 2013 till 2015 targets set within the GG budgetary framework 2013-15; 1-target, B-budget

Source: IFP

\*\* Fiscal impulse (+ restriction, - expansion)

Implications for 2012 are muted

On the one hand, the fiscal outperformance of 0.7% of GDP in 2011 might have a positive effect in 2012. On the other hand, more negative macroeconomic forecast (since the time the budget was prepared) and pre-election promises of increased wages in the healthcare are likely to have a negative impact. The net impact is estimated to be relatively limited. The government sticks to a fiscal target of maximum 4.6% of GDP and is prepared to take additional measures if necessary.

Long-term budgetary outlook

Consolidation effort of 2% of GDP is planned for 2013 so that the fiscal deficit will fall below 3% of GDP. The budget draft ("budgetary framework for 2013-2015") already assumes some measures, but additional measures are yet to be decided by the new government. Consolidation measures are best examined in the context of no-policy change scenario (NPC). One should compare the primary balances since reaching the fiscal targets has obviously a positive effect on debt service. The total consolidation required in 2013 amounts to EUR 1.7bn in 2013. Since some of the measures are already included in the first draft of the budget mainly on the expenditure side, **additional EUR 1.2bn (1.6% of GDP) need to be specified**. In 2014 additional measures of 0.4 % GDP and in 2015 of 0.6 % GDP will be necessary to implement.

Debt trajectory of passive no-policy change scenario

Comparison of NPC scenario with budgetary outlook 2013 - 2015 (ESA 95, % of GDP)			
	2013	2014	2015
1. Primary general government balance – target budgetary outlook	-0.9	-0.2	-0.5
2. Primary general government balance – no-policy change scenario	-3.2	-3.0	-2.8
Difference (1-2)	2.3	2.7	3.3
y-o-y change (in % of GDP)	-	0.4	0.6
Difference (in EURm)	1 713	2 155	2 773
y-o-y change (in EURm)	-	442	618
<b>In addition to what is assumed in the budget draft (in EURm)</b>	<b>1 166</b>	<b>1 480</b>	<b>1 612</b>
<b>in % of GDP</b>	<b>1.6</b>	<b>1.9</b>	<b>1.9</b>

Source: IFP

they could incur unreasonable levels of debts. Hence, the annual indebtedness of these companies reflected government's real spending policies in these sectors.

<sup>7</sup> For detailed information on consolidation effort in Slovakia, please refer to the recent IFP [policy brief 2012/01](#).

Without measures to curb increasing debt, in such a passive no-policy change scenario, the debt Maastricht limit could be breached in 2015. Meeting the planned fiscal targets, the debt is expected to reach its high of 53% of GDP in 2014.

<b>Scenarios of Gross General Government Debt development (in % GDP)</b>					
	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Passive/no-policy change (NPC) scenario	43.3	50.2	54.3	57.9	60.3
<b>Budget draft (budgetary framework 2013 – 2015)</b>	<b>43.3</b>	<b>50.2</b>	<b>52.0</b>	<b>53.0</b>	<b>52.3</b>
difference	0.0	0.0	2.3	4.9	8.0

Source: IFP

### Possible measures in 2013

Proposals to reduce the expected shortfall between the target and the budgetary framework for the next three years include the measures to cut back expenditures and/or increase revenues of the general government budget. The following measures are being considered:

#### Expenditures

A gross wage expenditures freeze (except wages of teachers) in general government is already built-in under the draft budget framework 2013 – 2015. A 5% cut in the following years in expenditures on goods and services in the state budget is planned<sup>8</sup>. With regards to state benefits, an implementation of means-testing affecting child benefits is being considered.

#### Revenues

On the revenues side, the emphasis will be on taxes which do not put additional strain on disposable income of lower earning population. Proposed measures include reassessing banking sector levies and a possible hike in property, income and excise taxes. The government will also take steps to forestall tax leaks and improve tax collection of VAT as well as continuing to put increased pressure on state companies.

<sup>8</sup> With the exception of defense budget and a planned reserve for co-financing EU projects in case of higher financial drawing of EU funds.

## Appendix – Detailed table on general government balance in 2011

<b>General government balance in 2011 (ESA 95)</b>		
	EUR mill.	% of GDP
<b>GENERAL GOVERNMENT BALANCE - BUDGET</b>	<b>-3 449</b>	<b>-4.91</b>
<b>1. Impact on general government revenues</b>	<b>123</b>	<b>0.18</b>
<b>Tax revenues and social security contributions</b>	<b>-184</b>	<b>-0.27</b>
- of which debt bailout of hospitals (arrears on social contributions)		
<b>Other than tax revenues of the general government</b>	<b>291</b>	<b>0.42</b>
- dividends	85	0.12
- telecommunication license fees	89	0.13
- unrealized sales of emission quotas	-100	-0.14
- contribution from Solidarity fund	20	0.03
- levy from providers of transmission and distribution systems (sector of energy)		
- other revenues of the state budget	80	0.12
- other revenues of other general government entities	118	0.17
<b>Change in general government receivables</b>	<b>15</b>	<b>0.02</b>
- receivables of guarantee fund of Social Insurance Agency		
- other general government entities	15	0.02
<b>2. Impact on general government expenditures</b>	<b>398</b>	<b>0.58</b>
<b>EU funds co-financing including induced investments</b>	<b>316</b>	<b>0.46</b>
- co-financing	227	0.33
- induced investments (railways, roads)	88	0.13
<b>Transfer to the EU budget</b>	<b>80</b>	<b>0.12</b>
<b>Interest expenditures</b>	<b>156</b>	<b>0.23</b>
<b>Expenditures related to state-owned companies</b>	<b>-327</b>	<b>-0.47</b>
- expenditures on contract with state railway companies and accumulated debt in 2011	-227	-0.33
- debt of hospitals related to 2011	-100	-0.14
<b>Consolidated core state budget expenditures*</b>	<b>-162</b>	<b>-0.23</b>
- impact of unused funds of state budget carried over to the next fiscal year	-1	0.00
- expenditure savings on investment incentives	20	0.03
- expenditures on reconstruction of ICT (emergency line)	-16	-0.02
- expenditures on lawsuits	-24	-0.03
- other changes in expenditures	-142	-0.21
<b>Expenditures of other general government entities</b>	<b>331</b>	<b>0.48</b>
- local governments	123	0.18
- Social Insurance Agency	130	0.19
- public health insurance	116	0.17
- other entities	-38	-0.06
<b>Change in general government liabilities</b>	<b>5</b>	<b>0.01</b>
<b>One-off factor - VAT from PPP projects</b>	<b>150</b>	<b>0.22</b>
<b>One-off factor - assumption of old debts (railways, hospitals) related to previous years – net impact</b>	<b>-574</b>	<b>-0.83</b>
<b>3. Impact of other factors - residual</b>	<b>26</b>	<b>0.04</b>
<b>GENERAL GOVERNMENT BALANCE</b>	<b>-3 326</b>	<b>-4.82</b>
of which: impact of updated nominal GDP forecast (p.p.)		-0.08

(+) indicates improvement and (-) deterioration of the general government balance

\* excluding induced investments and expenditures on contracts with state railway companies

Source: IFP

More detailed data is available <http://www.finance.gov.sk/en/Default.aspx?CatID=529>.