CBR
COUNCIL FOR BUDGET RESPONSIBILITY

Report on the Long-term Sustainability of Public Finances

December 2012

The English version of the report is abridged. The full version is available in Slovak only.

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Summary

One of the main tasks of the Council for Budget Responsibility is to draw up Reports on the Long-term Sustainability of Public Finances. The CBR views the sustainability concept from four angles: solvency, stability, growth and equity. Solvency evaluates the ability to discharge liabilities in the long term. The stability concept monitors significant fluctuations in the living standard of households overtime, and examines the impact of changes in the input parameters on the resulting sustainability indicators. The growth principle encompasses mutual links between the fiscal and macroeconomic scenarios. The equity concept is primarily about looking at the net position of individual age-segments of the population vis-à-vis public finances.

This report contains mainly solvency analysis through flow values, such as adjusted public finance deficits, and the newly defined long-term sustainability indicator. Next April, the report should also include historically the first estimate of the net worth of the Slovak Republic. In 2014, the report should cover all four aspects of sustainability.

The bottom line is that, under the baseline scenario (unchanged policies) the public debt of Slovakia would surge to 593% of GDP by 2061. This is a hypothetical scenario, because the markets would cease to finance Slovakia's needs at much lower debt levels. On the other hand, calculations clearly show that in order to make public finances sustainable in the long term, major changes have to be made. Using the long-term sustainability indicator (GAP) the CBR has quantified the need for additional consolidation. **For the general government debt not to exceed the upper limit defined in the Fiscal Responsibility Act in the next 50 years, it will be necessary to either increase general government revenues or decrease expenditures on a permanent basis (or a combination of the two) by 6.8% of GDP**.

We are presenting the long-term sustainability indicator (GAP) as a new key indicator of fiscal development which will be used to evaluate the government's fiscal policy. GAP comprehensively evaluates the measures taken and creates the right motivations. It is essential for the government to formulate their plans with due account of how the GAP develops. A new legislation governing the expenditure ceilings will shortly enter the legislative pipeline; one of the options under consideration is to tie the calculation of expenditure ceilings to the GAP indicator.

In order to illustrate possible changes, the document also quantifies four scenarios: (i) consolidation scenario (by 2013); (ii) reform scenario (linked to changes in the pension system); (iii) debt-slashing scenario (reduction of public debt by 10% of GDP); and (iv) distant-horizon scenario (60 years). The first and second reduce the magnitude of necessary consolidation by 0.6 and 1.4 p.p., respectively. The third and fourth increase GAP value by 0.1 p.p. and 0.5 p.p., respectively.

The long-term benefits of the measures taken by the government since 2011 can be evaluated (provided that the medium-term budget objectives are met) by comparing the consolidation and reform scenarios with the baseline scenario. This comparison shows that short-term consolidation effort at 1.3% of GDP in 2013 reduces GAP only by 0.6% of GDP, which is due to

the 2012 debt increase as well as to other factors (EFSF commitments, ESM contribution, financial reserve). On the other hand, the reforms in the pay-as-you-go pillar of the pension system, which does not result in a deficit reduction today, reduces GAP by 1.4% of GDP.

The overall conclusion is that if public finances in 2013 develop in line with the approved budget, the GAP indicator will improve (taking also into account the effects of the pay-as-you-go pillar reform) by 1.9% of GDP. With these effects included, the value of GAP will drop to 4.8% of GDP. The above-mentioned also shows that any further reduction in GAP will require continued budget consolidation or the adoption of structural changes in those expenditure categories that are sensitive to population ageing (pensions, healthcare, long-term care).

The first step in the analysis of long-term sustainability is to set the initial value for the "actual condition" of public finances. The balances published by Eurostat need to be adjusted to eliminate certain impacts unrelated to the long-term perspective. The 'structural primary balance' is an indicator which gives the most accurate view of the situation in public finances. The 2011 deficit (4.94% of GDP), adjusted for the impact of the economic cycle, one-off effects, debt interest payments, and for the fiscal performance of state corporations and the NBS, amounts to 2.8% of GDP.

The second step is to quantify the baseline scenario, which the Fiscal Responsibility Act defines as a long-term forecast of general government revenues and expenditures (including the implicit and contingent liabilities), which takes into account future economic and demographic developments and the current legislative framework. In other words, what would happen if policies did not change. The baseline scenario quantification requires (i) demographic forecasts, (ii) macroeconomic forecasts, (iii) medium-term scenario, (iv) projection of revenues and expenditures sensitive to population ageing, and (v) other implicit and contingent liabilities.

The demographic forecasts of Eurostat indicate quite a major change for Slovakia over the next decades. The increase in life expectancy, coupled with the retirement of strong baby-boom population segments, will bring about massive population ageing, which will not be reverted by the forecast horizon even by the anticipated increase of fertility. The number of those aged 65+ will more than double by 2060, whereas and the number of those in the productive age will fall by 30%. With five persons in the productive age per pensioner today, there will be less than two in 2060.

This bleak demographic outlook is also closely linked with macroeconomic development. While in the next 15 years, Slovakia will be catching up with the advanced economies in terms of the living standard, the rate of economic growth between 2030 and 2060 is expected to consolidate at 0.6% to 1.7%.

If we assumed no change of policies after 2011, Slovakia's deficit would reach 5.2% to 5.8% of GDP in 2015. The most negative factors would have included, in particular, year-on-year VAT revenue, rising debt interest payments, and falling dividend revenues.

The pension, healthcare, education and social care systems are the susceptible to changes in demographic parameters. In addition, the population structure must also be taken into account when planning expenditures under the insurance and unemployment schemes. Total public expenditures in these areas are likely to increase from 18.3% of GDP in 2011 to 25.8% in 2061. At the same time, general government revenues should decrease by 1.1% of GDP.

In respect of other implicit and contingent liabilities, the CBR took into account the debt ensuing from PPP projects, as well as the long-term forecasts connected with the decommissioning of nuclear power plants.

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