Report on the Long-term Sustainability of Public Finances

April 2013

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

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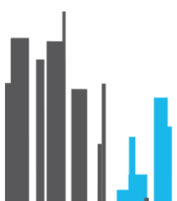


Summary

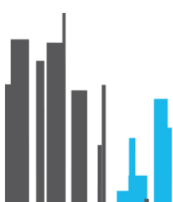
One of the main tasks of the Council for Budget Responsibility is to draw up annual Reports on the Long-term Sustainability of Public Finances (as of 30th April). Even though the extraordinary report of December 2012 was published only several months ago, the long-term trend analysis has been enriched fairly substantially. **The following factors, in particular, have introduced new perspectives: incorporation of the adopted pension system reform into the key indicators, first indicative quantification of the government's net worth for 2011, development of the health-cost scenario, other sensitivity analyses, and calculation of the cost of consolidation delay.**

On the whole, the **changes adopted in the pension system's pay-as-you-go pillar, as well as the 2011-2012 reduction in general government deficit, improved Slovakia's long-term sustainability of public finances quite significantly**. If Slovakia's public debt is to remain below the upper limit set by the Fiscal Responsibility Act in the following 50 years, **the public finance balance will have to improve by 4.3% of GDP (i.e. 2.7% less than in 2011) through a combination of permanent revenue- and expenditure-side measures**. If fiscal consolidation continues through 2018 as planned (according to the 2013-2016 Stability Programme), the long-term sustainability indicator will fall to 0.6% of GDP, bringing public finances significantly closer to the trajectory of sustainability .This will, however, require the adoption of additional measures designed to boost the growth potential or structural measures focusing on those expenditure categories that are sensitive to population ageing, or debt reduction through budget surpluses.

In addition to the analysis of the results for 2012, the report also looks back at 2011. Each year, fiscal indicators are subject to minor or major revisions two years in retrospect. The revisions for 2011 are due to the following reasons: upward revision of the notified deficit, adjustments of one-off impacts, and revised fiscal results of state corporations. As a result, the 2011 structural primary balance reached -2.7% of GDP.

Eurostat published the 2012 debt and deficit figures at the end of April. The 2012 general government budget was approved with a deficit of 4.6% of GDP. **According to the preliminary data released by Eurostat, the deficit reached 4.3% of GDP, which is 0.3% of GDP better than budgeted. The 2012 primary structural balance reached -2.3% of GDP, which is 0.3% of GDP better compared to 2011.** Without the legislative measures adopted during 2012, the deficit would have reached 4.8% of GDP. General government debt in 2012 reached 52.1% of GDP, up 8.8% of GDP year-on-year.

Apart from the adopted legislative measures, the results for 2012 deviated quite considerably from the budgeted figures in a number of areas. The most negative impacts were due to the lower-than-budgeted tax revenues and certain one-off non-tax revenues. On the other hand, the EU budget-related expenditures were lower than planned. The budgets of municipalities, self-governing regions, public universities and the Social Insurance Agency, came in as a positive



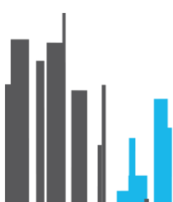
surprise. However, the CBR believes that some of these improvements are neither sustainable nor desirable, such as the cuts in co-financing or radical reductions in capital expenditures.

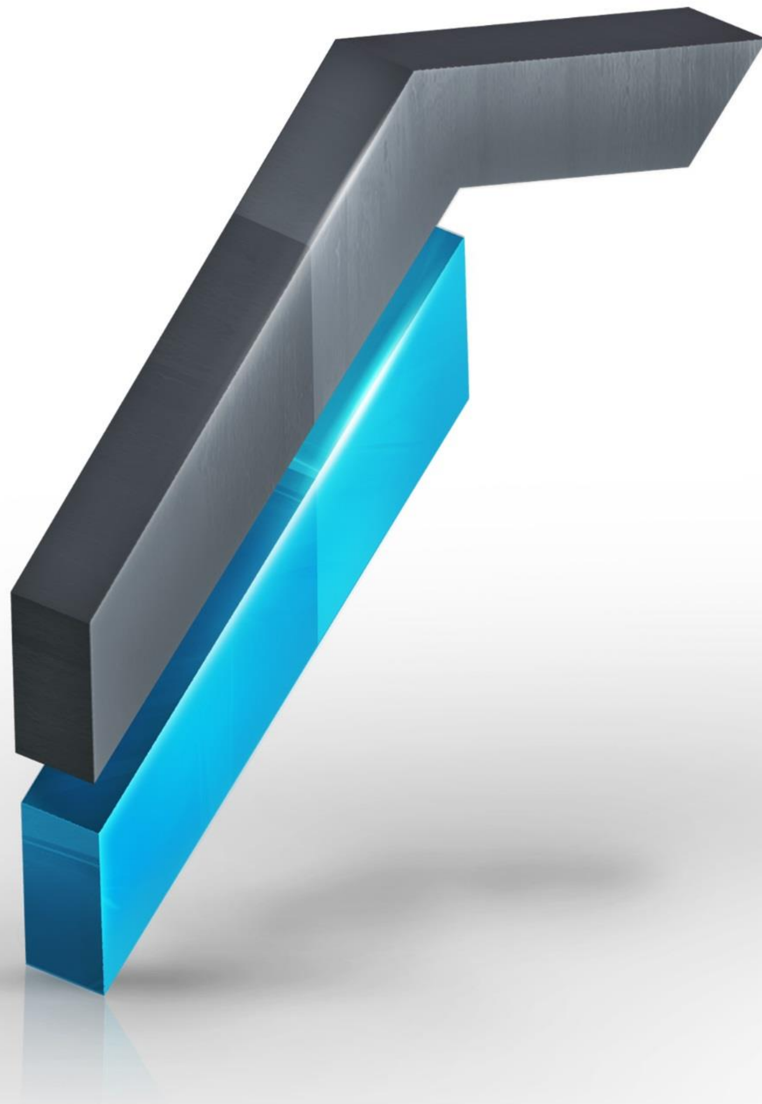
Calculation of the long-term sustainability indicator (GAP) is a standard component of the reports. **In the scenario based on 2012, the indicator reached 4.3% of GDP, which was 2.7% of GDP lower than under the 2011 scenario.** Apart from the better initial position (deficit reduction), the **improvement is mainly attributable to the measures taken in the pension system (linking the retirement age to average life expectancy, modified pension indexation mechanism, and higher social insurance contributions)**, which have been reflected in more favourable macroeconomic assumptions (higher rates of participation in the labour market due to increasing retirement age). By 2062, the expenditures sensitive to population ageing should increase by 3.7% of GDP compared to 2012 (of which healthcare and long-term care represent 2.2% of GDP).

Notwithstanding the GAP reduction in 2012, it is obvious that any further GAP reductions will require continued budget consolidation or adoption of structural changes for those expenditure categories that are sensitive to population ageing. With the pension system reform implemented, significant risks concentrate **mainly in the healthcare and long-term care sectors**. The analysis of the cost of consolidation delay also shows that a five-year inactivity would necessitate additional long-term consolidation effort of 0.4% of GDP.

In order to illustrate possible changes, the document also quantifies three alternative scenarios: consolidation scenario (by 2018), debt-slashing scenario (reduction of public debt by 10% of GDP), and the distant-horizon scenario (60 years). The first reduces GAP by 3.7 percentage points. The second and third increase GAP by 0.1 p.p. and 0.3 p.p., respectively. Sensitivity to the changes in the interest rate and labour productivity assumptions has been analysed in a similar fashion. With interest rate lower by 0.5 p.p. the GAP indicator falls by 0.1% of GDP. If labour productivity increases by 0.25 p.p. over the entire horizon, the effect is even more beneficial, with GAP lower by 0.2% of GDP.

The first-ever quantification of the government's net worth in 2011 reached negative €198.5bn (-287% of GDP). The negative value is mainly attributable to high implicit liabilities – unprovided-for commitments in the pension system and healthcare due to population ageing. Net worth is a sort of 'equity of the state'. As in the corporate sector, it appears on the right side of the balance sheet. **Generally speaking, this indicator should be considered mainly in qualitative terms for the time being; its quantitative dimension can be analysed more deeply based year-on-year changes.** Once the 2012 data are available (based on the same methodology), it will be possible to analyse more in depth what contributed towards the increase/decrease in Slovakia's net worth, be it the overall setup of public expenditures, changes in the value of assets on financial markets, fiscal performance of state corporations, or reforms in the pension and healthcare systems. Such an analysis is beneficial mainly in that it gives the right incentives to the economic policy makers.





Council for Budget Responsibility

Imricha Karvaša 1
Bratislava 1
813 25
Slovakia

www.rozpoctovarada.sk