



Report on the Long-term Sustainability of Public Finances for 2016

Summary

April 2017

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This report presents the official positions of the Council for Budget Responsibility in line with its mandate laid down in Act No. 493/2011 on Fiscal Responsibility.

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Any suggestions or comments on the report are welcome at sekretariat@rrz.sk.

Summary

The drawing up of Reports on the Long-term Sustainability of Public Finances is one of the main tasks of the Council for Budget Responsibility (“CBR”) laid down in the Fiscal Responsibility Act. The objective of these annual² reports is to evaluate the condition of public finances over the next fifty years, taking into account the current setup of policies. The present report evaluates the long-term sustainability of public finances based on the 2016 general government’s fiscal performance and revises the 2015 evaluation in order to ensure methodologically correct comparison.

The long-term sustainability of public finances improved further when public finances in 2016 got on a sustainable footing in the long run for the first time ever. This means that under the current macroeconomic scenario, demographic development and policy assumptions (i.e., the baseline scenario), the debt should not exceed the upper constitutional limit (50 % of GDP) until 2066. Under current policies, the debt should decline below 20 % of GDP in the next 20 years, which will create sufficient room for it to spring back towards the constitutional limit at the end of the period when the impacts of negative demographic development are expected to culminate. Therefore, in setting its medium-term budgetary objectives the government should take into account the baseline scenario, the materialisation of which a necessary condition for keeping public finances on a sustainable basis in the long term. In the medium term, the government should make full use of the currently favourable macroeconomic conditions, coupled with reduced expenditures resulting from the measures adopted under the pay-as-you-go pension system pillar, in order to attain a surplus of 0.4 % of GDP by 2020 and reduce the debt to 43 % of GDP. The objectives defined by the government in the 2017-2020 Stability Programme³ for the years 2017 to 2019 are in line with the long-term sustainability of public finances. Nevertheless, once the 2020 objective has been met, the government will have to take additional measures worth 0.3 % of GDP to bring public finances on a sustainable basis in the long run.

In February 2017, Eurostat published its updated demographic forecasts (EUROPOP₂₀₁₅) which the CBR took into account in assessing dynamics in the development of individual demographic assumptions (fertility, mortality, migration). The update of the Eurostat demographic projections (EUROPOP₂₀₁₃ versus EUROPOP₂₀₁₅) has attenuated the negative impacts of population ageing in the next fifty years, particularly as a consequence of higher birth rates and a slightly higher inflation. In spite of that, from 2066 onwards Slovakia will be confronted with the second biggest age-structure change in the whole of Europe and thus remains among the countries that are most affected by population ageing. **Updated demographic assumptions have improved the sustainability indicator by 0.2 p.p. in both 2015 and 2016.**

¹ [Constitutional Act No. 493/2011 on Fiscal Responsibility](#), Article 4, paragraph 1a)

² The long-term sustainability report is published annually by 30 April and always within 30 days of the parliamentary vote of confidence and government manifesto of the incoming government.

³ In 2018, the general government deficit is at 0.5 % of GDP and the objective for 2019 and 2020 is to achieve a balanced budget.

The long-term sustainability indicator published in the report of April 2016 was based on the 2015 figures. **Its value of 1.4 % of GDP has been revised to the present 0.4 % GDP.** This improvement is mainly attributable to the updated projection of pension system expenditures in connection with updated demographic forecasts and the reduced general government deficit in 2015. At the same time, the better-than-projected macroeconomic development increases the forecast of tax revenues in the medium term.

In 2016, the long-term sustainability indicator reached negative 0.1 % of GDP for the first time ever, which means that the **long term sustainability of public finance has been achieved.** The sustainability of public finances is mainly attributable to lower pension system expenditures (declining in the next twenty years), education sector expenditures (declining number of students) and anticipated favourable development in the medium term. On the other hand, **sustainability is negatively affected by the continually rising healthcare and long-term care expenditures; their adverse contribution to the long-term sustainability indicator represents almost 1.0 p.p.**

One of the factors contributing to the year-on-year improvement of the indicator by 0.5 % of GDP was the 2016/2015 reduction in general government deficit, which is partially offset by lower deficit reductions in the medium term⁴. The remaining factors, including the long-term projections of the revenues and expenditures sensitive to demographic changes, had a minimal impact on the change of the indicator⁵.

Since 2011, when the CBR began to evaluate long term sustainability, **the indicator has improved significantly, from the original 6.8 % of GDP to -0.1 % of GDP in 2016.** This development has been driven by three main factors. The first entails gradual improvements in the structural primary balance of public finances – particularly the general government deficit reductions, better macroeconomic development in the medium term, as well as the parametric changes in the pay-as-you-go pension system⁶ and the pension system of the uniformed corps.

Keeping the size of the deficit and debt at the 2016 level will not be sufficient to maintain public finances sustainable in the long term. Quite the contrary, the baseline scenario assumes that **favourable macroeconomic development and the measures taken in the pension system create a margin to improve the government's fiscal performance by 2.1 % of GDP by 2020** and thus bring the budget in a slight surplus. These savings will need to be reflected in the government's budgetary objectives and the already adopted long-term measures in the pension system will have to be maintained.

Given the degree of uncertainty inherent in long-term projections, the report contains several sensitivity scenarios which illustrate the long-term sustainability indicator's sensitivity to the nature of fiscal policy, to its different definitions and to changes in various demographic and macroeconomic assumptions. Although several scenarios do not have a significant impact on the change of the indicator (impact under 0.5 p.p.), **their cumulative effect may cause a**

⁴ These items are not influenced by demographic development; the change of balance in the last year of the medium-part is compared against the balance in the baseline year. In the 2015 baseline scenario, years 2015 and 2019 are compared, while in the 2016 baseline scenario, years 2016 and 2020 are compared.

⁵ From the perspective of policies, the new projections now include the increase in the maximum assessment base from 5 to 7 times the average wage, one-off increase in the 2017 indexation at 2%, and an adjustment to solidarity ratios. These measures had a marginal impact from the perspective of long term sustainability.

⁶ Increase in the statutory pensionable age depending on life expectancy, and indexation based on inflation.

considerable deviation from the baseline scenario and necessitate the adoption of additional measures.

- The indicator would rise most steeply, by as much as 2.3 p.p., if, in the medium term, the government failed to use the margin created by faster economic growth and slower increase in expenditures, for example, due to low inflation, or by the cost-reducing measures adopted in the pension system.
- To achieve and maintain a balanced budget by 2020 in line with the government's objective set in the 2017-2020 Stability Programme is insufficient to make public finances sustainable in the long term. Since the objective is less ambitious than the baseline scenario, its meeting would worsen long term sustainability by 0.4 p.p. compared with the present evaluation.
- The negative impacts of demographic development will culminate beyond 2066 which the law defines as a reference horizon for the evaluation of long term sustainability. The extension of this horizon by 10 years would push the long-term sustainability indicator up by 0.2 p.p.
- The importance of structural changes in the areas sensitive to demographic development can be illustrated by the impact of the rise in the healthcare and pension-system expenditures. Sustainability would deteriorate significantly, by 0.8 p.p., under a risk scenario assuming higher increase in healthcare expenditures⁷ compared with the baseline scenario. The abolition of the parametric changes⁴ adopted in the pay-as-you-go pillar would inflate the indicator by at least 2 p.p.⁸
- Concerning macroeconomic assumptions, the most significant impact comes from the revised productivity growth assumption. A slower convergence of Slovakia to the EU average may increase the long-term sustainability indicator by 0.4 p.p.⁹ The implementation of structural changes which accelerate the pace of Slovakia's convergence to the EU average will have the opposite effect.
- The impacts of debt levels on economic growth, which are not reflected in the baseline scenario, can be dynamic. The positive effects of low debt levels include favourable perceptions of economic agents who, in anticipation of stable environment (low risk premia, enough capital for investments), contribute to higher economic growth. Rising debt also increases uncertainty about future developments, which may slacken economic activity and, subsequently, further increase the government debt. If consolidation was postponed (a scenario under which cost-saving measures are not implemented in the medium term) and these effects were taken into account, the debt would start to increase as early as in 2018 (against 2046 under the baseline scenario) and the level of 60 % of GDP would be overrun in 2040.

⁷ In the case of healthcare sector, the higher degree of uncertainty of projections stems from the sensitivity of expenditures to economic growth and the pace of technological progress. For this reason, a risk scenario assuming maximum elasticity at 1.4 has been used, compared with 1.1 in the baseline scenario.

⁸ In assessing the impact of parametric changes, the CBR considered only the changes in the pension system's revenues and expenditures, without calculating their macroeconomic impact on other expenditures sensitive to population ageing. For this reason, the resulting impact of these changes on the long-term sustainability may be even more significant.

⁹ The baseline scenario envisages Slovakia's convergence to 90 % of the EU-28 average, the sensitivity scenario assumes the convergence rate at 80 %. The impact should be symmetrically positive if 100 % of the EU-28 average is reached.

The results of generational accounts indicate a shift of the fiscal burden onto future generations. While each child born in 2016 will receive from public budgets in their lifetime EUR 34,000 more than their contribute, future generations would be in a completely different situation for they would have to contribute EUR 34,000 more than what they receive. The total amount of government liabilities, assuming no change in the present fiscal policy, would reach 216 % of GDP¹⁰. On the other hand, the fiscal burden on future generations in 2016 decreased compared with 2015, mainly due to improved fiscal position.

At the end of 2015, the net worth of the Slovak Republic reached negative 134.5 % of GDP, improving 15 p.p. year-on-year¹¹. This was mainly attributable to the decrease of implicit liabilities by 11.1 % of GDP in the healthcare sector¹² and in the pension system. Implicit liabilities in the pension system decreased mainly under the influence of a change in methodology based on which the liabilities connected with the pension system of the uniformed corps were excluded from implicit liabilities¹³. The year-on-year GDP growth contributed 6.5 p.p. towards the net worth increase. The equity of the entire general government sector decreased by 2.8 % of GDP, mainly under the influence of the fiscal deficit that year. In the interest of making the net worth indicator more representative, it would be appropriate to amend the methodology of data processing in a manner that links the government's fiscal performance to changes in net worth. The Summary Annual Report¹⁴ also contains a chapter on the deposits of ground water, as one of the components of net worth, without specifying their value in the financial statements; the chapter contains only a basic overview of water resources without quantifying their impact on net worth.

¹⁰ The amount is expressed at 2016 prices. This is a different concept from the long-term sustainability indicator because it takes into account a longer time horizon, and the expenditures linked to population ageing will culminate beyond the baseline scenario's 50-year horizon.

¹¹ The interpretation of the negative value of net worth remains difficult due to problems with the valuation of certain assets and liabilities which may change the net worth value quite significantly. For this reason, the analysis of a year-on-year variation appears to be more appropriate.

¹² The improvement is mainly due to the revised forecast of revenues from social security contributions.

¹³ The change removed a duplication in the net worth estimate, since the reserves created to finance future expenditures of the uniform corps' pension system are part of the equity of the entire general government sector.

¹⁴ [2015 Summary Annual Report](#) (available only in Slovak)

Long-term sustainability indicator

It expresses by how much the budget balance must be improved on a permanent basis (by reducing public expenditures or increasing tax revenues) for gross public debt in the next 50 years not to exceed 50 % of GDP, that is the upper limit set by the constitutional act. The government should strive to bring the value of the indicator to or below zero.

0.4 % of GDP

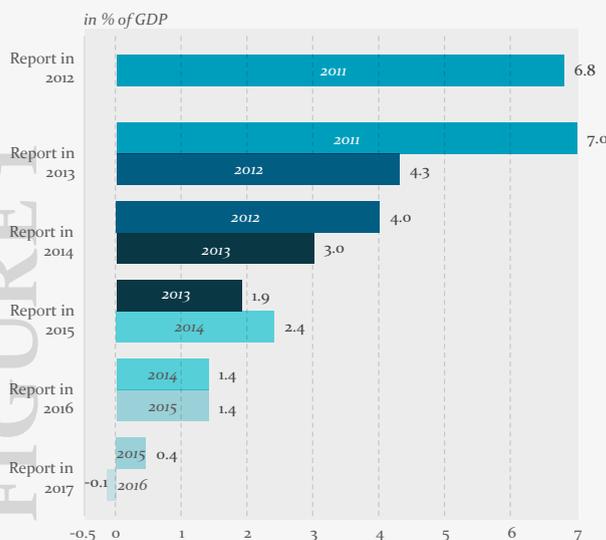
is the value of the indicator in 2015

-0.1 % of GDP

is the value of the indicator in 2016

Long-term sustainability has improved compared with the past year

Long-term sustainability indicator



Change



Most significant impacts on long-term sustainability

Reform of the pension system, consolidation measures in 2013

Improved budget balance, reform of the pension scheme for the uniformed corps

Worsened balance in 2014, partially offset by changes in tax legislation in 2015

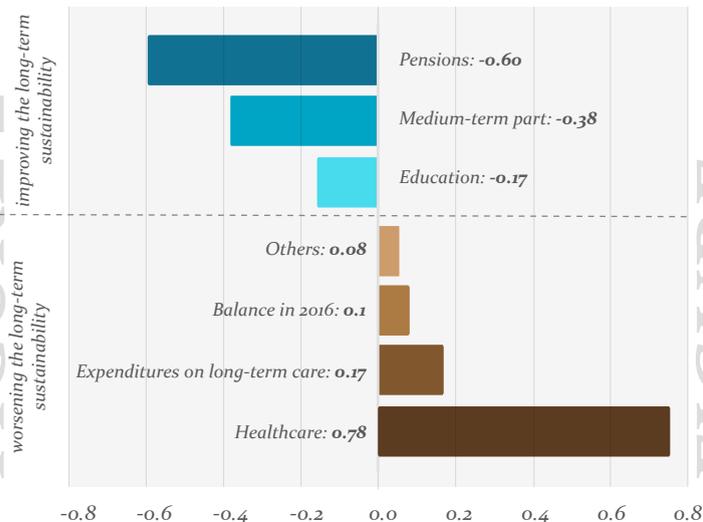
Worsened balance in 2015, introduction of minimum pensions, compensated by lower debt and more favourable impact of macroeconomic development on the medium-term scenario

Improved budget balance

Long-term sustainability is mainly worsened by the healthcare

long-term sustainability indicator = -0.11 % GDP

in % of GDP Source: CBR

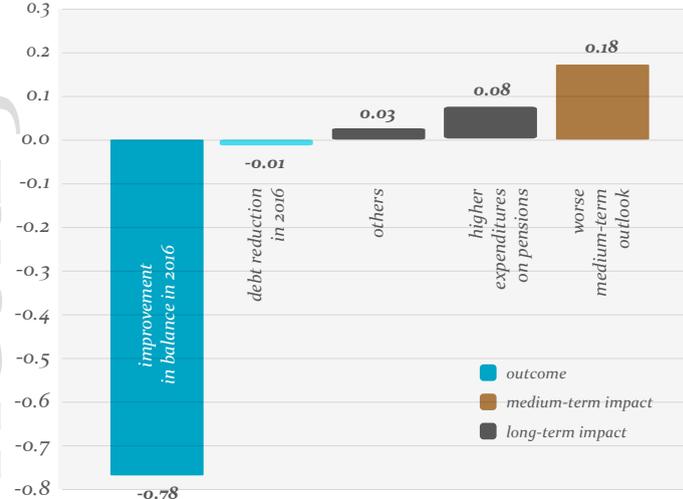


Note: Impact of the starting fiscal position, i.e. structural primary balance in 2016

Contributions to change in long-term sustainability between 2015-2016

Total change in the long-term sustainability indicator = -0.5 %

in % of GDP Source: CBR



Sensitivity scenarios

Long-term projections are typically accompanied by a higher degree of uncertainty. From the viewpoint of their stability, it is also useful to know the impact which the more optimistic or less pessimistic developments of key assumptions would have on the budget.

A failure to use favourable development for consolidation would increase the need to adopt measures with an impact of

2.2 % of GDP

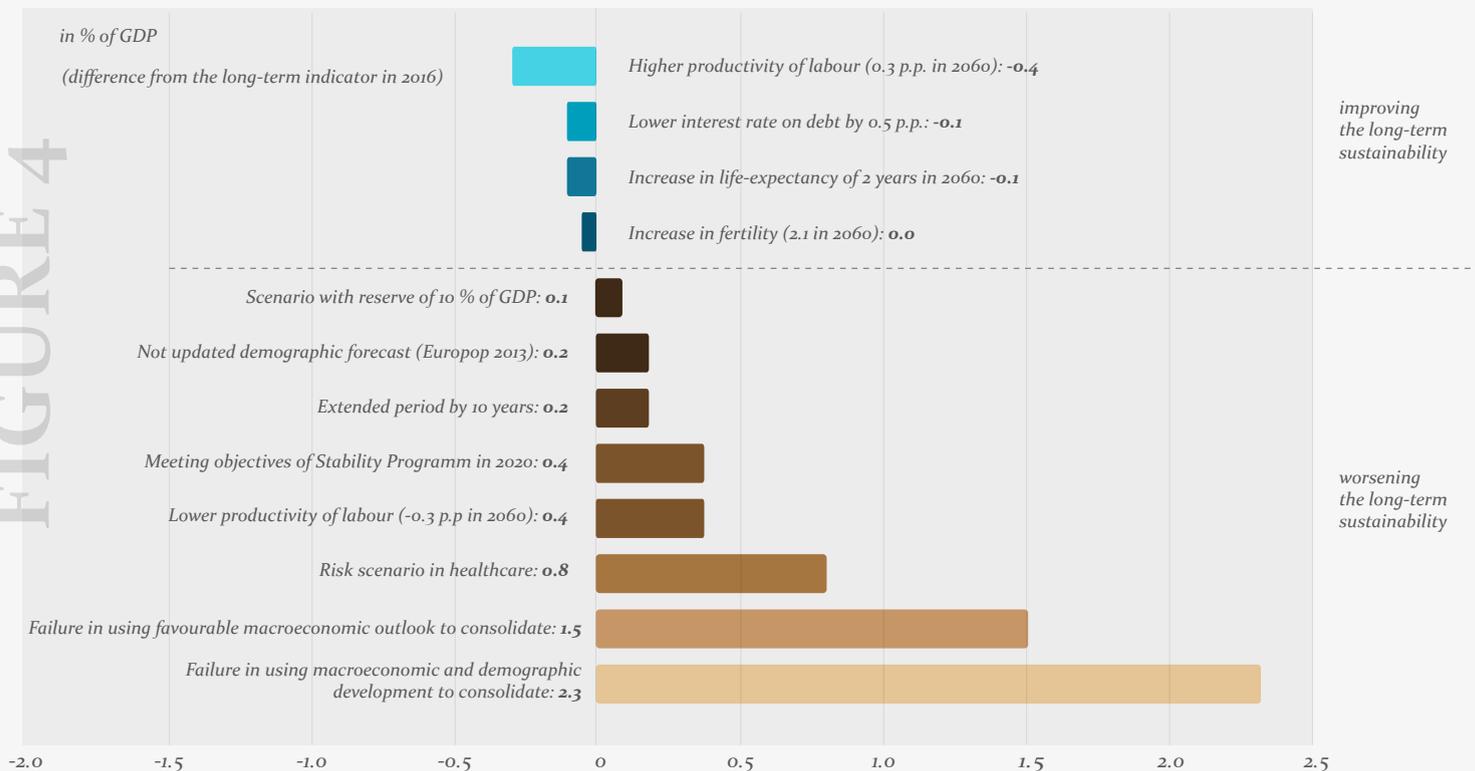
Higher labour productivity by 0.3 p.p. would reduce the need to adopt measures with an impact of

0.3 % of GDP

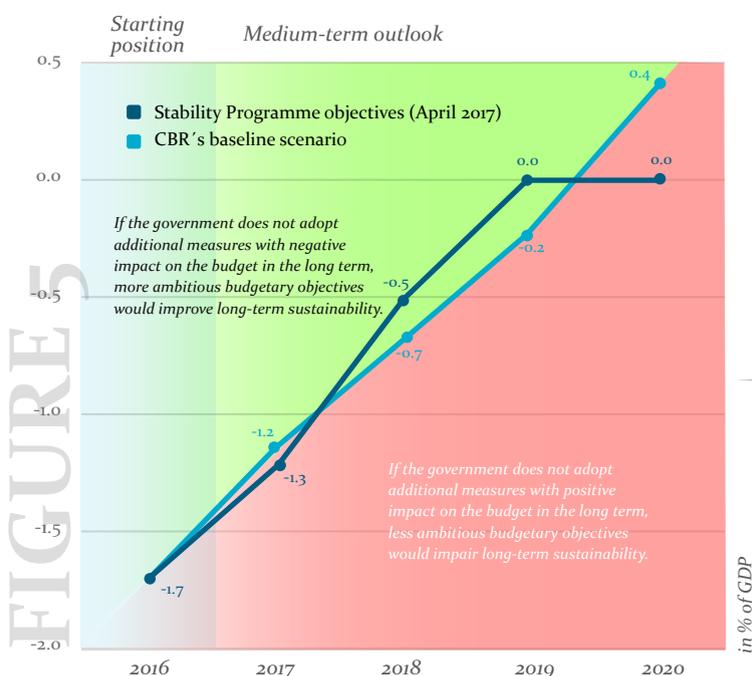
A faster increase in healthcare expenditures would increase the need to adopt measures with an impact of

0.6 % of GDP

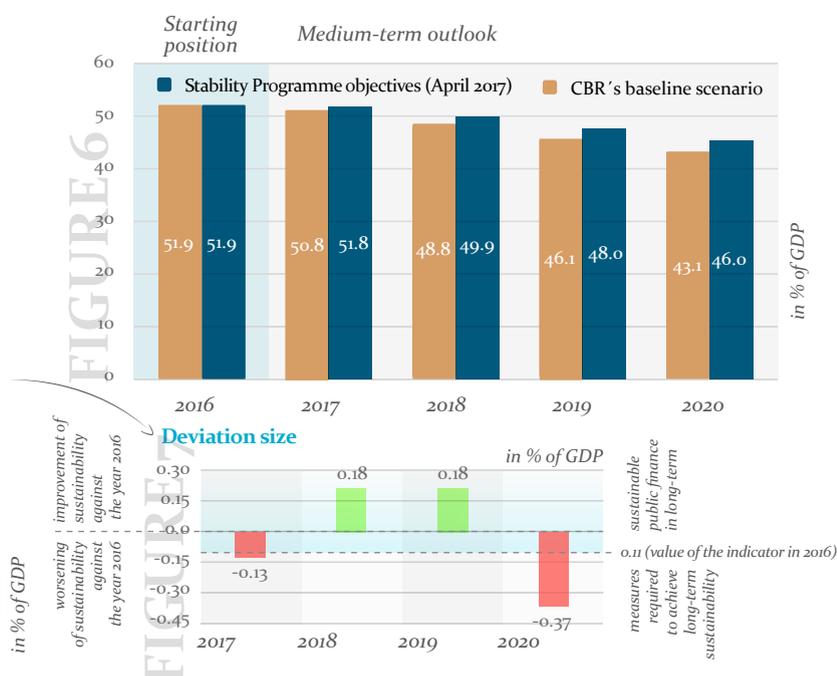
FIGURE 4



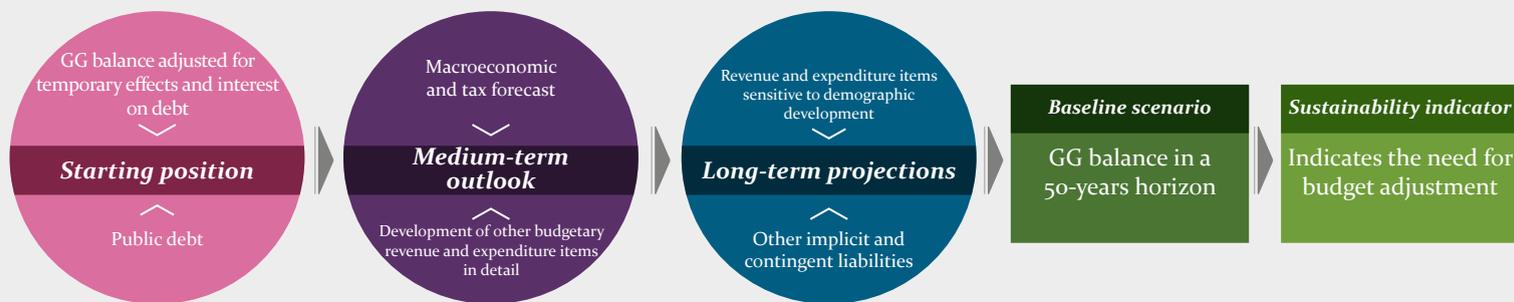
Government's budgetary objectives and their impact on long-term sustainability



Stability Programme assumes a slower debt reduction



Approach to evaluate long-term sustainability (public finance solvency)



Starting position (2016)

Compared with 2015, structural primary balance improved by 0.7 % of GDP, mainly as a consequence of better fiscal performance of the general government sector (also after the exclusion of dividends received from state corporations) and better results of the NBS compared with the year before. General government gross debt reached 51.9 % of GDP at the end of 2016. It declined 0.5 p.p. year-on-year, particularly under the influence of GDP growth.

FIGURE 8

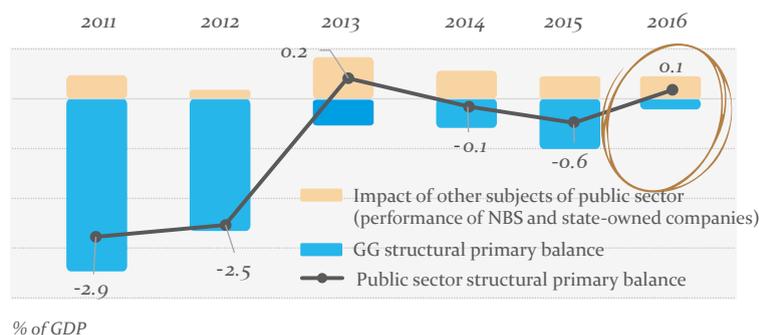
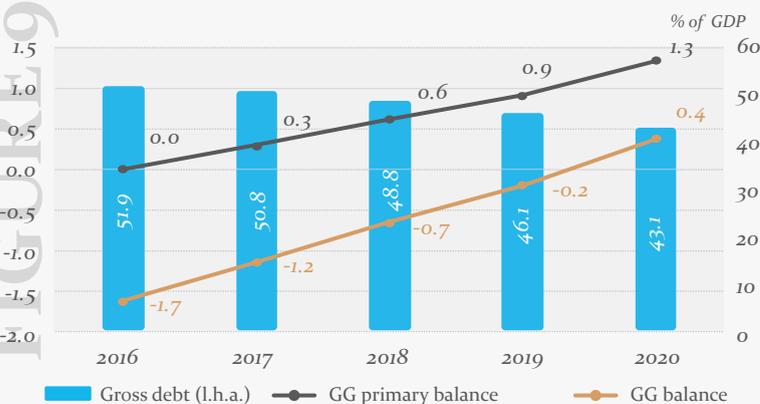


FIGURE 9



Medium-term outlook (2017-2020)

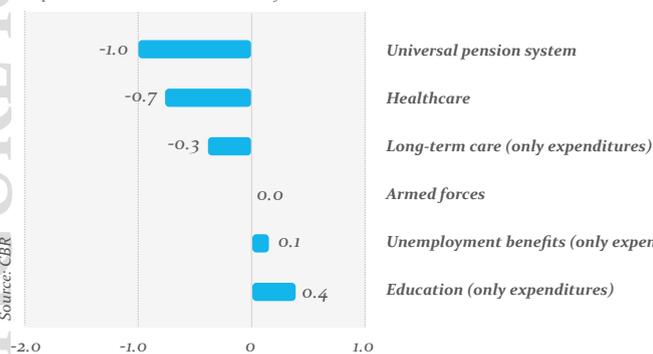
In the medium-term, assuming no change in policies, the deficit is expected to shrink gradually and the budget will show a surplus of 0.4 % of GDP in 2020. This will also be due to lower interest expenditures (lower interest rates) and gradual debt decline to 43.1 % of GDP. The medium-term scenario shows that the present outlooks for economic development create room for substantial improvement of the balance without government interventions.

Long-term impacts of demographic development

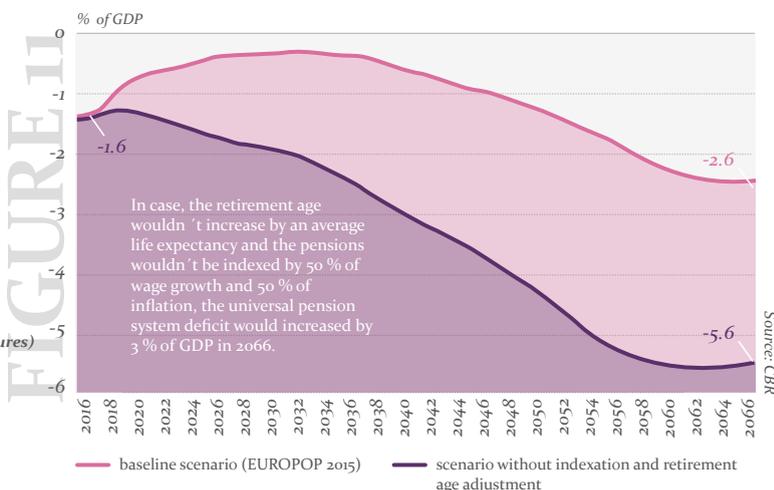
By 2066, demographic changes will contribute towards the worsening of the balance by 1.9 % of GDP, mainly under the influence of pension schemes and rising expenditures on healthcare and long-term care.

FIGURE 10

Impact on GG balance in 2066 in % of GDP



Measures of the pension system will contribute to the GG balance improvement in the next 15 years



Baseline scenario of general government budget development

The baseline scenario shows how the general government balance and debt would develop if the government and parliament refrained from adopting new measures and the development would be influenced solely by anticipated economic and demographic developments. It provides useful information on the consequences of current policies in the future.

44.6 % GDP

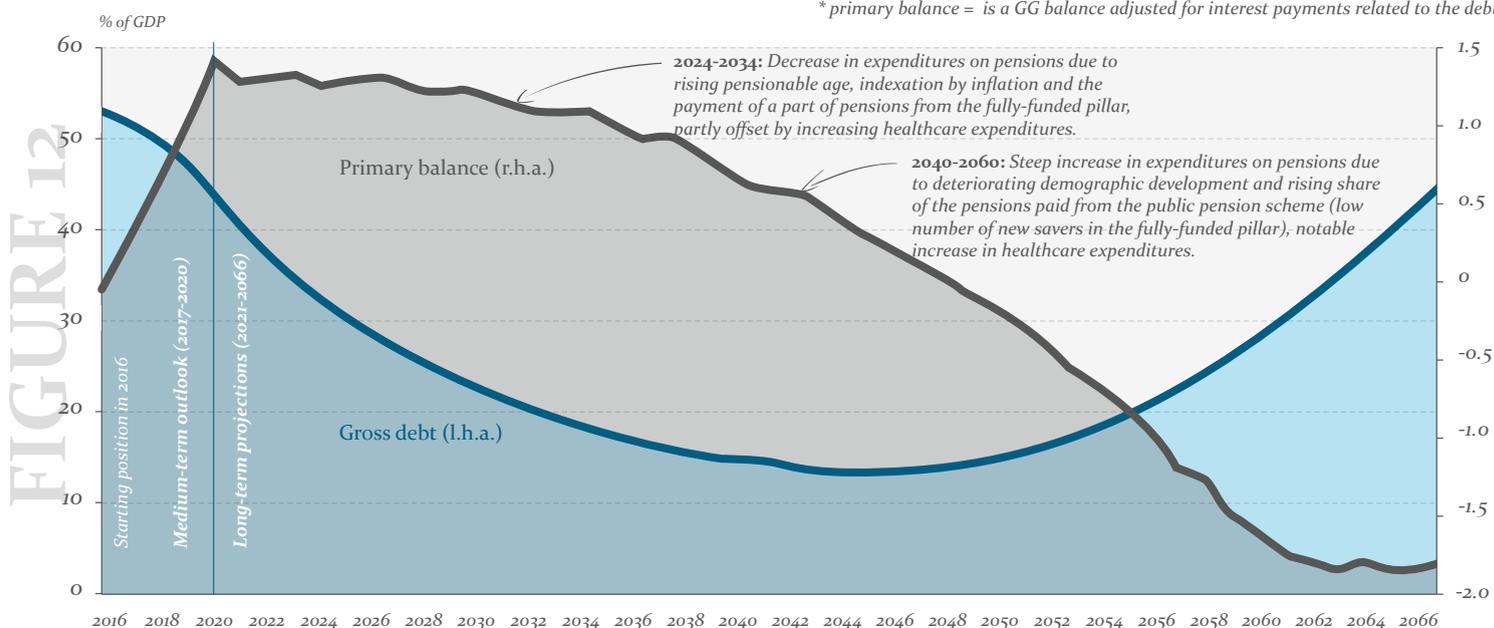
debt amount
in 2066

2046

is the year when the
debt begins to grow

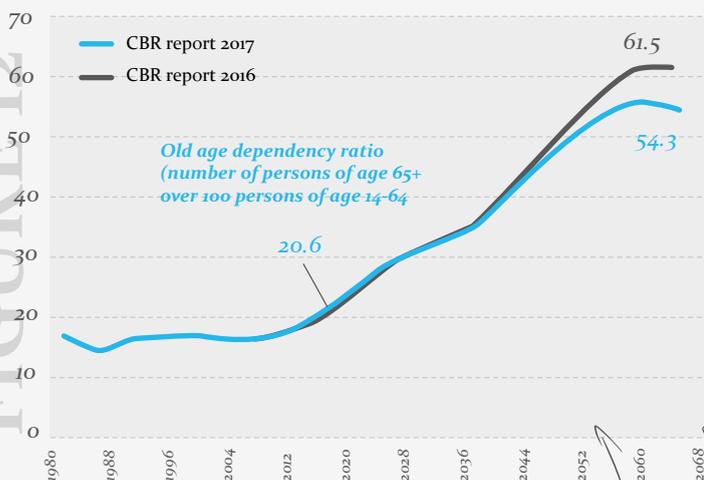
-1.6 % GDP

is the decline in
primary balance by
2066*

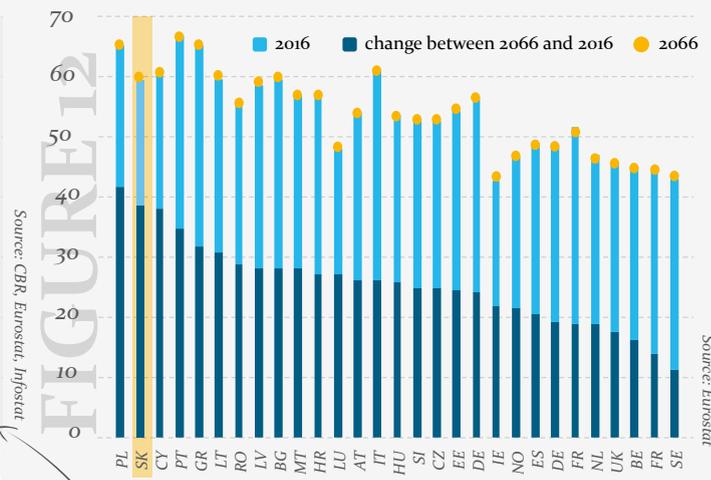


Demographic outlook

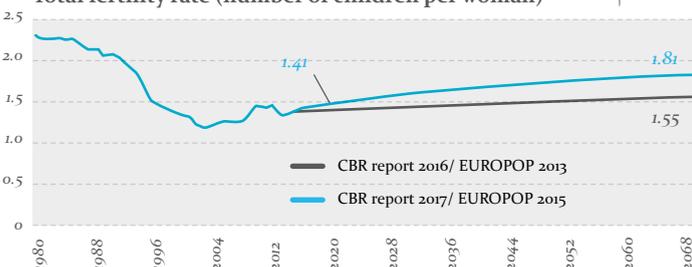
Old age dependency ratio - outlook until 2066



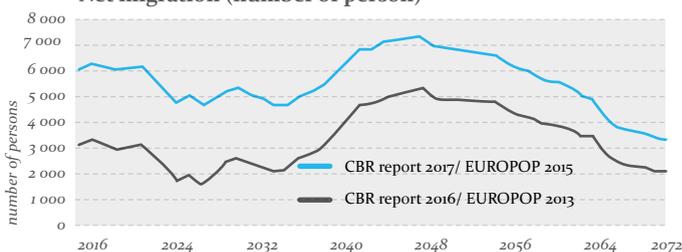
Old age dependency ratio - country comparison



Total fertility rate (number of children per woman)



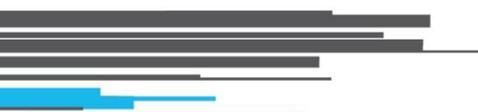
Net migration (number of person)





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