



Report on the Long-term Sustainability of Public Finances for 2017

Summary

April 2018

© Secretariat of the Council for Budget Responsibility, 2018

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 the Report 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 the report is to evaluate the condition of public finances over the next fifty years, taking into account the public finance outcomes in 2017 and the existing setup of policies. In order to ensure a methodologically correct comparison, the report also includes an update to the 2016 evaluation. Because the new Slovak government approved its Manifesto on 26 March 2018, the report is therefore submitted on 25 April 2018¹, i.e., outside the standard reporting cycle, as prescribed by the Fiscal Responsibility Act.

The long-term sustainability indicator reached 1.1 % of GDP in 2017. In order to keep the general government debt below the debt ceiling (50 % of GDP) over the next fifty years, it is necessary to adopt (beyond the framework of baseline scenario assumptions) additional measures totalling some 1.1 % of GDP in the medium term. Sustainability worsened by 0.3 % of GDP year-on-year. The Government has not taken full advantage of the favourable economic developments in 2017 for improving the fiscal position. The adjusted budget balance improved by 0.2 % of GDP year-on-year, which is 0.2 % of GDP less than the expectations under the no-policy change scenario using the figures for 2016². As regards other measures, the long-term sustainability has worsened year-on-year also due to the introduction of the temporary minimum pension indexation amount. The baseline scenario for the development of general government revenues and expenditures³ based on 2017 assumes that, by 2021, the budget balance would automatically improve by 0.5 % of GDP without further measures of the government. The deficit will be declining in particular as a result of savings in interest payments and expenditures in the pension systems due to parametric changes made in the previous years⁴. In order to prevent the long-term sustainability from worsening in comparison with 2017, these savings must inevitably be fully reflected in a better budget balance. Reaching the trajectory of long-term sustainability requires a structural surplus between 0.3 and 0.4 % of GDP by 2021, and this would have to be taken into account when setting the medium-term budgetary objectives.

¹ In accordance with Article 4(1)(a) of [Act No. 493/2011 Coll. \(the Fiscal Responsibility Act\)](#), the CBR draws up and publishes the long-term sustainability report, including the baseline scenario and determination of the long-term sustainability indicator, annually as of 30th of April and always within 30 days of the parliamentary debate on the Government Manifesto and the vote of confidence in the government.

² Reduction of the general government deficit from 2.2 % of GDP in 2016 to 1.0 % of GDP in 2017 was, to a large extent, influenced by one-off factors beyond the control of the government (e.g., corrections to EU funds, debt interest payments, impact of the economic cycle). When adjusted for these items, the balance improved by 0.2 % of GDP year-on-year, which is 0.2 % of GDP less than assumed in the no-policy change scenario (a year-on-year improvement in the balance by 0.4 % of GDP).

³ Reflecting the fiscal performance results in 2017, the current macroeconomic and demographic development in the application of the existing policies.

⁴ Increasing the age of retirement to 62 years and subsequently linking it to the average life expectancy, pension indexation on the basis pensioners' inflation rate (parametric changes).

One of the reasons why Slovakia's public finances failed to reach the long-term sustainability in 2017 was the revised evaluation for 2016. In the Report on the Long-term Sustainability of April 2017, the long-term sustainability indicator had a negative value of 0.1 % of GDP, which allowed the CBR to note that the long-term sustainability of public finances had been reached. The updated indicator reached a positive value of 0.8 % of GDP for 2016 and deviated from the long-term sustainability. The revision of fiscal performance results in the general government sector for 2016⁵, as well as the expectations of worse budgetary development in the medium term until 2021⁶ contributed to the worsening of the indicator with an amount of 0.27 p. p. (involving, in particular, a more rapid decline in tax revenues relative to GDP). The contribution of changes unrelated to the government measures, which were included for the sake of comparability in the development of the indicator between 2016 and 2017, amounted to 0.67 p. p. This involves updated projections of expenditures related to population aging due to changes in the long-term assumptions and improvements in modelling⁷.

In 2017, the long-term sustainability indicator represented 1.1 % of GDP and slightly surpassed the low risk threshold⁸ for long-term sustainability. The starting position, structural primary surplus, contributed positively to sustainability in 2017. However, expenditures sensitive to demographic changes have worsened the sustainability by 0.5 % of GDP. The increasing health care sector expenditures and long-term care expenditures have the most negative impact, at 0.8 % of GDP, which is partly compensated for by the positive effect of expenditures on pensions (due to a decline in expenditures over the next twenty years⁹). The development in other revenues and expenditures until 2021¹⁰ has a negative impact on sustainability, at 0.7 % of GDP, in particular due to the expected decline in tax revenues and non-tax revenues in proportion to GDP.

⁵ The April 2017 report was based on preliminary data as notified by Eurostat in April 2017. The data is subsequently revised in October 2017 and April 2018.

⁶ The medium-term horizon reflects the most recent medium-term macroeconomic forecast which is based on the actual figures for 2016. At the time of the long term sustainability evaluation (April 2017), the medium term forecast is based on the actual data which is regularly updated in the fall (2017) and can be fully reflected only in the revision of the evaluation in the subsequent year (2018).

⁷ This involves incorporating the European Commission's current projections regarding the long-term care, education, unemployment and capital revenues with a total contribution of 0.41 p. p. and the update of input data regarding the number of new pensioners, the new method of modelling the widow's and widower's pensions based on the probability of the partner's death for the married population (the previously applied approach was based on the share in the total population of the given age cohort), a more precise link between the income-based disaggregation of existing pensions and new pensions by including the age dimension (previously the age- and income-based disaggregation had been modelled separately), as well using its own approach to the projection of expenditures on education and unemployment with a total contribution of 0.26 p. p.

⁸ The indicator values below 1 % of GDP are considered by the CBR a slight deviation carrying a low level of risk for the long-term sustainability. This threshold corresponds to uncertainty associated with long-term projections when, as a result of standard updates to assumptions or improvements in methodology, the indicator may be subject to more significant changes. This approach is also used by the CBR in evaluating the balanced budget rule and in assessing the appropriateness of the medium-term budgetary objective.

⁹ Even though the pension expenditures until 2067 will grow by 0.9 % of GDP in comparison with the current situation, their effect on the long term sustainability will be positive. The reason is that they will be declining over the next twenty years, which, due to discounting, will bring a more positive contribution to sustainability than the negative effect brought by an increase in expenditures in the subsequent years.

¹⁰ After 2021 these expenditures are fixed as a share in GDP.

The government used part of the positive factors occurring in macroeconomic development and savings in the pension system (parametric changes) for additional expenditure measures which caused the deterioration of sustainability. The year-on-year worsening of the indicator by 0.3 % of GDP was contributed to by a higher deficit in public finances in 2017 in comparison with the assumptions of the baseline scenario using the figures for 2016 (0.17 p. p.). The favourable macroeconomic development and the application of existing policies would reduce, according to the 2016-based baseline scenario, the 2017 deficit to 0.9 % of GDP. In 2017, the general government deficit reached 1.0 % of GDP which means that the year-on-year improvement in the balance was not sufficient for preserving the long term sustainability and has departed from the 2016-based baseline scenario². The current projections also include the effect of the introduction of the minimum pension indexation amount applicable to 2018 through 2021. In terms of the long-term sustainability, this measure will have a negative impact (by 2021, expenditures on pensions will increase by some 0.15 % of GDP; subsequently, their negative effect will gradually diminish over the period of 30 years)¹¹.

Taking full advantage of the favourable macroeconomic development, lower pension system expenditures and interest payments which will be automatically improving the fiscal performance until 2021 is a determining factor for preventing the deterioration of the long-term sustainability against the situation in 2017. The baseline scenario assumes an improvement in the budget balance by 0.5 % of GDP in the medium term. In terms of structure, the positive contribution can be attributed to revenues and expenditures sensitive to demographic development (in particular a decline in expenditures in the pension system), at 0.4 % of GDP, and to the reduced interest payments in the amount of 0.5 % of GDP. Other revenues and expenditures worsen the balance by 0.5 % of GDP in the medium term. If the expected positive factors of the budget are not reflected in the improved balance, the long-term sustainability would worsen in comparison with the current evaluation of the year 2017.

In order to achieve sustainable public finances, the structural surplus of the budget would have to be between 0.3 % and 0.4 % of GDP by 2021, depending on the chosen pace of consolidation¹². Beyond the framework of the 2017 baseline scenario, which already assumes that the structural balance will improve from -1.2 % of GDP in 2017 to -0.8 % of GDP in 2021, it is necessary to adopt additional measures amounting to some 1.1 % of GDP (the value of the long-term sustainability indicator). The medium-term budgetary objective should reflect, in addition to short-term and long-term government targets, also the risks arising from long-term sustainability. Compliance with the medium-term budgetary objective as defined in

¹¹ Savings brought by the pension system reform in 2012 (in particular linking the age of retirement to the average life expectancy and pension indexation with the pensioners' inflation) provide the funding for measures aimed at additional increase in pensions (Ministry of Finance, [Draft Budgetary Plan for 2018](#), pg. 43). This reduces the positive effect of the reform on the long-term sustainability of public finances.

¹² In the event of an immediate improvement in the balance as of 2018, achieving the long-term sustainability would require measures totalling 1.09 % of GDP, i.e., the 2021 structural surplus would reach 0.34 % of GDP. With a gradual and steady improvement of the balance against the baseline scenario, the total amount of measures would have to amount to 1.12 % of GDP, thus requiring a structural surplus of 0.37 % of GDP in 2021. The difference between both approaches involves the so-called cost of delay (amounting to 0.03 % of GDP).

the Stability and Growth Pact¹³ (a structural deficit of 0.5 % of GDP) would not be sufficient for ensuring the long-term sustainability of public finances.

Given the high 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 (up to 0.5 p.p.), **the potential cumulative effect of negative impacts may cause a considerable deviation from the baseline scenario and necessitate the adoption of additional measures.** On the contrary, positive effects may reduce the need for adoption of measures aimed at attaining the long-term sustainability.

- Sustainability would worsen to as much as 2.1 % of GDP (i.e., by 1.0 p.p.), if the government fails to use, in the medium term, the margin created by faster economic growth and slower increase in expenditures, for example, due to low inflation or cost-reducing measures adopted in the pension system, in order to reduce the debt.
- 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 worsen significantly, by as much as 0.8 percentage points, under a risk scenario assuming higher increase in healthcare expenditures¹⁴ compared with the baseline scenario.
- Sustainability would worsen by 0.4 p.p. if the considerations regarding the introduction of an upper limit for retirement age at 65 years materialise.
- The negative impacts of demographic development will culminate beyond 2067 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 0.2 p.p.
- On the front of macroeconomic assumptions, the most significant impact comes from the revised productivity growth assumption. Slovakia's slower convergence to the EU average may increase the long-term sustainability indicator by 0.2 p.p.¹⁵ The implementation of structural changes which accelerate the pace of Slovakia's convergence to the EU average will have the opposite effect.
- The growing public debt may affect the perception of investors (higher risk premium on sovereign bonds) and limit the domestic resources for investments. If the effects of the growing debt are reflected in economic growth, the constitutional debt limit may be exceeded sooner than predicted in the baseline scenario (roughly by five years).

¹³ According to the Stability and Growth Pact, when setting the minimum level of the medium-term budgetary objective, the expected costs associated with population ageing are taken into account as well. However, only one third of the future costs is included (EC, [Vade Mecum on the Stability and Growth Pact – 2018 Edition](#), pg. 29), while CBR considers the full amount of the costs for the next fifty years when estimating the long-term sustainability indicator and the ensuing need to improve the structural balance.

¹⁴ In the case of the healthcare sector, the higher uncertainty in projections arises from the sensitivity of expenditures to economic growth and technological progress. For this reason, the CBR used the risk-based scenario which takes into account the maximum elasticity of 1.4, whereas the baseline scenario uses 1.1.

¹⁵ The baseline scenario envisages Slovakia's convergence to 90 % of the EU-28 average, sensitivity scenario suggest convergence to 80 %. The impact should be symmetrically positive if 100 % of the EU-28 average is reached.

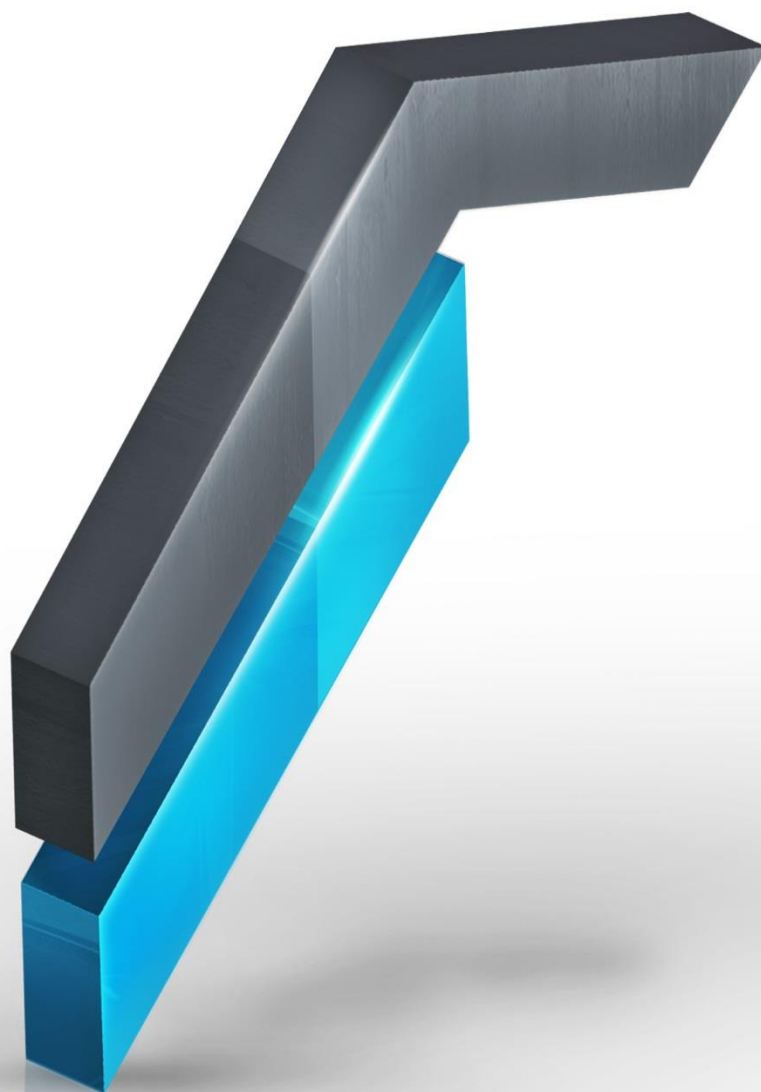
The measures adopted in the healthcare may have a more significant impact on the long-term sustainability than demographic changes. In comparison with the 2016-based baseline scenario, healthcare sector outperformed the budget by 0.3 % of GDP (almost zero year-on-year nominal growth in expenditures) which improved the general government deficit in 2017 and positively influenced the long-term sustainability indicator for 2017 by the same amount. To allow comparison, the long-term projection of revenues and expenditures in the healthcare sector worsens the long term sustainability indicator by 0.5 % of GDP. In terms of the sustainability of public finances, it is therefore necessary to proceed with currently adopted measures because the total costs in the healthcare sector are, to a large extent, influenced by the functioning of the institutions active in that sector (regulatory framework and management) and effectiveness in the provision of healthcare.

In comparison with 2016, there were no changes in the fiscal burden on future generations. The results of generational accounts analysis still indicate a shift of the fiscal burden onto future generations. While each child born in 2017 will receive from public budgets in their lifetime EUR 34,000 more than what they contribute, future generations would be in a completely different situation because they would have to contribute EUR 31,000 more than what they receive. The total amount of government liabilities, assuming no change in the present fiscal policy, would reach 218 % of GDP¹⁶.

At the end of 2016, the net worth of the Slovak Republic reached negative 148.8 % of GDP, improving 21.7 percentage points¹⁷ year-on-year. This was mainly attributable to a reduction in implicit liabilities by 17.2 % of GDP in the healthcare sector due to an updated forecast of revenues from contributions. The year-on-year GDP growth contributed 4.7 p.p. towards the net worth increase. The equity of the entire general government sector decreased by 3.3 % of GDP, mainly under the influence of the fiscal deficit that year and corrections in input parameters necessary for estimating the reserve for employee emoluments in the general government sector. Net worth also improved due to the inclusion of additional assets (receivables of the Slovenská konsolidačná in the process of recovery of claims) and the reassessment of contingent liabilities from legal disputes (MH Manažment). The inclusion of new contingent liabilities (National Highway Company) had the opposite effect. The information value of the net worth indicator would be improved by the valuation of net worth components that have not been quantified to date, the removal of methodological discrepancies in its reporting and by making adjustments to data processing method in a way that will allow linking the government's fiscal performance with its impact on the change in net worth.

¹⁶ The amount is expressed in the prices of 2017. This concept is different in comparison with the long-term sustainability indicator, as it uses a longer time horizon, while the expenditures related to population aging will peak after the 50-year horizon of the baseline scenario.

¹⁷ The interpretation of the negative value of net worth has so far been 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.



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