CBR
COUNCIL FOR BUDGET RESPONSIBILITY

Report on the Long-term Sustainability of Public Finances for 2018

Summary

April 2019

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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.

This publication is available at the CBR website (http://www.rozpoctovarada.sk).

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[1]. 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 and the existing setup of policies in 2018. In order to ensure a methodologically correct comparison, the report also includes an update to the 2017 evaluation.

The long-term sustainability of public finances was not achieved in 2018. The long-term sustainability indicator reached 1.32 % of GDP, thus moving away from the low risk threshold[2] for long-term sustainability (Figure 1). In comparison with 2017, it worsened by 0.13 % of GDP[3]. In order to keep the general government debt below the debt ceiling (50 % of GDP) over the next fifty years, additional measures on the revenue or expenditure side amounting to some 1.32 % of GDP, which will permanently improve the general government balance, would have to be adopted in the medium term (beyond the baseline scenario assumptions). This estimate does not include the negative impact resulting from the introduction of the retirement age cap[4] which will worsen the long-term sustainability by an additional 1 % of GDP.

The evaluation of the long-term sustainability for 2018 is based on data taken from the preliminary spring notification of deficit and debt which will be revised in the fall of 2019. Eurostat has expressed a reservation on the quality of the data reported by the Statistical Office of the Slovak Republic in relation to the recording of expenditures in extra-budgetary accounts[5]. Based on the currently available information, the transaction associated with the recording of a part of expenditures on extra-budgetary accounts was classified by the CBR inside one-off effects because, due to its nature, an identical positive effect on the balance is not likely to be seen in the years ahead. Should the deficit be revised for this reason, it will not have an impact on the evaluation of sustainability. If the general government deficit remains unchanged after examining the transactions referred to in the reservation and, at the same time, if their one-off effect turns out not to be the case, the long-term sustainability indicator would improve to 1.12 % of GDP in comparison with the present CBR's evaluation.

[1] 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] 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 in assumptions or improvements in methodology, the indicator may be subject to more significant changes.

[3] Due to an update, the long-term sustainability indicator for 2017 increased from 1.09 % of GDP to 1.20 % of GDP. The indicator has worsened due to a less favourable projection of the long-term macroeconomic development, which was partially offset by a reduced general government deficit in 2017, as well as by an expected and slightly more favourable development in public finances in the medium term.

[4] The reason is that the baseline scenario was based on legislation applicable as at the end of 2018, while the retirement age cap was approved in March 2019.

[5] In connection with the notification of deficit and debt of 23 April 2019, Eurostat expressed a reservation on the quality of data reported by Slovakia. This involves the recording of certain expenditures which could increase the deficit by 0.3 % of GDP in 2018. According to a statement by the Ministry of Finance of the Slovak Republic, the reservation concerns accounting changes in extra-budgetary accounts of the state budget.

The long-term sustainability has worsened for two years in a row. While its deterioration in 2017 was attributable mostly to factors beyond the government's control, in 2018 the long-term sustainability worsened in particular due to the government's fiscal performance (0.24 percentage points)(Figure 5). Some of the positive effects resulting from the macroeconomic development and savings in the pension system due to adopted parametric changes[6] have been spent by the government on additional expenditure measures. The adjusted budget balance (net of the one-off effects, the impact of the economic cycle and interest payments) has worsened by 0.4 % of GDP year-on-year, which is 0.2 % of GDP higher than expected under the no-policy-change scenario based on 2017[7]. There is a slightly positive impact on the evaluation (0.13 p.p.) due to better-than-expected development in the medium term.

The baseline scenario for the development of general government revenues and expenditures[8] based on 2018 assumes that, by 2022, the budget balance would automatically improve by 0.5 % of GDP without further measures of the government (Figure 6). In that period, the deficit will be declining in particular as a result of savings in interest payments amounting to 0.4 % of GDP, higher social security contributions in proportion to GDP also thanks to the approved annual settlement system for social security contributions, and lower pension expenditures as a share of GDP in a total amount of 0.4 % of GDP due to parametric changes made in previous years[9]. Other revenues and expenditures worsen the balance by 0.5 % of GDP in the medium term. In order to prevent the long-term sustainability from worsening beyond the impact of the retirement age cap in comparison with 2018, it is inevitable that the above savings be fully reflected in the improvement of the budget balance.

According to the 2018 baseline scenario, reaching the trajectory of long-term sustainability requires a structural surplus of 0.5 % of GDP[10] by 2022[11], and this would have to be taken into account when setting the medium-term budgetary objectives (Figure 6). Beyond the framework of the 2018 baseline scenario, which already assumes that the structural deficit will improve from 1.3 % of GDP in 2018 to 0.8 % of GDP in 2022, it is necessary to adopt additional measures amounting to some 1.32 % of GDP (the value of the long-term sustainability indicator). Compliance with the budgetary objectives set in the Stability Programme of the Slovak Republic for 2019–2022 (a structural deficit of 0.2 % of GDP in 2022) will not thus be sufficient for ensuring the long-term sustainability of public finances.

With budgets reaching a surplus of some 0.1 % of GDP between 2023 and 2038, a sufficient fiscal space would be available through a reduced debt for absorbing the ageing-related costs, which means that the ageing costs would be more evenly distributed in time

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6 Increasing the retirement age to 62 years as from 2004 and subsequently linking it to the average life expectancy; pension indexation on the basis pensioners' inflation rate (parametric changes approved in 2012).

7 According to the CBR, a decline in the general government deficit from 0.8 % of GDP in 2017 to 0.7 % of GDP in 2018 was, to a large extent, influenced by one-off factors (recording of wages in extra-budgetary accounts with a one-off positive effect in 2018) and beyond the control of the government (e.g. debt interest payments, impact of the economic cycle).

8 Reflecting the fiscal performance in 2018, the current macroeconomic and demographic development in the application of the existing policies (Figure 3).

9 Expenditure development under the 2018 baseline scenario does not reflect the impacts resulting from the introduction of the retirement age cap, which is expected to gradually increase the pension system expenditures beginning from 2022.

10 In the event of an immediate improvement in the balance as of 2019, achieving the long-term sustainability would require measures totalling 1.32 % of GDP, i.e. the 2022 structural surplus would reach 0.50 % of GDP. With a gradual and steady improvement of the balance against the baseline scenario, the total amount of measures would have to reach 1.36 % of GDP, thus requiring a structural surplus of 0.53 % of GDP in 2022.

11 Achieving the long-term sustainability would require a structural surplus of 1.5 % of GDP, if the most recent estimate of the impact resulting from the introduction of the retirement age cap is taken into account.

without having a more significant negative impact on the living standard of the current and future generations (Figure 8). If the long-term sustainability of public finances is achieved in 2019, the debt would be declining in the upcoming years due to the achieved primary surpluses; however, after reaching a turning point (13.6 % of GDP in 2046) when the effects of ageing will prevail (the impacts on the balance will become apparent as from 2039), the debt will start rising again to the level of 50 % of GDP (Figure 7). Maintaining the primary surplus (without items affected by ageing) at a level of some 1.0 % of GDP annually throughout the entire 50-year period would cover the growing costs related to population ageing after 2038. The resulting deterioration of the balance, attributable to population ageing in the absence of countervailing measures, can be absorbed only under the condition that the starting level of the debt will be reasonably low. To allow comparison, in a situation where the same period of time would start off with a debt amounting to 40 % of GDP (with deficits staying below 2 % GDP until 2038) and, subsequently, population ageing would increase the debt to a level of 50 % of GDP, the primary surplus (excluding the items affected by ageing) would have to be at 2.2 % of GDP on average annually in order to keep the debt at that level until 2068. The negative impacts of the ongoing population ageing on the budget in the upcoming decades would be such that, with debt amounting to 40 % of GDP, it will be impossible to compensate for them every year[12]. It is very likely that, after 2038, the government would hit the taxation limits coupled with restricted options for reducing the expenditures. Therefore, reducing and maintaining the debt to/at levels just below the sanction brackets of the debt brake should not be seen as sufficient, because population ageing in the future will significantly worsen the options for meeting the debt limit levels prescribed by the Fiscal Responsibility Act.

The Fiscal Responsibility Act was adopted with a view to ensuring the long-term sustainability of public finances. In this Act, the debt limit is considered a last resort instrument designed to prevent excessive debt growth even at the cost of freezing public expenditures, including social transfers, all of which would have a negative impact on the living standard of the Slovak population. The economic policy should thus be aimed at maintaining the debt below the sanction brackets with a sufficient room, so that any negative impacts on the budget could be absorbed without the need to adopt extraordinary measures to stabilise the debt. The impact of population ageing in Slovakia must be seen, from this perspective, as a negative effect that will continue to have a significant impact on public finances in the long term and, for this reason, the nature of this effect cannot be likened to that of a random and temporary economic shock. Under the Fiscal Responsibility Act, the binding expenditure ceilings are expected to be a tool for operational management of the budget. **If the long-term sustainability indicator is taken into account in determining the medium-term budgetary objectives which should serve as the basis for expenditure ceilings, the intent of the Fiscal Responsibility Act would be met.** From this angle, compliance with the medium-term objective with the structural deficit reaching 0.5 % of GDP would improve the long-term sustainability in comparison with 2018 (without taking into account the impact of the retirement age cap); however, the long-term sustainability would still not be achieved. If a more relaxed approach is used for the medium-term objective by allowing the structural deficit to reach a level of 1 % of GDP, the long-term sustainability would be worse even in comparison with the current evaluation of 2018. Therefore, it would be desirable to intensively continue the discussion about how the expenditure ceilings should look like and, after thoroughly testing all modalities, a legislative proposal for their introduction could be presented within a short timeframe.

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12 Based on the conclusions from the analysis: Múčka, Z.: Fiscal Limits - The Mirror Does Not Lie, Secretariat of the CBR(2019). A commentary by Múčka, Z. and Novysedlák, V.: A Safe Debt Level for Slovakia, Secretariat of the CBR (2019).

Given the high degree of uncertainty inherent in long-term projections, the report contains several scenarios which illustrate the long-term sustainability indicator's sensitivity to the nature of fiscal policy, to its different definitions or to changes in various demographic and macroeconomic assumptions (Figure 2). 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.

- The upper ceiling for the retirement age (which was set at 64 years, allowing a reduction to 62.5 years for women who raised three or more children) approved by the Slovak Parliament in March 2019 will cause sustainability to worsen by 1.0 p.p.
- Sustainability would worsen by an additional 0.6 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, interest rates or cost-reducing measures adopted in the pension system, in order to improve the balance and 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 0.7 p.p., under a risk scenario assuming higher increase in healthcare expenditures[13] compared with the baseline scenario.
- On the front of macroeconomic assumptions, the most significant impact comes from changing productivity growth assumption. Slovakia's slower convergence to the EU average may increase the long-term sustainability indicator by 0.3 percentage points[14]. 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 debt limit under the Fiscal Responsibility Act may be exceeded sooner than predicted in the baseline scenario (roughly by six years).

In 2018, the fiscal burden of the future generations has increased in comparison with 2017 in particular due to the worsened fiscal performance of the government in 2018 after taking into account one-off effects, economic cycle and interest payments. The results of the generational accounts analysis still indicate a shift of the fiscal burden onto future generations. While each child born in 2018 will receive from public budgets in their lifetime EUR 38,000 more than what they contribute (in 2018 prices), future generations (born in 2019 and later) would be in a completely different situation because they would have to contribute EUR 37,000 more than what they receive. The total amount of government liabilities, assuming no change in the present fiscal policy, would reach 229 % of GDP[15].

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13 In the case of the healthcare sector, the higher uncertainty in projections arises from the sensitivity of expenditures to economic growth and the pace of progress in technology. For this reason, the CBR applied a risk scenario which takes into account the initial elasticity amounting to 1.4, whereas the baseline scenario uses 1.1. A gradual convergence towards elasticity amounting to 1 is assumed under both scenarios.

14 The baseline scenario assumes Slovakia's convergence to 107 % of the EU-28 average; however, sensitivity suggests slower catching up with the EU, which is expected to reach 91 % of the EU average at the end of the period.

15 The amount is expressed in 2018 prices. 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 ageing will peak after the 50-year horizon of the baseline scenario.

At the end of 2017, the net worth of the Slovak Republic reached negative 207.5 % of GDP, worsening by 58.9 percentage points[16] year-on-year. This was mainly attributable to an increase in implicit liabilities by 66.6 % of GDP due to updated long-term demographic and macroeconomic projections published by the European Commission in 2018. The year-on-year GDP growth contributed 6.3 percentage points towards the net worth increase. The equity of the entire general government sector has decreased by 1.4 % of GDP, in particular due to an increase in reserves for employee emoluments. The net worth has also improved after including the estimated value of forest stock. This was the most important methodology change which increased the net worth (other assets) by EUR 4.0 billion (4.7 % of GDP) year-on-year. The information value of the net worth indicator would be further 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 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.

Long-term sustainability indicator

(without taking into account the impact of the retirement age cap)

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.

1.20 % of GDP

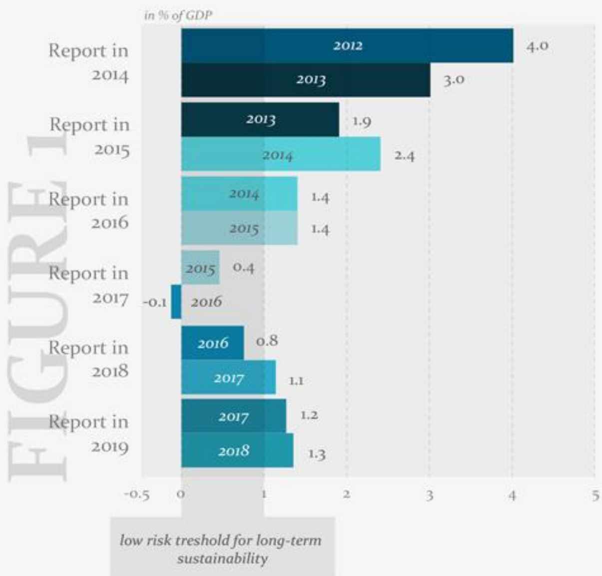
value of the indicator in 2017

1.32% of GDP

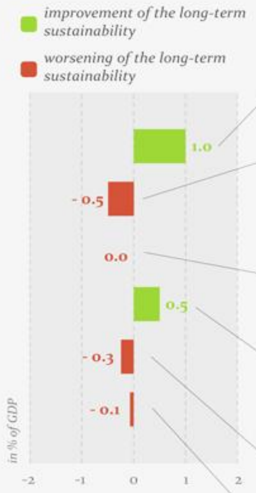
value of the indicator in 2018

The long-term sustainability has worsened compared with the previous year.

Long-term sustainability indicator



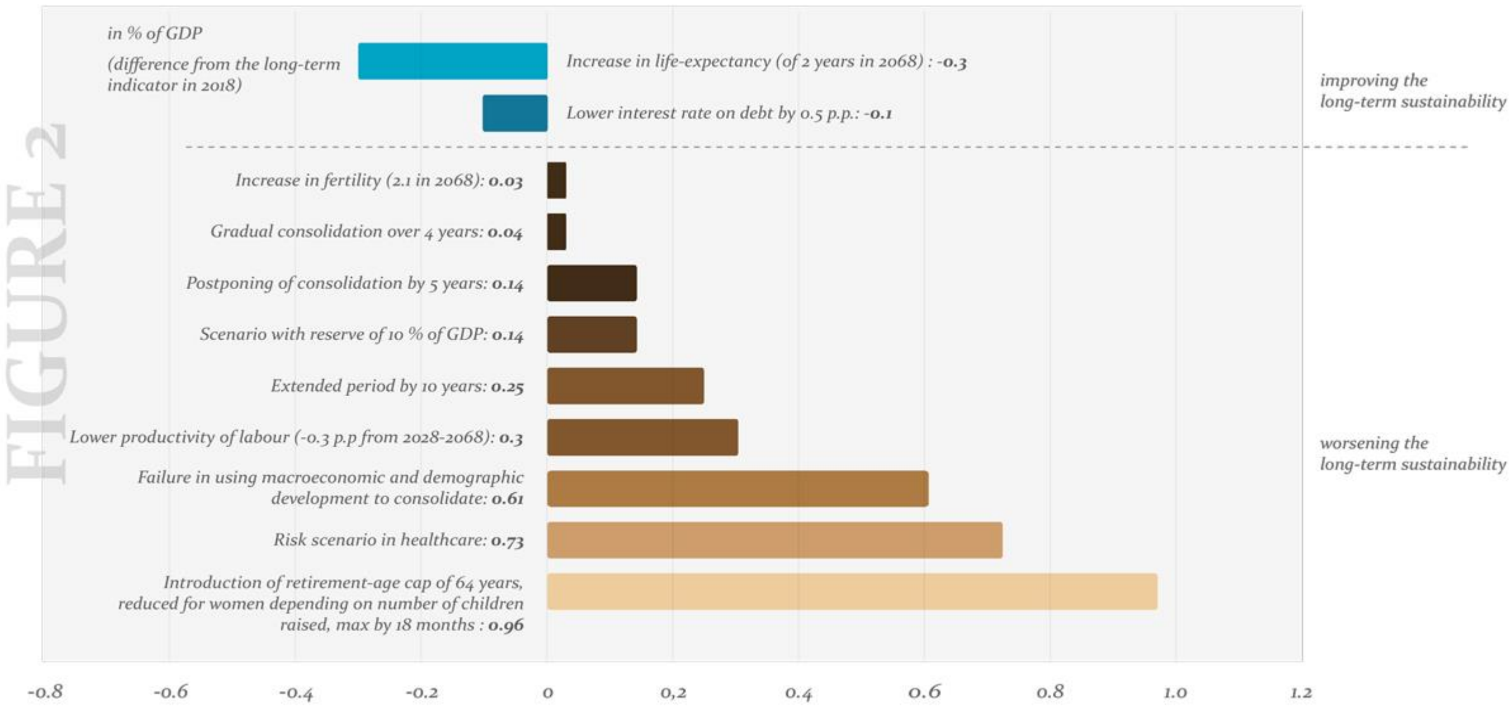
Change



Most significant impacts on long-term sustainability

- Improved budget balance, reform of 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 partly offset by less favourable decline in deficit over the medium-term horizon
- Insufficient improvement of budget balance in 2017, introduction of temporary minimum amount of pension indexation
- Worsening of structural balance partly offset by favourable deficit reduction over the medium-term

Sensitivity scenarios overview



Source: Report on the long term sustainability of public finances (April 2019)

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Baseline scenario of general government budget development

(without taking into account the impact of the retirement age cap)

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.

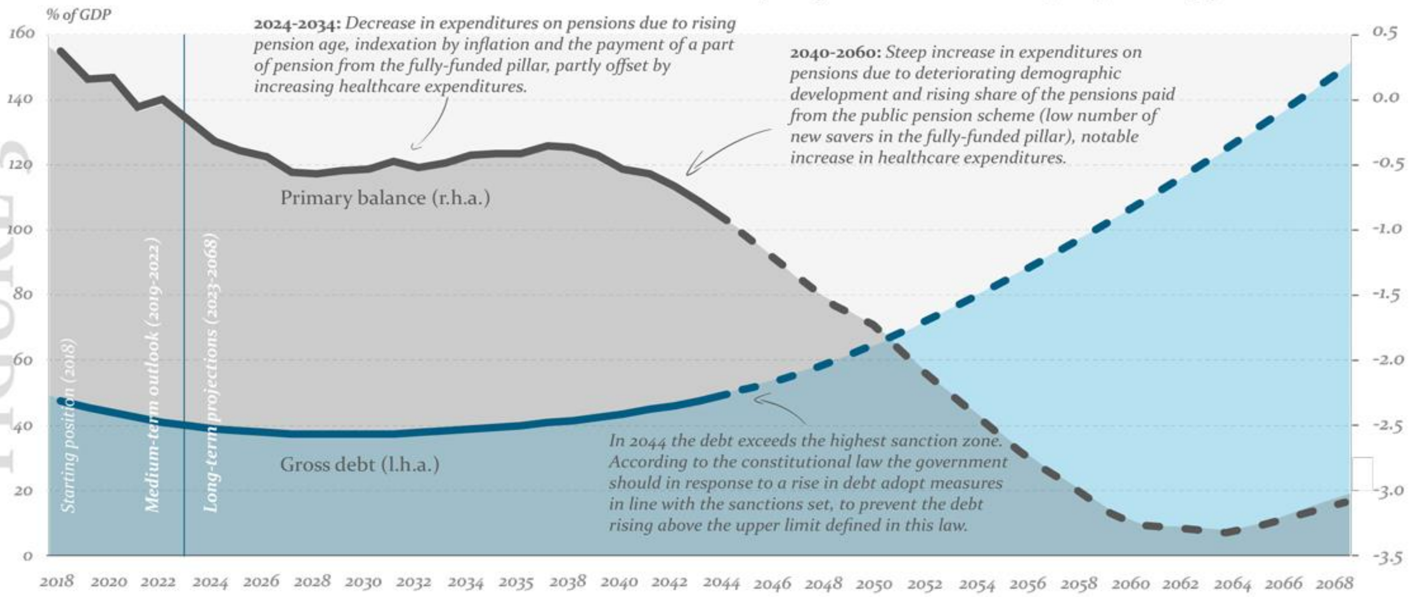
148.6 % of GDP
debt amount in 2068

2030
is the year when the debt begins to grow

-3.1 % of GDP
is the decline in the primary balance by 2068*

* primary balance = is a GG balance adjusted for interest payments related to the debt

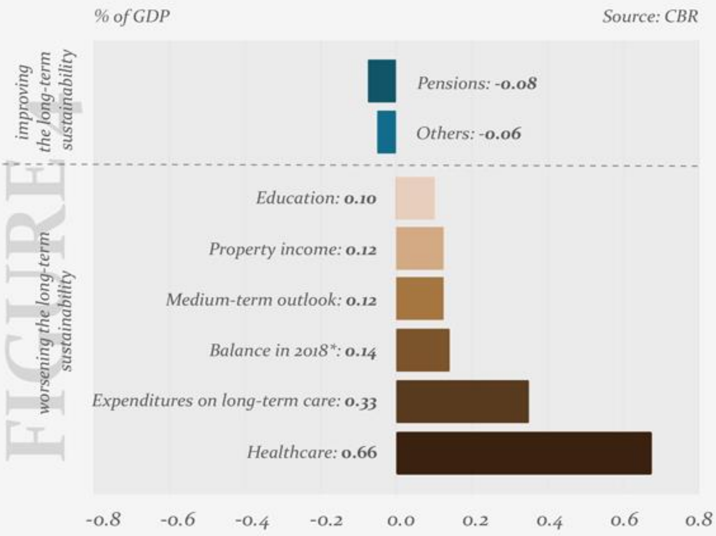
FIGURE 3



Long-term sustainability is mainly worsened by the healthcare and expenditures on long-term care

Long-term sustainability indicator = 1.32 % GDP

FIGURE 4

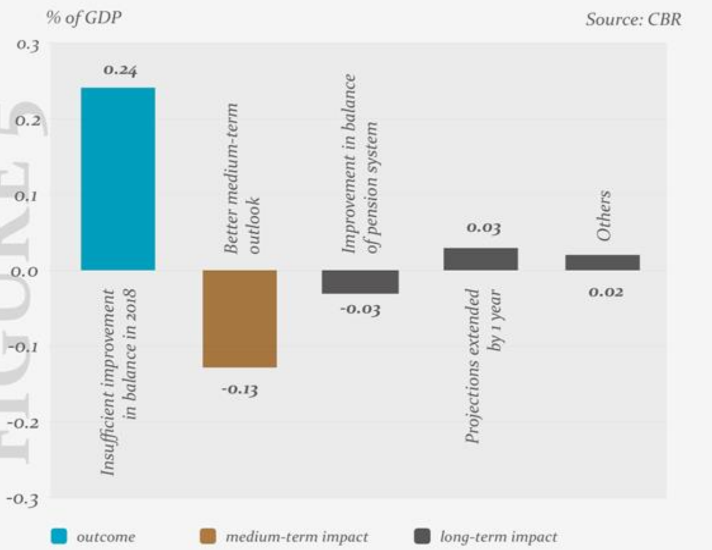


Note: *Impact of the starting fiscal position, i.e. structural primary balance in 2018

Contributions to change in long-term sustainability between 2017-2018

Total change in the long-term sustainability indicator= 0.13 % GDP

FIGURE 5



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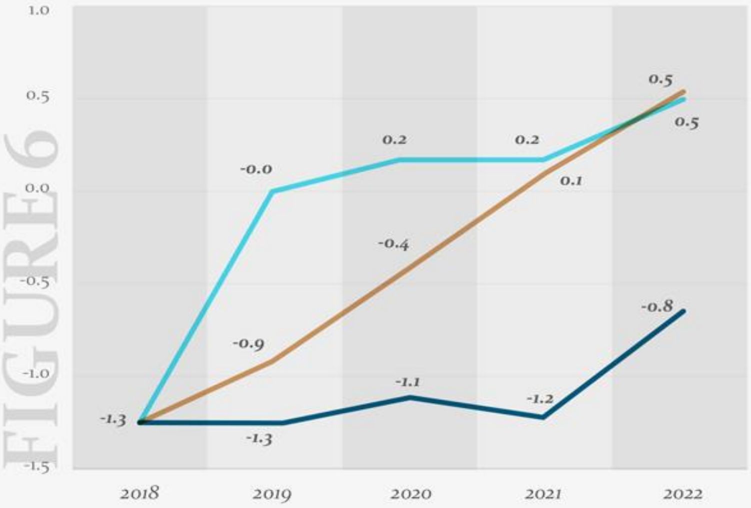
How to achieve the long-term sustainability
(without taking into account the impact of the retirement age cap)

GG structural balance development in the medium-term horizon

in % of GDP

FIGURE 6



Baseline scenario 2018 | Long-term sustainability scenario (immediate) | Long-term sustainability scenario (gradual)

General government (GG) structural balance will automatically improve from 1.3 % of GDP in 2018 to 0.8 % of GDP in 2022 due the expected macroeconomic development and current legislation.

To achieve long-term sustainability of public finances a structural surplus of 0.5 % of GDP until 2022 is required.

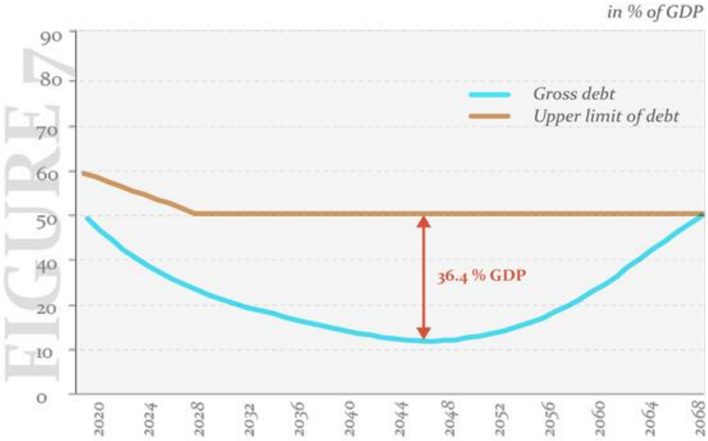
With budgets reaching a surplus of some 0.1 % of GDP between 2023 and 2038, a sufficient fiscal room would be available through a reduced debt for absorbing the ageing-related costs after 2038 (the debt will decline by 36.4 % of GDP under the limit set by the constitutional law).

The negative impacts of the ongoing population ageing on the budget in the upcoming decades would be such that, with debt amounting to 40 % of GDP, it will be impossible to compensate for them every year. It is very likely, the government would hit the taxation limits coupled with restricted options for reducing the expenditures. Therefore, reducing and maintaining the debt to/at levels just below the sanction brackets of the debt brake should not be seen as sufficient.

GG debt and deficit development if the long-term sustainability is achieved

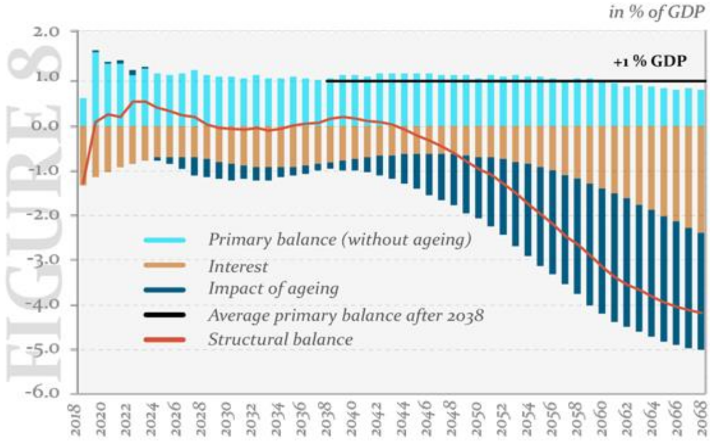
in % of GDP

FIGURE 7



in % of GDP

FIGURE 8



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