



Report on the Long-term Sustainability of Public Finances for 2019

Summary

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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 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 constitutional Fiscal Responsibility Act¹. The objective of this report is to evaluate the situation in public finances over the next fifty years, taking into account the government’s fiscal performance and the setup of policies existing in 2019, while also considering the macroeconomic development.

The present report is specific in that it has been prepared during the pandemic of coronavirus SARS-CoV-2. The ramifications of the pandemic for the economic development and public finances will be substantial, although their magnitude is very uncertain at this point. For this reason, the long-term sustainability of public finances has been evaluated in two steps:

- In the first step, the CBR performed a standard evaluation of **the long-term sustainability in 2019** based on the legislation applicable in 2019, without taking into account the changes in the economic development caused by the pandemic. This approach enabled us to better isolate the impacts of the measures taken by the government in 2019 on the long-term sustainability of public finances against the backdrop of the originally anticipated economic development.
- In the second step, the CBR used sensitivity scenarios to **quantify the long-term sustainability in 2020**, taking into account the legislation adopted in 2020 (until 22 April 2020), including the measures taken by the government to alleviate the consequences of the coronavirus pandemics, plus several macroeconomic scenarios reflecting the impacts of the pandemic. This approach better reflects the current condition of public finances and provides up-to-date information that the government may feed into its future economic policy decisions. However, this scenario is presented as yet another sensitivity scenario because the actual impacts of the pandemic on the economic development are very uncertain and the long-term sustainability of public finances is typically evaluated against the data available for the previous year².

Evaluation of the long-term sustainability in 2019

The long-term sustainability in 2019 was not achieved. The long-term sustainability indicator reached 4.2 % of GDP and thus the risk of public finances becoming unsustainable in the long run increased, but remained in the medium-risk zone³. This means that in order to keep the general government debt below the debt ceiling (50 % of GDP) over the next fifty years, the government will have to take additional measures (above the baseline scenario assumptions) in the medium run on the expenditure and/or revenue side

¹ The CBR prepares and publishes its long-term sustainability report, including the baseline scenario and determination of the long-term sustainability indicator, each year as of 30 April, and always within 30 days of the parliamentary debate on the incoming government’s manifesto and vote of confidence in the new government.

² The report for the previous year is published typically in a period which is not busy in terms of major legislative changes or significant revisions of projections. Thus the past year’s evaluation normally provides an accurate snapshot of the condition of public finances. However, in the course of 2020 (until 22nd April) Slovakia adopted a number of significant legislative changes and the economic development has changed quite considerably.

³ The CBR considers the value of up to 1 % of GDP as a ‘slight deviation’ carrying a low level of risk to long-term sustainability. This threshold corresponds to the uncertainty inherent in long-term projections when, as a result of standard updates of assumptions or methodological improvements, the indicator may be prone to more significant changes. The CBR classifies the value between 1 – 5 % of GDP as a ‘medium risk’ value. Any value above 5 % of GDP is considered a ‘high risk’ to long-term sustainability.

amounting to 4.2 % of GDP that improve the general government's balance on a permanent basis.

The long-term sustainability of public finances worsened for the third year in a row. Compared to 2018, the long-term sustainability indicator worsened by 2.6 % of GDP; the measures adopted by the government and parliament had the most adverse impact (1.7 p.p.). The legislative changes adopted in the pension system worsened the indicator by 1.3 p.p. **They mainly include the introduction of a the retirement age cap, increase of the minimum pension level, and lower cuts in pensions payable from the pay-as-you go pillar to pensioners participating also in the fully-funded pillar, which will increase the pension system's deficit by 2.7 % of GDP by 2069.** The government missed the opportunity to use the 'better economic times' to improve the public finance deficit in 2019. The adjusted balance (net of one-off effects, impacts of the economic cycle and interest payments) deteriorated by 0.2 % of GDP, even though the 2018 no-policy-change scenario assumed that the balance would improve by 0.3 % of GDP. The downward revision of the projection of the tax and social security revenues in the medium term has also had a negative impact on the indicator (0.7 p.p.).

The baseline scenario of the development of general government revenues and expenditures⁴ based on the 2019 results assumes that, unless the government takes additional measures, the budget balance will automatically deteriorate by 0.7 % of GDP in 2023. The increase in deficit is largely attributable to the expected rise in expenditures on pensions, healthcare and long-term care (0.6 % of GDP). This comes as a result of the new legislation that increases government expenditures, combined with the augmenting effects of population ageing, a trend which picked up in 2011.

Long-term sustainability in 2020 – 2020 legislation and impacts of SARS-CoV-2

Given the fact that the SARS-CoV-2 coronavirus pandemic (which causes COVID-19) is stifling the global economy, Slovakia including, the CBR applies sensitivity scenarios to **illustrate the likely impacts of the pandemic on the development of public finances in the medium term and on the long-term sustainability indicator.**

Although the individual institutions differ in their projections for 2020, with the latest information taken into account, they generally concur on the interval of Slovakia's economic slump⁵. **The CBR estimates that the economy will shrink by 10.3 % in 2020.**

From the perspective of the long-term sustainability of public finances, **more important than the result for 2020 will be the development in the years ahead, determined by the current pandemic and the related economic consequences.** Since there is no consensus across the professional community on how the pandemic and the adopted fiscal and monetary measures will influence the production capacity of countries, the CBR has prepared three likely economic scenarios for the post-2020 period: **1/ Optimistic**, which assumes that the pandemic will, in all likelihood, have a short-term impact on the economy; **2/ Medium**, which assumes that the pandemic will have a permanent impact in terms of reduced productivity factors and

⁴ The baseline scenario reflects the results of the 2019 budget, and the current macroeconomic and demographic developments assuming no change in policies.

⁵ Apart from the medium scenario of economic decline by 7.2 %, the Ministry of Finance has presented its alternative scenarios of decline, by 11.4 % and 12.5 %, depending on how long the measures remain in place. The National Bank of Slovakia has presented three scenarios of decline, spanning from -5.8 to -13.5 %. The macroeconomic projections published by selected Slovak banks also indicate a fairly broad spread of decline, from -5 to -12.5 % (Source: National Bank of Slovakia).

permanent deviation of the potential output from its original trajectory and **3/ Pessimistic**, which, above the medium scenario, assumes that the adverse pandemic situation will last longer and the loss of the potential output will be even more significant.

Apart from the impact of the pandemic, these three scenarios equally reflect also other factors, mainly the present fiscal development⁶, the impact which the introduction of the so-called 13th pension will have on the pension system's expenditures in the long run, and the measures adopted by the government to alleviate the impacts of the pandemic.

Under all three scenarios, unless the government adopts additional measures, the 2020 general government deficit will increase to 7.8 % of GDP. In the years to come, as the economic growth picks up and wage expenditures are partially adjusted, the deficit should automatically decrease. Under the optimistic scenario, the deficit should decline to 5.0 % of GDP in 2023, compared to a decline to 6.7 % of GDP under the pessimistic scenario. The difference between the two scenarios lies partly in the impact of the economic cycle since we assume that the 2023 **structural deficit** should span from 4.4 to 5.4 % of GDP, depending on the scenario⁷.

The gross debt, also due to the economic slump, will reach 60.4 % of GDP at the end of 2020 and will then rise annually, depending on the scenario. At the end of 2023, it will reach 62.1 to 68.9 % of GDP. This means that if no additional measures are taken, the debt will exceed the upper limit set in the constitutional law in all years covered by the forecast.

In 2020, the long-term sustainability indicator will increase to 8 % of GDP, which represents a high risk to long-term sustainability. Depending on the economic development, the indicator will reach its best value at 7.6 % of GDP under the optimistic scenario and its worst value at 8.2 % of GDP under the pessimistic scenario. The differences between these scenarios are not significant and they are mainly due to the different levels of the structural primary balance in 2023. In order to bring and keep the general government debt below the upper debt limit (50 % of GDP) in the next fifty years, it will be necessary to adopt, in the medium term, additional measures on the revenue and/or expenditure side of the budget which will improve the general government balance permanently to the tune of about 8 % of GDP. This would require achieving a structural surplus by 2023 of about 2.2 to 2.6 % of GDP depending on the scenario.

If we took into account only the impact of the 13th pensions and wage increases in the public sector, then the long-term sustainability of public finances would land in the high-risk zone even without the influence of the coronavirus pandemic.

Although the pessimistic macroeconomic scenario does not yield dramatically worse results in terms of long-term sustainability than the optimistic one, **the evaluation of the consequences of the pandemic must also take into account their impact on the standard of living.** A slower economic growth will have an adverse impact on the standard of living. For example, the average old-age pension in 2069 may be almost 9 % higher in the optimistic scenario compared to the pessimistic one, yet the relative pension level will not change compared to the rest of the population.

⁶ The CBR publishes the monthly 'budget traffic lights' which quantify the 2020 budget risks based on up-to-date information.

⁷ Estimates based on the assumption of no change in policies. The draft of the government's budgetary objectives, including the scope of the planned consolidation, will be known after the publication of the 2020-2023 Stability Programme.

Safe debt level

The safe debt level changes in time depending on the general government's fiscal performance, applicable legislation, expected changes in the demographic structure and the ensuing increase in expenditures sensitive to population ageing, and projections for domestic economic growth.

The safe debt analysis shows that the debt will have to be reduced more considerably in the future and that the pace and scope of the required debt reduction will depend on the extent to which the present and future governments adopt measures designed to improve the general government's balance permanently. **If no fundamental measures with impact in the long run are taken (to boost the economic growth potential and implement structural reforms in the areas sensitive to population ageing), the steep rise in public debt caused by growing expenditures due to population ageing (particularly in the pension and healthcare systems) can be absorbed only if the baseline debt level is adequately low.** This would currently require a consolidation effort of about 8 % of GDP, a pace at which the debt would fall below zero⁸ by 2035 (i.e. the government would no longer carry debt and would start accumulating assets). By 2046, the government would accumulate assets representing 16.0 % of GDP; then, due to the effects of demographic development, public debt would rise to reach 50 % of GDP in 2070.

The **fiscal limit analysis** is based on a similar approach. It looks at the maximum level of the net debt which the government is still able to service irrespective of the limits imposed by the Fiscal Responsibility Act. In addition to the approach described above, this approach also takes into account the fiscal policy expectations (e.g., tax increases in reaction to rising debt) and credibility, turbulences in the economic cycle and the external shocks. The fiscal limit can be quantified for several probability levels of default; the choice of the specific level defines the corresponding level of safe debt. The CBR considers the probability of default of up to 1 % safe in standard economic times⁹.

In 2018, the safe level of net debt oscillated around 39 % of GDP. In 2019, the safe debt threshold decreased by 11 % of GDP to around 28 % of GDP. The decrease in the safe debt threshold between 2018 and 2019 is due the introduction of the retirement age cap (impact of 7 p.p.) and other measures. As a consequence of the pandemic and the legislative changes in the pension system adopted in 2020 (introduction of the 13th pension), the safe debt level in 2020 may decrease by two additional percentage points, depending on the scenario. **Should the medium scenario materialise, the safe debt level will reach approximately 27 % of GDP at the end of 2020.** In the medium term, the increase in the safe debt level reflects the deteriorating situation in public finances; once these impacts ebb, the safe debt level will decrease by 2040 under each of the scenarios to approximately 24 % of GDP.

In 2019, the net debt of Slovakia reached 43.2 % of GDP. **The analysis of the safe debt level shows that it was about 15 % of GDP higher than the level required for the debt to develop on a sustainable basis.**

How to improve the long-term sustainability of public finances

⁸ The data are based on the medium sensitivity scenario.

⁹ The safe debt level corresponds to the AA-AAA rating according to the methodology of Standard & Poor's, i.e. the likelihood of sovereign default of up to 1 % in standard economic conditions. The thus defined safe debt level also roughly corresponds to the 10 % probability of default if Slovakia was exposed to negative economic shocks.

Even though the long-term sustainability of public finances is the main fiscal policy objective¹⁰, the government and parliament have adopted a number of measures in recent years that run counter to this objective. The public finances have become less sustainable mainly because the government kept postponing the deficit-reduction effort leading towards a balanced budget despite the favourable macroeconomic development, despite the numerous legislative changes and measures adopted to increase revenues, and despite the margin made available on the expenditure side of the budget by the 2012 pension system reform. The improved balance of the Social Insurance Agency as a result of increasing the retirement age in correlation with life expectancy was erroneously viewed as an exercise for the current election term, although it was a temporary, desirable and planned intervention as part of changes aimed at fostering the long-term sustainability of the system. In the long run, these cost reductions will not suffice to cover the pension system's deficit. The use of these temporary cuts as a pretext for the adoption of measures with permanent negative impacts automatically impairs the long-term sustainability of public finances.

The need to create the necessary fiscal space in good economic times is underscored by the occurrence of unexpected shocks, such as the present economic shock caused by the coronavirus pandemic, which may quickly spin the debt growth out of the safe zone. Thus the priority of public finance management in good times should be to reduce public debt to the safe level. The monitoring and evaluation of risks, not only in the short-term, but mainly in the long-term, should be part of the economic policy of any government in Slovakia.

Macroeconomic scenarios confirm that **the government, as a consequence of the coronavirus pandemic, will face a higher structural deficit** than the one before the pandemic, which will adversely affect the sustainability of public finances.

Against the backdrop of impaired long-term sustainability, the government and parliament have several options of **how to improve long-term sustainability**. When a need to adopt measures of significant size arises, a combination of various types of measures is usually used.

One of such measures is to consolidate **public finances by improving the current fiscal performance of general government**. In order to attain long-term sustainability under the 2020 scenario, the government would have to attain a structural surplus of over 2 % of GDP by 2023 which is – given the scope of the necessary consolidation and its impacts on the economy – a hardly viable scenario. Considerable cost-savings could be achieved through a rigorous revision of expenditures and full-fledged implementation of the value-for-money principle in the budgeting process. Under the Fiscal Responsibility Act, the binding expenditure ceilings are to be used as a tool for the operational management of the budget. If the long-term sustainability indicator is taken into account in setting the medium-term budgetary objectives, which should serve as a basis for setting the expenditure ceilings, the intention of the Fiscal Responsibility Act would be met.

Given the pressing need for consolidation, Slovakia needs to **accelerate the implementation of structural reforms**. These are the measures which have a long-term positive impact on economic growth and budget performance, although they may temporarily involve extra costs. This is because the gains in productivity, alongside with the rising standard of living, create prerequisites for significant improvements in the long-term sustainability of public finances. At the end of the day, they should lead to the permanent increase in budgetary revenues or decrease in expenditures. These changes include a number of areas:

¹⁰ Based on government documents (such as the Stability Programme, national reform programmes) and the Fiscal Responsibility Act.

- **Long-term structural changes in the areas sensitive to population ageing, mainly the pension system, healthcare and long-term care.**

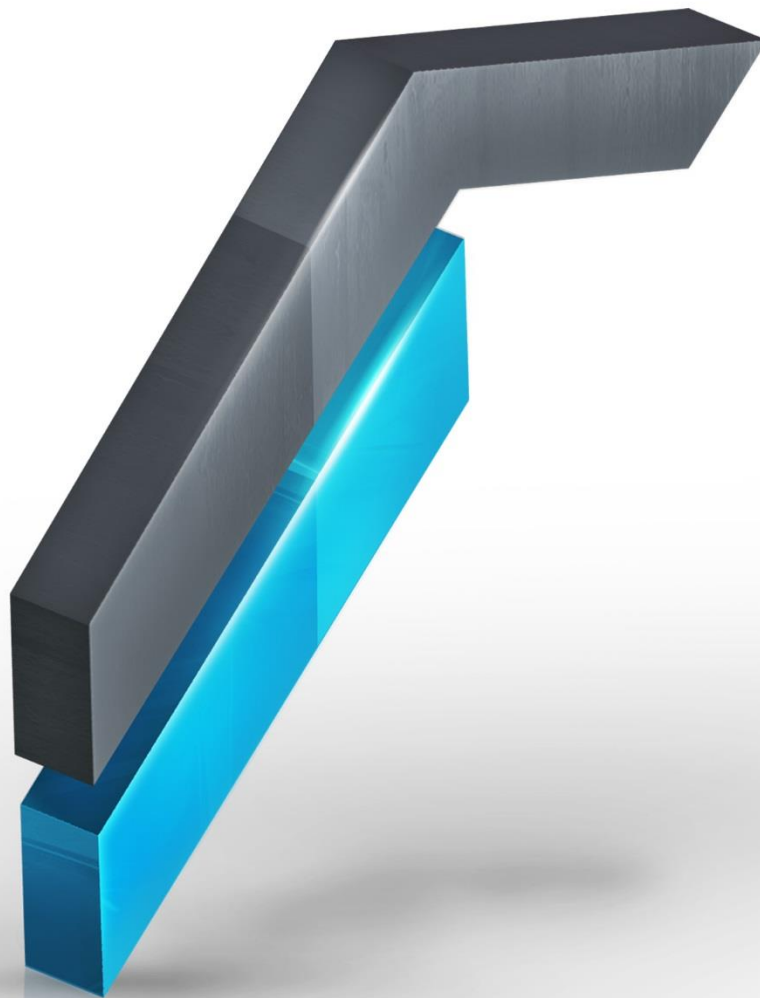
The measures should focus on the comprehensive assessment of the level and efficiency of benefits (their amount and duration of eligibility) and their alignment with the existing budgetary constraints, while respecting the principle of intergenerational solidarity and fairness. The reduction of the overall level of benefits does not necessarily have to be the objective. The lack of accurate information on the condition of the social security system often leads to hasty and frequent changes which, despite the declared intentions, do not necessarily improve the standard of living or make public spending more efficient.

- **Fostering competitiveness and productivity**

The overall increase of productivity in Slovakia would generate the additional funds needed to remedy public finances without the need to reduce the level of benefits. The government may facilitate the meeting of this objective in particular by building credible and well-functioning public institutions, creating an attractive business environment, developing an efficient tax system, reforming the system of education and labour market, including the managed migration, and by mainstreaming the marginalised groups of population. The other challenges include automation, digitalisation and potential changes in the automotive industry.

The post-2020 development will also largely depend on whether the government puts in place a public health protection system capable of reacting swiftly to any future epidemics as they occur. It has become clear that the economic consequences of the pandemic are triggered mainly by the imposed preventive and quarantine measures, including social distancing.

In September 2019, Slovakia set up the National Productivity Council, the role of which is to monitor the competitiveness of the country. Apart from monitoring productivity in qualitative terms, a set of indicators should also be developed in order to assist the government in adopting measures aimed at boosting productivity.



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