Medium-term fiscal outlook for 2021-2024

Main conclusions and recommendations

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Basic information about CBR's positions

In order to achieve long-term sustainability of Slovakia's economy, enhance transparency and increase public spending efficiency and in an effort to promote long-term competitiveness of the Slovak Republic while taking into account the requirement of economic and social justice and solidarity between the present and future generations, the Council for Budget Responsibility (CBR) was formed in 2012 as an independent body set up to monitor and evaluate the fiscal performance of the Slovak Republic. Its role is to provide professional, comprehensive and politically unbiased information to the public on the development of public finances.

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Main conclusions and recommendations

The Council for Budget Responsibility (the Council, CBR) evaluates the development of public finances in order to achieve their long-term sustainability. Slovakia's public finances are currently reaching a high risk level in terms of sustainability[1]. From this perspective it is crucial to identify, for the purposes of an overall evaluation, how the measures adopted or planned by the government will affect the revenue and expenditure balance in the long-term and whether it is possible to expect the long-term sustainability to improve at least to the medium-risk level.

- The approved Stability Programme is based on the expected deficit of 9.9% of GDP[2] for 2021, which the CBR describes as the upper limit with room to absorb the impacts of the second wave of the pandemic seen at the beginning of this year, as well as any potential negative shocks resulting from the third pandemic wave. **Considering the most recent estimate of the pandemic and macroeconomic development, the CBR estimates the deficit at 7.9% of GDP.**

- The CBR expects that, without any additional measures, the deficit after 2021 would be automatically improving to roughly 3.7% of GDP in 2024[3]. In order to improve the long-term sustainability only through consolidation, it would be necessary to keep deficits below such assumed adjustment path. The approved Stability Programme has no such ambition. **Taking into account the measures specified in the Stability Programme (without the adoption of the pension reform), the CBR estimates that the long-term sustainability would deteriorate by 0.2% of GDP to 6.3% of GDP.** If the objectives set by the government are met, the deterioration of the long-term sustainability would be more significant, reaching at least 0.5% of GDP[4].

- **The government's consolidation effort is insufficient. The Council considers it desirable and achievable for the government to squeeze the deficit below 3% of GDP by the end of its election term, while at the same time bringing the long-term sustainability safely into the medium-risk zone.** This would require adopting measures in a total amount of 2.3% of GDP and reducing the long-term sustainability indicator to some 4% of GDP. To achieve this objective, the government has several options available. The entire improvement can either be achieved by reducing the budget deficit or by adopting other measures with a long-term effect that would improve the revenue and expenditure balance in the future, in particular through the announced pension reform on the expenditure side. This recommendation would also be in line with the discussed amendment of the constitutional Fiscal Responsibility Act.

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[1] CBR, Report on the Long-term Sustainability of Public Finances as at 18 May 2021 (June 2021)

[2] The government has not published the updated estimate or objective following the approval of the state budget amendment by the parliament. With a purely mechanical calculation, additional changes in the amendment (beyond the version approved by the government) could increase the government's estimate from 9.9% of GDP to 10.3% of GDP.

[3] This development of the deficit in the medium-term horizon corresponds to the long-term sustainability indicator at 6.1% of GDP, which reflects the legislation as at 18 may 2021.

[4] If the objectives are achieved by one-off measures rather than by improving the structural deficit, sustainability would worsen by some 1 p. p. to 7% of GDP.

- **The favourable macro-economic development expected in 2022 and 2023, along with the high initial structural deficit, exacerbates the need for a gradual adoption of consolidation measures already during the post-crisis year of 2022, at a level of 0.5% of GDP.** In 2023, the budget consolidation could reach at least 1% of GDP without compromising economic growth. Despite the restrictive budgetary policy, the fiscal stimulus during the inevitable consolidation could be fuelled, along with intensified drawing of regular European funds under the programming period that is nearing its end, also by new resources from the Next Generation EU recovery fund.

- In order to achieve a medium-risk level of sustainability, it is necessary to continue the recovery of the public finances also in 2024; however, unlike in 2022 and 2023, the immediate improvement of the balance could be partly or wholly replaced by improving the long-term sustainability of the pension system in a manner announced by the government in the Stability Programme and in Slovakia's recovery and resilience plan. **Nonetheless, the draft constitutional act amending the pension system[5], as submitted to a legislative process of the Ministry of Labour, Social Affairs and Family of the Slovak Republic[6], improves the long-term sustainability only at half the rate declared in Slovakia's recovery and resilience plan**, therefore the remaining portion should be covered by deficit consolidation at a level of 1% of GDP also in 2024, unless a "fully-fledged" pension system reform takes place.

- **The Council views as negative that, in the Stability Programme, the government has not outlined a clear strategy for reducing the structural deficit in the future, i.e. one that is supported by specific measures.** Considering the period necessary for the preparation and implementation of specific measures, it is advisable that such measures be presented as soon as possible. The pandemic itself cannot be a reason justifying the absence of such structural measures, because any **potential support to the economy can always be addressed by temporary** and, if necessary, more robust **measures**, or by shifting future investments into the present.

- **In the case of a better-than-expected economic development, all positive aspects** (including the unspent part of the reserve to address the impacts of the pandemic) **need to be strictly reflected in the improvement of fiscal performance.** As with 2020, additional room for expenditures allowed by the state budget amendment approved in May 2021 should thus not be used for additional measures that are increasing the structural expenditures in the long-term.

Budget with reserves

The amendment to the State Budget Act and the government's estimate of the deficit under the ESA2010 methodology at 9.9% of GDP do not reflect the savings which the CBR identified in the state budget or in other general government entities based on the current fiscal development. Therefore, according to the CBR, the current deficit estimate stands at 7.9% of GDP, down by 2.1% of GDP[7] in comparison with the government's estimate.

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5 Considering the previous frequent changes in the pension system, it would be advisable that a comprehensive pension reform improving the sustainability of public finances is approved by means of a constitutional act.

6 https://rokovania.gov.sk/RPO/Material/2333/1 (available in Slovak only)

7 Compared to the mechanical calculation of 10.3% of GDP, this would represent a reduction by 2.4% of GDP.

Table 1: Comparison between the expected balance and debt in the Stability Programme and the CBR's estimate (% of GDP)

	2020 S	2021	2022	2023	2024
GG balance – SP 2021-2024 (government's objectives)*	-6.2	-7.4	-5.1	-4.1	-3.8
GG balance – SP 2021-2024 (excl. non-specified measures)	-6.2	-9.9	-5.1	-4.6	-4.5
GG balance – CBR's forecast	-6.1**	-7.9	-4.3	-4.2	-3.9
- **difference**	**0.0**	**2.1**	**0.8**	**0.4**	**0.6**
GG gross debt – SP 2021-2024 (after meeting the objectives)	60.6	64.1	65.5	64.6	65.8
GG gross debt - CBR's forecast	60.3**	61.0	62.3	62.1	62.7
- **difference**	**0.3**	**3.0**	**3.2**	**2.5**	**3.2**

** The data for 2021 corresponds to the approved general government budget for 2021-2023, the data for 2022-2024 is based on the objectives published in the Stability Programme.*

Source: Finance Ministry, CBR

*** The CBR's data reflects the revised nominal GDP in 2020, as presented by the Statistical Office on 30 April 2021.*

The budget proposal is compiled in accordance with the budgetary objective only for 2022, but not for the years to follow. The Stability Programme envisages, as from 2022, the consolidation of public finances from 9.9% of GDP in 2021 to 3.8% of GDP in 2024, which will require the adoption of consolidation measures, according to the government. However, to achieve this objective, the government has not specified a concrete and realistic strategy to be followed beyond the horizon of 2022.

High deficits in the Stability Programme affected by a maximalist deficit estimate for 2021 were also the reason for differing debt development dynamics where the CBR expects the debt to stand at 62.7% of GDP in 2024, which is 3.2 p. p. less than the government's estimate. But the stabilisation of the debt level is still not seen in the CBR's estimate as well, because it would require reducing the deficit down to 3% of GDP.

Pandemic response measures not an obstacle to improving the health of public finances

Public finances are going through shocks brought by the spread of the virus. The years 2020 and 2021 are considered as the crisis years, bringing the need to stimulate the economy in terms of the fiscal policy due to a negative output gap. From the perspective of providing a stimulus to the economy, it is important that public finances are not burdened for a long time. Therefore, it should rather rely on targeted one-off anti-crisis measures or effective public investments, and not on the recurring current expenditures.

This approach seems to be highly effective in 2020 and 2021, when increased budgetary expenditures for addressing the pandemic were necessitated in particular by the strong second wave at the beginning of 2021. If the debt increases as a result of one-off anti-crisis measures without deteriorating the structural deficit, the impact on the long-term sustainability is only temporary and very limited.

Table 2: Overview of basic budgetary indicators as seen by the CBR (likely scenario according to CBR, ESA2010, % of GDP)

	2020	2021	2022	2023	2024
General government balance	-6.1	-7.9	-4.3	-4.2	-3.9
Structural balance	-3.5	-4.1	-3.7	-3.5	-3.3
Government consolidation effort*	-	-0.1	-0.3	0.0	0.0
General government gross debt	60.3	61.0	62.3	62.1	62.7
General government net debt	50.1	56.1	56.5	57.8	59.1
Fiscal impulse (+ means restriction, - expansion)	-2.9	-2.2	2.3	-1.1	3.2

Note: Columns highlighted in grey represent the crisis years. *Source: CBR*

**Consolidation effort is defined as a year-on-year change in the structural balance beyond the developments under the no-policy-change scenario after taking into account the impact of support for short-time work (kurzarbeit) introduced as from 2022. This is a different approach compared to that of the Ministry of Finance which quantifies consolidation as a change in structural balance (regardless of whether it was caused by automatic developments in public finances due to the existing legislation and policies or by new additional measures of the government).*

The macroeconomic forecast anticipates a moderate overheating of the economy as early as next year[8]. The economic impact of the sudden stop of the pandemic support in 2022 will be largely restrictive (see the fiscal impulse in Table 2), however, this will happen with the private sector being in a better condition owing to the increased support in 2021 and an accumulated demand that can begin to be satisfied next year. If necessary, the pandemic support may always be temporarily resumed even during 2022, or the investments slated for 2023 may be moved to 2022, thus eliminating the adverse effects of the fiscal cliff on the economy in the coming year. For these reasons, too, the drawing of the funds for the projects financed from Slovakia's recovery and resilience plan and EU funds should be increased to maximum next year.

According to the finance ministry's plans, the refusal to carry out consolidation next year is particularly driven by unrealistically high expectations regarding the 2021 deficit, affecting the fiscal performance in the subsequent years, too. However, the measures included in the Stability Programme alone contribute to the worsening of the deficit and sustainability by 0.2% of GDP, which only proves that Slovakia has no consolidation strategy beyond 2021.

Box 1: Why not to a priori reject consolidation in 2022 (vs 2024)

A so-called fiscal cliff may develop in 2022 when the ending of the fiscal stimulus does not necessarily be fully offset by an additional support from EU resources. General recommendations made by international institutions (European Commission, IMF)[9] therefore call for a slower launch of consolidation of public finances. These recommendations, however, do not necessarily reflect Slovakia's specifics. In this context, the Council considers it important to highlight the effects it deems to be sufficient reasons to start fiscal consolidation as early as 2022:

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[8] Output gap estimates are associated with a large degree of uncertainty. In the case of Slovakia, however, all relevant institutions but IMF forecast a positive and relatively similar output gap. The Slovak finance ministry expects a positive output gap at 0.9% of GDP and the NBS at 0.3% of GDP; the OECD's May 2021 forecast and the Commission's spring forecast of May 2021 both estimate an output gap at +0.8% of GDP; the only exemption is the IMF with an estimate of -1.5% of GDP (April 2021).

[9] The EC recommends that consolidation should be started in 2023, whereas the IMF has not yet presented its opinion whether it would be desirable to start in 2022 or 2023 due to prevailing uncertainty. The IMF consents to intensified incentives in 2021 and recommends consolidation when the recovery of the economy becomes sufficiently rooted. In the event of a better-than-expected development, the unused reserves should be spared and used for debt reduction.

- according to the current forecasts, the Slovak economy is expected to be moderately overheating in 2022 and, on the other hand, there is a risk of economic cool-down in 2024 (a decline in the drawing of EU funds is expected due to the transition from the third to fourth programming period);
- political cycle – accumulating consolidation effort into 2024 may prove non-credible;
- the government may continue addressing any potential deterioration of the pandemic situation through one-off targeted support and/or by shifting the future investments into the present, while none of these forms of fiscal stimulus *exacerbate consolidation*. Temporary support and consolidation measures are not mutually exclusive;
- if an amendment to the constitutional Fiscal Responsibility Act was adopted, it would require consolidation effort amounting to 0.5% of GDP in 2022 and 1% of GDP in the following years (it could be less in 2024, if the adoption of a pension system reform eased the high risk of long-term sustainability to a medium level);
- Slovakia is in a different position than an average EU country:
  - the estimated inflow of resources from the Next Generation EU recovery fund to Slovakia is nearly triple the average level for EU countries, therefore, its economy may start overheating sooner;
  - Slovakia shows the worst long-term sustainability of all EU Member States (indicator S2 according to the Commission) and, according to the Commission assessment, its short-term fiscal risk indicator (indicator S0) is at high risk, as well. The medium-term fiscal risk indicator (indicator S1) is at medium risk;[10]
  - according to the Commission forecast, Slovakia's economy has the highest level of overheating in the EU in 2022;
  - the macroeconomic impacts of the pandemic are rather weaker in Slovakia, the less affected industry sector has a much greater influence and household consumption is more resilient in Slovakia (a higher share of basic goods and services).

Measures missing to improve sustainability

Due to the pre-crisis fiscal policy and the pandemic, the long-term sustainability of public finances at 6.7% of GDP reached the high-risk threshold. Fiscal policy measures adopted after the general elections have so far improved the indicator by 0.6% of GDP, pushing it down to 6.1% of GDP. Improving the long-term fiscal sustainability is a key objective of fiscal policy in Slovakia[11]. Therefore, the government's fundamental ambition should be to present a specific plan on how and to what extent it intends to achieve that improvement.

The May 2021 sustainability assessment[12] already contains a baseline scenario of how the budget is expected to develop if no additional measures are adopted. The deficit automatically decreases under this scenario from the estimated level of 7.7% of GDP in 2021 to 3.7% of GDP in 2024. In order to improve the long-term sustainability and in the absence of other measures with long-term effects (such as, for example, a pension system reform), it would thus be necessary to keep the deficits below this envisaged adjustment path. The approved Stability Programme has no such ambition. Meeting the government's objective in 2024 means the structural primary balance will be 0.4% of GDP worse off, increasing the sustainability

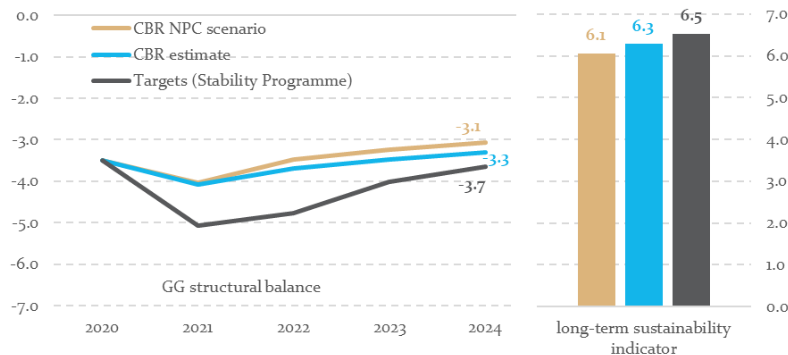
[10] https://ec.europa.eu/info/sites/default/files/economy-finance/swd-2021-501_en_v2.pdf

[11] The National Reform Programme of the Slovak Republic 2020: "*The main objective of the budgetary policy is to ensure the effectiveness and long-term sustainability of public finances in order to support sustainable economic growth and enhancement of the quality of life in the context of ageing, with due regard to contingent liabilities. This objective is anchored in the constitutional Fiscal Responsibility Act and, as such, affects the regular updates of the public finance management strategy.*"

[12] CBR, Report on the Long-term Sustainability of Public Finances at 18 May 2021 (June 2021)

indicator by the same amount, that is, the long-term sustainability indicator would raise to at least 6.5% of GDP[13].

Chart 1: General government's structural balance and long-term sustainability indicator under scenarios (% of GDP)



Source: Slovak Statistical Office, CBR

The government has committed to improve the long-term sustainability of public finances by 1.8% of GDP (measured by indicator S2) under the Slovak recovery and resilience plan, which is equivalent to approximately 0.9% of GDP as measured by the CBR's sustainability indicator (50 years). At the same time, the Ministry of Labour, Social Affairs and Family of the Slovakia Republic submitted in late May 2021 a constitutional act on adequate material security in old age for discussion by the government's Legislative Council and the Economic and Social Council of the Slovak Republic[14]. From the perspective of public finances, the effect of the proposed pension system reform on the improvement of their long-term sustainability is considerably lower than expected, at the level of 0.5% of GDP.

The reason is that the positive effect of linking the retirement age to the average life expectancy (-1.5% of GDP) would largely be curtailed by the negative effects of introducing a parental bonus (+0.7% of GDP) and other measures which, taken together, contribute to the worsening of the long-term sustainability of public finances by +0.4% of GDP (higher pension entitlements for the periods of parenthood, introducing the possibility of early retirement after having worked 40 years)[15].

Even though the new legislation was expected to anchor the fundamental principles of the good functioning of all pension system pillars and to radically improve the long-term sustainability of public finances, it goes only halfway to meeting these parameters. Moreover, the sustainability of the pension system will fail to return to its 2018 level because the impact of this proposal is just a third the size of this objective.

[13] If the objectives were achieved through one-off measures rather than by improvements in the structural deficit, the sustainability would worsen roughly by 1 p.p. towards the 7% of GDP level.

[14] The CBR, along with the finance ministry and the NBS, raised several major objections to the amendment which, however, have not been resolved.

[15] More details can be found in part 2 of the analytical paper (available in Slovak only).

Recommended budgetary objectives and how to achieve them

Given the economic development that serves as the basis for the preparation of the Stability Programme, the Council believes it realistic to expect from the government that, by 2024, it will adopt measures to stabilise the gross debt and safely reduce the high-level sustainability risk to the medium risk level (indicator around the level of 4% of GDP). This would require that measures in a total size of 2.3% of GDP be adopted by the end of 2024. The objective may be achieved by combining cuts in the structural deficit with other measures having a long-term effect, such as the pension system reform.

Defining specific fiscal policy objectives is the responsibility of the Ministry of Finance and the government. With respect to the recommended improvement of the long-term sustainability indicator by 2024, the CBR presents three possible scenarios in the following table, which could be considered when defining the fiscal policy objectives. The scenarios differ by the "size" of the pension reform. While the first scenario assumes that the obligation under the recovery and resilience plan and the Stability Programme is fully met, having an effect of 0.9% of GDP[16], the last scenario does not expect any change in the pension system. The necessary medium-term consolidation effort then ranges from approximately 1.4% of GDP under the first scenario to as much as 2.3% of GDP under the third one. Since the CBR does not expect now that the obligation under the recovery and resilience plan will be fully met, given the current wording of the draft constitutional act, a more likely, medium scenario, is also included.

Table 3: Consolidation scenarios (50-year horizon, long-term sust. indicator, % of GDP)

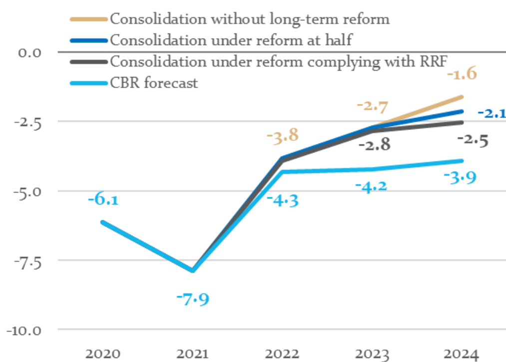
	CBR's baseline estimate	Effect of the reform	Consolidation needed by 2024	Indicator after consolidation and reform
1. Recovery and resilience plan obligation fully met	6.29	-0.93	-1.36	4.00
2. Long-term reform at 50%	6.29	-0.47	-1.83	4.00
3. No long-term reform	6.29	0.00	-2.29	4.00

Source: CBR

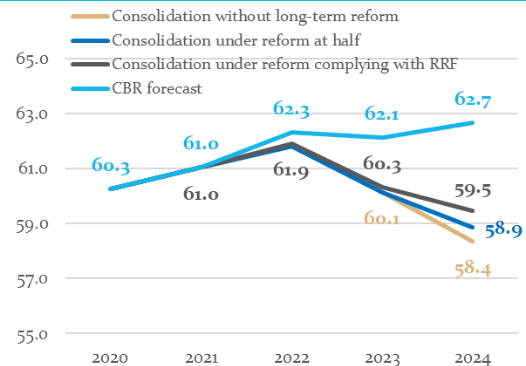
Even though the gradual economic recovery curbs the supply-chain restoration and the economy is returning to its original potential level by degrees only, the economy may, under the current forecast, reach its potential as early as 2022 which is a strong argument in favour of starting the consolidation of public finances. Therefore, regardless of the expected effects of long-term reforms, the CBR recommends resuming the consolidation effort in 2022 and continue with temporary, targeted support should the pandemic situation worsen.

[16] That is, 1.8% of GDP measured by indicator S2.

Chart 2: General government balance development under scenarios (% of GDP)



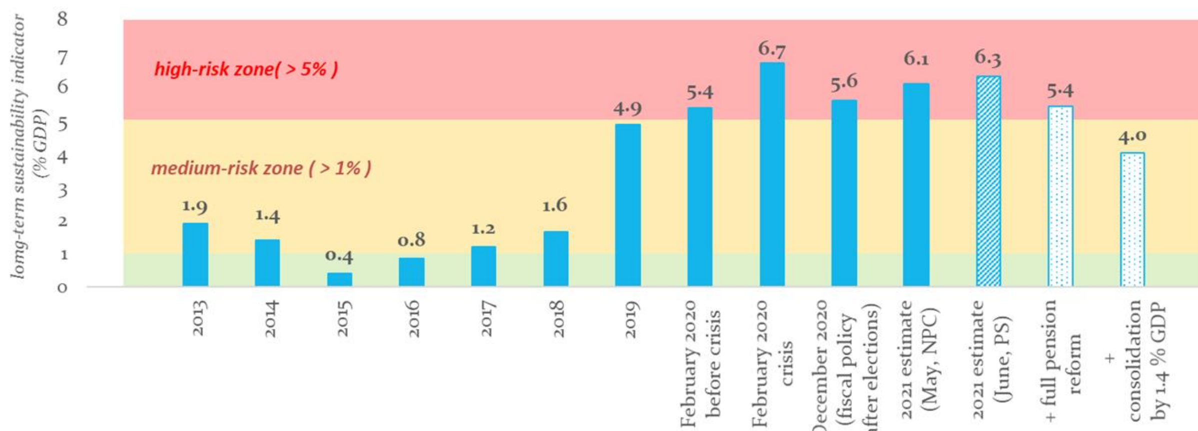
Graf 3: General government debt development under scenarios (% of GDP)



Source: Slovak Statistical Office, CBR

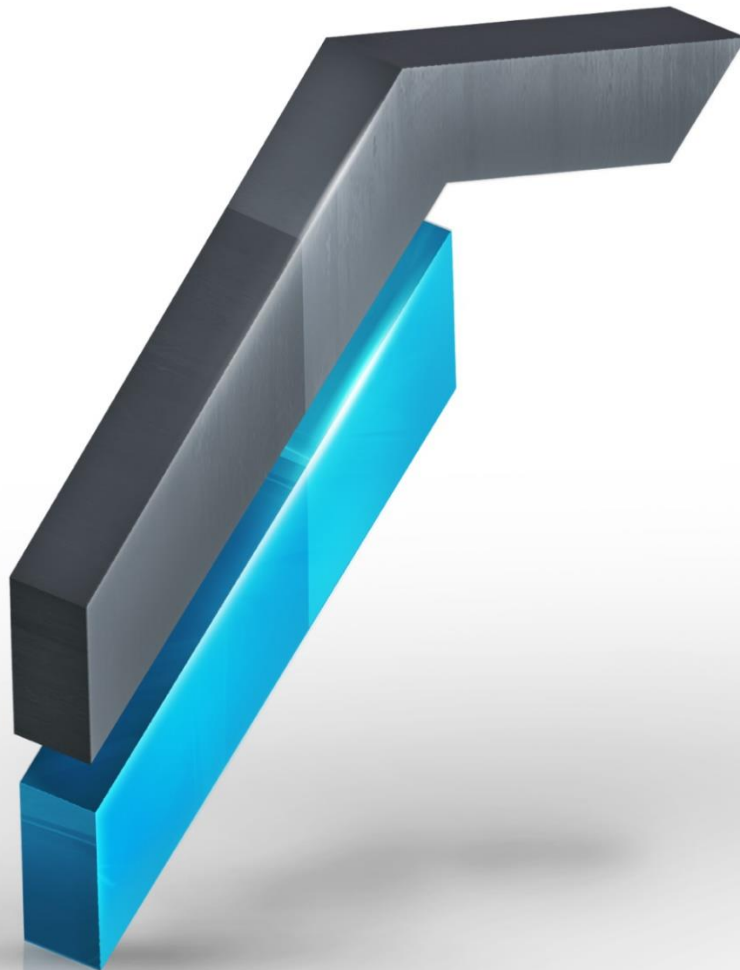
According to the CBR, the most suitable of the three presented scenarios on how to achieve the recommended budgetary objectives (debt stabilising the deficit below 3%, long-term sustainability indicator at least at a level of 4% of GDP) is scenario No. 1 which assumes that the obligation declared in Slovakia's recovery and resilience plan will be fully met. However, this would represent only a partial recovery of the pension system's fiscal stability to the 2018 level, and a lesser need to adopt additional essential debt-reducing measures in the future[17].

Chart 4: Long-term sustainability development (long-term sustainability indicator in % of GDP, including the recommended scenario)



Source: CBR

[17] Additional measures totalling 1.2% of GDP would have to be adopted to bring the pension system's sustainability to its 2018 level.



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