CBR
COUNCIL FOR BUDGET RESPONSIBILITY

Report on the Long-term Sustainability of Public Finances for 2021

Main conclusions

April 2022

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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's website (http://www.rrz.sk/en).

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

Main conclusions

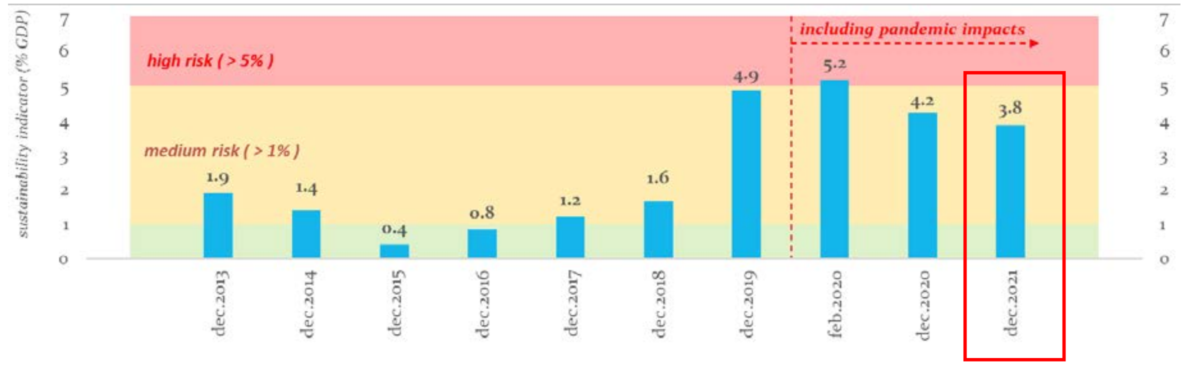
Within the upcoming decades, Slovakia will be facing higher costs caused by demographic developments, exposing the public finances to an ever-increasing pressure. One of the main tasks of the Council for Budget Responsibility ("CBR") laid down in the Fiscal Responsibility Act[1] is to publish the Report on the Long-term Sustainability of Public Finances. The report evaluates whether public policies, in conjunction with the assumed demographic and macroeconomic development, have been set up in a sustainable manner from the perspective of public finances.

Evaluation of the long-term sustainability for 2021

The baseline scenario presented in this report is based on the **end of 2021** and captures the impacts of the coronavirus pandemic on the long-term sustainability of public finances, **but does not take into account consequences of the war in Ukraine**[2]. **The Council notes that the long-term sustainability of public finances was not achieved**[3] **even in 2021.**

However, **the most recent results for the 2021 budget**, along with the revised results for 2020, **indicate a clear turning point as the long-term sustainability indicator improved deeper into the medium-risk zone and reached 3.85% of GDP (EUR 4.1 billion)**[4].

Chart 1: Long-term sustainability indicator (% of GDP)



Source: CBR

The long-term sustainability of public finances has significantly deteriorated in 2019 in particular due to legislative changes in the pension system[5], as well as a worsened budgetary policy (i.e., an increase in the structural deficit in comparison with 2018). At the end of 2019, **when Slovakia enjoyed**

1 The Council prepares and publishes the long-term sustainability report, including the baseline scenario and the calculation of the long-term sustainability indicator, annually as of 30th of April and within 30 days of the parliamentary debate on the Government Manifesto and the vote of confidence in the government.

2 The most recent macroeconomic forecasts from March 2022 were not included to better reflect the state of sustainability for 2021. The war in Ukraine broke out in February 2022, therefore its impact on sustainability should be considered as late as in the 2022 evaluation.

3 Outside the low-risk zone. 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 the 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.

4 According to the CBR, indicator values between 1 % and 5% of GDP represent a medium risk. Indicator values above 5% of GDP are considered by the CBR a high risk for the long-term sustainability.

5 This involved, in particular, introduction of the retirement age ceiling, an increased minimum pension benefit, doubled Christmas bonus and a correction (decrease) of the future pensions benefit reduction from the pay-as-you-go pillar for fully-funded pillar participants.

economically good times and unemployment was at all-time lows, **public finances came very near to the high-risk threshold**.

Sustainability continued to deteriorate also during the first months of 2020 (e.g., a significant increase in public sector wages, along with the introduction of the 13th pension payments, albeit with no additional resources allocated for this purpose), which contributed to **public finances entering the high-risk zone in sustainability in February 2020** (with the long-term sustainability indicator reaching 5.2% of GDP).

The original estimates from April 2021 **suggested even further deterioration of the long-term sustainability** of public finances for 2020 to 5.6% of GDP, in particular, due to the outbreak of the pandemic. However, after taking into account the revised results of fiscal performance for 2020[6] and updated forecasts of implicit liabilities associated with population ageing[7], the **value of the long-term sustainability indicator reached** 4.18% of GDP **at the end of 2020** despite the pandemic, thus falling within the **medium-risk zone**[8]**.**

[6] The general government deficit dropped by 0.7% of GDP in particular due to higher revenue from corporate income tax, which has also been fully reflected in the structural balance improvement in 2020. The improvement of the indicator by 0.12 p.p. was also driven by the expected medium-term development following the incorporation of the current medium-term macroeconomic forecast based on actual figures for 2020.

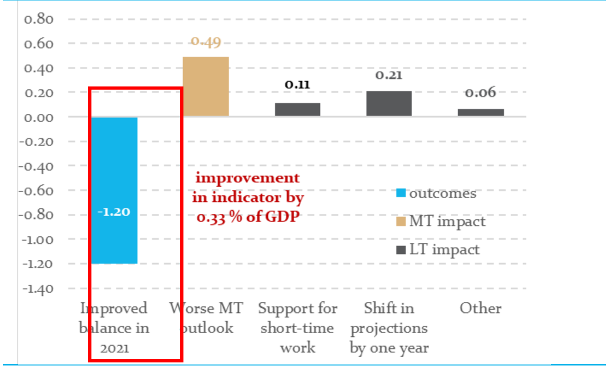
[7] The most significant effect came from a change in the projection of the universal pension system in particular due to the revision of medium-term expenditure forecasts. The revision of the assumed long-term development in the non-accelerating wage rate of unemployment has been reflected positively beyond the medium-term horizon. In the long-term horizon, due to a significant reduction in the 2020 estimate of the current development in material need expenditure for pensioners, the 2070 estimate was decreased significantly as well.

[8] According to the methodology of the European Commission (S2 indicator), which places more emphasis on the results in the last year of the projection in comparison with the national methodology, the public finances would remain within the high-risk range (6.26% of GDP). For 2021, however, they would already enter the medium-risk zone even according to the S2 indicator (5.64% of GDP, the medium-risk threshold is 6% of GDP).

In 2021, long-term sustainability continued to improve deeper into the medium-risk zone year-on-year

In comparison with 2020, the sustainability of public finances has improved by an additional 0.33% of GDP in 2021. **The most significant positive effect of 1.2% of GDP was driven by a reduction in the general government structural deficit in 2021**, the second greatest improvement since 2012 in particular due to the unspent higher revenue from taxes and non-spending of capital expenditure.

Chart 2: Factors contributing to the change in the long-term sustainability indicator between 2020 and 2021 (% of GDP)



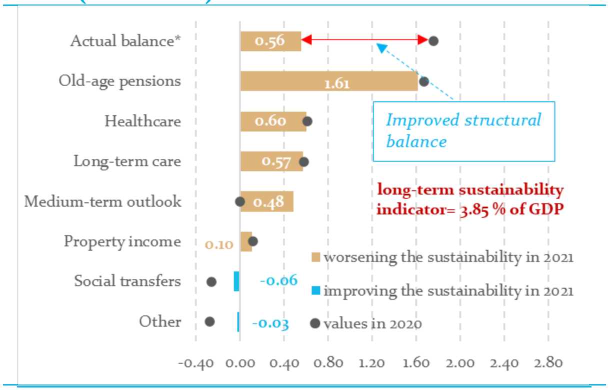
Note: MT – medium-term, LT – long-term *Source: CBR*

The negative impact comes in the form of worse development in public finances in the medium-term horizon, contributing with 0.49 p.p. This deterioration is partly related to the fact that some items contributing to the improvement of the structural balance in 2021 are of temporary nature and will not be reflected across the entire horizon of projections. The indicator also worsened by 0.11 p.p. due to the introduction of support for short-time work, the so-called kurzarbeit[9], from March 2022. In the long-term horizon, negative impacts have not changed significantly year-on-year because of the absence of a pension reform.

Problems in the long-term sustainability of public finances are primarily caused by pensions; budget development has improved significantly

If, over the next 50 years, **fiscal performance remains permanently at the levels seen in 2021**, the long-term sustainability indicator would be only at **0.6% of GDP.** However, already in the medium-term horizon, the Council expects less favourable development in public finances, which will **contribute to sustainability worsening by 0.5% of GDP**, thus totalling 1.1% of GDP.

Chart 3: Long-term sustainability indicator in 2021 (% of GDP)



*Note.: *the impact of the initial budgetary position, i.e. structural primary balance and gross debt in 2021, Medium-term outlook – items with own indexation within the medium-term part of the baseline scenario.* *Source : CBR*

Maintaining the balance at such levels is not automatic, because long-term sustainability is negatively affected in particular by future increases in expenditure sensitive to population ageing. **By 2071**, such expenditure is expected to **rise by 5.0% of GDP, where the pension system balance constitutes the most significant negative impact, contributing 1.6% of GDP**. Higher **healthcare and long-term care** expenditure will cause sustainability to worsen by an **additional 1.2% of GDP**.

In the baseline scenario, the debt would decline below 50% of GDP already in 2025 assuming no negative shocks (such as the war in Ukraine) or changes in policies

[9] The estimated negative impact is related to the fact that support will be paid from the social security system subject to meeting the conditions prescribed by law, while the overall social contribution burden (i.e., sources of funding for such support) remains unchanged. This is only a direct financial impact, not including the positive impact of this measure on saving jobs.

At the end of 2021, general government gross debt reached 63.1% of GDP, whereas net debt came in at 51.3% of GDP. The reason is that the cash reserve, as a percentage of gross debt, reached an all-time high of 18.7%. **If the cash reserve percentage remained at its long-term average, gross debt would have been lower by 4.1% of GDP, i.e., slightly below the level of 60% of GDP**.

When taking into account the fiscal policy setup at the end of 2021, a gradual release of the above-average cash reserve and the absence of additional measures and negative shocks (such as the war in Ukraine**), gross debt relative to GDP would be declining sharply to temporarily fall below the level of 50% of GDP at the end of 2025, as required by the constitutional Fiscal Responsibility Act (**see Chart 4**).**

Subsequently, the debt would start rising again due to demography and, in 50 years, **under the baseline scenario** (i.e., without a pension reform), **it would reach 271.8% of GDP.** This is a hypothetical scenario because the **markets would cease to finance Slovakia's needs at much lower debt levels**. If the state deviates from a credible fiscal policy and the risk of sovereign default becomes higher, **interest rates** will rise **in the form of higher risk premiums**. In terms of the long-term sustainability, it is crucial to keep the debt level as low as possible in the present times, so that it could be moving around "a safe level" when taking into account the possibility of rising risk premiums in the future.

Chart 4: Debt projection under the baseline scenario (% of GDP)

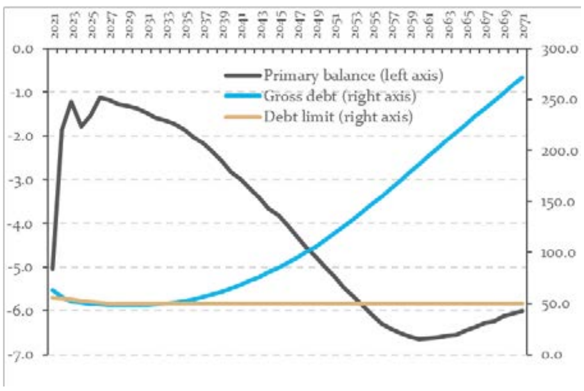
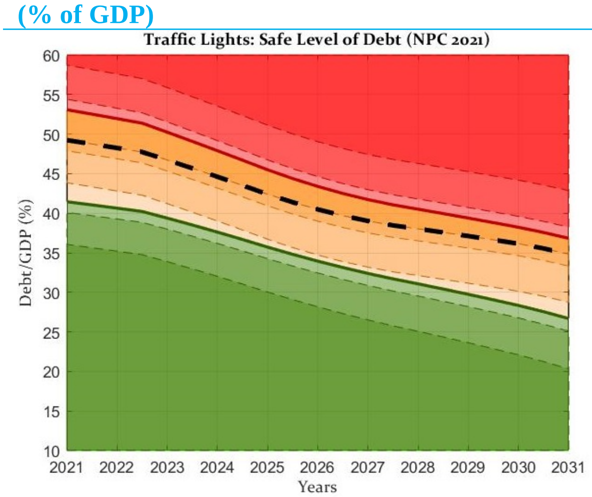
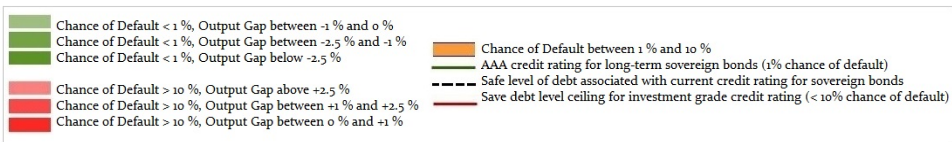


Chart 5: Traffic lights for a safe debt level (% of GDP)





Source: CBR

According to the modelling assumptions (and without the pension reform), **the upper threshold of a safe debt level for 2021 is 53% of GDP.** Exceeding the level of indebtedness significantly above this level for a longer time would carry an increased risk of falling to the non-investment grade unless additional reforms are undertaken to improve the long-term sustainability of public finances. **If governments let the upcoming years,** characterised by decent economic growth and relatively stable expenditure associated with population ageing, **slip through** their fingers without undertaking any reforms (in particular the reforms in pension, healthcare or long-term care systems) and without making further cuts in the structural deficit, the **safe level of indebtedness would gradually fall to as low as 37% of GDP by 2030.**

As shown by the risk scenarios quantifying the impacts of higher increases in energy prices or the response of financial markets and the ECB, **full use of the state's short-term surplus revenue brought by high inflation could worsen the long-term sustainability of public finances.**

If investors become sensitive again to the country's ability to repay its long-term liabilities (for instance, after quantitative easing comes to an end), an increase in the risk premium would become, particularly after 2040, an essential factor causing the debt to increase to unsustainable levels, even much worse than the levels under the baseline scenario (505% of GDP vs. 272% of GDP).

Without pension reform, long-term sustainability will worsen in 2022 due to the war in Ukraine and government measures

Following the amendment to the Budgetary Rules Act introducing expenditure ceilings, this is the first time that the CBR is publishing the baseline scenario for development in public finances, as well as the long-term sustainability indicator necessary for calculating the public expenditure ceiling[10]. The baseline scenario is based on the estimated development of public finances in 2022[11] and reflects the most recent official macroeconomic and tax forecasts, i.e., including the initial partial estimate of the impact of the war in Ukraine, as considered by the Macroeconomic Forecasting Committee at the Ministry of Finance of the Slovak Republic. However, the announced pension reform is not taken into account, as it has not been approved by the parliament to date.

Assuming that this scenario will materialise, the **long-term sustainability indicator** would **reach 5.38% of GDP**, thus implying **high risks associated with long-term sustainability**. In comparison with the baseline scenario based on 2021 where the long-term sustainability indicator stood at 3.85% of GDP, this represents an overall deterioration of 1.53 p. p. Part of the deterioration (with a contribution of 0.57 p. p.) is related to the revised macroeconomic development reflecting the initial impacts of the war in Ukraine, by using the forecasts of the Tax Revenue Forecasting Committee and shifting the horizon of the baseline scenario by one year. Deterioration of the indicator by 0.96 p. p. is attributed to the government's measures included in the 2022 estimate (in particular, full use of reserves for supporting the economy and new legislative measures, adoption of measures to offset inflation and additional investments). After taking into account the requirements for sustainability improvement based on the approved expenditure ceilings amounting to 0.5% of GDP per year (1% of GDP cumulatively for 2023 and 2024), **making full use of the expenditure ceilings at the end of 2024 would only compensate for the estimated deterioration of sustainability in 2022 caused by the inclusion of government's measures.**

[10] The purpose of the baseline scenario for the development of general government revenue and expenditure is to determine the planned structural balance as a base value for calculating the ceiling for individual years. The value of the long-term sustainability indicator then determines the actual riskiness of public finances which serves as the basis for calculating the required structural balance improvement in individual years. This provides a link between the public expenditure ceiling and the long-term sustainability of public finances.

[11] Considering that the ceilings are calculated for the first time and, atypically, in the middle of the election cycle, a unique approach[11] to determine the balance estimate in 2022 has been chosen following an agreement with the Ministry of Finance. The estimate respects the current legislative framework established by the approved 2022 State Budget Act and the ensuing updated estimate of spending by the Ministry of Finance. For other general government entities, the baseline scenario is based on the development in 2021 after incorporating the CBR's assumptions.

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