Public finance consolidation in Slovakia

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The document offers a brief overview of the public finance consolidation in Slovakia over the period 2008-2018. Slovakia decreased public finance deficit from almost 8% of GDP in 2009 to less than 3% in 2014 and plans to decrease it further to less than 0.5% in 2018. Two major consolidations appeared in 2011 – mostly on expenditure side and in 2013 – mostly on revenues side. At the same time, Slovakia succeeded in stabilizing the public debt growth that almost doubled from 28.2% of GDP in 2008 to 54.6% in 2013; then decreased to 53.6% in 2014 and should decrease further to 50.3% of GDP in 2018. Besides public finance deficit reduction the reform to the pay-as-you-go (PAYG) pension system adopted in 2012 helped significantly to improve the long-term sustainability of the public finance when the GAP indicator decreased from over 9% of GDP in 2009 to less than 2% in 2013. After the 2009 crises, major consolidation measures included cutting public expenses in 2011, binding the retirement age to longevity and gradual introduction of pension valorization by inflation legislated in 2012, as well as raising taxes and improving tax collection efficiency since 2013. To guard public finance stability the constitutional law enacted public debt brakes and established the Council for Budget Responsibility in 2012. The case of Slovakia shows that internal rules guarding public finances might work well if legislated by constitutional majority and controlled by high-quality and credible people in the leadership of the guarding body. The European Commission helped a lot by strengthening its oversight especially under the Excessive Deficit Procedure imposed on Slovakia in 2009-2013. The ESA2010 standards helped to disclose some hidden debt; nevertheless the PPP projects and the old debt of public hospitals remain off-balance.

The document was prepared for a webinar "Public Finance Consolidation" taking place on May 22, 2015 under the project "Hidden Triggers of Economic Growth in V4 plus Ukraine"[1] supported by the International Visegrad Fund. The project is led by INEKO with partners from Poland, Hungary, Czech Republic and Ukraine.

The Institute for economic and social reforms (INEKO) is a Bratislava-based non-governmental non-profit organization established in support of economic and social reforms which aim to remove barriers to the long-term positive development of the Slovak economy and society. See also http://www.ineko.sk/.

[1] See http://www.ineko.sk/projekty/visegrad-fund.

Introduction

People in all Visegrad countries (Czech Republic, Hungary, Poland, and Slovakia) consider the government debt to be among the top problems faced by their country. In all countries people list unemployment as the biggest problem. In the Czech Republic government debt is on the second place, in all other countries it is on the 5th or 6th place. However, the gross public debt is the lowest in the Czech Republic – 42.6% of GDP in 2014. For comparison, it was 53.6% of GDP in Slovakia or 76.9% in Hungary (see Tables 1 and 2). It is difficult to explain this difference. One of hypothesis might be that the more people think public debt is the problem the bigger is the pressure on government so solve it.

Table 1: Most important issues faced by the country

Czech Republic	Hungary	Poland	Slovakia
Unemployment (40%)	Unemployment (50%)	Unemployment (54%)	Unemployment (57%)
Government debt (27%)	Economic situation (30%)	Health care system (25%)	Economic situation (31%)
Rising prices/Inflation (24%)	Health care system (21%)	Rising prices/Inflation (19%)	Health care system (23%)
Economic situation (20%)	Rising prices/Inflation (20%)	Pensions (19%)	Rising prices/Inflation (21%)
Crime (20%)	**Government debt (13%)**	Economic situation (17%)	Pensions (13%)
Pensions (17%)	Pensions (13%)	**Government debt (11%)**	**Government debt (11%)**

Source: Eurobarometer, November 2014

Table 2: Gross public debt (% GDP, 2014)

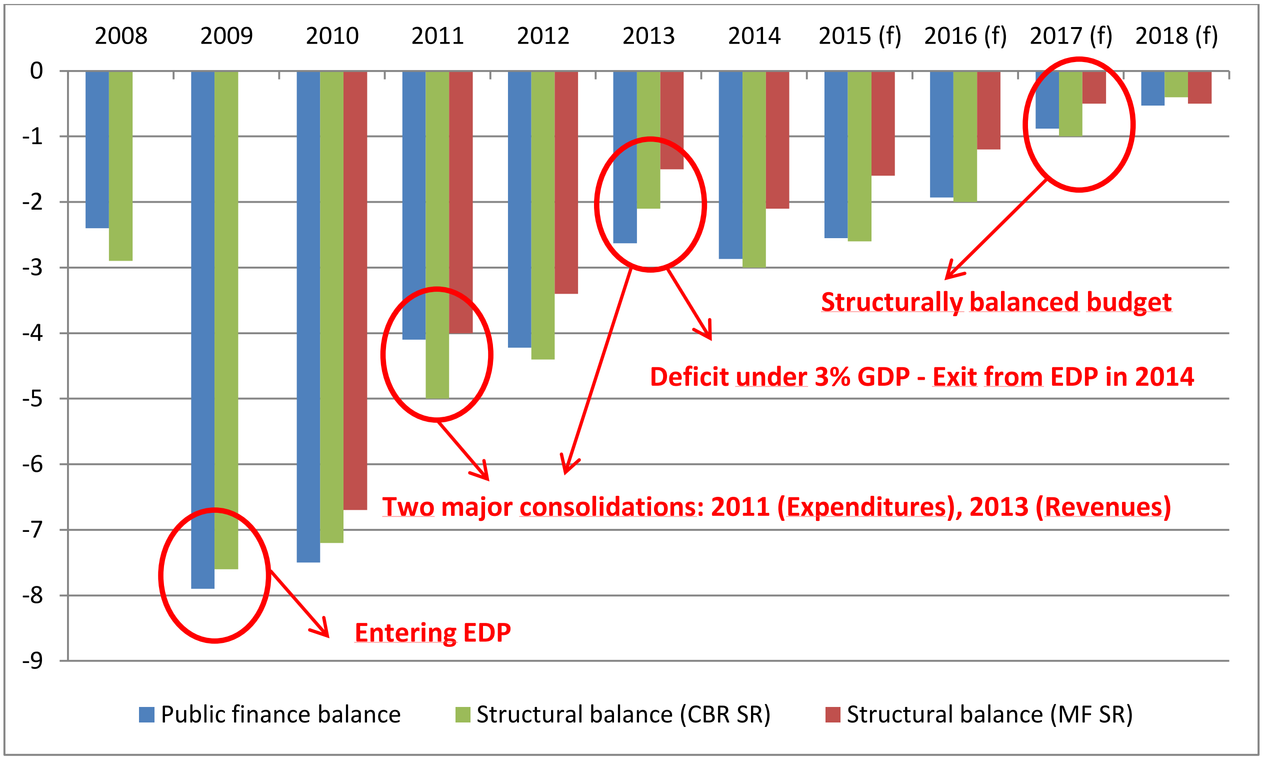
Czech Republic	Hungary	Poland	Slovakia
42.6	76.9	50.1	53.6

Source: Eurostat

Public finance balance

The crises blew up the public finance deficit in Slovakia from 2.4% of GDP in 2008 to 7.9% in 2009. After two major consolidations in 2011 – mostly on expenditure side and in 2013 – mostly on revenues side, the deficit decreased to less than 3% in 2014 and the Ministry of Finance plans to decrease it further to less than 0.5% in 2018. As shown in Figure 1, Slovakia entered the Excessive Deficit Procedure imposed by the European Commission in 2009 and left it in 2014. The deficit increased in 2014 but remained under 3% threshold.

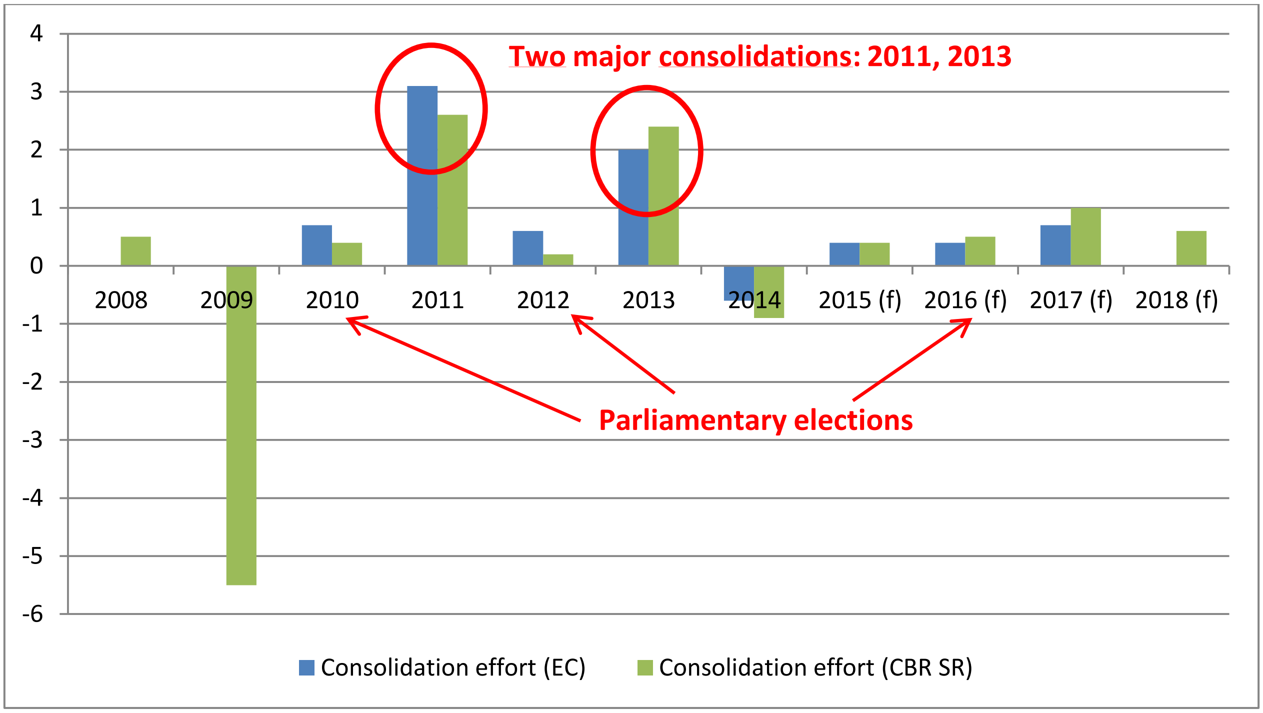
Figure 1: Public finance balance in Slovakia (% GDP)



Sources: Ministry of Finance (MF SR), Council for Budget Responsibility (CBR SR)

The Ministry of Finance plans to have structurally balanced deficit (i.e. cleared by one-off measures and economic cycle) by 2017. To achieve this goal the consolidation must continue in 2015- 2017. However, in March 2016 there will be parliamentary elections which might prove it difficult to cut the deficit especially in 2015 and 2016. The Figure 2 shows that the major consolidations in 2011 and 2013 came one year after the parliamentary elections. Therefore it will be crucial what will be the size and structure of measures adopted by a new government coming into power after 2016 elections.

Figure 2: Consolidation effort – change in structural deficit (% GDP)

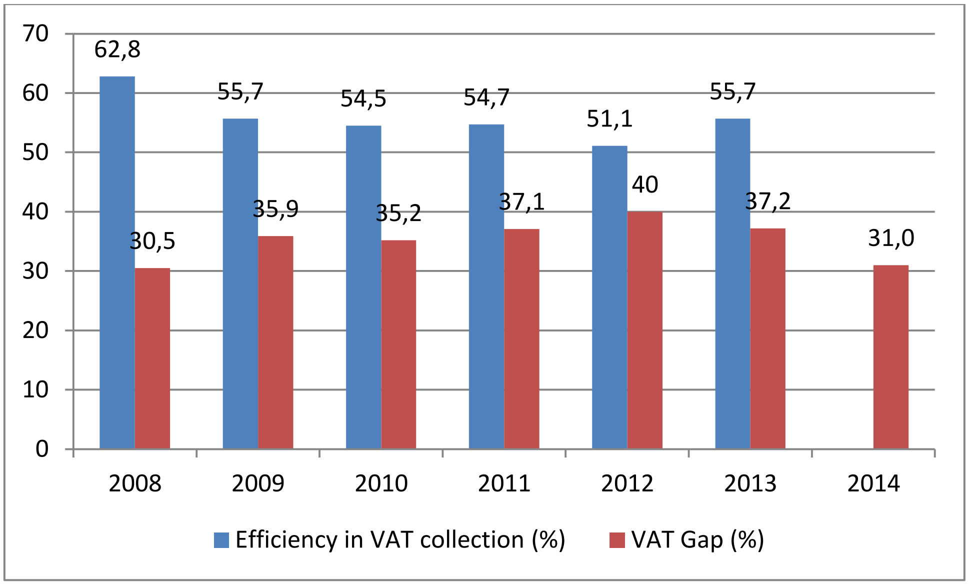


Sources: INEKO based on data from the European Commission (EC) and from the Council for Budget Responsibility (CBR SR)

The 2011 consolidation included cuts in expenditure on public procurement, staff remuneration and also increasing the value-added tax (VAT) from 19% to 20%.

The 2013 consolidation included increasing corporate income tax from 19% to 23% (since 2014 decreased to 22%), introducing higher rate of the personal income tax for top-earners at 25% (lower rate remained at 19%), increasing social contributions for top-earners, increasing taxes for self-employed, as well as introducing special tax levies for regulated monopolies and financial institutions. Besides increasing taxes the government adopted around 50 measures with the aim to improve tax collection. From among them the most important included more targeted effort to disclose fraud cases (establishing “tax-cobra” commando), introducing electronic central evidence of invoices enabling cross controls, increasing tax transparency (publishing taxes paid by firms), extending “reverse charge” VAT payment mechanism with the VAT paid by buyers, extending the use of registration machines (i.e. by hotels, physicians, taxi drivers, etc.), more targeted controls of transfer prices, etc. The results became evident in 2013 when the efficiency in VAT collection increased from 51.1% to 55.7% (see Figure 3) and the VAT gap decreased from 40% in 2012 to 31% in 2015. Thus the additional VAT revenues brought by the improved efficiency in collection amounted to more than 1% of GDP in 2014 compared to 2012.

Figure 3: Efficiency in VAT collection

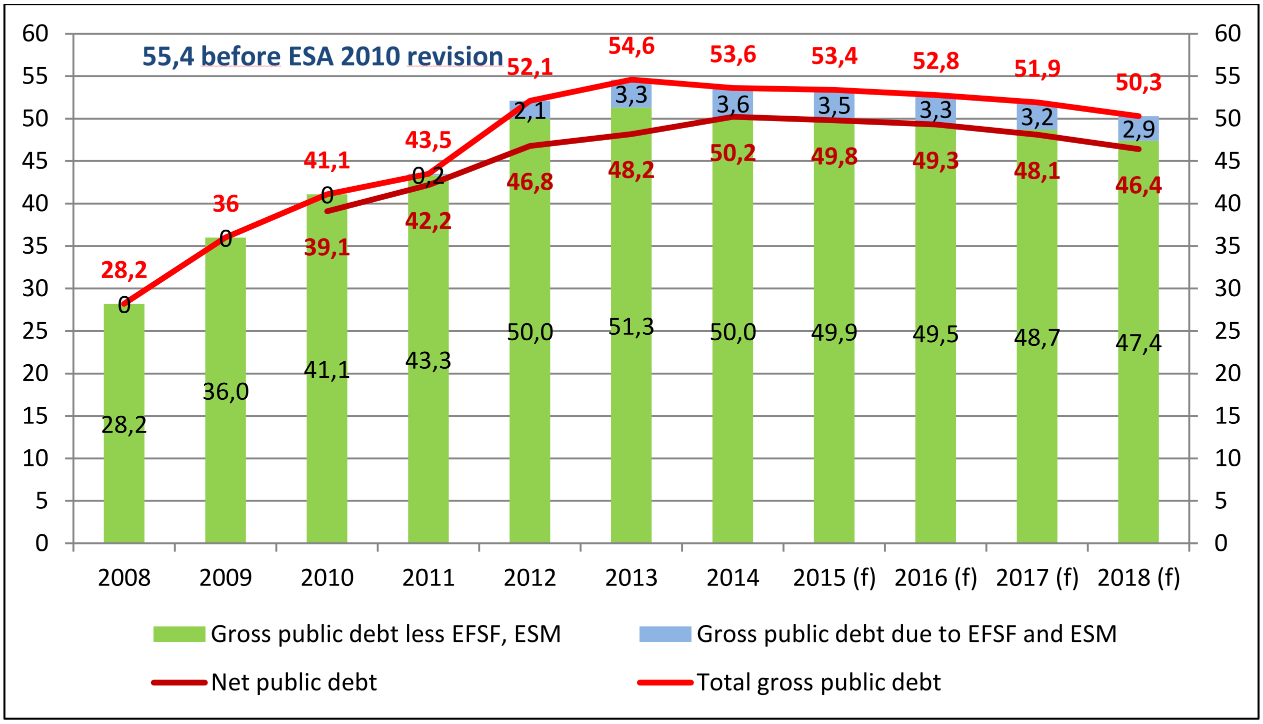


Source: MF SR

Public debt

Slovakia succeeded in stabilizing the public debt growth that almost doubled from 28.2% of GDP in 2008 to 54.6% in 2013; then decreased to 53.6% in 2014 and should decrease further to 50.3% of GDP in 2018. Since 2012 the public debt has been increased by 2.1-3.6 percentage points due to participation of Slovakia in the European Financial Stability Facility (EFSF) and later in the European Stability Mechanism (ESM), i.e. mostly by the guarantees provided by Slovakia for the debt of Eurozone countries unable to pay their liabilities after the crises. The net public debt, i.e. gross debt less the liquid assets peaked at 50.2% of GDP in 2014 and is expected to decline to 46.4% by 2018.

Figure 4: Public debt in Slovakia (% GDP)



Source: INEKO based on data from the Ministry of Finance (MF SR)

The debt growth stabilization was supported by the Constitutional Act on Budget Responsibility adopted in 2012 introducing the debt brakes and the new institution for guarding public finance stability – the Council for Budget Responsibility. The Act introduced following levels of public debt brakes:

- Public debt at 50% of GDP:
  - The Ministry of Finance has to inform the National Parliament about reasons of surpassing the debt level and about the measures to decrease the public debt.
- Public debt at 53% of GDP:
  - The Government has to propose to the National Parliament measures to reduce the debt; the salaries of the Government Members are frozen.
- Public debt at 55% of GDP:
  - Additionally to measures adopted under previous levels, the Government has immediately to cut 3% of the state budget expenditure (less the expenditure on (1) public debt service, (2) relations with the EU, (3) transfers from the state budget to the Social Insurance Agency and (4) liquidation of damages caused by natural catastrophes).
  - For the next year the government has to freeze the public finance expenditure (less the expenditure on (1) public debt service, (2) relations with the EU, and (3) liquidation of damages caused by natural catastrophes).
  - At the same time the municipalities have to freeze their expenditure for the next year (less the expenditure on (1) relations with the EU and (2) liquidation of damages caused by natural catastrophes).

  - Moreover, the Government has to stop drawing money from its reserve and from the reserve of the Prime Minister.
- Public debt at 57% of GDP:
  - Additionally to measures adopted under previous levels, the Government and the municipalities have to propose balanced budgets for the next year.
- Public debt at 60% of GDP:
  - Additionally to measures adopted under previous levels, the Government has to ask the National Parliament for the vote on confidence.

These debt brake levels are valid until 2017. In the transition period from 2018 until 2027 the limits will be decreasing gradually by 1 percentage point every year to final 40% for the lowest level and 50% for the highest level.

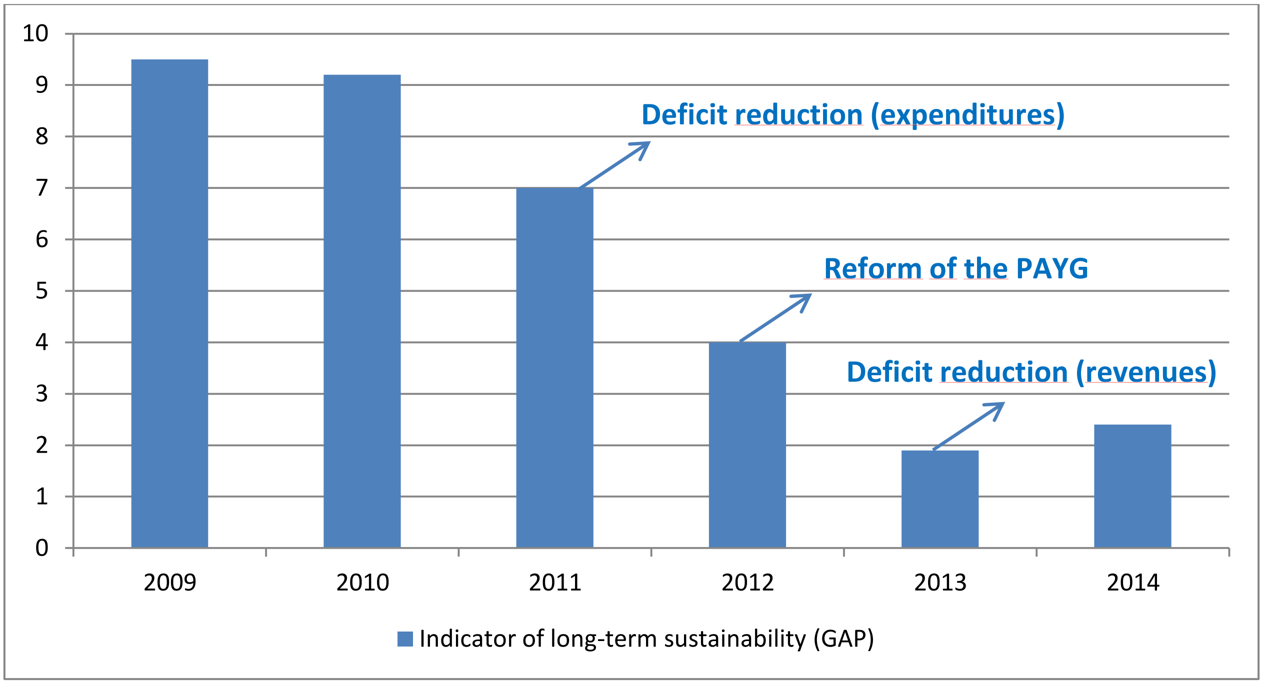
As shown in Figure 4 the 50% limit was surpassed in 2012 and the 53% limit was surpassed both in 2013 and 2014. In fact, early in 2014 the Eurostat confirmed even surpassing the 55% limit with the debt at 55.4% of GDP in 2013. However later due to adopting new ESA2010 methodology and especially new methodology for GDP calculation the debt level for 2013 was revised down to 54.6% of GDP.

The ESA2010 standards helped to disclose some hidden debt; nevertheless the PPP projects and the old debt of public hospitals remain off-balance. The biggest liabilities from PPP projects stem from the project on building a highway R1 in the amount of 2.7% of GDP. The old debts of state hospitals amount to 0.6% of GDP. Other hidden debt includes the off-public-balance-sheet debt of state and half-state firms (e.g. debt taken to pay-out the super-dividends; debts of firms owned by municipalities, etc.) as well as liabilities conditioned on ongoing court processes or state guarantees. The methodology for calculating this debt has not yet been set but the Congressional Budget Office estimated the conditional debt at 16.4% of GDP as of 2013; out of which 3.0% of GDP is EFSF.

Long-term sustainability

Besides public finance deficit reduction the reform to the pay-as-you-go (PAYG) pension system adopted in 2012 helped significantly to improve the long-term sustainability of the public finance when the long-term sustainability GAP indicator decreased from over 9% of GDP in 2009 to less than 2% in 2013. After the 2009 crises, major consolidation measures included cutting public expenses in 2011, binding the retirement age to longevity and gradual introduction of pension valorization by inflation legislated in 2012, as well as raising taxes and improving tax collection efficiency since 2013.

Figure 5: Long-term sustainability GAP indicator in Slovakia (% GDP)



Source: INEKO based on data from the Ministry of Finance (MF SR) and the Council for Budget Responsibility (CBR SR)

The 2012 reform of the PAYG pension pillar contributed heavily to the stabilization of the pension system by halving its long-term deficit. However it did not solve the entire problem. According to the Institute for Financial Policy at the Ministry of Finance[2], the pension system deficit is expected to decrease from 1.4% of GDP in 2013 to 1.1% in 2030 but than to increase to 3.7% of GDP in 2060.

The 2012 reform included following major changes:

- Prolonging retirement age: In 2004-2006 the retirement age of men went up from 60 to 62 years. Since 2004 also the retirement age of women has been increasing gradually up to final 62 years. The 2012 reform enacted that from 2017 the retirement age of both men and women will be linked to life-expectancy.
- Indexing pensions: The 2004 reform enacted automatic pension valorization by the index computed as an average of wage growth and inflation. The 2012 reform introduced a transition period from 2012-17 in which the pensions are being valorized by a fixed sum computed as the weighted average of wage growth and inflation divided by the average wage in the economy. The weight of inflation is gradually increasing. From 2018 the pensions will be indexed purely by the inflation for basket of goods bought by pensioners.

Besides changes to the PAYG pillar the government adopted several changes to the second fully-funded pension pillar that helped it to stabilize the public finance. The impacts of these changes on the public

[2] Source: http://www.finance.gov.sk/Default.aspx?CatID=10181

finance balance are positive or neutral until 2060 and increasingly negative afterwards. The most important changes included:

- Reducing the contribution rate to the fully-funded pillar from 9% of gross earnings to 4% with the effect from September 2013. This change has increased public finance revenues by around 0.6% of GDP annually. The rate is expected to grow up gradually to 6% by 2024.
- The government has four times re-opened the second pillar (in 2008, 2008/09, 2012/13, and 2015), i.e. it allowed people inside to return their full contributions back to the PAYG. During first three re-openings approximately 15% of people returned back to the PAYG.
- In 2008 and (after temporary restatement) repeatedly in 2013 the government introduced voluntary entry for young people, i.e. the young people entering the labor market are by default paying their full contribution to the PAYG unless they actively decide to enter the second pillar.

Current challenges and lessons learned

The need for public finance stability is becoming less imminent and the problem is less visible in the public discourse after reducing public finance deficit below 3% of GDP and public debt below 55% of GDP. The top government priorities reflecting people's concerns include high unemployment (especially long-term) and low quality of public services (especially in health care and education). Nevertheless the expert attention is still focused on following areas related to the public finance stability:

- Inefficiency and high indebtedness of the health care system; long-term predictions of growing deficit in health care and long-term care mainly due to demography changes.
- Long-term pension deficit predictions, growing after 2030.
- Inefficient use of the funds of the European Union which is resulting in substantial "corrections" meaning that the European Commission refuses to pay for some projects and the money has to be provided from the state budget increasing the public finance deficit.
- Further improvement of tax collection efficiency; increasing revenues from the real estate taxes; deepening tax transparency.

The case of Slovakia shows that internal rules guarding public finances might work well if legislated by constitutional majority and controlled by high-quality and credible people in the leadership of the guarding body. The European Commission helped a lot by strengthening its oversight especially under the Excessive Deficit Procedure imposed on Slovakia in 2009-2013 but also by introducing the Fiscal Compact, disclosing some of hidden debts under ESA2010 and strengthening the Stability and Growth Pact. Importantly, the public discourse supportive for fiscal prudence helps a lot with major roles played by media, think-tanks, and economic analysts. As an example of think-tank initiative, early in 2014 the INEKO institute launched a computer game[3] aiming to educate public about the need of public finance consolidation. The game is based on the actual long-term public debt projections. The goal is to decrease public debt by 2062 as much as possible. The game allows for choosing from over 200 consolidation

[3] Source: http://hra.ineko.sk/

measures and limits the player's options based on his/her political support which depends on measures already taken. The biggest news portal SME.sk displayed the game on its website and helped to attract several tens of thousands of players shortly after launching the game.