



**MINISTRY OF FINANCE
OF THE SLOVAK REPUBLIC**

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Calm After The Storm

Slovak Fiscal Strategy In The Post-Crisis World

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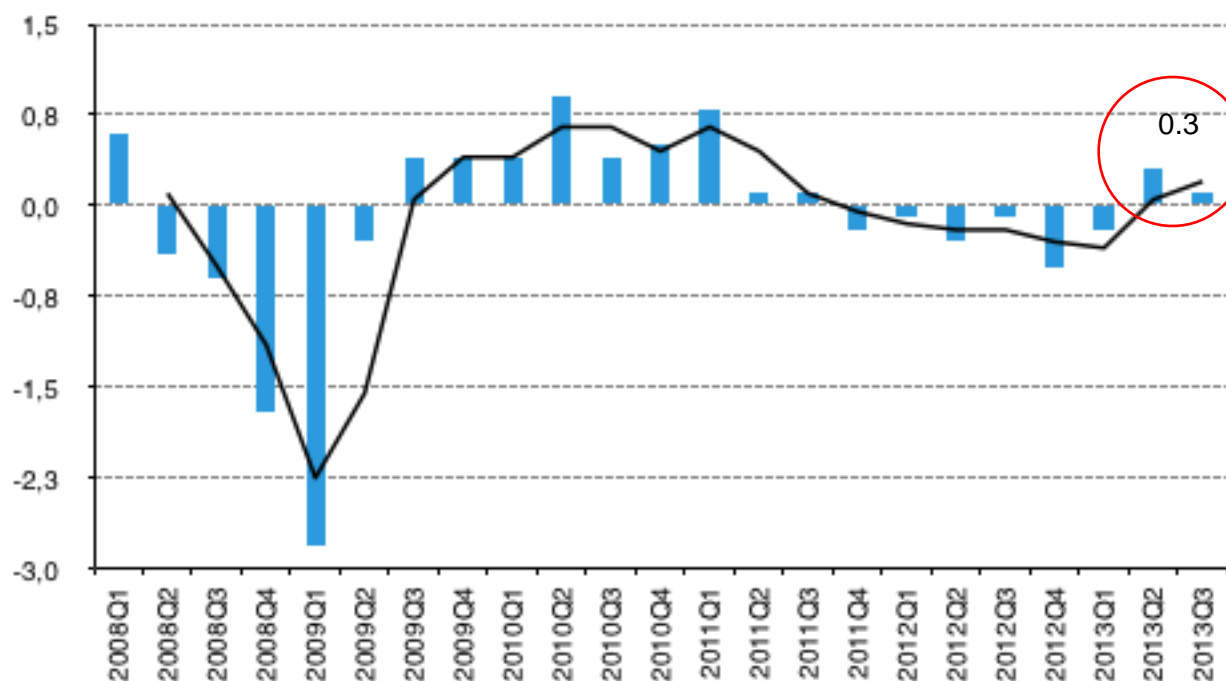






I Recession in the euro area is over

GDP growth in euro area (QoQ)



- ✦ Two quarters of growth after six quarters of decline
- ✦ First signs of growth in the periphery



"The" problems persist

Growth divergence within the euro area

- lacklustre growth across the board
- differences between the core and the periphery are widening

Indebtedness of the private sector

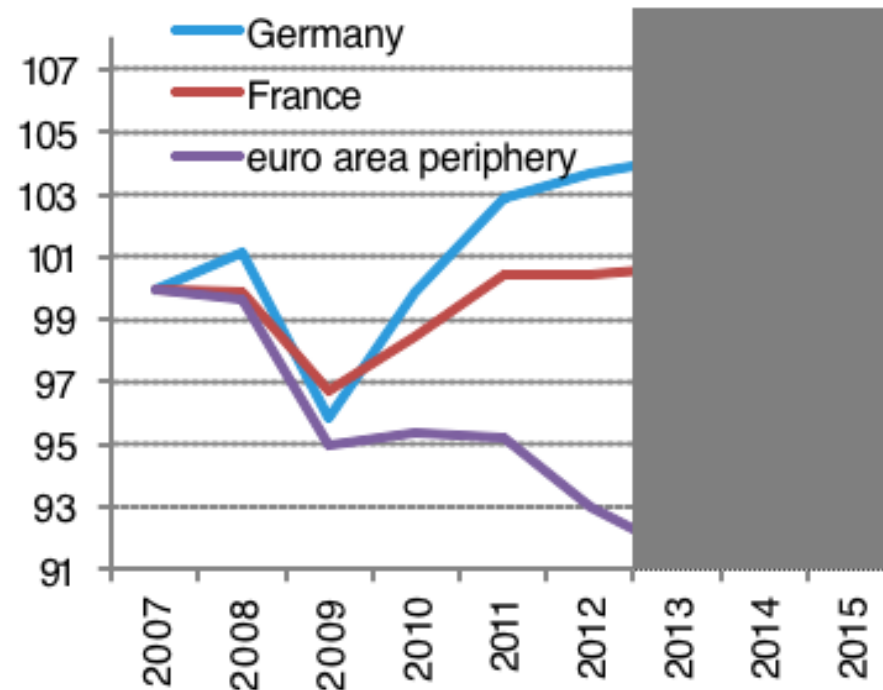
- negative growth effects of private deleveraging may be worse than future changes in fiscal positions and current levels of public debt

Weak banking sector

- nonfunctional transmission mechanism in periphery countries
- weak balance sheets

Divergences are widening

Real GDP growth (index=2007)



source: Eurostat

- Significant growth differences between periphery and core countries of euro area



Putting out fires

Priority up till now: solving acute problems in order to prevent the break-up

Fiscal consolidation

- cutting deficits and debts, not always structurally (one-offs, sell-offs)
- more negative impact on the economic growth than previously thought

Structural change

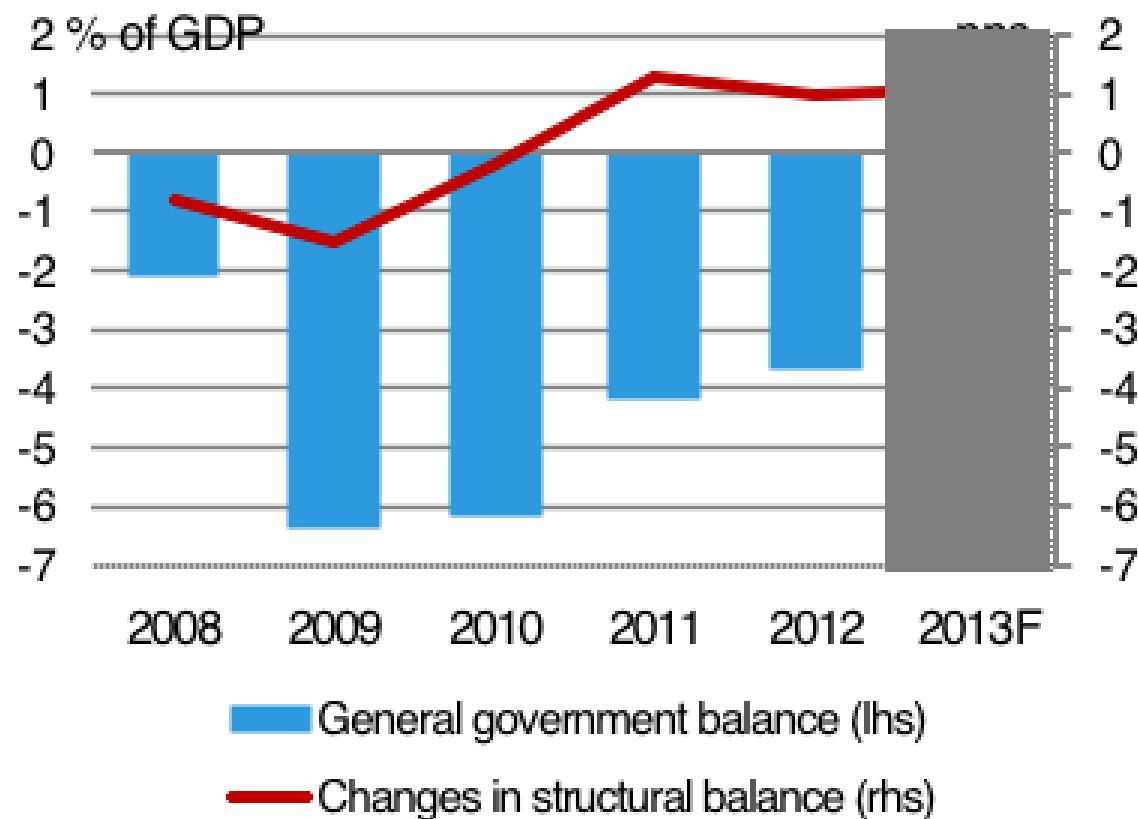
- declared to soften the impact of the austerity measures and to support the recovery
- however, their contribution is slow and positive only over the longer term; may be negative immediately
- rarely seen outside of the periphery anyway

Monetary policy

- OMT: prevention of the eurozone break-up by softening the differences in the access to credit between the core and periphery countries



Heavy fiscal lifting done

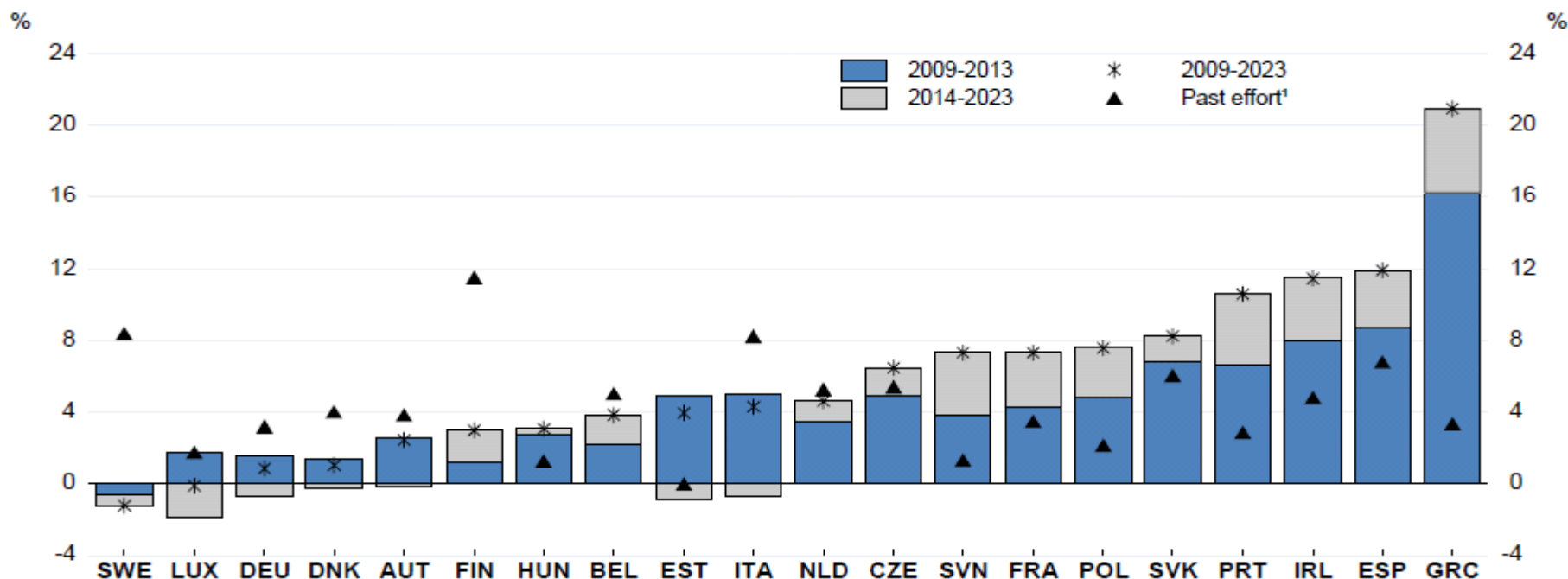


source: IMF



Consolidation continues in 2014 and 2015

A. Changes in the underlying primary budget balance



- Despite significant past consolidation the Eurozone would require further effort in 2014 and 2015 (0.75% of GDP, OECD)
- The pace should slow down from 1% in 2013 to 0.5% in 2014 (IMF-WEO)
- The impact on growth will continue to be negative



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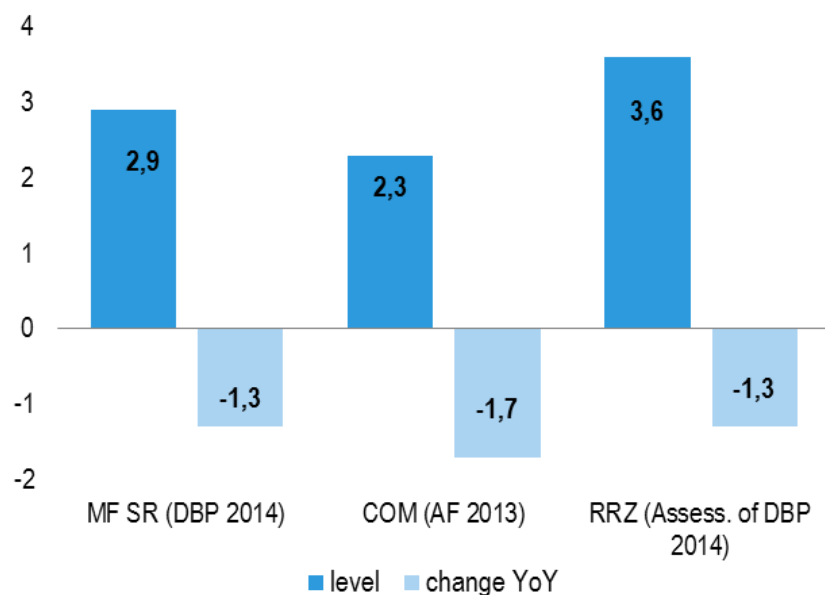
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Our fiscal fate has been decreed

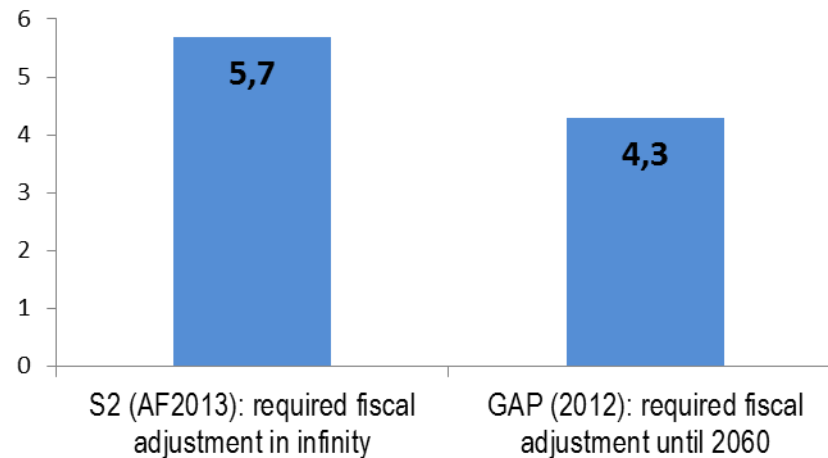


Fiscal gaps

Structural deficit, 2013, % of GDP



Long-term sustainability challenge, % of GDP



Source: MF SR calculations based on COM AF 2013, CBR



European constraints

Corrective arm

- Deficit below ($<3\%$ of GDP)
- Debt criterion ($<60\%$ of GDP)
- 2009 EDP recommendation: 'adjusted' average annual structural budgetary effort of 1% of GDP over the period 2010-2013
- Actual average effort 1.3% of GDP

Preventive arm

- Medium-term budgetary objective of 0.5% of GDP to be achieved by 2017
- Required annual structural effort of 0.5% of GDP as a benchmark (BUT eligibility for investment clause may change between-years pace)
- Expenditure benchmark (growth of expenditure aggregate below lower reference rate)





National constraints

Constitutional Fiscal Responsibility Act (3/2012)

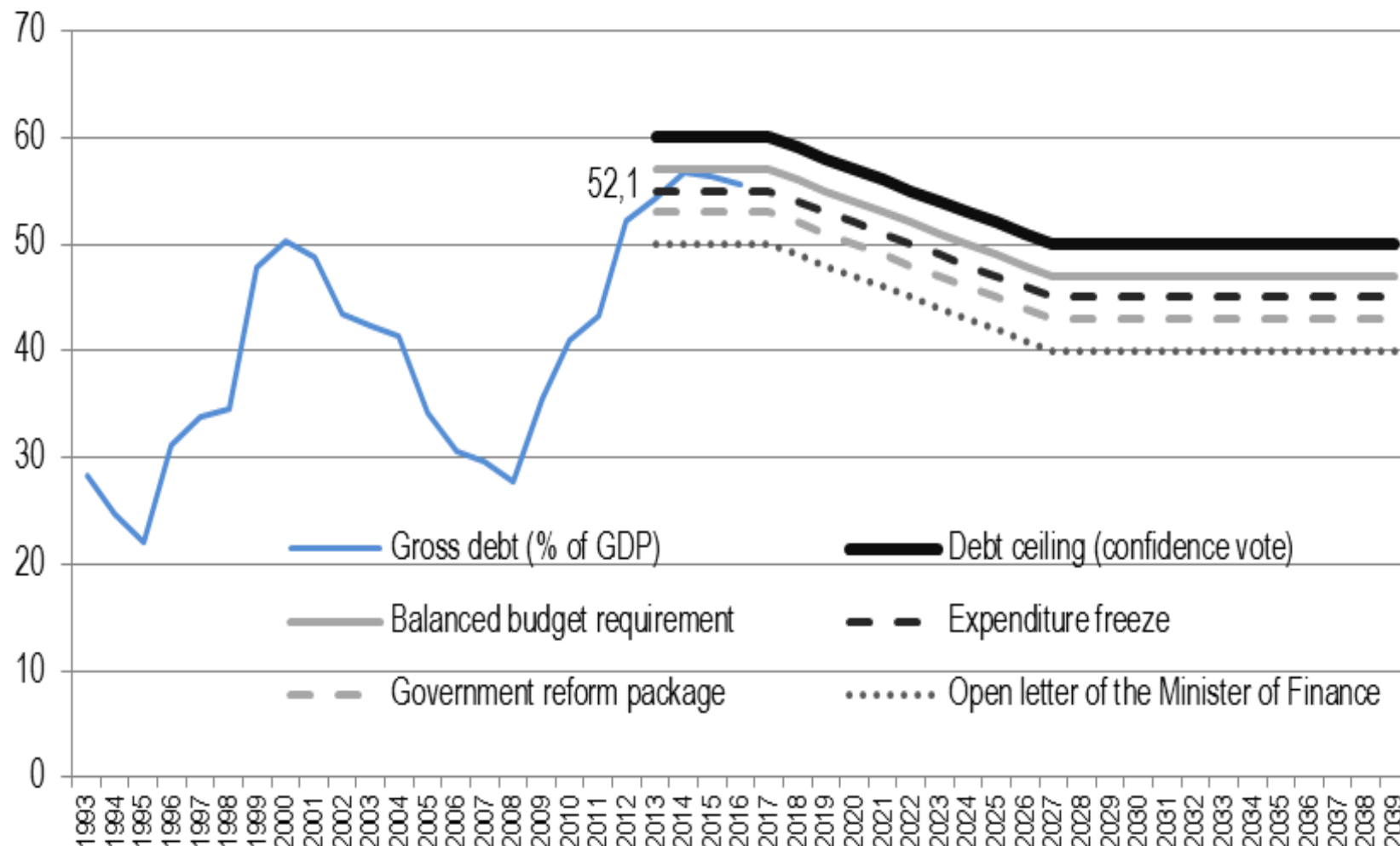
- Fiscal Responsibility Council
- Rules on fiscal responsibility
- Rules on transparency

Ongoing reforms (in parliament)

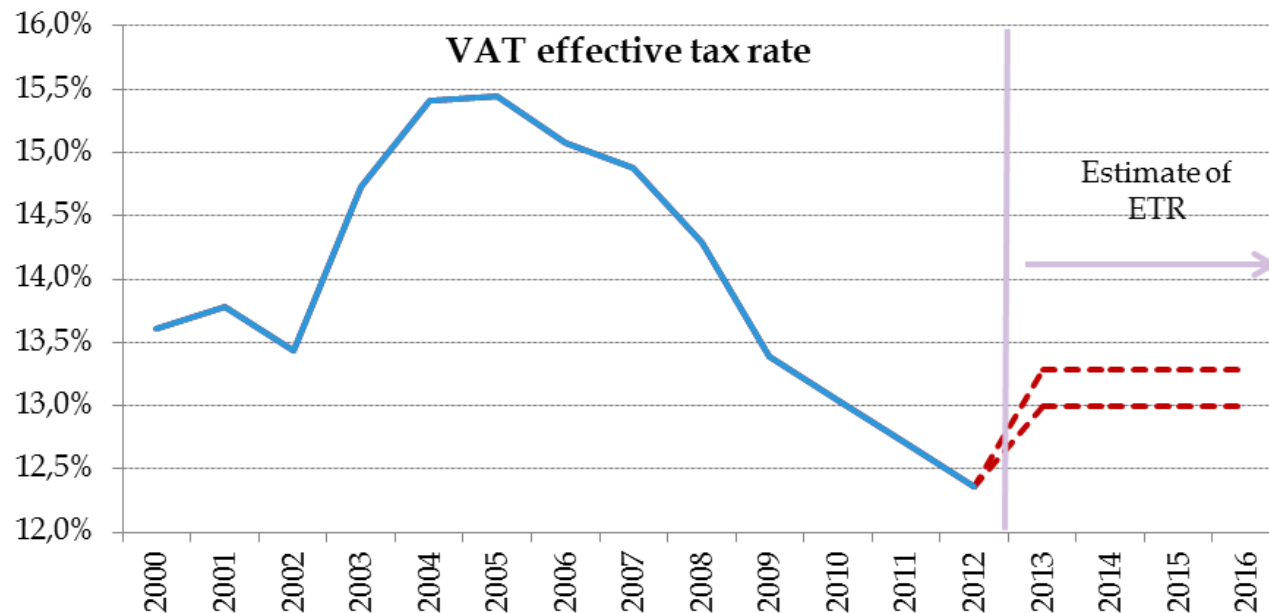
- Transposition of the Fiscal Compact (Draft amendment to Act on Budgetary Rules of General Government)
 - Balanced budget rule
 - Corrective mechanism including expenditure ceilings
 - Revision of rules for local governments (Draft amendment to Act on budgetary rules for local governments)
 - Stricter budgetary rules for local governments



Rules on fiscal responsibility: Debt brake



Will better tax collection save us?

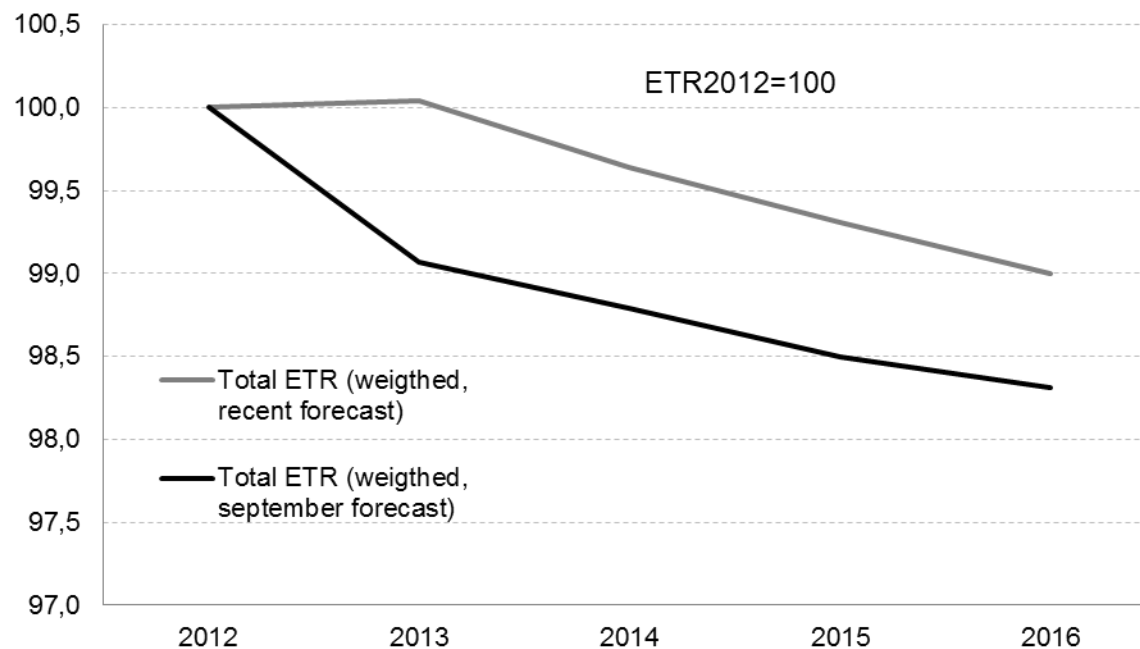


- Effectiveness of **VAT** collection has finally increased in 2013 after a continuous decline since 2005
- **CIT** still a black box: decline of CIT due to lower profitability of companies but also some effect of tax avoidance (trend as well as rates effect)



ETR 2012 - 2016

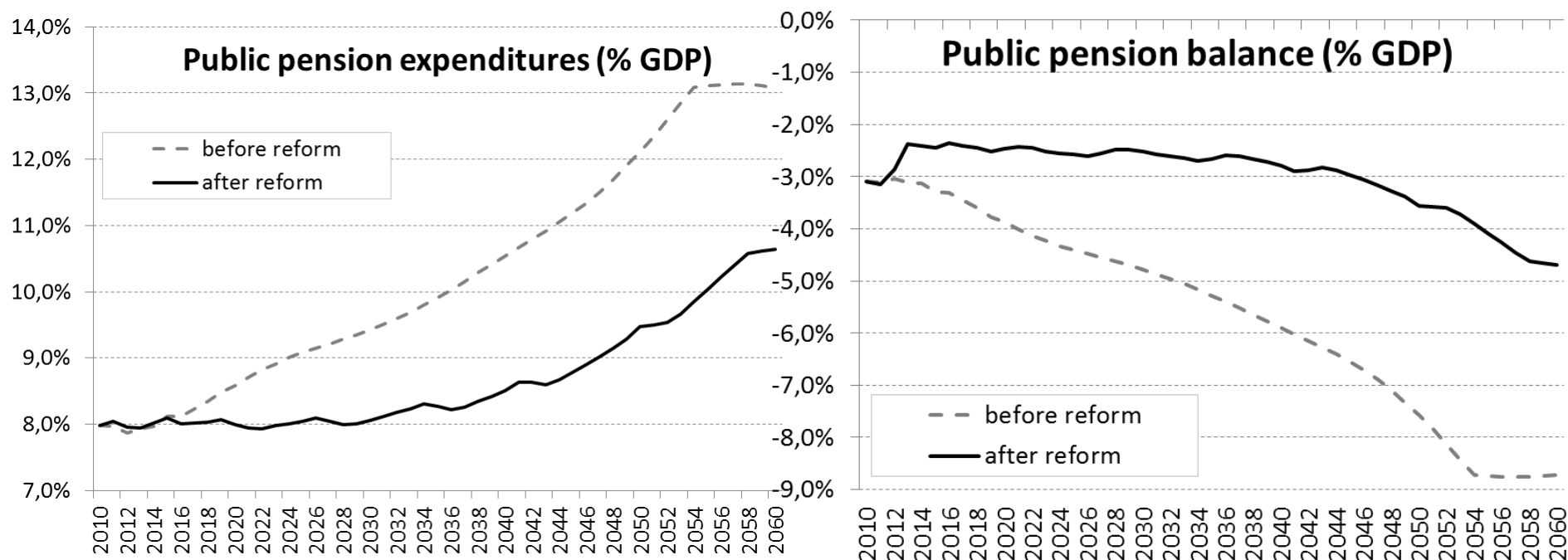
- VAT success story
- but total (weighted) ETR may be still falling





Pension reform improved long-term sustainability...

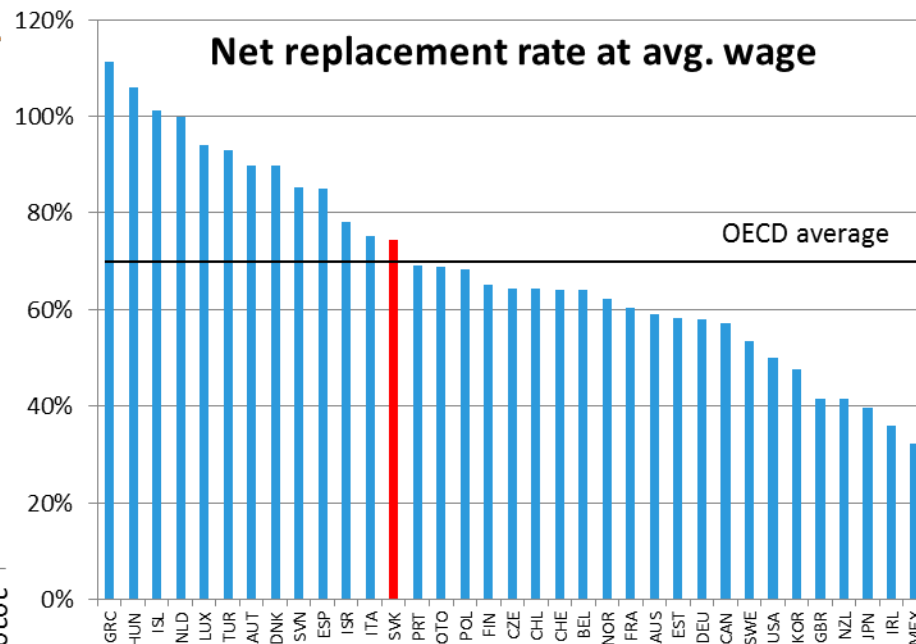
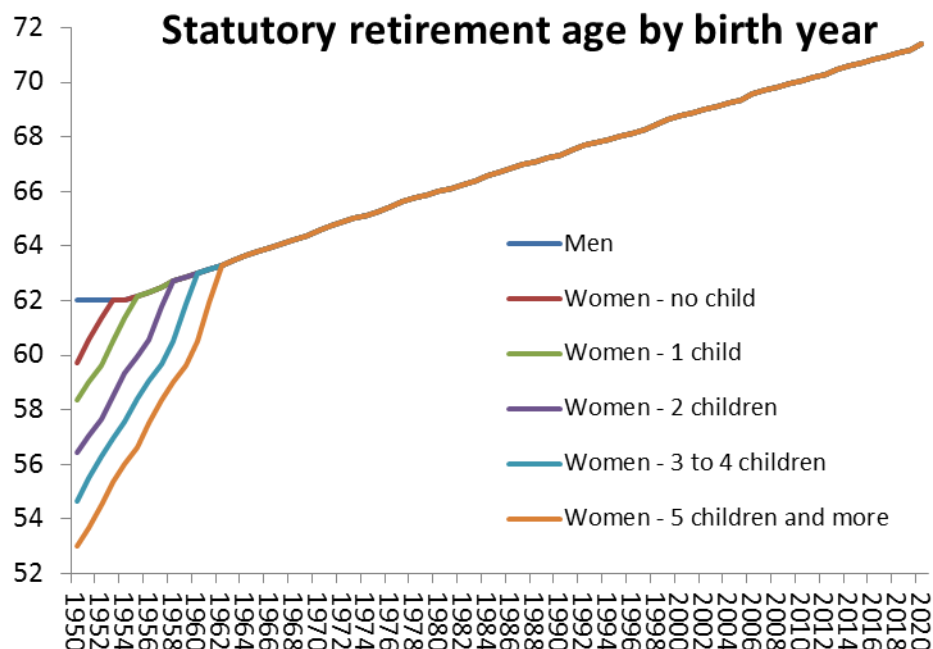
- 2012 reform: parametric changes to PAYGO pillar and reduced fully funded pillar
- Changes to the pension system decrease the pension expenditures by 2.6 p.p and improve the balance of the system by 4 p.p. of GDP in 2060





.. and increased contributory period

- Longer contributory period means higher accrued rights and thus higher replacement rates
- Include sustainability directly into the pension formula?





Impact of the reform on sustainability indicators

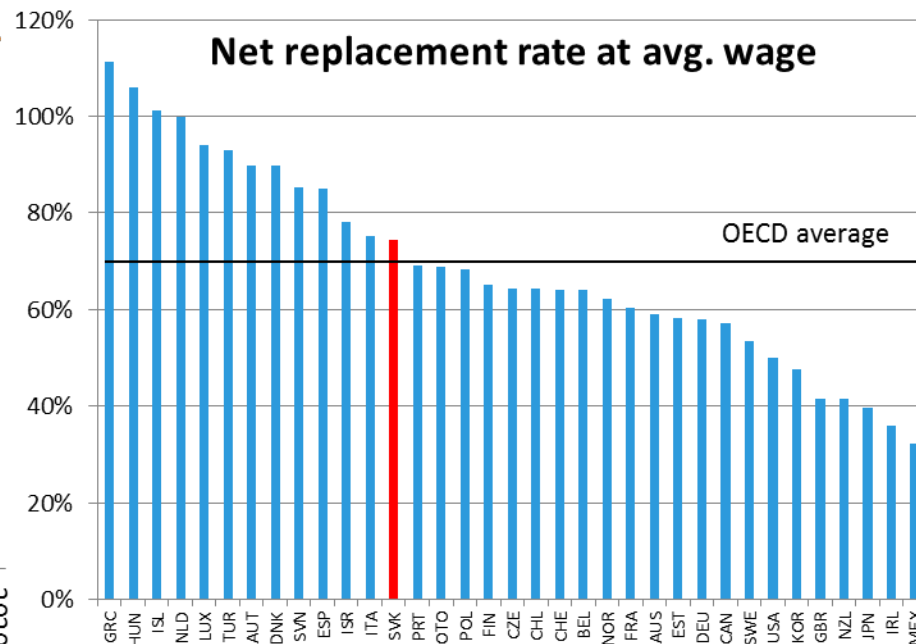
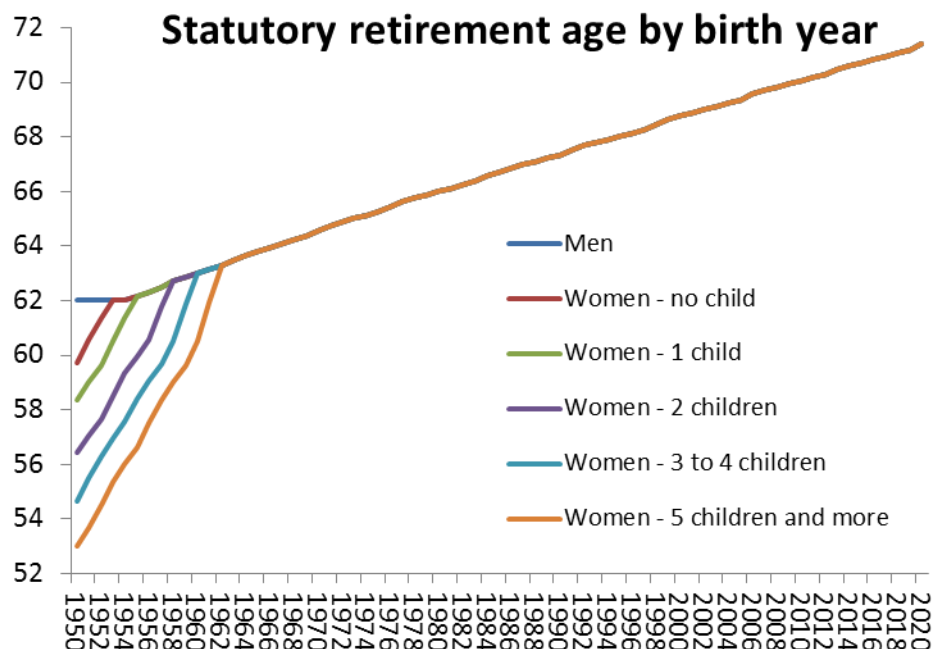
- COM revised the assessment of Slovak long-term public finances sustainability from high risk to medium risk

Long-term sustainability gap represented by COM sustainability indicators	Before pension reform (COM 2012 Autumn Forecast)	After pension reform (COM 2013 Spring Forecast)
S2	6.9	4.9
<i>of which:</i>		
<i>Initial budgetary position</i>	1.8	1.5
<i>Pensions</i>	3.5	1.5
<i>Health & Long-term care</i>	1.7	2.2
<i>Others</i>	-0.1	-0.3
S1	2.2	0.6
<i>of which:</i>		
<i>Initial budgetary position</i>	0.8	0.2
<i>Cost of delaying adjustment</i>	0.3	0.1
<i>Debt requirement</i>	-0.2	-0.2
<i>Ageing costs</i>	1.3	0.5



Limited scope for further parametric changes in pensions

- Statutory retirement age increases rapidly in line with life expectancy
- Net replacement rate is close to the OECD average





Remaining challenges in long-term sustainability

COM recommendations to SK

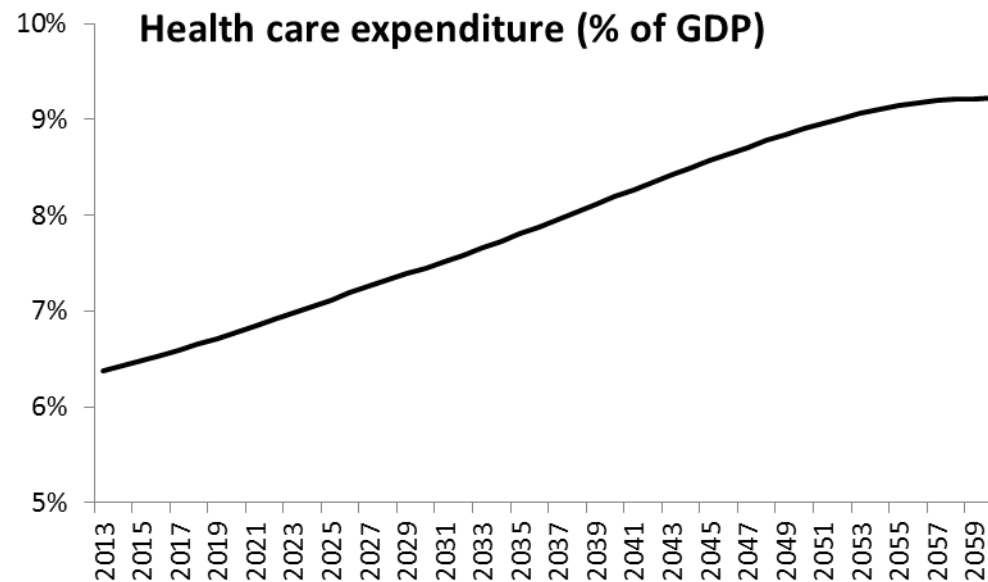
- Building on the pension reform already adopted, further improve the long term sustainability of public finance by reducing the financing gap in the public pension system and increasing the cost-effectiveness of the health-care sector
- Reform of the health care system (streamlining the hospital network, changing costing and remuneration, improving control and monitoring, promoting better management practices)

Additional alternative proposals

- Introduce sustainability factor in the pension formula
- Further parametric changes to the pension system of the armed forces
- Boost labour market policies and tackle the shadow economy to increase employment rate
- Support innovation and knowledge economy to increase productivity



Urgent need for change in (very inefficient) health care

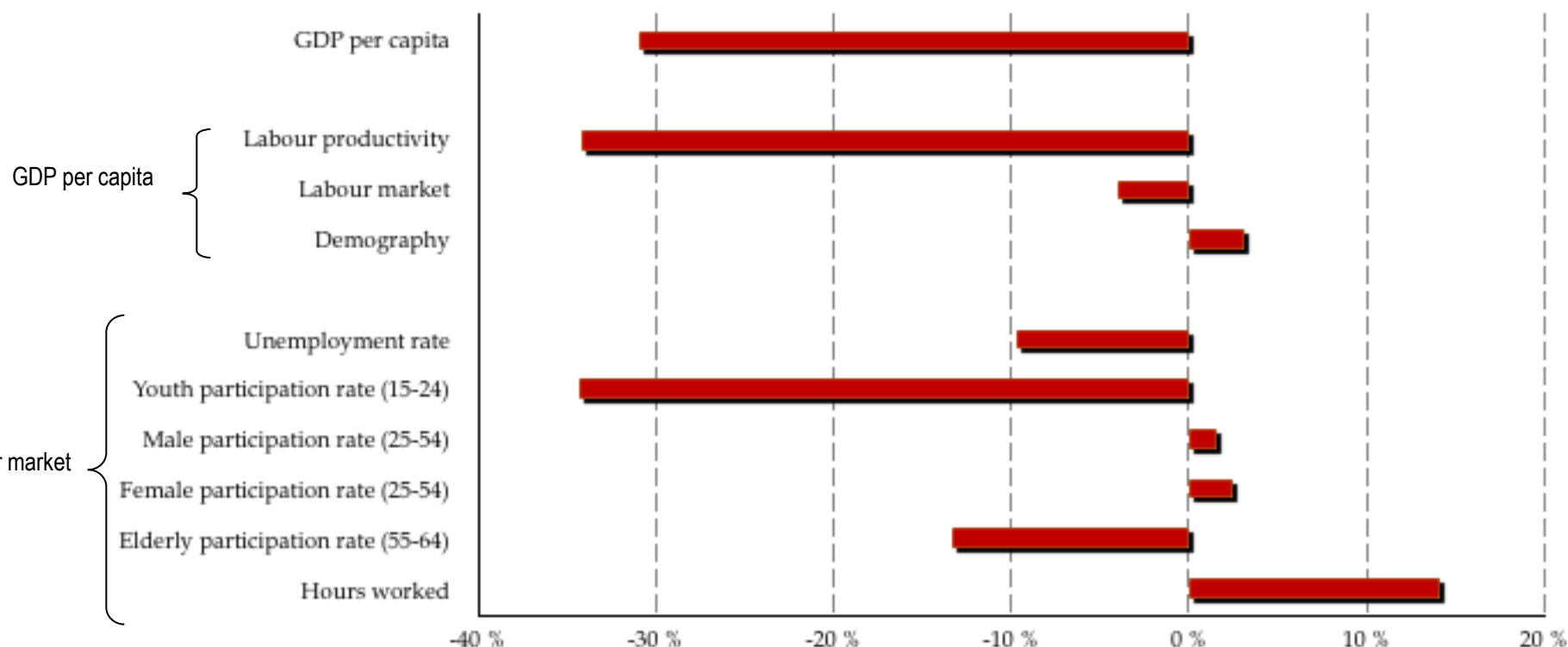


Source: COM Ageing Working Group



Lacking in productivity and (youth) employment

Decomposition of GDP per capita (SK vs. EU15, 2012)

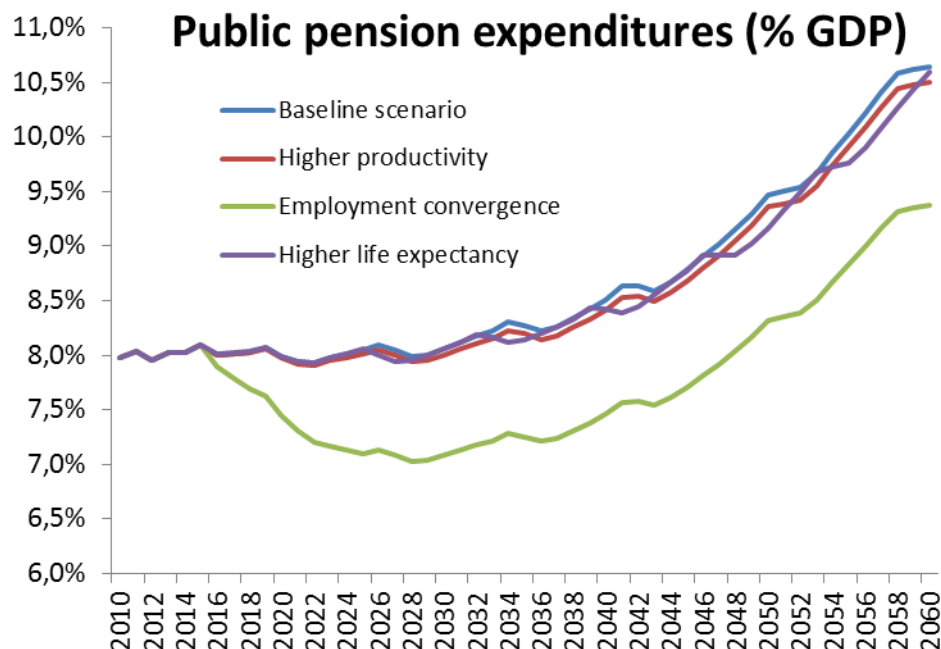




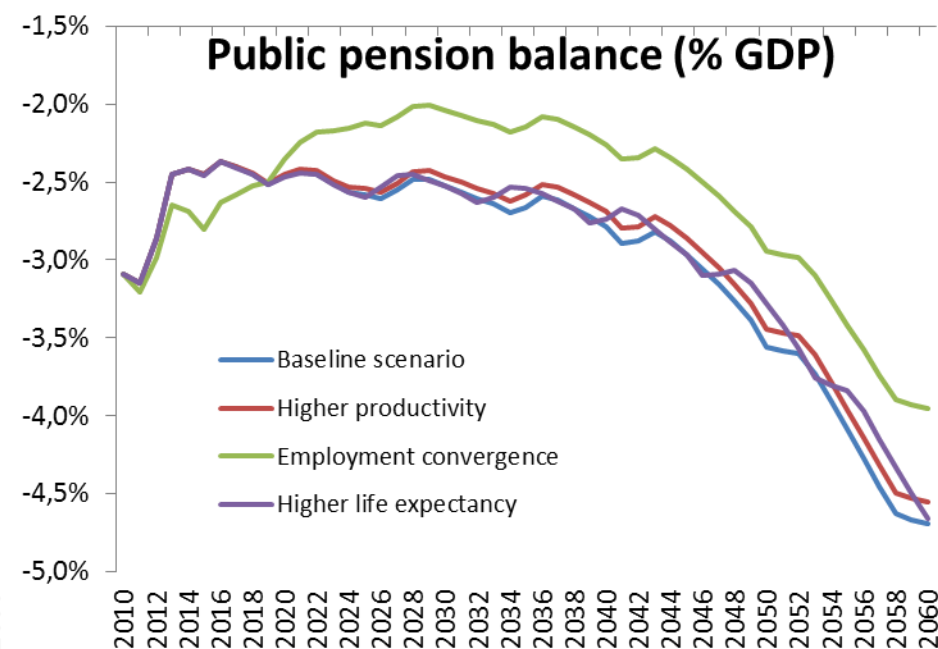
Employment is more important than productivity

- Higher employment rate – convergence of the employment rate to the EU average
- Higher productivity – 0.1 p.p. higher productivity growth compared to the baseline scenario
- Higher life expectancy – 1 year increase in life expectancy at birth

Public pension expenditures (% GDP)



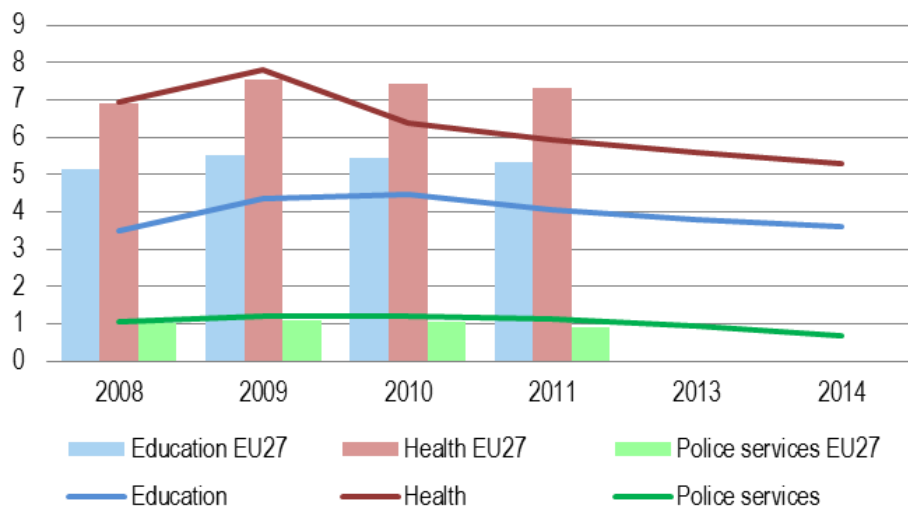
Public pension balance (% GDP)



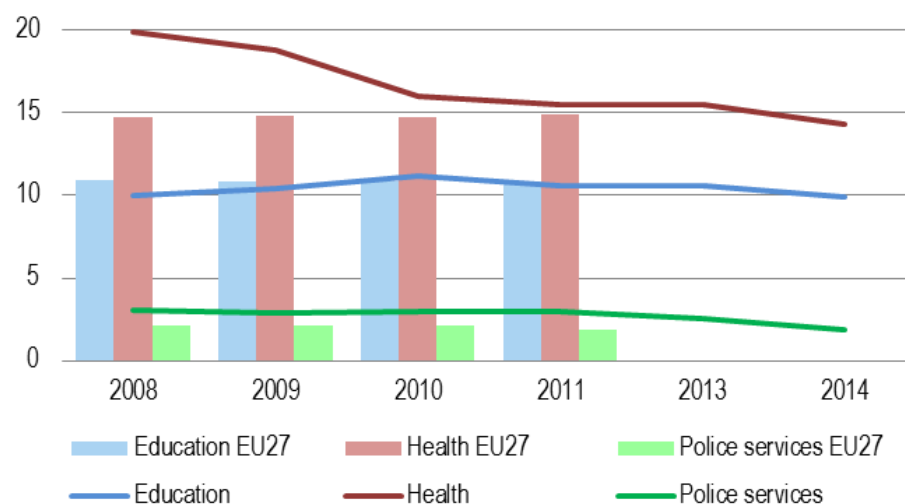
Composition of public expenditure

- Slovak public sector is relatively small compared to the EU average
- Expenditure as % of GDP are budgeted to fall further (especially in the health sector and the police services sector)
- In education, the goal is to reach the OECD level of public expenditure (5.8 % of GDP) in 2020

Public expenditure (COFOG, % of GDP)



Public expenditure (COFOG, % of total expenditure)





Some expenditure efficient, other not

Education

- one of the most efficient ones among the OECD countries
- based on PISA evaluation
- what would happen if money increased?

Health

- highly inefficient
- abrupt drop in efficiency between 2003 and 2007: botched reform or too much money into the fragile system?

General administration?

Police?

What policies

- **Tight national budgets need central macrofiscal capacity**
 - loose fiscal stance before the crisis and probably too tight in its wake; coordination problem
 - central fund able to run deficit/surpluses, borrow, earmarked revenues
 - conduct policy rather than just implement rules (stabilization, defense, infrastructure, R&D, maybe social security)
 - grave political constraints; but in the Slovak national interest
- **More revenues through better collection tough but feasible**
 - CIT in addition to VAT, allows for lower rates
 - low rates/broad base still a sensible approach; effective rates more important than nominal
 - switch from social health insurance to other (mostly direct) taxes
 - "self-collecting" taxes
 - withstand pressure for "sexy" exemptions (R&D, "investment") to prevent base erosion once fiscal improve
- **Look beyond pensions to improve sustainability**
 - Bloated and inefficient healthcare
 - Labor market is the key; boost participation and employment



Thank you for your attention



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