Underlying Risks to Sustainability of Public Finances

Practical example of the use of KNI in an international audit

The Supreme Audit Office of the Slovak Republic (SAO SR) has joined the international parallel audit of the underlying risks for the sustainability of public finances. This audit was conducted in 2016. Apart from Slovakia joined the audit also Finland, the Netherlands, Latvia, Portugal and Sweden. Supreme Audit Institutions from mentioned countries have agreed to try to identify the underlying risks for the sustainability of public finances in their countries and under the supervision of the SAI of Sweden to establish common conclusions of this effort.

The common approach to the audit assumes the identification of underlying risks for sustainability of public finances by analysing the recommendations from international institutions and the assessment of government measures in identified risk areas. The approach is described by common audit questions:

- **Have the recommendations from the European Council, the IMF, the OECD (and other relevant institutions) been followed, regarding underlying risks to sustainable public finances?**
- **Did these measures contribute to reduce the risks identified?**

SAO SR extends the common approach by the use of key national indicators for the evaluation of the progress in elimination of identified risks. These indicators are linked to appropriate measures and change in them indicates the development in identified risk area. The use of indicators allows a better assessment of progress in risk reduction. The methodology for using indicators in public policy evaluation is based on outcomes of INTOSAI Working Group on Key National Indicators.

The audit group from SAO SR uses for the analysis and evaluation of government measures, as well as for selecting appropriate measurable indicators the (1) government materials, evaluations, analyses, reports, action plans, etc. (2) budgets, closing accounts, program budgeting, (3) conclusions from previous audits, (4) other available documents (ECA, ECB, CBR, etc.) and (5) interviews at MoF, CBR, Ministry of Education and the Statistical Office. The evaluation whether the declared progress is identical with the real progress and the differentiation of external influences and the measures at risk elimination is beyond the audit scope and the capacity of audit group.

Overview of country specific recommendations and identified risks to sustainability of public finances

The audit group from SAO SR identified, based on the analysis of recommendations, a total of seven risk areas for medium and long-term sustainability of public finances. Separate part is fiscal consolidation, which falls under the Stability and Growth Pact. Other risks are related to structural policies, two are linked to aging (pensions and health care), two to human capital (education and labour market) and two to the Slovak specifics (tax discipline and Roma inclusion).

The recommendations from international organisations regarding the **fiscal consolidation** were focused on (1) lowering the deficit below 3 % of GDP in 2013, during the excessive deficit procedure, (2) achieving the medium-term objective by structural reforms on reference level 0,5 % of GDP, after exiting from excessive deficit procedure, (3) creating an independent fiscal institution, (4) ensuring binding and enforceable multiannual expenditure ceilings and (5) creating enough room over time to allow automatic stabilizers to work.

The recommendations from EC and other relevant institutions regarding **pensions** were related to (1) strengthening of long-term sustainability of public finances by changes in the pay-as-you-go (PAYG) pillar, mainly by changing the indexation mechanism, directly linking the statutory retirement age to life expectancy and introducing a sustainability factor in the pension calculation formula, which will reflect the demographic changes; (2) ensuring the stability and viability of the capitalization pillar; and (3) improving long-term sustainability of public finances by reducing the financing gap in the public pension system, while ensuring adequate pensions.

Slovakia has received the recommendations from the EC, IMF, OECD and other relevant institutions to improve the long-term sustainability of public finances in the **health sector** by increasing the cost-effectiveness of the health care sector, particularly the rationalization of hospital care and management, as well as strengthening primary care. Among the underlying risks in the Health care system with regard to the sustainability of public finances are (1) cost effectiveness of health care system, especially hospitals, primary and long-term care, (2) availability and quality of health care for all groups of population, (3) indebtedness of health care system.

Recommendations from international organizations to Slovakia, were in the **administration and collection of taxes** focused to (1) increase tax compliance and collection, in particular by improving the efficiency of VAT collection, (2) improve the efficiency of tax administration, including the strengthening of analytical and audit-capacity, (3) link taxation of real estate with their market value, (4) increase revenues from environmental taxes.

International organizations have recommended Slovakia to focus mainly on two critical areas for long-term sustainability of public finances related to **education** in the form of (1) the quality of education and (2) linking education and the labour market. Recommendations on the quality of education were linked to all levels of education, from pre-primary to university. This part also includes a focus on future teachers and the attractiveness of teaching as a profession, including raising teachers' salaries and the corresponding structural reforms. Linking education and the labour market is recommended in two levels, (a) the creation of professionally oriented study programs and (b) the provision of practical training in companies directly.

Slovakia has received the recommendations from international organizations in the field of **labour market** aimed primarily at the employment services, particularly to the area of active labour market policies / measures (ALMP) and counselling. Measures in the area of ALMP should focus on the long-term unemployed, youth and labour mobility. Public employment services should be reorganized and go towards guidance and support for targeting of ALMP. An additional repetitive recommendation is the support for returning to work after parental leave, by improving the availability of childcare facilities for kids in pre-school age.

One of the underlying and partially hidden risks to the sustainability of public finances in Slovakia represents members of the Roma minority[1] and their inclusion. The Roma minority is the biggest minority in the EU. The inclusion of Roma communities is a challenge for all countries with this minority. The Roma minority represents more than 9% of the Slovak population, estimated at 440 000 inhabitants[2]. Slovakia received in the area of **Roma inclusion** recommendations in all relevant areas regarding education, employment, health, housing, financial inclusion and non-discrimination including approaches towards the majority (inclusion through communication).

Government response to country specific recommendations and the Effectiveness of Government measures

The overview of the identified risk areas, the respective risks and corresponding key indicators provides the Table 1 (on the next page), while the last two columns indicate the semaphore evaluation of the individual risks by EC and SAO SR.

The risk area of **fiscal consolidation,** during the audited period from 2011 to 2015, managed Slovakia through measures and favourable economic developments eliminate the most. Slovakia carried out in individual year's consolidation effort above average and managed to stand out from the excessive deficit procedure. It also managed to adopt a constitutional law on fiscal responsibility and establish the Council for Budget Responsibility. But it failed to meet recommendations concerning the implementation of expenditure ceilings.

Pensions and adjusting the pension system were, taking into account the expected demographic development in Slovakia, about the most fundamental long-term risks to public finance sustainability. Through the reform of the pension system during the audited period, it managed to reduce that risk to an acceptable level. Adequate pensions remain an ongoing risk.

Health care is another risk area interoperating with aging of population. Slovak healthcare system showed significant reserves particularly in terms of cost effectiveness and continuous indebtedness. These risks are managed to eliminate only minimally. The result indicators of the availability and quality of health care also did not experience significant improvement.

Tax collection and tax compliance achieved during the audited period its bottom. The VAT gap was almost 40%. The Action plan to combat tax fraud and other measures managed to improve tax compliance and tax collection. The recommendations were directed also to the taxation of real estate according to their market price. These recommendations were not fulfilled.

Education is an essential area for the development of human capital. The main risks in Slovakia are the age structure of teachers, which during the audited period shifted in favour of older teachers, learning outcomes, and the structure of graduates, in which changes were invested great effort, but the results, because of an effects delay, cannot be clearly assessed.

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[1] *According to the Council of Europe, 'Roma' refers to Roma, Sinti, Kale, and related groups in Europe, including Travellers and the Eastern groups (Dom and Lom), and covers the wide diversity of the groups concerned, including persons who identify themselves as Gypsies*

[2] *http://ec.europa.eu/justice/discrimination/files/roma_country_factsheets_2014/slovakia_en.pdf*

Table 1

Area	*Risk*	*Indicator*	*EC evaluation*[3]	*SAO SR evaluation*[4]
Fiscal consolidation	Excessive deficit	*General government balance*		
	Consolidation effort	*Consolidation effort*		
	Budgetary responsibility	*General government gross debt*		
	Expenditure ceilings	*x*		
	Automatic stabilisers	*x*		Not rated
Pensions	Pensions and aging	*Pension system balance*		
	Adequate pensions	*x*		
Health care	Cost effectiveness	*Expenditures*		
	Availability and quality	*Healthy life years*		
		Avoidable mortality		
	Indebtedness	*Hospital's debt*		
Taxes	Tax discipline	*Effective tax rate for respective taxes*		
	Effectiveness of VAT collection	*VAT gap*		
	Real estate taxation linked to its market value	*x*		
Education	Age structure of teachers	*Average age*		
	Student outcomes	*PISA testing*		
	Structure of absolvents	*x*		
Labour market	ALMP targeting	*Chance of being engaged*		
	Effectiveness of Labour Offices	*Clients per employee*		
		Efficiency of job mediation		
	Return from parental leave	*x*		
Roma inclusion	Education	*x*		
	Employment	*x*		
	Health	*x*		
	Housing	*x*		
	Non discrimination	*x*		

The **labour market** is a place where the inhabitants of the country use their human capital. Active labour market policies and the efficiency of the labour offices which mediate it should help them in that. ALMP´s accuracy and transparency has improved, but their contribution to employment prospects for disadvantaged groups (low qualified, long-term unemployed) are low and in eliminating this risk, there are still reserves. Effectiveness of labour offices, according to the reported indicators has improved. The

[3] *Colour (traffic light) EC evaluation is based on Country reports for respective years.*
[4] *Colour (traffic light) SAO SR evaluation is based on analysis described in the Country paper, where:*
Green: Measures were taken, which have significant impact or the impact can be considered positive for long-term sustainability of public finances.
Yellow: Measures were taken, which do not have significant impact, or the impact is not significantly positive for long-term sustainability of public finances.
Red: No measures were taken or the measures have little or insignificant effect on the sustainability of public finances.

labour market in Slovakia has a high sensitivity to the external environment and therefore it is difficult to distinguish when assessing the impact of measures to eliminate the risk and impact of other factors.

Partially hidden risk (positive and negative) for the sustainability of public finances is the **inclusion of the Roma population**. If successful, elimination of identified risks and changes in demographic behaviour of the national minority represents another source of potential growth of the Slovak economy. During the audited period, Slovakia managed to reduce the risks, especially in the education of Roma.

Public availability and follow-up procedures

Slovakia under the EU 2020 strategy as a continuation of the Lisbon Strategy builds on the process of publishing of the National Reform Programme as an implementation report responsive to the recommendations of the Council / Commission. The European Semester is a procedure whereby Member States are given Country-specific recommendations (CSR). In addition to these recommendations the country receives recommendations of other international organizations (WB, IMF, and OECD) on the basis of membership or on request.

EC recommendations are regularly published on the websites, as the Slovak Government so the Commission. The recommendations of the OECD and the IMF publish relevant organizations on their websites and unlike CSR they are not translated into Slovak. Publication process is not regulated, whereas the recommendations are published by the Government Office or Ministry of Finance. The recommendations are published in full.

The National Reform Programme is the Government's response to the individual CSR, and it also includes an Action Plan, outlining further activities, including responsibilities linked to specific recommendations. NRP responds to all the recommendations of EC and selected OECD recommendations are part of analytical parts of the NRP. NRP including an action plan is approved every year by the Government.

The follow up of implementation of recommendations to the relevant ministries, NRP is evaluated through the fulfilment of tasks in the Action Plan in the year following the sending of relevant recommendations. The evaluations are part of NRP and with it were also made public. In the event of inconsistency, this usually does not comment directly, but there’s comment like space for more detailed analysis or future focus on further measures.