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**Assessment of the 2015 Stability Programme for
SLOVAKIA**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Slovakia's April 2015 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 29 April 2015 and covers the period 2014-2018. It was approved by the government and presented to the national parliament for a debate without a vote.

The Stability Programme presents headline deficit targets, a no-policy-change scenario and a fully-fledged central scenario, which assumes some (unspecified) measures especially at the level of the state budget that is under the direct control of the government, but would nevertheless require additional measures to reach the fiscal targets.

Slovakia is currently subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its MTO.

This document complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability programme. Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2015 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

Driven by a recovery in domestic demand, the Slovak economy gathered pace in 2014 with real GDP growing by 2.4%. The macroeconomic scenario underlying the Stability Programme forecasts growth to increase to 2.9% in 2015 and 3.6% in 2016.¹ The Stability Programme projects domestic demand to remain the main driver of growth over the coming years, although it also expects an increasing contribution from net exports². Compared to the latest Draft Budgetary Plan, the GDP growth projections for 2015 have been increased by 0.3 pp., reflecting upward revisions of investment and private consumption.

The output gaps as recalculated by Commission based on the information in the programme, following the commonly agreed methodology point to improving cyclical conditions. The output gap is estimated to have been -3.2% of potential GDP in 2014 and is projected to decline to -2.6% in 2015 and -1.8% in 2016³.

¹ This scenario underlines both the central and the no-policy-change scenario.

² The macroeconomic scenario underlying the Stability Programme and the Commission 2015 spring forecast have a similar external outlook: both project external demand to grow by around 4½% in 2015 and by more than 5% in 2016.

³ The output gaps based on the Commission 2015 spring forecast are very close to the recalculated output gaps: -3% in 2014, -2.5% in 2015, and -1.8% in 2016.

The macroeconomic outlook presented in the Stability Programme is in line with the Commission 2015 spring forecast. Both project real GDP growth rates of around 3% in 2015 and of around 3½% in 2016. The composition of growth is also similar in the two forecasts: both project domestic demand to be the main driver of growth over the coming years. Both the Commission forecast and the Stability Programme project the unemployment rate to decline over the coming years and compensation of employees to increase by more than 3% in 2015 and by around 4½% in 2016, in line with the recovery in economic activity. Growth is foreseen to be tax rich in both projections. Overall, the Stability Programme is underpinned by plausible macroeconomic assumptions.

The Stability Programme also contains a quantitative assessment of the impact of fiscal policy on GDP growth over the coming years; the assessment is realistic and is consistent with the overall macroeconomic scenario.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.4	2.4	3.0	2.9	3.4	3.6	3.6	3.7
Private consumption (% change)	2.2	2.2	2.4	2.8	2.7	2.7	2.8	2.9
Gross fixed capital formation (% change)	5.7	5.7	4.6	3.7	3.7	1.8	1.7	2.1
Exports of goods and services (% change)	4.6	4.6	4.2	1.4	5.6	5.9	6.0	6.1
Imports of goods and services (% change)	5.0	5.0	4.1	1.0	5.2	4.5	4.9	4.8
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	3.2	3.2	2.8	2.7	2.8	2.0	2.1	2.2
- Change in inventories	-0.4	-0.7	0.0	-0.3	0.0	-0.1	0.1	-0.2
- Net exports	-0.2	0.0	0.3	0.5	0.6	1.6	1.5	1.7
Output gap ¹	-3.0	-3.2	-2.5	-2.6	-1.8	-1.8	-0.8	0.3
Employment (% change)	1.4	1.4	1.3	0.6	1.5	0.7	0.7	0.8
Unemployment rate (%)	13.2	13.2	12.1	12.9	10.8	12.2	11.4	10.5
Labour productivity (% change)	1.0	1.0	1.7	2.3	1.9	2.9	2.8	2.9
HICP inflation (%)	-0.1	-0.1	-0.2	0.0	1.4	1.6	1.8	2.0
GDP deflator (% change)	-0.2	-0.2	0.1	0.0	1.3	1.5	1.8	1.9
Comp. of employees (per head, %)	3.4	3.4	2.4	2.6	3.2	3.9	4.4	4.6
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.8	2.9	2.6	3.2	1.5	4.2	4.9	6.0

Note:

¹In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Commission 2015 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

The headline general government deficit reached 2.9% of GDP in 2014, somewhat higher than the original target of 2.6% of GDP presented in the 2014 Stability Programme and later confirmed in the 2015 Draft Budgetary Plan. A comparison with the 2014 Stability Programme is complicated by the fact that as of 2014, mainly in the context of the changeover to ESA2010, a number of government-owned units were included in the sector of general government⁴. While this reclassification had an overall neutral impact on the 2014 deficit, comparing the outcome with the original 2014 budget is made difficult by the fact that none of these units were included in the budget itself. Nevertheless, a number of issues related to the 2014 deficit outcome can be highlighted.

In the first place, government expenditure in 2014 was impacted by the activation of the first stage of the national debt brake in May 2014.⁵ Expenditure freezes triggered by the debt brake were applied from May 2014 to October 2014. In addition, lower co-financing requirements for EU Structural and Cohesion Funds led to lower spending compared to the budget. On the other hand, negative developments in expenditure were mainly due to higher outlays on public healthcare, social spending, and financial corrections related to the EU funds following audit findings. On the revenue side, while the tax receipts were stronger than budgeted, dividend and capital (e.g. from sale of telecom licences, emission allowances quotas) revenue fell short of the plans.

Finally, several one-off measures⁶, which were reflected also in the Commission 2015 spring forecast, had an overall positive effect on public accounts in the amount of 0.3% of GDP that was, nevertheless, still lower than expected in the 2014 Stability Programme. The structural balance in 2014 deteriorated by 0.6% of GDP to -2% of GDP (see section 4).

3.2. Target for 2015 and medium-term strategy

The 2015 Stability Programme presents two fully-fledged fiscal scenarios – a no-policy-change and a central scenario. The no-policy-change scenario does not assume any additional measures beyond the adopted 2015 budget. The central scenario is presented as the most likely outcome of fiscal policy and implies the adoption of measures in certain expenditure categories, especially within the competences of the central administration, but without providing sufficient detail. Fiscal targets are presented separately in the programme and,

⁴ The units that were reclassified into the general government sector were the railway infrastructure operator ZSR, the National Motorway Company, the agency managing emergency oil stocks EOSA, Eximbanka, hospitals and transport companies belonging to local governments.

⁵ In spring 2014 based on the estimates for GDP and public debt validated by Eurostat, the debt-to-GDP ratio was estimated to have exceeded 55% of GDP in 2013, the threshold that activates the national debt brake. In the first step, as stipulated by the law, as of May 2014 the Ministry of Finance froze 3% of state budget expenditures (excluding several items, notably interest expenditure and co-financing of projects financed through EU funds). In the second stage, on 15 October the government submitted to the Parliament a general government draft budget for 2015 that did not include an increase in (adjusted) nominal expenditure compared to the 2014 budget and local governments were obliged to retain their spending at levels budgeted for 2014. A new estimate of the debt ratio based on the October notification later led to a repeal of the second phase and a revision of the budget for 2015, as explained in section 3.2.

⁶ These included revenue from the sale of telecom licenses, a penalty for cartel in the construction sector, higher pension outlays related to a ruling of the Supreme Court on pension rights of former employees of armed forces and a downward revision of contributions to the EU based on the decision of Eurostat.

beyond 2015, they are more demanding than the central scenario.⁷ The current assessment and thus the tables in the Annexes are based on the central scenario; however, the no-policy-change scenario is also useful in judging the risks that surround the central scenario.

The target for 2015

In the 2015 Stability Programme, the target for the 2015 headline deficit is set at 2.5% of GDP, the same as in the 2014 Stability Programme. The 2015 Draft Budgetary Plan still presented a much more ambitious target of 2.0% of GDP for 2015. This was, however, conditional on the application of the second stage of the national debt-brake rule in 2015, for which it had become clear last autumn that the conditions for its activation were not in place. Following the October 2014 notification, the estimate of the 2013 public debt ratio was revised downwards, the debt brake rule was deactivated and the Parliament adopted additional measures, reverting to the original deficit target of 2.5% of GDP. Already the Draft Budgetary Plan announced additional measures that would increase the deficit target to 2.5% of GDP should conditions allow it.

The central scenario (i.e. in the scenario that forms basis of the current assessment) projects the deficit to reach 2.6% of GDP in 2015. The deviation of 0.1 pp from the target reflects essentially expected financial corrections related to the EU funds following audit findings.

The Commission's 2015 spring forecast projects the 2015 headline deficit to reach 2.7% of GDP. The difference of 0.1pp of GDP with the programme's central scenario comes mainly from the assumption in the Commission forecast that more EU funds would be drawn and hence the national co-financing would be higher, as 2015 is the last year in which available resources from the 2007-13 programming period can be used.

The medium-term strategy

The fiscal strategy, as represented by the fiscal targets in the programme⁸ and taken at face value, aims at reaching the medium-term objective (MTO) by 2017. The programme defines the MTO as a structural deficit of 0.5% of GDP, which is more stringent than what the Pact requires. This is in line with the 2014 Stability Programme. Afterwards, the programme aims at remaining at the MTO. However, based on the recalculated structural balance of the central scenario, the MTO would not be reached during the programme horizon (see Table 2).. Under the central scenario, the headline deficit decreases from 1.9% of GDP in 2016, to 1.4% of GDP in 2017 and 1% of GDP in 2018. The recalculated structural balance would decline only marginally from -1.2% of GDP in 2016 to around -1% of GDP in 2017 and 2018.

The envisaged fiscal adjustment as appears from the central scenario is back-loaded in the two final years of the programme. The 0.7 pp adjustment in the headline 2016 balance would come almost exclusively from the expenditure side (see Table 2); with a sharp decline in investment and other expenditure partly counterbalanced by an increase in the public wage bill. As these envisaged developments which are reflected in the central scenario are not

⁷ The no-policy-change scenario is the starting point of the authorities to define their fiscal targets in the medium term. It assumes a steep decline in trend expenditure for 2016. This decline, which impacts also the subsequent years, is difficult to explain. The Commission 2015 spring forecast projection for 2016, which is prepared under the assumption of unchanged policies, projects the growth of general government expenditures to be well above that assumed in the programme.

⁸ In terms of the nominal targets, the programme aims at reducing the general government deficit to 1.9% of GDP in 2016, 0.9% of GDP in 2017 and 0.5% of GDP in 2018.

underpinned by specified measures in 2016, the Commission 2015 spring forecast assumes unchanged policies and hence does not project savings as presented in the programme. Restraint on spending would be the main source of the adjustment also in 2017 and 2018, where the programme assumes lower growth of employees' compensations and intermediate consumption in the state budget compared to the no-policy-change scenario⁹ and somewhat higher growth of non-tax revenue. No concrete measures underpinning the projected savings in 2017 and 2018 are specified in the programme.

⁹ Based on the no-policy-change scenario presented in the programme, the headline deficit would reach 1.6% of GDP in 2016, 1.5% of GDP in 2017 and 1.4% of GDP in 2018. This would imply that the government has additional fiscal space of some 0.3% of GDP in 2016 compared to the current fiscal target, while additional measures would be required for the latter two years of the programme. For 2016, however, the expenditure projection of the no-policy-change scenario seems optimistic in view of the Commission 2015 spring forecast (see footnote 6).

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	Change: 2014-2018
	COM	COM	SP ⁴	COM	SP	SP	SP	SP
Revenue	38.9	39.6	38.3	37.5	36.6	36.6	36.2	-2.7
<i>of which:</i>								
- Taxes on production and imports	10.6	10.5	10.5	10.4	10.2	10.0	9.8	-0.8
- Current taxes on income, wealth, etc.	6.6	6.9	6.8	7.1	6.8	6.7	6.7	0.1
- Social contributions	13.7	13.3	13.3	13.4	13.2	13.1	13.0	-0.7
- Other (residual)	8.0	9.0	7.8	6.6	6.4	6.9	6.7	-1.4
Expenditure	41.8	42.4	40.9	40.1	38.5	37.9	37.2	-4.6
<i>of which:</i>								
- Primary expenditure	39.8	40.7	39.2	38.5	37.0	36.5	35.7	-4.1
<i>of which:</i>								
Compensation of employees	8.7	8.5	8.1	8.5	7.9	7.6	7.2	-1.5
Intermediate consumption	5.4	5.7	5.7	5.7	5.5	5.6	5.4	-0.1
Social payments	19.1	18.6	18.6	18.2	18.0	17.7	17.4	-1.7
Subsidies	1.0	0.8	0.8	0.8	0.7	0.7	0.6	-0.3
Gross fixed capital formation	3.7	4.1	3.0	3.0	2.5	2.7	2.9	-0.8
Other (residual)	1.9	3.1	3.2	2.3	2.3	2.2	2.3	0.3
- Interest expenditure	1.9	1.6	1.7	1.6	1.6	1.4	1.4	-0.5
General government balance (GGB)³	-2.9	-2.7	-2.5	-2.5	-1.9	-1.4	-1.0	1.9
Primary balance	-0.9	-1.1	-0.9	-1.0	-0.4	0.1	0.5	1.4
One-off and other temporary	0.3	0.1	0.1	0.0	0.0	0.0	0.0	-0.3
GGB excl. one-offs	-3.2	-2.8	-2.6	-2.5	-1.9	-1.4	-1.0	2.2
Output gap ¹	-3.0	-2.5	-2.6	-1.8	-1.8	-0.8	0.3	3.2
Cyclically-adjusted balance ¹	-1.7	-1.8	-1.5	-1.8	-1.2	-1.0	-1.1	0.6
Structural balance (SB)²	-2.0	-1.9	-1.6	-1.8	-1.2	-1.0	-1.1	0.9
Structural primary balance ²	-0.1	-0.2	0.1	-0.3	0.3	0.4	0.3	0.4

Notes:

¹Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

²Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

³The general government balance reflects the baseline scenario presented in the programme.

⁴The figures for 2015 presented in this table reflect data from the Annex Table 2a, which was resubmitted by the Slovak authorities on 7 May 2015.

Source:

Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.

Measures underpinning the programme

In 2015, revenue measures (see Table below) are well specified and focus on broadening of the tax base. In addition to keeping the VAT rate at 20% (as opposed to earlier plans to reduce it) and continuing efforts to increase the efficiency of VAT collection, the government has introduced several measures to broaden the tax base for the corporate income tax¹⁰). On the other hand, support of R&D investment by widening tax-deductibility and the reduction of the tax wedge for the low-paid (through the introduction of an allowance for healthcare contributions) will curb growth in tax revenues. Only one single one-off revenue amounting to 0.1% of GDP is planned in 2015 relating to the postponed repayment of the loan of the railway freight transporter Cargo. On the expenditure side, the programme projects an increase in social subsidies, higher wages for teachers and support of education for marginalised groups. Lower spending on healthcare is underpinned by several measures focused on hospitals¹¹ and by the expectation that hospitals will balance their books in 2015¹². The largest savings are, however, are notional savings vis-à-vis the no-policy change scenario implicitly assumed in the programme, mainly in terms of the public wage bill and lower investments which are not underpinned by concrete measures.

The Commission 2015 spring forecast incorporates the revenue measures in full (including the one-off revenue). However, given the implementation risks of reforms in the healthcare sector and lacking measures to support savings on public wage bill, the Commission forecast reflects these expenditure measures only partially. In addition, the Commission projects a higher use of EU funds, which is expected to be channelled mainly towards investment. Under this assumption, investment would be higher compared to the scenario presented in the programme.

In 2016, the revenue measures are not quantified in the programme. Nevertheless, they are not expected to yield significant amounts of additional revenue as they focus at improving collection of some specific taxes (e.g. consumption taxes on cigars and cigarillos) and better functioning of the tax system¹³. In terms of expenditure, the central scenario projects higher spending on public wage bill and investment compared to the no-policy-change scenario.¹⁴ These measures are not reflected in the Commission 2015 spring forecast as not sufficiently specified until now.

¹⁰ For example, depreciation rules were revised and low capitalisation rules were introduced. Low capitalisation rules aim at limiting profit-shifting between inter-connected companies. In the Slovak case, interests on loans from connected companies (e.g. intercompany loans) can be accounted as tax expenditure up to 25% of EBITDA.

¹¹ These include price referencing of important cost items such as medical equipment, energy, pharmaceuticals, etc.

¹² A balanced budget is expected for all hospitals except the main university hospital in Bratislava, which is the largest and the largest source of slippages in healthcare expenditure compared to plans.

¹³ For example, the business environment should be supported by the planned measures in the area of VAT payments where the government plans to propose a cash accounting scheme whereby suppliers do not become liable for tax until paid by their customer.

¹⁴ Since the programme's no-policy change scenario projects for 2016 a lower deficit (1.6% of GDP) than the central scenario, the government expects to have room for additional spending amounting to some 0.4% of GDP.

Main budgetary measures

Revenue	Expenditure
2014	
<ul style="list-style-type: none"> • Fine for a cartel in the construction sector – one-off measure (0.1% of GDP) • Sale of telecom licenses – one-off measure (0.2% of GDP) 	<ul style="list-style-type: none"> • n.a.
2015	
<ul style="list-style-type: none"> • Keeping VAT rate at 20% (0.3% of GDP) • Changes to the depreciation rules (0.2% of GDP) • Introduction of low capitalisation rules (0.1% of GDP) • Extending compulsory use of cash registers (0.1% of GDP) • Introduction of an allowance for healthcare contributions (-0.2% of GDP) • Reduction in non-specified revenues of extra-budgetary accounts (-0.4% of GDP) 	<ul style="list-style-type: none"> • Spending on priorities of the government such as support of free train transport for students and retired people, supporting pre-school facilities, etc. (0.1% of GDP) • Increase in teachers' salaries (0.1% of GDP) • Increase in expenditures on goods and services (0.4% of GDP) • Savings in healthcare (-0.1% of GDP) • Savings on public wage bill (-1% of GDP) • Lower spending on investments (-0.6% of GDP)
2016	
<ul style="list-style-type: none"> • n.a. 	<ul style="list-style-type: none"> • Higher spending on investment and intermediate consumption (0.4% of GDP)
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

3.3. Debt developments

The debt-to-GDP ratio of the general government in 2014 reached 53.6% of GDP. The outcome was lower than originally expected in the 2014 Stability Programme. The difference is largely explained by a lower-than-budgeted cash deficit and the repayment of the debt of Emergency Oil Stocks Agency, which is reflected in the stock-flow adjustment.

The envisaged decline in the debt ratio in 2015 – based on the central scenario – largely reflects the expected use of privatisation proceeds from the sale of shares in Slovak Telecom for debt management and additional buybacks of government bonds. Although the Commission 2015 spring forecast takes into account this information, it projects a larger primary deficit that pushes up the debt ratio. The programme projects a further decline in the general government debt after 2015 to around 50% of GDP by 2018 (see Table 3 and Figure 1), driven mainly by the denominator effect.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018
			COM	SP	COM	SP	SP	SP
Gross debt ratio¹	45.4	53.6	53.4	53.4	53.5	52.8	51.9	50.3
Change in the ratio	5.3	-1.0	-0.2	-0.2	0.1	-0.6	-0.9	-1.6
<i>Contributions²:</i>								
1. Primary balance	3.7	0.9	1.1	0.9	1.0	0.4	-0.1	-0.5
2. “Snow-ball” effect	0.8	0.7	0.0	0.2	-0.8	-1.0	-1.3	-1.3
<i>Of which:</i>								
Interest expenditure	1.6	1.9	1.6	1.7	1.6	1.6	1.4	1.4
Growth effect	-0.5	-1.3	-1.6	-1.5	-1.8	-1.8	-1.8	-1.8
Inflation effect	-0.3	0.1	0.0	0.0	-0.6	-0.7	-0.9	-0.9
3. Stock-flow adjustment	0.8	-2.7	-1.3	-1.2	0.0	0.1	0.5	0.2
<i>Of which:</i>								
Cash/accruals diff.				-0.6		-0.1	0.3	0.0
Acc. financial assets				-0.8		0.2	0.5	0.4
<i>Privatisation</i>				-1.3		0.0	0.0	0.0
Val. effect & residual				0.1		0.0	0.2	0.3

Notes:

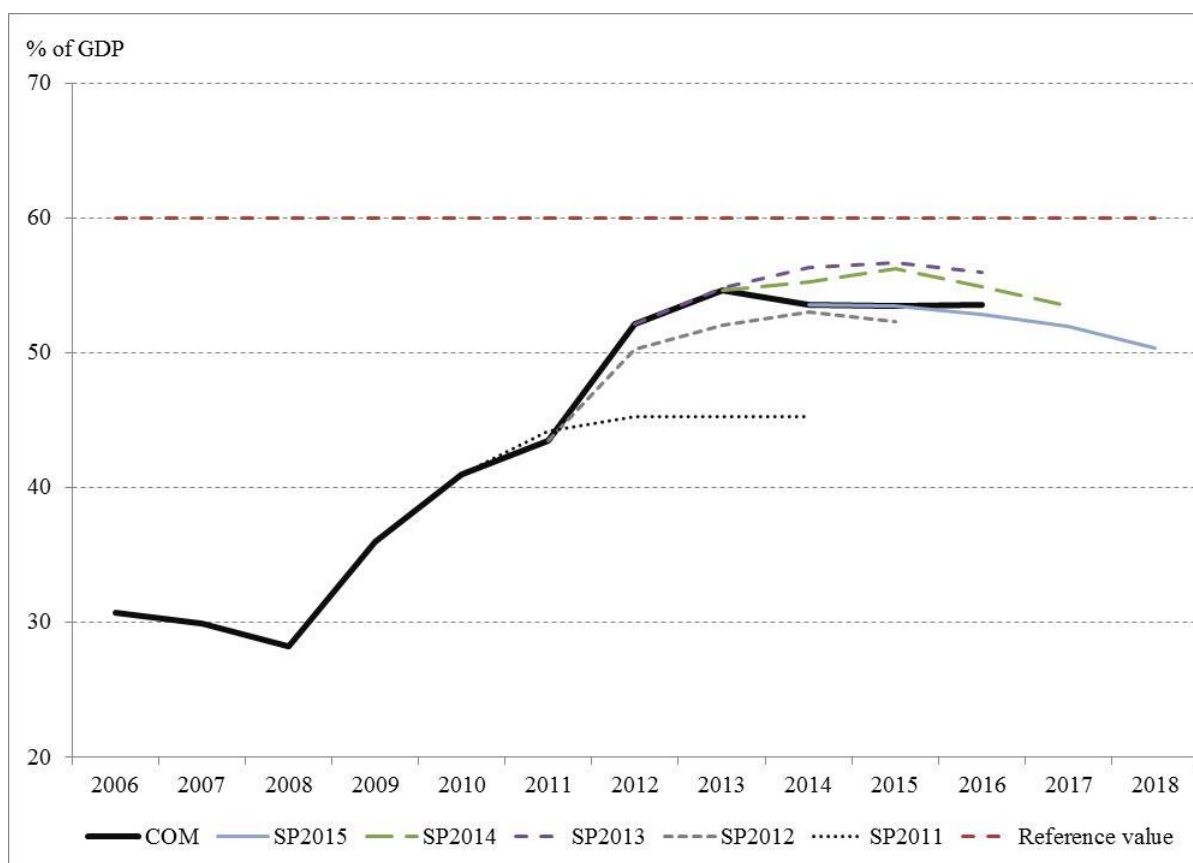
¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Commission 2015 spring forecast (COM); Stability Programme (SP), Commission calculations.

Figure 1: Government debt projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Stability Programmes

3.4. Risk assessment

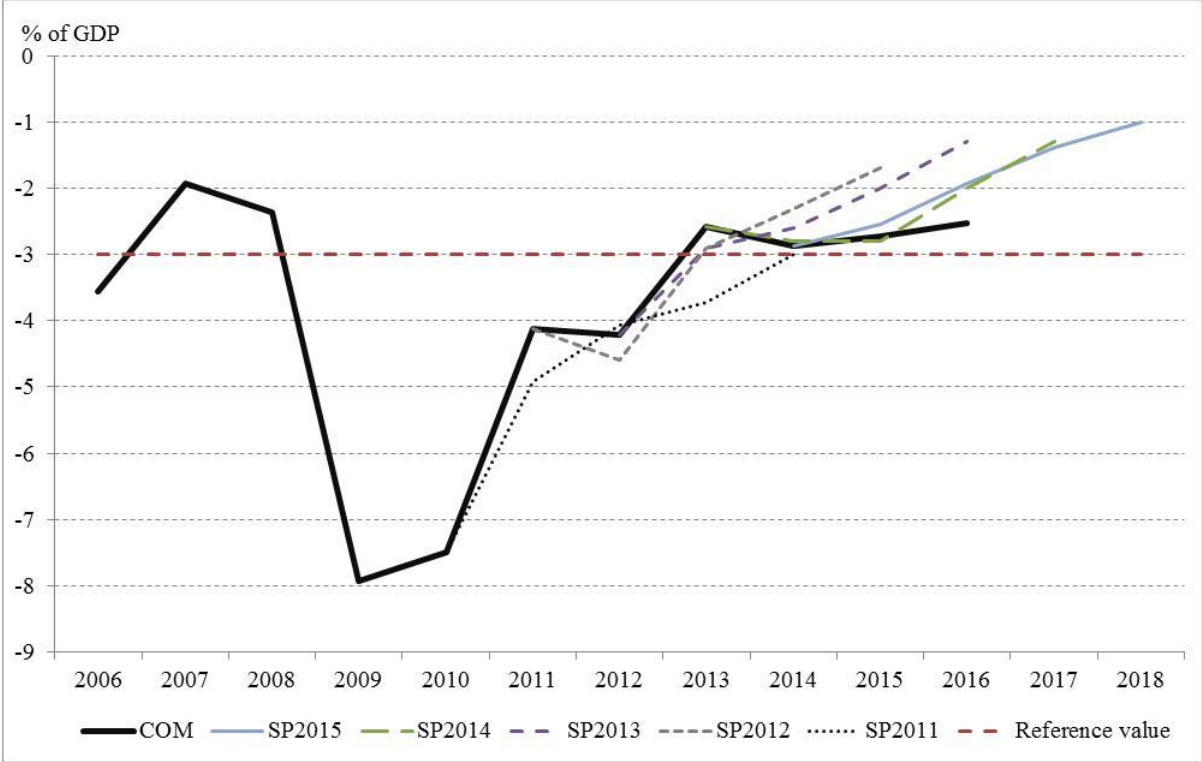
Deficit developments

There are a number of risks that point to higher deficits than what is presented in central scenario of the Stability Programme. In the first place, expected expenditure savings may be overstated. The government's plans to stop hospitals making losses are subject to implementation risks, as it is not clear to what extent the Ministry of Health can impose on the hospitals the envisaged financial framework. It is also not clear to what extent the specified measures could yield envisaged savings even if fully implemented. Planned savings (vis-à-vis the no-policy-change scenario) on public wage bill are also prone to risks, as the larger part of these savings is envisaged in (non-budgeted) extra-budgetary accounts. The programme does not provide details on these accounts and hence it is not clear how much influence the government has on this spending. Finally, savings in public wages at local governments, which would deliver the larger share of these savings, would require an inversion of the trend observed in 2014, when local governments exceeded budgeted wage expenditures.

Moreover, there are reasons to question the important reduction in investments pencilled in the programme. The Stability Programme formally expects full usage of the remaining EU funds from the 2007-13 financing period. However, somewhat inconsistently, this is not reflected in the central scenario underpinning the programme. Hence, if Slovakia manages to fully use the remaining resources available from the EU funds, the co-financing needs are likely to increase which would lead to higher investment.

The consolidation of public financiers will be supported in the coming years by low interest rates. The Stability Programme projects the interest payments to decline from 1.9% of GDP in 2014 to 1.4% of GDP in 2018. An increase in interest rates will require Slovakia to identify other sources of consolidation.

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Stability Programmes

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council recommendations addressed to Slovakia

On 8 July 2014, the Council addressed recommendations to Slovakia in the context of the European Semester. In particular, in the area of public finances the Council recommended Slovakia to reinforce the budgetary measures for 2014 in the light of the emerging gap of 0.3% of GDP relative to the preventive arm of the Stability and Growth Pact requirements based on the Commission services 2014 Spring forecast. In 2015, ensure the required adjustment of 0.1% of GDP towards the medium-term objective taking into account the expected weak economic conditions. Thereafter, until the medium-term objective is achieved, pursue an annual structural adjustment of 0.5 % of GDP as a benchmark. Further strengthen the fiscal framework, also by ensuring binding and enforceable expenditure ceilings. Improve the long-term sustainability of public finance by increasing the cost-effectiveness of the healthcare sector, in particular by rationalising hospital care and management and by strengthening primary care.

Given the cyclical position (as measured by the output gap), Slovakia did not have to ensure a structural adjustment towards the MTO in 2014. In addition, Slovakia was granted the

investment clause for 2014 that allowed a deviation of 0.4% of GDP from the requirement. Based on the Commission forecast and outturn data, Slovakia's structural balance deteriorated by 0.6% of GDP, i.e. 0.2 pp more than what was allowed. At the same time, based on outturn data, the growth rate of government expenditure, net of discretionary revenue measures, in 2014 did not exceed the applicable expenditure benchmark rate (4.1%). The discrepancy between the two indicators is explained by the difference in GDP deflators that enter their calculations. Since the expenditure benchmark is not affected by inflationary shocks it is judged to be the more suitable indicator. Based on the overall assessment, Slovakia appears to be in line with the requirements of the preventive arm in 2014.

Slovakia is required to avoid any deterioration in its structural balance in 2015. Based on the Stability Programme, the structural balance would improve by 0.3% of GDP while the Commission 2015 spring forecast projects a slightly smaller improvement of 0.2% of GDP. When it comes to the expenditure benchmark, the programme assumes a decline of net expenditures while the Commission forecast projects a moderate increase. In both cases, the growth rate of government expenditure, net of discretionary revenue measures, will not exceed in 2015 the applicable expenditure benchmark rate (2.9%). The average adjustment over 2014-2015 is above the required level. Therefore, following an overall assessment, Slovakia appears to be in line with the requirements of the preventive arm in 2015.

Based on the Stability Programme, Slovakia would deliver a structural effort of 0.4% of GDP in 2016, some 0.1pp higher as compared to the required 0.25% of GDP improvement. This result assumes that the government meets the fiscal target – a deficit of 1.9% of GDP. The Commission 2015 spring forecast projects that the improvement in the structural balance in 2016 would fall 0.2 pp short of the required adjustment. At the same time, both projections suggest that growth of net expenditures, net of discretionary revenue measures, would not exceed the applicable expenditure benchmark rate (2.2%). The structural balance appears to be significantly affected by actual tax elasticities being lower than their long-term average. The expenditure benchmark is thus judged to be more relevant for assessing government's efforts in 2016. Following the overall assessment, Slovakia appears to be in line with the requirements of the preventive arm in 2016.

In sum, the ex-post assessment suggests that the adjustment path towards the MTO was in line with the requirement of the preventive arm of the Pact in 2014 and, based on the Commission spring 2015 forecast, the adjustment towards the MTO seems to be in line with the requirements both in 2015 and 2016.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2014	2015		2016	
Initial position¹					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance ² (COM)	-2.0	-1.9		-1.8	
Structural balance based on freezing (COM)	-2.0	-1.9		-	
Position vis-a-vis the MTO³	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	2014	2015		2016	
	COM	SP	COM	SP	COM
Structural balance pillar					
Required adjustment ⁴	0.0	0.0		0.3	
Required adjustment corrected ⁵	-0.4	0.0		0.3	
Change in structural balance ⁶	-0.6	0.3	0.2	0.4	0.0
<i>One-year deviation from the required adjustment⁷</i>	-0.2	0.3	0.2	0.1	-0.2
<i>Two-year average deviation from the required adjustment⁷</i>	In EDP	0.0	0.0	0.2	0.0
Expenditure benchmark pillar					
Applicable reference rate ⁸	4.1	2.9		2.2	
<i>One-year deviation⁹</i>	0.8	1.4	-0.2	0.4	0.7
<i>Two-year average deviation⁹</i>	In EDP	1.1	0.3	0.9	0.2
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Overall assessment	Compliance	Overall assessment
Conclusion over two years	In EDP	Compliance	Compliance	Compliance	Compliance
Notes					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points is allowed in order to be evaluated as having reached the MTO.					
² Structural balance = cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 28.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1.					
⁷ The difference of the change in the structural balance and the required adjustment corrected.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is not at its MTO.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<i>Source:</i>					
<i>Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.</i>					

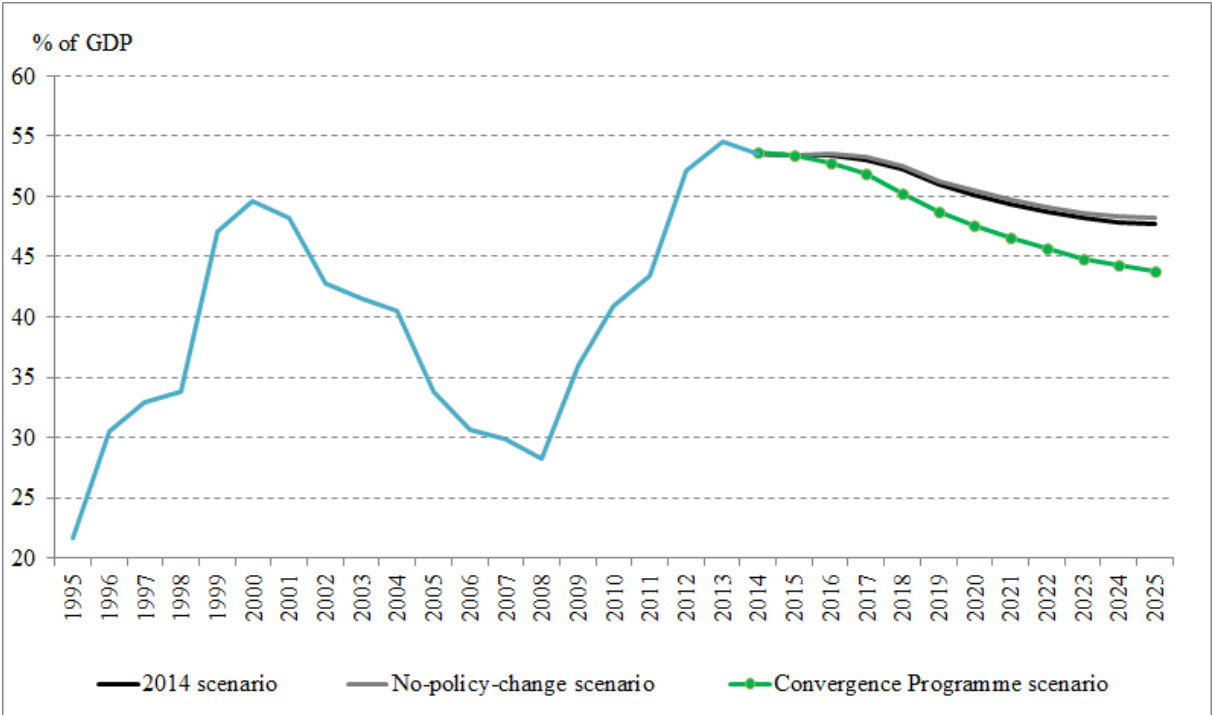
5. LONG-TERM SUSTAINABILITY

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits)

from the 2015 Ageing Report¹⁵ published on 12 May. It therefore updates the assessment made in the Country Reports¹⁶ published on 26 February.

Government debt stood at 53.6% of GDP in 2014. It is expected to fall to 48.3% in 2025, remaining below the 60% of GDP Treaty threshold. The full implementation of the programme would put debt on a decreasing path by 2030, remaining below the 60% of GDP reference value in 2025 (see the graph below).

Figure 3: Gross debt as % of GDP – Medium-term deb projections



Source: Commission 2015 spring forecast; Stability programme; Commission calculations

The medium-term sustainability gap is at -1.0% of GDP, indicating no need for an upfront adjustment effort to bring debt ratios to 60% of GDP in 2030. In the long-term, Slovakia appears to face medium fiscal sustainability risks, as measured by the long-term sustainability gap, which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path. The gap of 3.2% of GDP is by one third due to the initial primary balance. The remaining part (i.e. 2.1% of GDP) is related to the projected ageing costs over the very long run. With 1.4% of GDP, healthcare is the main contributor to the long-term sustainability gap. Pension expenditure accounts for additional 0.8% of GDP. Risks would be higher in the event of the structural primary balance reverting to lower values observed in the past, such as the average for the period 2004-2013. It is therefore appropriate for Slovakia to continue to implement measures that reduce risks to the long-term fiscal sustainability and contain age-related expenditure growth related primarily to the healthcare and to a lesser extent to pensions.

¹⁵ See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

¹⁶ See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

Sustainability of public finances has improved mainly through pension system adjustments while efforts to increase efficiency of the healthcare system have stalled. Changes to the public pillar of the pension system introduced in 2012, such as linking the statutory pension age to life expectancy and pension indexation to inflation, have contributed to better sustainability of public finances.¹⁷ The introduction of the minimum pension approved by the government and the possibility to opt-out of the private pension pillar for the current participants between mid-March and mid-May will on the other hand contribute to a higher deficit of the public pension system in the long term. The on-going healthcare reform is at a very early stage of implementation. Since the contribution of healthcare expenditure to ageing costs is particularly high, efforts in this area need to be accelerated. The focus should be on the overall inefficiencies in the system. Therefore, proper incentives to avoid overconsumption and duplication of healthcare services is crucial.

Table 5: Sustainability indicators

	Slovak Republic			European Union		
	2014 scenario	No-policy-change scenario	Stability Programme scenario	2014 scenario	No-policy-change scenario	Stability/Convergence Programme scenario
S2*	3.1	3.2	2.7	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	0.9	1.1	0.5	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	2.2	2.1	2.2	1.0	1.1	1.1
<i>of which:</i>						
pensions	0.8	0.8	1.0	0.0	0.1	0.1
healthcare	1.4	1.4	1.3	0.8	0.7	0.6
long-term care	0.3	0.2	0.2	0.7	0.7	0.6
others	-0.4	-0.3	-0.3	-0.4	-0.3	-0.2
S1**	-1.0	-1.0	-1.9	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	-0.7	-0.5	-1.1	-0.4	-0.3	-1.6
Debt requirement (DR)	-0.4	-0.5	-0.9	1.7	1.9	1.8
Long-term cost of ageing (CoA)	0.1	0.0	0.1	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.20	:	:	:	:	:
<i>Fiscal subindex</i>	0.11	:	:	:	:	:
<i>Financial-competitiveness subindex</i>	0.23	:	:	:	:	:
Debt as % of GDP (2014)	53.6			88.6		
Age-related expenditure as % of GDP (2014)	18.2			25.6		
Source: Commission, 2015 Stability Programme						
Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.						
* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.						
** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.						
*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indices, thresholds are respectively at 0.35 and 0.45.						

¹⁷ The government reformed also the special pension system of armed forces, which is not part of the general public pension system.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES¹⁸

6.1. Fiscal framework

Since January 2015 a new budgetary rule for local governments entered into force. It defines sanctions if the debt level of a municipality or regional government exceeds 60% of current revenue of the past budgetary year. Furthermore, in April, the government approved amendments to the law on budgetary rules in reaction to the inclusion in the national accounts of new budgetary units in the sector of the general government. At the same time, this amendment designates the Stability Programme as a document that defines national medium-term fiscal plans, replacing the currently used document for announcing fiscal plans.¹⁹ Although the law has not yet been adopted by the Parliament, the Stability Programme explicitly states that it is to be considered as the national medium-term fiscal plan in the sense of Article 4.1 of Regulation 473/2013. Nevertheless, neither the Stability Programme nor the national reform programme includes indications on the expected economic returns on non-defence public investment projects that have a significant budgetary impact.

Major challenges for the medium-term budgetary framework have been identified in Slovakia's Country Report 2015.²⁰ Involvement of local governments or the parliament in the budgetary process is relatively limited. The final years of the multi-annual budget are only indicative and there are no expenditure ceilings²¹ that would limit expenditure growth in years following the upcoming budgetary year although they are envisaged by a constitutional law.

The macroeconomic forecasts underpinning the programme were prepared by the Institute for Financial Policy, which is a part of the Ministry of Finance. The forecasts were subsequently discussed and endorsed by the Macroeconomic Forecasting Committee (established by a constitutional law), which consists of analysts from the Central Bank, a think tank, and commercial banks. The forecasts were assessed as realistic by all members except one who deemed them optimistic. The minutes of the committee meeting including the voting were published on the website of the Ministry.²²

6.2. Quality of public finances

Efficiency of tax collection is set to improve further and measures have been taken to introduce tax incentives supporting R&D and job creation. Measures implemented since 2012 to fight tax fraud – especially in the area of VAT – are proving effective.²³ The government

¹⁸ This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability programme.

¹⁹ Currently, the government is required to adopt by 15 April a document called 'starting points of the general government budget', where it defines its fiscal targets for the coming three years. This document then serves as an input for the subsequent preparation of the general government budget and its targets are also used in the Stability Programmes.

²⁰ COM (2015), "Commission Staff Working Document – Country Report Slovakia 2015"; http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_slovakia_en.pdf.

²¹ The expenditure ceilings that can be applied in case there is a significant deviation from the adjustment path towards the MTO are not a part of an annual budgetary process and their application is at government's discretion.

²² Another committee – Tax Revenue Forecast Committee- endorses in a similar fashion projections of tax revenues and social security contributions.

²³ The effective VAT tax rate increased by 2 pps from its through in 2012, reaching 14% in 2014.

plans to increase the efficiency of tax collection further mainly through enhancing audit and risk-assessment capacities and in the medium term by merging collection of taxes and social security contributions (e.g. project UNITAS). The overall efficiency of the tax system was improved also by measures aimed at broadening the tax base for corporate taxation that entered into force in 2015. At the same time, the possibility to deduct R&D-related expenditure up to 150% of actual costs aims at promoting private R&D investment, while a new allowance for healthcare contributions for low-paid is meant to support creation and demand for lower-paid jobs. On the other hand, plans to revamp the real-estate and environmental taxation are on hold. A reform of real-estate taxation that would reflect the market value of underlying property in tax base is envisaged only after 2015.

The government has adopted measures to increase cost-effectiveness of the healthcare sector. The introduction of transparent price ceilings for large-ticket items (e.g. large medical instruments, pharmaceuticals, etc.), compulsory external audits and the optimization of beds are expected to contribute to slowing the generation of debt by state hospitals already in 2015. Other measures such as the introduction of the diagnostic-related groups payments are envisaged only for later stages of a broader healthcare reform. Efforts continue also in the area of upgrading the motorway infrastructure, which is one of the causes for lagging economic development of central and eastern regions. The EU funding from the 2014-20 programming period is expected to be the main source.

7. CONCLUSIONS

In 2014, Slovakia's structural balance deteriorated by 0.6% of GDP, some 0.2 pp more than what was allowed in view of the investment clause. On the other hand, the growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark. Overall, in 2014, Slovakia appears to have complied with the provisions of the Pact.

In 2015, Slovakia plans an improvement in the (recalculated) structural balance of 0.3% of GDP and a further adjustment of 0.4% of GDP in 2016. In addition, the projected growth of government expenditures in both years is below the applicable expenditure benchmark rates. According to the Commission 2015 spring forecast, the structural balance would fall short of the requirement in 2016, but Slovakia would abide by the requirements based on the expenditure benchmark. This suggests that Slovakia would be in line with the requirements of the preventive arm both in 2015 and 2016.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	2.9	6.0	3.7	1.6	1.4	2.4	3.0	3.4
Output gap ¹	-0.1	-0.2	2.4	-2.3	-3.1	-3.0	-2.5	-1.8
HICP (annual % change)	8.5	5.3	2.3	3.7	1.5	-0.1	-0.2	1.4
Domestic demand (annual % change) ²	2.7	5.0	2.1	-4.1	0.0	3.0	2.9	3.0
Unemployment rate (% of labour force) ³	15.9	17.0	12.2	14.0	14.2	13.2	12.1	10.8
Gross fixed capital formation (% of GDP)	32.2	26.8	24.1	21.3	20.4	21.1	21.4	21.3
Gross national saving (% of GDP)	25.5	21.1	20.8	21.3	21.5	22.6	22.7	21.6
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-7.4	-3.9	-4.8	-4.2	-2.6	-2.9	-2.7	-2.5
Gross debt	42.4	37.9	35.7	52.1	54.6	53.6	53.4	53.5
Net financial assets	-2.0	-3.8	-16.0	-25.1	n.a	n.a	n.a	n.a
Total revenue	40.0	36.0	35.1	36.0	38.4	38.9	39.6	37.5
Total expenditure	47.5	39.9	39.8	40.2	41.0	41.8	42.4	40.1
<i>of which: Interest</i>	3.2	2.2	1.4	1.8	1.9	1.9	1.6	1.6
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-1.4	-2.3	1.1	5.9	4.1	4.0	3.7	2.6
Net financial assets; non-financial corporations	-69.2	-63.3	-68.4	-71.0	n.a	n.a	n.a	n.a
Net financial assets; financial corporations	-12.1	-3.5	-1.9	3.1	n.a	n.a	n.a	n.a
Gross capital formation	21.7	19.2	16.9	13.7	13.2	12.9	12.9	13.9
Gross operating surplus	25.3	26.1	26.6	26.6	26.2	25.7	25.6	25.8
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	2.3	-1.4	0.0	0.2	0.8	1.1	1.0	0.9
Net financial assets	51.7	33.3	33.9	37.1	n.a	n.a	n.a	n.a
Gross wages and salaries	32.2	30.6	30.3	30.5	30.4	31.5	31.7	31.7
Net property income	4.9	2.0	1.6	1.1	2.0	2.1	1.7	1.8
Current transfers received	16.7	16.5	17.5	18.4	18.4	18.3	17.7	17.3
Gross saving	7.2	4.1	4.9	4.5	5.3	5.4	5.3	5.2
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-6.5	-7.7	-3.7	1.8	2.3	2.8	2.6	1.5
Net financial assets	31.5	37.2	52.3	55.9	n.a	n.a	n.a	n.a
Net exports of goods and services	-7.0	-4.1	-1.5	3.7	4.5	4.2	4.4	4.9
Net primary income from the rest of the world	-0.2	-2.9	-1.9	-2.0	-2.0	-1.8	-1.8	-1.9
Net capital transactions	-0.2	-0.4	1.1	1.5	1.5	0.8	0.8	0.8
Tradable sector	54.1	53.1	51.6	51.3	50.5	50.5	n.a	n.a
Non tradable sector	36.0	36.7	39.2	40.2	40.7	40.5	n.a	n.a
<i>of which: Building and construction sector</i>	6.2	6.2	8.3	8.2	7.8	7.5	n.a	n.a
Real effective exchange rate (index, 2000=100)	61.7	72.3	97.1	98.7	98.7	100.7	98.3	98.3
Terms of trade goods and services (index, 2000=100)	107.1	106.1	100.9	97.5	97.0	97.1	97.3	97.3
Market performance of exports (index, 2000=100)	62.3	81.1	101.2	116.5	120.1	119.2	117.9	117.4
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source:								
Commission 2015 spring forecast								