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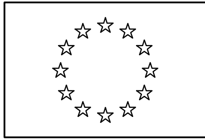

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.11.2009
SEC(2009) 1539 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Slovakia

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[1], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[2], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is

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[1] See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No 103/2009.

[2] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the Commission services' spring 2009 forecast and in particular the forecast for the general government balance, which pointed to a risk of an excessive deficit, the Commission adopted a report under Article 104(3) for Slovakia on 7 October 2009[3].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 October 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

The Commission services' spring 2009 forecast projected the general government deficit in Slovakia at 4.7% of GDP in 2009, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the projected deficit was not close to the 3% of GDP reference value but that the projected excess over the reference value could be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact, on the basis of the information available at the time of the report. Furthermore, the projected excess over the reference value could not be considered temporary. The report under Article 104(3) concluded that there was a high risk that the deficit criterion in the Treaty was not fulfilled.

According to the data notified by the Slovak authorities in October 2009[4] the general government deficit in Slovakia is now planned to reach 6.3% of GDP in 2009, thus remaining above and not close to the 3% of GDP reference value. Based on the Commission services' autumn 2009 forecast, the planned excess over the reference value still qualifies as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results, among other things, from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission services' 2009 autumn forecast projects real GDP to contract by 5.8% in 2009 after increases of 10.4% and 6.4% in 2007 and 2008, respectively. While the excess over the 3% reference value mainly reflects the severity of the economic downturn, it also results from the significant deterioration of the structural balance since 2005. Furthermore, the planned excess over the reference value cannot be considered temporary, since the Commission services' autumn 2009 forecast projects the general government deficit to reach 6% of GDP in 2010 and 5.5% of GDP in 2011 based on the no-policy change assumption. The forecast takes into account the fiscal stimulus package

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[3] All EDP-related documents for Slovakia can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

[4] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notifications of Slovakia can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

introduced by the Slovak government amounting to 0.4% of GDP in 2009 and 0.6% of GDP in 2010, which is in line with the EERP and is an adequate response to the crisis given the limited fiscal space. The adopted measures target disadvantaged groups (e.g. an increase of the tax allowance and tax credit), and are in most cases of temporary nature (e.g. car scrapping scheme). The deficit criterion in the Treaty is not fulfilled.

According to data notified by the Slovak authorities in October 2009, the general government gross debt remains well below the 60% of GDP reference value and is planned to stand at around 30% of GDP in 2009. According to the Commission services' autumn forecast, the debt ratio is set to increase rapidly, reaching 42.7% of GDP in 2011 under the no policy change assumption.

In line with the provisions in the Stability and Growth Pact, the Commission in its 104(3) report gave due consideration to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on the estimates of the Slovak authorities, the net costs of this reform amount to 1.1% of GDP in 2009-2011, rising to 1.2% in 2012. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value. Since the deficit does not remain close to the reference value in 2009-2011, the cost of the pension reform cannot be taken into account.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report “relevant factors”. According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Slovakia, the double condition is not met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Slovakia. This opinion, adopted by the Commission on 11 November 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Slovakia with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which “should be completed in the year following its identification unless there are special circumstances”. Article 2(6) of the Regulation implies that the “relevant factors” considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article

3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Slovakia, special circumstances are considered to exist. Being a very open economy, Slovakia has been severely affected by the global crisis, primarily through a strong fall in external demand. Real GDP contracted by 11% quarter on quarter in the first quarter of 2009. The second quarter of 2009 brought signs of stabilisation but, according to the Commission services' 2009 autumn forecast, real GDP is expected to contract by 5.8% in 2009. Economic activity is projected to pick up gradually in 2010, with real GDP growth reaching 1.9%, reflecting the improvement in the global environment.

According to the Commission services' autumn 2009 forecast, the deficit is expected to deteriorate by 4 percentage points to 6.3% of GDP in 2009. This mainly reflects the impact of the economic crisis on government finances. The stimulus measures adopted by the Slovak government in response to the crisis and in the context of the EERP will not have any effect on the general government deficit in 2009 as they are being financed through reallocations within the budget. Based on the no-policy change assumption, the Commission services' autumn 2009 forecast projects the deficit to remain high in 2010 and 2011, at 6% and 5.5% of GDP, respectively. In response to the widening deficit, the Slovak government approved in September 2009 a three-year budget for 2010-2012, which envisages consolidation of public finances starting from 2010. According to these plans, the government deficit will be reduced to 5.5% of GDP in 2010, 4.2% of GDP in 2011 and 3% of GDP in 2012. The proposed budget is, however, subject to risks. Uncertainties on the expenditure side reflect a lack of sufficient specification of measures needed to achieve the adjustment path, a track record of expenditure overruns, and the absence of enforceable expenditure rules.

Considering the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. The required adjustment should take into account the fiscal room for manoeuvre which is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework, taking into account the path approved by the Slovak government in the 2010-2012 budget and associated risks, and with a deadline for the correction by 2013. In particular, in view of the size of the 2009 deficit, and of Slovakia's economic outlook, a credible and sustainable adjustment path would require the Slovak authorities to, first, implement the deficit reducing measures in 2010 as planned in the 2010-2012 draft budget; second, in order to bring the deficit below 3% of GDP in 2013, achieve an average annual structural budgetary adjustment of 1% of GDP over the period 2010-2013. The government will need to specify the necessary measures in order to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting, and it should accelerate the reduction of the deficit if permitted by better-than-expected economic or budgetary conditions.

The general government debt ratio declined by over 14 percentage points of GDP from 2003 on reaching 27.7% of GDP in 2008. In view of the crisis and subsequent widening of the general government deficit in 2009, the Slovak authorities notified in October 2009 gross general government debt at 30.4%. The Commission services' 2009 autumn forecast projects a further deterioration of the general government debt ratio to 42.7% in 2011 due to a persisting high deficit and a sluggish economic recovery.

In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In particular, the Slovak authorities should also carry out reforms conducive to enhancing the quality of public procurement. They should also undertake reforms supporting reallocation of expenditures towards education, R&D and innovation, and to improve business-research cooperation. In addition, the Slovak authorities should step up efforts to reduce administrative burdens on businesses and implement reforms to make progress in the implementation of the lifelong learning strategy and to address skill mismatches.

Slovakia has a multi-annual budgetary framework with three-year budgetary planning. Deficit targets set out in the past convergence programmes have been achieved mainly due to stronger-than-expected economic performance. However, expenditure plans outlined in the medium-term budgetary frameworks have always been exceeded in the past and subsequently revised upwards. In view of this experience, it is important to strengthen the enforceability of the medium-term budgetary framework.

As regards the long-term sustainability of public finances, the budgetary position in 2009 compounds the impact of population ageing, which is slightly below the EU average, on the sustainability gap. Improving the primary balance over the medium term should contribute to reducing the risk to the long-term sustainability of public finances as defined by the Commission Communication[5] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[6] on 10 November 2009.

Enhanced surveillance under the EDP, which seems necessary also in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Slovak stability programme which will be prepared between 2010 and 2012 could usefully be devoted to this issue.

5 Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf.

6 Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011	2012
Real GDP (% change)	COM Nov 2009	10.4	6.4	-5.8	1.9	2.6	n.a.
	MoF Sep 2009[3]	10.4	6.4	-5.7	1.9	4.1	5.4
Output gap (% of potential GDP)	COM Nov 2009[1]	7.5	9.2	-0.8	-2.1	-3	n.a.
General government balance (% of GDP)	COM Nov 2009	-1.9	-2.3	-6.3	-6.0	-5.5	n.a.
	MoF Sep 2009[3]	-1.9	-2.3	-6.3	-5.5	-4.2	-3.0
Primary balance (% of GDP)	COM Nov 2009	-0.5	-1.1	-5.0	-4.7	-4.1	n.a.
Cyclically-adjusted balance (% of GDP)	COM Nov 2009	-4.0	-5.0	-6.0	-5.4	-4.6	n.a.
Structural balance[2] (% of GDP)	COM Nov 2009	-4.0	-5.2	-6.2	-5.4	-4.6	n.a.
Government gross debt (% of GDP)	COM Nov 2009	29.3	27.7	34.6	39.2	42.7	n.a.
	MoF Sep 2009[3]	29.3	27.7	36.4	40.8	42.5	42.2

Notes:

[1] Based on estimated potential growth of 5.2%, 4.7%, 3.6%, 3.2% and 3.6% respectively in the period 2007-2011.
[2] Cyclically-adjusted balance excluding one-off and other temporary measures. The Commission services' 2009 autumn forecast includes deficit-increasing one-off and other measures of 0.2% of GDP in 2008 and 0.2% of GDP in 2009.
[3] Draft of the 2010-2012 general government budget

Source:
Stability programme (SP); Commission services' autumn 2009 forecasts (COM);Draft of the 2010-2012 general government budget, Commission services' calculations.

Recommendation for a

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Slovakia,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[7] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 479/2009[8] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in

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[7] OJ L 145, 10.6.2009, p. 1-9.
[8] OJ L 332, 31.12.1993, p. 7.

accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Slovakia. The Commission therefore addressed such an opinion to the Council in respect of Slovakia on 11 November 2009[9].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Slovakia, this overall assessment leads to the following conclusions.

(7) According to data notified by the Slovak authorities in October 2009 the general government deficit in Slovakia is planned to reach 6.3% of GDP in 2009, thus exceeding and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results, among other things, from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission services' 2009 autumn forecast projects real GDP to contract by 5.8% in 2009. While the excess over the 3% reference value mainly reflects the severity of the economic downturn, it also results from the significant deterioration of the structural balance since 2005. Furthermore, the planned excess over the reference value cannot be considered temporary, since the Commission services' 2009 forecast projects the general government deficit to reach 6% of GDP in 2010 based on the no-policy change assumption. The deficit criterion in the Treaty is not fulfilled.

(8) According to data notified by the Slovak authorities in October 2009, the general government gross debt remains well below the 60% of GDP reference value and is planned to stand at around 30% of GDP in 2009. According to the Commission services' autumn forecast, the debt ratio is set to increase rapidly, reaching 42.7% of GDP in 2011 under the no policy change assumption.

(9) In line with the provisions in the Stability and Growth Pact, the Commission in its report gave due consideration to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on the estimates of the Slovak authorities, the net costs of this reform amount to 1.1% of GDP in 2009-2011, rising to 1.2% in 2012. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value. Since the deficit does not remain close to the reference value in 2009-2011, the cost of the pension reform cannot be taken into account.

(10) According to Article 2(4) of Council Regulation (EC) No 1467/97, “relevant factors” can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Slovakia, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

[9] All EDP-related documents for Slovakia can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Slovakia.

Article 2

This decision is addressed to the Slovak Republic.

Done at Brussels,

For the Council
The President