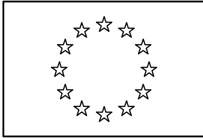


EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 8 July 2004
ECFIN/50105/04-EN

CONVERGENCE PROGRAMME OF SLOVAKIA (2004-2007)

AN ASSESSMENT

Table of contents

SUMMARY AND CONCLUSIONS 3

1. INTRODUCTION 6

2. MACROECONOMIC DEVELOPMENTS 6

   2.1. Macroeconomic scenario 6

   2.2. External accounts 8

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY 8

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES 9

   4.1. Budgetary developments until 2003 9

   4.2. Programme overview 11

   4.3. Targets and adjustment in 2004 13

   4.4. Targets and adjustment in 2005 and beyond 15

   4.5. Debt ratio 16

5. THE QUALITY OF THE PUBLIC FINANCES 17

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES 18

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME 20

SUMMARY AND CONCLUSIONS[1]

Slovakia submitted its first convergence programme on 14 May 2004. The programme covers the period 2004 to 2007 and, in addition, provides indicative projections until 2010. The document incorporates the measures taken in the budget 2004 and is consistent with the authorities' detailed draft multi-annual budget framework for the years 2005 to 2007. It expresses the authorities' intention to adopt the euro in 2008 or 2009 at the latest.

The programme is very well presented and largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[2]. It compares favourably with the pre-accession economic programmes 2001 to 2003 in terms of the richness and coherence of the supplied information.

The general government deficit decreased to 3.6% of GDP in 2003, above the 3% of GDP Treaty reference value. The Commission initiated the excessive deficit procedure for Slovakia on 12 May 2004, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on this report on 25 May. On 5 July 2004, the Council is expected, on the basis of Commission recommendations, to decide that an excessive deficit exists in Slovakia and to make recommendations to Slovakia to bring this situation to an end.

The macroeconomic scenario presented in the programme is plausible and broadly in line with the Commission forecast: after a steady increase of the real GDP growth rate from 1.5% in 1999 to 4.2% in 2003, the programme projects real GDP expansion to continue at about this rate in 2004 and 2005, underpinned by an increasingly stronger domestic demand and a weakening external growth contribution. Beyond the Commission forecast horizon, for 2006 and 2007, the programme plausibly predicts an acceleration of growth to almost 5% (i.e. roughly in the range of available estimates for potential growth by that time) -- driven by again strengthening exports as FDI-induced export capacity comes on stream. Throughout the programme period, exports benefit from a projected growth pick-up in Slovakia's major trading partners until 2005 and their flat but robust growth thereafter. In line with the growth outlook and, since recently, more decisive labour market reforms, unemployment is anticipated to drop gradually to around 14½% by 2007 (from somewhat over 17% in 2003).

Inflation is forecast to fall rapidly after the year 2004 (to below 3% in 2006 and 2007) as increases in administered prices taper off. The inflation projection is realistic under the assumption that second-round effects are strictly contained, notably by counter-acting

---

[1] This assessment has been carried out on the basis of information available as of 16 June 2004.

[2] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001. Indeed, with a few minor exceptions (a few missing projections for the years 2006 and 2007 in the table on external assumptions and the provision of public consumption only in aggregated form [lines 16 and 17 together] in table 2), the code-of-conduct tables annexed to the programme provide not only the required but also the optional information indicated in the code. In addition, the programme furnishes a broad array of supplementary data. Furthermore, estimated consolidated expenditure- and revenue-to-GDP ratios and disaggregations thereof in line with ESA95 classifications are now available back to 2002, whereas, before that, consolidated expenditure- and revenue-to-GDP ratios are still lacking.

backward-looking wage setting, in particular in the public sector because of potentially unfavourable demonstration effects. Monetary policy pursues an implicit inflation target, while trying to reduce excessive exchange rate volatility and to offset exchange rate pressures that are deemed inconsistent with economic fundamentals. Policy interest rates have been decreased, triggered by concerns about the strength of the currency, which appreciated by some 10 percent since mid-2002, and supported by the on-going fiscal consolidation efforts. The programme suggests that Slovakia would start participating in ERM II in 2005 or 2006.

The programme aims at a reduction of the general government deficit to 3.0% of GDP by 2007 from 3.6% of GDP in 2003 in order to comply with the Maastricht deficit criterion – with the adjustment path being almost completely in line with the 2003 pre-accession economic programme (up to 2006) and with the following intermediate deficit targets: 4.0% of GDP in 2004, 3.9% of GDP in 2005 and 3.9% of GDP in 2006. Against the backdrop of a far-reaching but expected to be basically revenue-neutral tax reform package, which essentially constitutes a shift of the tax burden from direct to indirect taxation and is effective since the beginning of 2004, the adjustment over the programme period is based on reductions in primary expenditures of 1.5 percentage points of GDP. These reductions are to a large extent underpinned by structural reforms, predominantly in the health and social protection area, which are mostly already enacted and in force.

In particular in an environment of robust growth, the envisaged deficit reduction of a mere 0.6 percentage of GDP over four years does not look very ambitious. In addition, it is back-loaded. However, the following modulating factors need to be taken into account: first, the relatively large deficit reduction from 2002 to 2003 of 2.1 percentage points of GDP, which was partly due to non-recurrent factors; second, the expenditure-based nature of the adjustment; third, the introduction of a funded pension pillar in 2005, which leads to a re-direction of social security contributions and, hence, a revenue decrease for general government, starting with ½ percentage point of GDP in 2005 and amounting to 1 percentage point of GDP by the end of the programme period; and fourth, the increase in public investment over the programme horizon. Contingent on the strict containment of risks on the expenditure side, which would be helped by binding medium-term expenditure ceilings, potentially higher than budgeted tax revenues in 2004 and beyond would provide a welcome opportunity to accelerate the deficit reduction in comparison to what is foreseen in the programme.

The possibility of accelerating the deficit reduction is an especially important consideration. Not only would it allow the general government deficit to be below 3.0% of GDP in 2007, but it would also pave the way to achieve the second major objective expressed in the programme, namely a structural budgetary position of close to balance or in surplus by the end of the decade, and to attain a sufficient safety margin against breaching the 3% of GDP Treaty reference value for the deficit criterion with normal macroeconomic fluctuations. Furthermore, accelerating the deficit reduction whenever the opportunity arises would also create a buffer against potential downside risks. Whereas risks in 2004 are somewhat tilted to the positive side, risks over the whole programme period seem to be broadly balanced. Nevertheless, important downside risks seem to be concentrated on the expenditure side and include in particular delays in the envisaged health care reform and a lack of public sector rationalisation.

The authorities' structural reform agenda, which is for the most part already enacted and in force, increases the quality of public finances both on the revenue side (tax reform package) and expenditure side (in particular health care and social protection) and is

likely to enhance growth, notably by strengthening the incentives to work (including through a better targeting of social transfers) and to create new jobs.

The programme projects an increase in the debt-to-GDP ratio between 2003 and 2005 by 2½ percentage points to 46.4% – broadly in line with the Commission forecast. Thereafter, it plans a reduction to 45.5% by 2007. The role of stock-flow adjustments in determining debt dynamics, which was large before 2003 due to privatisation and other exceptional factors, has substantially diminished. The year 2004 is a notable exception, mainly due to a lower accrual than cash deficit.

On long-term sustainability, the programme projections are contingent on the strict adherence to the fiscal consolidation targets (leading to a budgetary position of close to balance or in surplus by 2010), the full implementation of the envisaged policies (including additional increases in the retirement age after the programme horizon), and the underlying demographic assumptions, in particular potentially too optimistic fertility rates. Under these conditions, the projections suggest that Slovakia would be relatively well placed to meet the budgetary costs of an ageing population. Apart from some additional risks that may emerge in the long run, the main risks to these projections stem from a lack or a delay in reform implementation or from any backtracking on already implemented reforms.

Table 1: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP (% change)	**CP**	**4.2**	**4.1**	**4.3**	**5.0**	**4.7**
	COM	4.2	4.0	4.1	n.a.	n.a.
	PEP	*4.0*	*4.1*	*4.4*	*4.8*	*n.a.*
HICP inflation (%)	**CP**	**8.5**	**8.1**	**4.0**	**2.9**	**2.5**
	COM	8.5	8.2	4.5	n.a.	n.a.
	PEP	*8.6*	*8.1*	*4.3*	*3.0*	*n.a.*
General government balance (% of GDP)/1	**CP**	**-3.6**	**-4.0**	**-3.9**	**-3.9**	**-3.0**
	COM	-3.6	-4.1	-3.9	n.a.	n.a.
	PEP	*-5.0*	*-3.9*	*-3.9*	*-3.8*	*n.a.*
Primary balance (% of GDP)/1	**CP**	**-1.2**	**-1.4**	**-1.1**	**-1.2**	**-0.4**
	COM	-1.2	-1.4	-1.0	n.a.	n.a.
	PEP	*-2.1*	*-1.4*	*-1.1*	*-0.6*	*n.a.*
Government gross debt (% of GDP)	**CP**	**42.8**	**45.1**	**46.4**	**46.1**	**45.5**
	COM	42.8	45.1	46.1	n.a.	n.a.
	PEP	*45.0*	*45.7*	*47.4*	*48.5*	*n.a.*

/1 General government balance and primary balance include the revenue-decreasing and hence, *ceteris paribus,* deficit-increasing effect of the introduction of a funded pension pillar in 2005 (estimated at 0.5% of GDP in 2005; 0.9% of GDP in 2006; and 1.0% of GDP in 2007).
Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

1. Introduction

Slovakia submitted its first convergence programme on 14 May 2004. The programme covers the period 2004 to 2007 and, in addition, provides indicative projections until 2010. The document incorporates the measures taken in the budget 2004 and is consistent with the detailed draft multi-annual budget framework for the years 2005 to 2007, which has been passed in the same session of the Slovak government as the programme and will be forwarded to parliament in autumn this year. It expresses the authorities' intention to adopt the euro in 2008 or 2009 at the latest.

The programme is very well presented and largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".[3] It compares favourably with the pre-accession economic programmes 2001 to 2003 in terms of the richness and coherence of the supplied information.

The main goals of Slovakia's fiscal policy, as articulated in the programme, are: first, a reduction of the general government deficit from 3.6% of GDP in 2003 to 3% of GDP by 2007[4]. The envisaged fiscal consolidation is based on expenditure reforms, most of which have already become effective in 2004. The expenditure reforms take place against the backdrop of a projected fall in the revenue-to-GDP ratio by almost 1 percentage point of GDP by 2007, which is broadly equal to the revenue loss due to the introduction of a funded pension pillar in 2005, and of a tax reform package (effective since the beginning of 2004), which is expected to be basically revenue-neutral and constitutes a major shift of the tax burden from direct to indirect taxation. The deficit targets are almost completely in line with the 2003 pre-accession economic programme. The debt-to-GDP ratio is projected to increase by some 3½ percentage points to about 46½% of GDP by 2005 and to fall back to 45½% by 2007. A second goal of Slovakia's fiscal policy consists of "achieving long-term sustainability of public finances by 2010", i.e. "public finances which are either close to balance (in structural terms) or in a moderate surplus by 2010". The programme contains a commitment to a "stringent" interpretation of the Stability and Growth Pact as a means to achieve this goal.

2. Macroeconomic developments

2.1. Macroeconomic scenario

After a steady increase of the real GDP growth rate from 1.5% in 1999 to 4.2% in 2003, the programme projects real GDP expansion to continue at about this rate in 2004 and 2005. This projection as well as the underlying composition of growth, which consists of an increasingly stronger contribution by domestic demand[5] and a weakening of the external contribution, is broadly in line with the Commission Spring 2004 forecast. For

---

[3] See footnote 2.

[4] Including the revenue-decreasing and hence, *ceteris paribus,* deficit-increasing effect of the introduction of a funded pension pillar.

[5] In the authorities' forecast, this is to a considerable extent driven by changes in inventories.

2006 and 2007, the programme predicts an average growth rate of almost 5% (i.e. roughly in the range of available estimates for potential growth by that time). This appears to be plausible because, by then, higher export capacity will have come on stream, notably as a consequence of planned FDI in the automobile sector, and will have a favourable impact on the external growth contribution. Throughout the period, exports are bolstered by an assumed growth pick-up in Slovakia's major trading partners until 2005 and flat but robust growth in these countries thereafter. The external assumptions of the macroeconomic scenario are in line with the Commission Spring 2004 forecast.[6]

The unemployment rate reached a peak of 19% in 2001, mainly as a consequence of accelerated enterprise restructuring. Since 2002, the government has been tackling the deep-seated structural problems in the labour market more decisively and the unemployment rate has gradually been falling. It amounted to somewhat above 17% in 2003 (Labour Force Survey data). The programme forecasts a further gradual drop by almost 3 percentage points by 2007. In line with this and the Commission forecast, employment growth is projected at around ½% annually in 2004/2005. Thereafter, the macroeconomic scenario assumes an acceleration of employment growth to almost 1% in 2007, in line with higher GDP growth. Furthermore, for 2008 to 2010, the programme indicates an average employment growth of 0.7% and an average unemployment rate of 13.5%.[7]

Broadly in line with the Commission forecast, inflation is forecast to drop rapidly after the year 2004 when increases in administered prices and indirect taxes taper off. This requires a strict containment of second-round effects (see also section 3 below).

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**
Real GDP (% change)	4.2	4.2	4.0	4.1	4.1	4.3	n.a.	5.0	n.a.	4.7
Contributions:										
- Final domestic demand	0.1	0.1	3.0	1.6	4.1	3.9	n.a.	4.2	n.a.	3.0
- Change in inventories	-2.3	-2.3	0.7	2.0	0.5	1.4	n.a.	-0.9	n.a.	-0.3
- External balance on g&s	6.5	6.4	0.3	0.4	-0.5	-1.0	n.a.	1.6	n.a.	1.9
Employment (% change)	1.8	1.8	0.6	0.5	0.7	0.6	n.a.	0.6	n.a.	0.9
Unemployment rate (LFS)	17.1	17.4	16.5	16.4	15.9	15.9	n.a	15.2	n.a	14.6
HICP inflation (%)	8.5	8.5	8.2	8.1	4.5	4.0	n.a.	2.9	n.a.	2.5
GDP deflator (% change)	4.7	4.7	5.5	3.7	2.5	2.7	n.a.	3.0	n.a.	2.3
Current account (% of GDP)	-0.9	-0.9	-2.5	-2.0	-4.0	-2.7	n.a.	-1.1	n.a.	-0.4
Sources: *Convergence programme (CP); Commission services spring 2004 forecasts (COM);*										

6 The only exception is the exchange rate of the Slovak crown: the programme assumes a moderate nominal appreciation against the euro (6% between 2003 and 2007), whereas the Commission Spring forecast makes the purely technical assumption of a constant real effective exchange rate over the forecast period.

7 The programme also elaborates on the impact on its macroeconomic projections of the following deviations from the underlying assumptions, in particular: (1) 5% higher than assumed appreciation of the Slovak crown by the end of 2004; (2) a by 3% lower than assumed growth of euro-zone imports in each of the programme years; and (3) higher than assumed total productivity growth by 0.5 percentage points in each of the programme years.

2.2. External accounts

In 2003, the current account deficit narrowed remarkably to less than 1% of GDP (from around 8% of GDP in 2001 and 2002), due to an export boom on the back of an FDI-induced expansion in export capacity. The smaller current account deficit corresponded to a decline in general government net borrowing but also to positive private net savings.

The programme provides projections for the current account balance that, given the planned development of the fiscal deficit, would require continued positive private net savings throughout the programme horizon. These projections are subject to considerable uncertainties if one judges from the experience of other catching-up economies, which witnessed sharp swings of private net savings into the negative as their economic expansion accelerated and private investment and consumption took off. Risks may in particular arise towards the end and after the programme horizon: on the one hand, it is plausible that the considerable FDI that Slovakia is slated to receive in the years 2005/2006 (especially in the automobile industry) will lead to a second wave of export capacity creation and could well induce a new export boom. On the other hand, domestic demand growth could accelerate as well and could, via higher imports, result in a widening current account deficit. In addition, its financing may increasingly depend on short-term and more volatile capital inflows instead of FDI. Current account developments, coupled with a changed composition of capital inflows, may impose additional constraints on the size of the fiscal deficit.

This suggests the opportunity of considering alternative scenarios for the current account development and the underlying domestic savings-investment balances and of including the analysis of the composition of capital inflows, domestic credit growth, foreign debt dynamics and associated macroeconomic and financial stability issues. In this context, it would also be useful to examine the broader ramifications of growth, interest rate or exchange rate shocks on fiscal and external sustainability and the soundness of the financial sector.

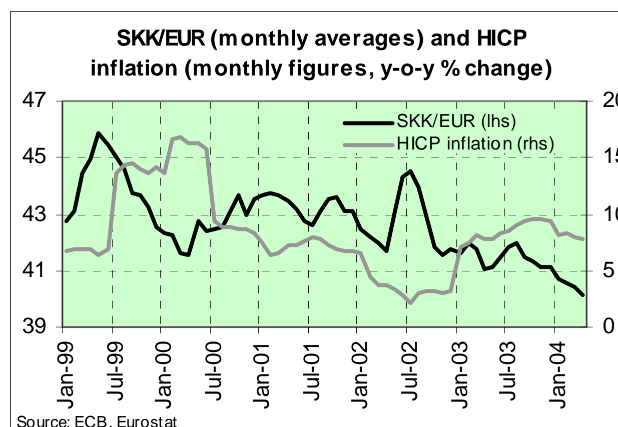
3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Slovakia's monetary policy regime is a combination of implicit inflation targeting and exchange rate management. The annual Monetary Programme of the central bank includes a projection of inflation for the next year and the subsequent three years, with the short-term inflation prediction being the implicit target. In addition, the Bank manages the exchange rate to reduce excessive volatility and to offset exchange rate pressures that are deemed inconsistent with economic fundamentals.

Slovakia's inflation performance in recent years has been strongly influenced by increases in administered prices, except in the election year 2002 when this process came to a temporary halt and average HICP inflation fell from 7.2% in 2001 to 3.5%. Hikes in administered prices, coupled with increases in indirect taxes resumed in 2003 and average headline HICP inflation reached 8.5%. For 2004, the same factors are expected to keep CPI inflation around 8%. With increases in administered prices gradually fading out, CPI inflation is expected to drop to 4% in 2005 and to below 3% in 2006 and 2007.

A noteworthy feature of Slovakia's inflation performance until recently have been the seemingly very limited second round effects of the hikes in administered prices and tax increases. If the mechanical impact of these hikes is excluded, underlying inflation dropped from over 5% in 1999 to around 2-3% in 2002 and 2003 and recently to below 2%. This has been supported by the strong currency. With nominal wages substantially outstripping price developments in 2002 and rising some 6% on average in 2003, it remains, however, to be seen whether underlying inflationary pressures will continue to be subdued. This will in particular depend on the authorities' ability to counteract potentially backward-looking tendencies in wage-setting, including by containing wage increases in the public sector, thus avoiding undesirable demonstration effects.

The relatively high level of headline inflation has not prevented the central bank from progressively lowering policy rates. Since late 2002, the two-week repo rate has dropped from over 8% to 5%, mainly triggered by concerns about the strength of the currency and supported by the on-going fiscal consolidation efforts. Although the koruna between 1999 and 2002 had been relatively volatile against the euro without showing a clear trend, it started to appreciate in mid-2002 and gained some 10% since then. The central bank has, to some extent, attempted to counter the appreciation by rate cuts and direct interventions. Nevertheless, the convergence programme foresees that the process of economic convergence may continue to require some nominal appreciation of the currency.



The programme leans towards the view that ERM II participation should be as short as possible and suggests that the koruna would start participating in the system in 2005 or 2006, depending on the perspective for meeting the fiscal criterion. A more precise timing of participation in ERM II will be decided by the Slovak Government in the second half of 2004. Inside ERM II, a stable koruna/euro exchange rate is expected to become an explicit monetary policy objective, though subordinated to the objective of achieving, by then, explicit inflation targets.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

The general government deficit figures in table 3 are heavily influenced by exceptional factors, mainly related to bank restructuring and government guarantees, which resulted in particularly high capital transfers in the years 1999 and 2000 of roughly 6% of GDP and 8% of GDP respectively. Adjusting for these exceptional factors would suggest that fiscal consolidation efforts strengthened in 1999 (as part of a macroeconomic stabilisation package) but weakened again in the run-up to the 2002 election. Fiscal consolidation efforts during this period were of a rather ad-hoc nature and not sufficiently embedded in a medium-term fiscal framework. The government pursued a policy of personal and corporate income tax reductions, which were only partly offset by increased other revenues. Compensating measures on the expenditure side were limited

and were not of a structural and sustained nature. On the contrary, expenditure overruns, notably in social transfers, were frequent and the attainment of budgetary targets sometimes depended on across-the-board cuts or compression of the least protected expenditure categories during the budget year.

Table 3: **General government balance and debt, 1998-2003 (% of GDP)**

	1998	1999	2000	2001	2002	2003
General government balance	-3.8	-7.1	-12.3	-6.0	-5.7	-3.6
General government gross debt	28.6	43.8	49.9	48.7	43.3	42.8
Source: *Commission services*						

The new government, formed after the elections in September 2002, broke with this past practice. It started to implement its agenda of structural public expenditure reforms in the budget 2003 and kept expenditures much better under control during budget execution. In addition, due to substantial unexpected under-spending (see below), the actual deficit for 2003 was much lower than budgeted: 3.6% of GDP instead of 5.0% of GDP. This was, to some extent, supported by real growth that turned out to be ½ percentage point higher than assumed. Nevertheless, on the revenue side, the higher GDP growth could not compensate for far too optimistic budgetary projections in the context of changes in tax rates and assessment procedures and revenues underperformed substantially.

Indeed, in spite of the higher growth, general government revenues were some 0.7% of GDP[8] lower than planned (at an estimated 37.4% of GDP in consolidated terms). In particular, tax receipts were much lower than budgeted. This is predominantly explained by a shortfall in VAT revenues, which were especially difficult to project due to changes of tax rates and assessment rules. The advancement of excise tax increases from 2004 to August 2003 compensated only partly for the lower VAT revenues. Social security contributions had also been overestimated. As a consequence, taxes and social security contributions were 1.6% of GDP below expectations. This was partly compensated by higher than planned other revenues, in particular a higher than budgeted interest income from the government's deposits at the National Bank of Slovakia.

General government expenditures were some 2.1% of GDP lower than in the budget (at an estimated 40.9% of GDP in consolidated terms). The following expenditure items contributed to this result – with each of them being roughly between ½% and 1% of GDP smaller than foreseen: (1) social transfers, in which, overruns were avoided and a few items performed slightly better than predicted; in particular, tighter registration requirements for unemployed and stronger GDP growth had a favourable effect on unemployment and social assistance benefits, while co-payments for health services, effective since mid-2003, seem to have been an important factor in containing health care expenditures; (2) interest outlays, owing to lower than expected interest rates; and (3) savings in government consumption, subsidies and capital expenditures, which resulted in particular from lower than foreseen capital transfers but in part also from spending postponements (including due to delays in the implementation of EU-sponsored projects).

[8] I.e., of actual 2003 GDP.

Only part of the savings on the expenditure side can potentially be considered as recurrent. While the under-spending on social transfers and interest outlays may have some favourable base effects in 2004, some spending delays on government consumption, subsidies and capital expenditures could, in contrast, create expenditure pressures, although this may well be compensated by similar delays at the end of 2004 (for details see section 4.3 below).

4.2. Programme overview

The programme targets a reduction of the general government deficit to 3.0% of GDP by 2007.[9] The debt-to-GDP ratio is projected at 45.5% in 2007, up from 42.8% in 2003.[10] The deficit reduction path in the convergence programme is almost completely in line with the pre-accession economic programme (PEP) submitted in August 2003, except that the PEP assumed a higher deficit in 2003, i.e. 5% of GDP, as a starting point.

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
			General government balance /1		
CP	**-3.6**	**-4.0**	**-3.9**	**-3.9**	**-3.0**
COM	-3.6	-4.1	-3.9	n.a.	n.a.
PEP	*-5.0*	*-3.9*	*-3.9*	*-3.8*	*n.a.*
			General government expenditure		
CP	**40.9**	**41.5**	**41.8**	**40.9**	**39.6**
			General government revenues /1		
CP	**37.4**	**37.4**	**37.9**	**36.9**	**36.6**

/1 This includes the revenue-decreasing and hence, *ceteris paribus,* deficit-increasing effect of the introduction of a funded pension pillar in 2005. The programme estimates this effect at 0.5% of GDP in 2005, 0.9% of GDP in 2006 and 1% of GDP in 2007.

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

The planned reduction in the nominal general government deficit from 3.6% of GDP in 2003 to 3.0% of GDP in 2007, i.e. by 0.6 percentage points over 4 years, does not look very ambitious – in particular in an environment of robust growth. However, the following factors need to be taken into account: First, the adjustment is based on

[9] Including the revenue-decreasing and hence, *ceteris paribus,* deficit-increasing effect of the introduction of a funded pension pillar. In this connection, the authorities argue in a footnote in the programme: “The introduction of the fully-funded pension pillar will decrease overall pension liabilities and transform a large part of them from implicit to explicit. It will not generate any new demand. As a result, Slovakia will request that these factors be taken into account in the evaluation of the fulfilment of the Maastricht deficit criterion.”

[10] Furthermore, the programme articulates “achieving long-term sustainability of public finances by 2010” as objective and specifies that “in practical terms this means that the Slovak Republic should enjoy public finances which are either close to balance (in structural terms) or in a moderate surplus by 2010.”

expenditure reductions, which are to a large extent underpinned by structural reforms, mostly in the health care and social protection area. Most of them have already become effective by 2004. They enhance the sustainability of the consolidation and increase the quality of public finances (see sections 5 and 6 below). The expenditure reductions take place against the backdrop of a tax reform package (effective since the beginning of 2004 as well), which is expected to be basically revenue-neutral and essentially constitutes a shift of the tax burden from direct to indirect taxation (for details, see section 4.3); second, the structural reforms include the introduction of a funded pension pillar in 2005. This leads to a revenue loss for general government because, from then on, part of the pension contributions will flow to the funded pillar (outside of general government[11]) instead of to the pay-as-you-go component of the pension system. The revenue loss is estimated at 0.5% of GDP in 2005, at 0.9% of GDP in 2006 and at 1.0% of GDP in 2007. Abstracting from this effect, the revenue-to-GDP ratio would basically remain constant over the programme horizon and the deficit reduction would be 1.6 percentage points, from 3.6% of GDP in 2003 to 2.0% of GDP in 2007; third, the deficit reduction from 2002 to 2003 was a sizeable 2.1 percentage points of GDP, partly due to one-off factors; and fourth, it is also noteworthy that the GDP share of gross fixed capital formation rises over the programme period.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003	2004	2005	2006	2007	2007-2003
Revenues	37.4	37.4	37.9	36.9	36.6	-0.8
(net of pension reform)	*37.4*	*37.4*	*38.4*	*37.8*	*37.6*	*+0.2*
of which:						
- Taxes	18.2	17.9	17.6	17.3	17.0	-1.2
- Social security contributions	13.9	13.1	13.2	12.7	12.6	-1.3
(net of pension reform)	*13.9*	*13.1*	*13.7*	*13.6*	*13.6*	*-0.3*
- Other (residual)	5.3	6.4	7.0	6.9	7.0	+1.7
Expenditure	40.9	41.5	41.8	40.9	39.6	-1.3
of which:						
- Primary expenditure	38.5	38.9	38.8	38.1	37.0	-1.5
of which:						
Gross fixed capital formation	2.6	3.3	3.6	3.7	3.6	+1.0
Consumption	15.0	14.7	14.5	14.0	13.5	-1.5
Transfers & subsidies	19.5	18.8	18.9	18.8	18.5	-1.0
Other (residual)	1.5	2.1	1.9	1.6	1.5	+0.0
- Interest payments	2.4	2.6	2.8	2.7	2.6	+0.2
Budget balance	-3.6	-4.0	-3.9	-3.9	-3.0	+0.6
(net of pension reform)	*-3.6*	*-4.0*	*-3.4*	*-3.0*	*-2.0*	*+1.6*
Primary balance	-1.2	-1.4	-1.1	-1.2	-0.4	+0.8
(net of pension reform)	*-1.2*	*-1.4*	*-0.6*	*-0.3*	*0.6*	*+1.8*
Sources: *Convergence programme; ECFIN calculations*						

Given the unexpectedly favourable deficit outcome of 3.6% of GDP in 2003, the reduction path of the nominal (and, although to a lesser extent, the primary deficit) over the programme period is now back-loaded: even net of the "funded pension pillar-effect", most of the reduction takes place in the last two years, i.e. out of the total adjustment of

[11] See Eurostat decision on the classification of funded pension schemes (Eurostat News Release 30/2004 of 2 March 2004)

1.6 percentage points of GDP, 0.4 percentage points are planned to take place in the election year 2006 and another 1.0 percentage point in the last year of the programme period. In terms of the primary balance, the total adjustment net of the pension reform effect is 1.8 percentage points of GDP, of which 0.3 percentage points are planned for 2006 and 0.9 percentage points in 2007. However, as mentioned, the adjustment is based on expenditure cuts – with the nominal expenditure-to-GDP ratio dropping by 1.3 percentage points and the primary expenditure-to-GDP ratio by 1.5 percentage points – and this is driven by a sustained reduction of the GDP share of social transfers and a relatively steady reduction of government consumption. Up to 2005, these reductions are not yet sufficient to lead to a decrease in the total expenditure-to-GDP ratio. On the contrary, the shares of revenues and expenditures in GDP are planned to increase until 2005 and this is to a substantial extent due to transfers from the EU budget on the revenue side and contributions to the EU budget on the expenditure side.

However, as the deficit target for 2007 is 3.0% of GDP, the fiscal strategy does not include any safety margin concerning the achievement of the Treaty reference value for the Maastricht deficit criterion, thus rendering the planned fulfilment of this criterion by 2007 vulnerable to any worse than assumed growth development or any other potential risk. A 3.0% of GDP general government deficit in 2007 also implies a considerable further fiscal adjustment need if the authorities are to achieve their goal of a (structurally) at least balanced position by the end of the decade.

4.3. Targets and adjustment in 2004

The budget for 2004, which was passed by parliament in December last year, targets a general government deficit of 4.0% of GDP, which is confirmed by the convergence programme. Compared to the then targeted deficit of 5.0% of GDP for 2003, this would have represented a narrowing of the deficit by 1 percentage point of GDP. In light of the actual 2003 outcome (for details, see section 4.1), it now amounts to a widening of 0.4 percentage points of GDP. The under-performance of revenues in the budget 2003 became evident already relatively early during budget execution and the related base effects, as well as the base effects stemming from compensatory measures taken on the revenue and expenditure side, were included in the projections for the budget 2004. In contrast, the under-spending on the expenditure side that went beyond the compensation for the revenue loss was not known before February 2004. It is mostly due to non-recurrent savings, in particular one-off savings in capital transfers but also some spending delays in government consumption and subsidies, therefore limiting any favourable base effects for 2004. On the contrary, some unexpected spending postponements may lead to additional expenditure pressures in 2004 – although similar postponements may well occur at the end of 2004.[12]

The budget 2004 reflects most of the government's structural reform agenda for the current legislative period, both on the revenue and expenditure side. It constitutes an important step to place public finances on a more sustainable footing and to increase their quality (see sections 5 and 6 below).

---

[12] Envisaged improvements in the treasury and budget execution information system will enable the authorities to know such "postponement plans" of budgetary organisations already before the end of the budget year 2004 and counter-measures could be taken, should the budgetary targets be jeopardised by a "lack of envisaged spending postponements".

The share of revenues in GDP is planned to remain broadly constant. The budget incorporates a comprehensive tax reform package effective from January 2004. This package is expected to be basically revenue-neutral and essentially constitutes a shift of the tax burden from direct to indirect taxation[13]: on the one hand, the individual and corporate income tax rates have been lowered and unified at 19%, partly compensated by the removal of tax exemptions. Before, the corporate income tax rate was 25% and personal income tax rates ranged from 10% to 38%. On the other hand, the value-added tax burden was effectively increased by unifying the tax rate at 19%, whereas before there was a lower rate of 14% and a higher rate of 20%. In addition, excise tax rates were increased already in mid-2003. Furthermore, some rather insignificant taxes (e.g. inheritance and gift tax) have been abolished.

Another important measure reflected on the revenue side of the budget 2004 is the reduction of health and social insurance contribution rates, although they remain still at a relatively high total level of more than 48% of gross wages (down from 51%), almost ¾ of which are paid by employers. Mainly as result of these lower rates, the GDP share of social security contributions is budgeted to be 0.8 percentage points lower than the 2003 outcome. However, this is more than compensated by social expenditure reforms, which lead to a reduction of the GDP share of social transfers by around 1 percentage point of GDP compared to the 2003 outcome.

Indeed, on the expenditure side, the social reform measures are likely to lead to sustained savings in mandatory expenditure categories, whereas expenditure increases are mostly implemented in more discretionary areas. The most important social reform areas are: pensions; sickness benefits; social assistance and social benefits; and health care. In addition, a fall in the GDP share of government consumption by 0.3 percentage points is envisaged. In contrast, (agricultural) subsidies are planned to increase by 0.3 percentage points. The GDP share of gross fixed capital formation is foreseen to increase by 0.7 percentage points. Altogether, the expenditure-to-GDP ratio is planned to increase by almost ½ percentage point compared to the actual outcome in 2003, thus explaining the widening of the deficit.

Slovakia's first contribution to the EU budget will amount to 0.7% of GDP in 2004 (and around 1% of GDP in the following years). Transfers from the EU flowing to the general government sector are 1.4% of GDP in 2004 (and increase to more than 2% of GDP in 2007). Nevertheless, the programme argues that the "net effect of [EU accession] on general government finances will be negative in the medium term". This statement and the related analysis in the programme tend to convey a spurious impression on the extent to which the presented "EU-related" expenditures (and their alleged deficit-increasing effect) are pre-determined or automatic. In reality, the expenditures listed are to a large degree discretionary and depend very much on domestic policy decisions (e.g. on the amount of agricultural "top-up payments"). It is also up to the discretion of the national authorities to what extent they compensate for co-payments on EU funds by savings on

---

[13] In the budget 2004, total nominal tax revenues have been projected as being broadly the same as they would be without tax reforms (and as higher than the 2003 outcome). Furthermore, the share of tax revenues in GDP is projected to fall only slightly between 2003 and 2004. In light of actual revenue collection figures to date, these estimates can be considered as being on the conservative side and higher tax revenues than estimated are well possible – in spite of the relatively low consumption growth and the related unfavourable effect on VAT revenues.

other expenditures in the budget or to what extent they draw on EU-funds, which require co-payments, at all.

Given the far-reaching nature of the reforms implemented in 2004, projections of the developments both on the revenue and expenditure side have been clouded with more uncertainties than usual. Nevertheless, the Commission 2004 Spring forecasts project that the government will broadly meet its net borrowing target – with a forecast deficit of 4.1% of GDP. Budget execution figures available to date confirm the attainability of the deficit target and suggest even a potential over-performance on the revenue side, although uncertainties remain. A downside risk could result from additional spending pressures, including due to the postponement of expenditures from 2003 into 2004, although similar postponements may well occur at the end of 2004. The budget outcome in 2004 will be crucial for the realism of the budgetary projections in the years thereafter. At this stage, taking all factors together, the risks in 2004 would appear to be somewhat tilted to the positive side.

4.4. Targets and adjustment in 2005 and beyond

Abstracting from the effect of the new funded pension pillar on general government revenues, the programme and the draft multi-annual budget 2005-2007 envisage an improvement of the nominal (and primary) budget balance by 2.0 percentage points between 2004 and 2007. The reduction is distributed rather unevenly: 0.6 (0.8) percentage points in 2005; 0.4 (0.3) percentage points in the election year 2006; and 1.0 (0.9) percentage points in the first year after the next elections, i.e. 2007. Including the effect of the already legislated introduction of a funded pension pillar, the headline adjustment between 2004 and 2007 is 1 percentage point of GDP and the general government deficit is envisaged to reach 3.0% of GDP by 2007.

On the revenue side, including the pension reform effect, the programme foresees a further drop in the GDP-share of taxes and social security contributions by around 1½ percentage points between 2004 and 2007. This results from the combined impact of the following programme projections: (1) a diversion of pension contributions from the pay-as-you-go pillar to the new funded pillar (in the amount of 1 percentage point of GDP by 2007); (2) an increase in the GDP-share of other social contributions (½ percentage point). This is concentrated in 2005 and includes the impact of changes in assessment bases and in contributions paid by the state on behalf of certain groups of the population (e.g. the unemployed); and (3) a reduction of the GDP-share of tax revenues (0.9 percentage points) – to some extent due to the abolition of dividend and real estate transfer taxes in 2005 but mainly resulting from a fall in the projected GDP share of indirect taxes. This latter projection would appear to err on the cautious side even if one takes into account that, in the macroeconomic scenario, consumption growth lags somewhat behind GDP-growth. The GDP-share of non-tax revenues is budgeted to increase by roughly ½ percentage point. Taking all these factors into account, the total revenue-to-GDP ratio is forecast to fall by some 0.8 percentage points between 2004 and 2007.

Hence, the fiscal consolidation from 2004 to 2007 relies fully on expenditure cuts – with the (total and primary) expenditure-to-GDP ratio declining by almost 2 percentage points. Apart from capital expenditure and with the notable exception of (agricultural) subsidies, all major expenditure categories are set to contribute to this consolidation effort, including public consumption (GDP-share reduction of 1.2 percentage points) and social transfers (GDP-share reduction of almost ½ percentage point).

The current government has already implemented the main part of its structural reform agenda for the legislature 2002-2006. Hence, the budget planning process for the years 2005 to 2007 takes place in a much stabler legislative environment. Downside risks concern mostly the expenditure side and consist in particular of: (1) a smaller than planned second health care reform package. The planned package has been submitted to parliament; (2) a faster or higher than projected participation in the new funded pension pillar and therefore an earlier or higher re-direction of contributions to this pillar; and (3) difficulties in advancing public sector rationalisation (public wage bill, education sector). These risks seem to be broadly balanced by tax revenue estimates which appear to err on the cautious side. Furthermore, given the track record of the current government, its firm commitment to the envisaged consolidation path until 2006 seems to be credible. The adjustment between 2004 and 2005 seems credible also in light of the Commission forecast. As for 2007 and beyond, it will be crucial that there is no backtracking on already implemented reforms and that fiscal consolidation is continued to be pursued as outlined in the programme.[14]

4.5. Debt ratio

The programme projects an increase of the debt-to-GDP ratio between 2003 and 2005 by 3½ percentage points, which is broadly in line with the Commission forecast, and a 1 percentage point reduction of the ratio to 45.5% by 2007. The dynamics of the debt-to-GDP ratio reflect the back-loaded deficit reduction over the programme period and are much less influenced by stock-flow adjustments and exceptional factors than in the past (bank restructuring, debt assumptions related to government guarantees, and privatisation operations[15]). With the exception of 2004, stock-flow adjustments are projected to be small. The year 2004 is a notable exception, mainly due to a lower accrual than cash deficit. This is caused by a delay in the collection of value-added and excise taxes on imports from other EU Member States resulting from changed administrative procedures upon EU accession. The contribution of the primary deficit (including the pension reform effect) stays above 1 percentage point until 2006 and drops significantly only in 2007. The contribution of interest outlays rises until 2005 and drops again thereafter but stays above its 2003 level. Nominal GDP growth has a substantial debt ratio-reducing effect throughout the period.[16]

---

[14] The programme very briefly discusses the effects on public finances of the three deviations from the assumptions of the macroeconomic scenario presented in footnote 7. The reported effects on the general government deficit are small, i.e. in the range between 0.1 and 0.3 percentage points, and mostly favourable. Only in the case of lower euro-area imports, the deficit target of 3.0% by 2007 would be missed (by 0.2 percentage points).

[15] The privatisation process in Slovakia is largely completed. The government still owns major stakes in public utilities (without management rights) as well as in the electricity sector, where privatisation is ongoing, and the Slovak Railway companies. While the programme does not specify details of further privatisation plans, it contains a commitment to use any further privatisation receipts for debt reduction.

[16] Furthermore, over the programme horizon, the gap between gross and net debt, defined as gross debt minus cash balances, is projected to diminish, in particular as government deposits at the National Bank of Slovakia will be drawn down to finance the additional deficit arising from the introduction of a funded pension pillar. Net debt as a share of GDP is foreseen to rise from 29.1% in 2003 to 36.6% in 2007.

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	42.8	42.8	45.1	45.1	46.1	46.4	46.1	45.5
Change in debt ratio (1= 2+3+6)	-0.5	-0.6	2.4	2.3	0.9	1.3	-0.3	-0.5
Contributions:								
- primary deficit (2)	1.2	1.2	1.4	1.4	1.0	1.1	1.2	0.4
- snow-ball effect (3 = 4+5)	-1.1	-1.3	-1.1	-0.6	0.1	-0.2	-0.8	-0.4
- interest expenditure (4)	2.4	2.3	2.7	2.7	2.9	2.9	2.7	2.6
- nominal GDP growth (5)	-3.5	-3.6	-3.8	-3.3	-2.8	-3.1	-3.5	-3.0
- stock-flow adjustment (6)	-0.6	-0.6	2.1	1.5	-0.1	0.4	-0.8	-0.5

Sources:
Convergence programme (CP); Commission services spring 2004 forecast (COM); ECFIN calculations

Concerning contingent liabilities, all outstanding government guarantees have been risk-assessed by the authorities and called-on or likely-to-be-called-on guarantees are already included in the government debt. Furthermore, the issuance of new guarantees has been strictly limited.[17]

A Debt and Liquidity Management agency has recently been established to improve debt management. The authorities plan to phase out loan financing of their debt and substitute it by bond issuance. Currently, around 30% of the general government gross debt is denominated in foreign currency. Against this background, the authorities plan to issue an increasing share of their debt in euro. They consider the associated exchange rate risk as limited as they assume that the Slovak crown will remain stable or appreciate against the euro until euro adoption.[18]

5. THE QUALITY OF THE PUBLIC FINANCES

The reforms on both the expenditure and revenue side, mentioned in the previous sections of this assessment and reviewed in the programme, improve the quality of public finances and are likely to enhance growth.

The reforms on the expenditure side aim in particular at a better targeting of social transfers towards the needy, a strengthening of incentives to work, the prevention of abuse, and improved public service delivery. They affect notably social assistance, sickness benefits and, already since 2003, unemployment benefits. In the pension area, changes in key parameters of the pay-as-you-go pillar have come into force and will foster these aims as well – through a stronger link between contributions and benefits, a gradual retirement age increase to 62 for both men and women, and a change in the indexation formula (combined basis of consumer price as well as wage developments). In

---

[17] The programme mentions litigation risks and debt relief in the health sector as factors which could influence debt developments unfavourably. Risks could also arise from the still on-going fiscal decentralization, in particular as some of the foreseen mechanisms to control the indebtedness of the non-central government level remain largely untested.

[18] The programme reports on a stress-test on interest outlays of moderate exchange rate and interest rate shocks but only identifies minor deviations (around 0.1 percentage point of GDP) from the baseline in this case. Further work on this and similar stress tests would be useful.

addition, a sizeable funded pension pillar, with contributions of 9% of gross wages, will be introduced at the beginning of 2005. After the implementation of a first package of health care reforms in 2003 (including the introduction of co-payments for health care services), additional reforms, in particular a streamlining of the benefit package, are planned to be passed by parliament this year and to become effective at the start of 2005. Furthermore, a rationalisation of the education system is envisaged.

Gross fixed capital formation is foreseen to increase by some 1% of GDP over the programme period. A less favourable development on the expenditure side is the planned increase of agricultural subsidies by ½% of GDP until 2007 and the continuation of transport subsidies, mainly to Slovak railways, at around 0.7% of GDP. Increased funds are also foreseen for active labour market policy measures, an area were close monitoring of effectiveness and efficiency seems to be particularly important.

On the revenue side, the comprehensive tax reforms in 2004 lead to a shift of the tax burden from direct to indirect taxation, simplify the tax system, broaden the tax base and have a potential to enhance growth. They are expected to strengthen incentives to work, to create new jobs and to refrain from tax evasion.

Altogether, the effective implementation of the structural public finance reform measures will go a long way in reaching compliance with the general guidelines of the BEPGs 2003-2005.

After considerable progress over recent years, the government is continuing with its efforts to improve the management of public finances in all phases of the budget cycle. Notably, starting with the budget year 2005, the budget planning process has been expanded to a multi-annual, i.e. three-years, budget, although there remains scope for increasing the binding character of this framework (e.g. by introducing sufficiently detailed binding multi-annual expenditure limits). Budget execution controls are being enhanced, especially by further improvements of the functioning of the state treasury.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The programme contains a section on the sustainability of public finances. It includes demographic and macroeconomic assumptions as well as projections for public expenditures on pensions, health-care, education, child allowances and unemployment benefits.

The current demographic situation in Slovakia is characterised by a fertility rate that is much lower and, on the other hand, an old-age dependency ratio that is more favourable than in the former EU-15. The programme's baseline scenario assumes full convergence of the fertility rate to the average of the former EU-15, i.e. from 1.17 in 2004 to 1.70 in 2050, as well as a rapid rise in life expectancy. Based on these two assumptions, which, taken together, would appear to be somewhat tilted towards the optimistic side, the old-age dependency ratio in Slovakia will basically reach the former EU-15 average by 2050. Given that the ratio is currently more favourable, Slovakia would still benefit from a more benign demographic situation than in the former EU-15 in the first decades of the projection period.

The already implemented structural public expenditure reforms mentioned in the previous section as well as recent labour market reforms mitigate the budgetary impact of ageing. Additional measures, such as the adoption of the second health care reform package, of the planned education reform and of further pension reform measures (in

particular an additional increase in the retirement age to 65, to be reached in 2020, and a switch to a purely inflation-based indexation from 2010 onwards) would further improve the long-term sustainability of public finances.

Overall, according to the programme projections, age-related expenditures are expected to increase by 1.6 percentage points from 2008 to 2050. The increase is driven mainly by health care expenditures but also by an increase in public pay-as-you-go pension expenditures that is relatively small (reflecting the introduction of a funded pension pillar), while expenditures on education, child allowances and unemployment benefits are projected to decrease.

Based on the described fiscal consolidation and reform scenario, the projections in the programme indicate a substantial fall of the government debt-to-GDP ratio from 2006 until around 2030. Thereafter, the ratio rises again as the impact of ageing gradually takes hold.

The projected debt developments depend crucially on the strict adherence to the fiscal deficit targets over the programme horizon and the attainment of a budgetary position close to balance or in surplus by 2010. In addition, the main risks to the debt projections stem from too optimistic assumptions, in particular with respect to fertility developments, from a lack or delay in the implementation of the already adopted or envisaged reforms (including labour market reforms crucial for the projected reduction of unemployment), and from any backtracking on already implemented reforms. Furthermore, debt developments could be unfavourably influenced by the specific factors already mentioned in section 4.5 above (litigation, debt relief in health sector, decentralisation).

Summing up, the programme projections are contingent on the strict adherence to the fiscal consolidation targets, the full implementation of the envisaged policies, and the (potentially too optimistic) demographic assumptions. Under these conditions, the projections suggest that Slovakia would be relatively well placed to meet the budgetary costs of an ageing population. Apart from some additional risks that may emerge in the long run, the main risks to the projections stem from a lack or a delay in reform implementation or from any backtracking on already implemented reforms.

* * *

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Table 1. Growth and associated factors

	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	4.2	4.1	4.3	5.0	4.7
GDP *level* at *current* market prices, SKK bn.	1,195.8	1,291.3	1,383.6	1,495.9	1,602.6
GDP deflator	4.7	3.7	2.7	3.0	2.3
HICP change	8.5	8.1	4.0	2.9	2.5
Employment growth [1]	1.8	0.5	0.6	0.6	0.9
Labour productivity growth [2]	3.4	3.5	3.6	4.3	3.7
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	-0.6	1.3	3.8	4.1	3.8
2. Government consumption expenditure	2.9	-0.1	1.0	1.9	1.5
3. Gross fixed capital formation	-1.2	3.8	7.0	7.0	3.3
4. Changes in inventories and net acquisition of valuables as a % of GDP [3]	-0.7	1.3	2.5	1.6	1.2
5. Exports of goods and services	22.6	9.7	8.7	13.0	8.4
6. Imports of goods and services	13.8	9.5	10.0	11.6	6.8
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	0.1	1.6	3.9	4.2	3.0
8. Change in inventories and net acquisition of valuables (=4) [3]	-2.3	2.0	1.4	-0.9	-0.3
9. External balance of goods and services (5-6)	6.4	0.4	-1.0	1.6	1.9

(1) According to the Labour Force Survey.
(2) GDP growth at market prices per person employed at constant prices.
(3) Including statistical discrepancy.

Table 2. General government budgetary developments

% of GDP	2003	2004	2005	2006	2007
Net lending by sub-sectors					
1. General government	-3.6	-4.0	-3.4	-3.0	-2.0
2. Central government	-4.2	-4.3	-4.1	-3.6	-2.7
3. State government	-0.2	0.0	0.0	0.0	0.0
4. Local government	0.0	0.0	0.0	0.0	0.0
5. Social security funds	0.8	0.3	0.7	0.5	0.7
General government					
6. Total receipts	37.4	37.4	38.4	37.8	37.6
7. Total expenditures	40.9	41.5	41.8	40.9	39.6
8. Budget balance	-3.6	-4.0	-3.4	-3.0	-2.0
9. Net interest payments	2.4	2.6	2.8	2.7	2.6
10. Primary balance	-1.2	-1.5	-0.6	-0.3	0.6
Components of revenues					
11. Taxes	18.2	17.9	17.6	17.3	17.0
12. Social contributions	13.9	13.1	13.7	13.6	13.6
13. Interest income	0.8	0.5	0.6	0.6	0.5
14. Other	4.5	5.9	6.4	6.3	6.5
15. Total receipts	37.4	37.4	38.4	37.8	37.6
Components of expenditures					
16. Collective consumption	15.0	14.7	14.5	14.0	13.5
17. Social transfers in kind					
18. Social transfers other than in kind	18.1	17.1	17.1	17.1	16.8
19. Interest payments	2.4	2.6	2.8	2.7	2.6
20. Subsidies	1.4	1.7	1.8	1.7	1.7
21. Gross fixed capital formation	2.6	3.3	3.6	3.7	3.6
22. Other	1.5	2.1	1.9	1.6	1.5
23. Total expenditures	40.9	41.5	41.8	40.9	39.6

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	42.8	45.1	46.4	46.1	45.5
Change in gross debt	-0.6	2.3	1.3	-0.3	-0.5
Contributions to change in gross debt					
Primary balance	1.2	1.5	1.1	1.2	0.4
Interest payments	2.3	2.7	2.9	2.7	2.6
Nominal GDP growth	-3.6	-3.3	-3.1	-3.5	-3.0
Other factors influencing the debt ratio	-0.6	1.5	0.4	-0.8	-0.5
Of which: Privatisation receipts					
p.m. implicit interest rate on debt	6.0	6.4	6.7	6.3	6.0

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	4.2	4.1	4.3	5.0	4.7
2. Actual balance	-3.6	-4.0	-3.9	-3.9	-3.0
3. Interest payments	2.4	2.6	2.8	2.7	2.6
4. Potential GDP growth	4.6	4.0	3.9	4.8	4.7
5. Output gap	-0.2	-0.1	0.2	0.4	0.4
6. Cyclical budgetary component	0.0	0.0	0.0	0.1	0.1
7. Cyclically-adjusted balance (2-6)	-3.5	-4.0	-3.9	-4.1	-3.1
8. Cyclically-adjusted primary balance (7-3)	-1.2	-1.5	-1.1	-1.4	-0.5

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	4.0	4.1	4.4	4.8	--
Latest update	4.2	4.1	4.3	5.0	4.7
Difference	0.2	0.0	-0.1	0.2	--
Actual budget balance					
Previous update	-5.0	-3.9	-3.4	-2.9	--
Latest update	-3.6	-4.0	-3.4	-3.0	-2.0
Difference	1.4	-0.1	0.0	-0.1	--
Gross debt levels					
Previous update	43.9	44.8	46.4	47.6	--
Latest update	42.8	45.1	46.4	46.1	45.5
Difference	-1.1	0.3	0.0	-1.5	--

Table 6. Long-term sustainability of public finances

% of GDP	**2004**	**2005**	**2010**	**2020**	**2030**	**2050**
Total expenditure	41.5	41.8	37.0	35.2	35.9	38.0
Old age pensions	7.2	7.3	6.6	5.8	6.7	7.4
Health care (including care for the elderly)	4.7	4.6	4.9	5.3	5.7	6.3
Interest payments	2.6	2.8	2.1	0.8	0.3	1.0
Total revenues	37.4	38.4	37.6	37.6	37.6	37.6
Of which: from pension contributions	13.1	13.7	13.6	13.6	13.6	13.6
National pension fund assets (if any)						
Assumptions						
Labour productivity growth	3.5	3.6	3.4	3.4	2.5	2.3
Real GDP growth	4.1	4.3	4.1	3.3	2.0	1.5
Participation rate males (aged 20-64)	76.7	77.2	78.0	79.9	79.4	78.7
Participation rates females (aged 20-64)	62.9	63.4	64.1	67.8	68.2	68.1
Total participation rates (aged 20-64)	69.8	70.3	71.0	73.9	73.8	73.5
Unemployment rate	16.4	15.9	13.2	10.8	8.8	4.9

Table 7. Basic assumptions

	2003	**2004**	**2005**	**2006**	**2007**
Short-term interest rate (annual average)	2.3	2.1	2.8	3.0	3.9
Long-term interest rate (annual average)	4.1	4.3	4.8	5.1	5.4
United States: short-term (three-month money market)	1.2	1.2	1.7	4.0	4.7
United States: long term (10-year government bonds)	4.0	4.2	4.6	5.6	5.6
USD/€exchange rate (annual average)	1.13	1.25	1.24	1.15	1.12
Nominal effective exchange rate (euro area)	11.8	4.2	-0,2	--	--
Nominal effective exchange rate (EU)	12.8	6.9	-1.1	--	--
SKK/€exchange rate (annual average)	41.5	40.2	39.4	39.0	39.0
World GDP growth, excluding EU	4.4	5.1	4.7	--	--
United States, GDP growth	3.1	4.5	3.7	3.7	3.3
Japan, GDP growth	2.7	3.4	2.3	1.0	1.1
EU-15 GDP growth	0.8	2.0	2.4	2.5	2.4
Growth of relevant foreign markets	1.2	2.1	2.7	2.7	2.7
World import volumes, excluding EU	7.3	9.7	8.5	--	--
World import prices (goods, in USD)	8.8	6.4	0.7	--	--
Oil prices (Brent, USD/barrel)	28.5	31.1	28.9	28.9	28.9
Non-oil commodity prices (in USD)	6.6	15.6	-2.6	--	--