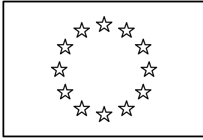

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 15/02/2005
ECFIN/50239/05-EN

NOVEMBER 2004 UPDATE OF THE CONVERGENCE PROGRAMME OF SLOVAKIA (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

Slovakia submitted its update of the convergence programme on 30 November 2004. The update covers the period 2004 to 2007 and, in addition, provides indicative projections until 2010. The document was adopted by the government. It is in line with the budget 2005, which the parliament passed on 9 December 2004, and the government's multi-annual budgetary framework 2005-2007, which the parliament took into account. The programme is very well presented and complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".[2]

The update projects real GDP expansion at an average rate of 5% over the period 2004 to 2007 – with an expected slowdown to 4½% in 2005 (due to a falling external contribution) and an acceleration to almost 5½% in 2007 (when the external contribution is expected to rebound). Unemployment is predicted to fall only gradually from around 18½% in 2004 (in labour force survey terms) to 16½% in 2007. These developments are plausible and broadly confirmed by the Commission Autumn 2004 forecasts covering the period until 2006. A rapid fall of inflation to some 2½% in 2007 is only plausible if second-round effects from the high headline inflation in 2004 are strictly contained. The update anticipates the current account balance to become positive in 2007 (after a temporary deterioration to a deficit of almost 3% of GDP in 2005). Projected current account balances and planned fiscal deficits imply positive private net savings throughout the update horizon.

Slovakia recently switched from implicit to explicit inflation targets but continues with a managed float of the exchange rate. The update confirms the authorities' intention to join the euro area in 2009 and states that Slovakia is likely to enter ERM2 no later than in the first half of 2006. In 2004, the headline inflation of 7.5% reflected again mostly the impact of adjustments in regulated prices and indirect taxes. The spread towards the euro area of long-term interest rates has been hovering at or below 100 basis points. After some months of stabilisation in the wake of cuts in the policy interest rate, the exchange rate has recently started to appreciate again. Altogether, the koruna has gained almost 6% in 2004.

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[1] This technical analysis, which is based on information available up to 25 January 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme. It has been carried out by the staff of the Directorate-General for Economic and Financial Affairs of the European Commission and approved by Klaus Regling, Director-General of Economic and Financial Affairs. The views expressed in the assessment do not necessarily correspond to those of the European Commission. Comments should be sent to Siegfried Steinlein (siegfried.steinlein@cec.eu.int).

[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. The programme provides not only the required but, with a few exceptions, also the optional information indicated in the code. It furnishes a broad array of supplementary data, thus facilitating the analysis. While not hampering the assessment, there remain (relatively small) differences with the Statistical Office as regards the consolidated expenditure- and revenue-to-GDP ratios for 2003 and, furthermore, concerning the classification of components of general government consumption; notably social transfers in kind are not provided as separate category. The other optional data missing are the nominal effective exchange rates for the years 2006 and 2007. Furthermore, in part of the programme update, the general government primary balance is calculated on the basis of net interest payments.

The update aims at reducing the deficit to the 3% of GDP reference value in 2007, in line with the Council recommendation under Article 104 (7). The reduction of the headline and primary general government deficits is back-loaded: both are envisaged to stay basically constant at, respectively, around 3.8% and 1.5% of GDP until 2006 and their planned overall adjustment by 0.8 percentage points is postponed to 2007. Even net of the impact resulting from the introduction of a funded pension pillar at the beginning of 2005 (estimated at 0.4% of GDP in 2005 and some 1% of GDP in 2006 and 2007), most of the deficit reduction takes place in the last two years. Compared to the May 2004 programme, in which the adjustment was expenditure-based, the update plans a correction of the deficit through expenditure retrenchment and revenue increases. In spite of a more favourable macroeconomic scenario, the update broadly confirms the planned adjustment path of the previous programme and looks therefore less ambitious. Notwithstanding the considerable past consolidation achievements and the pension reform impact, accelerating the deficit reduction (in particular in 2005) becomes thus an even more important consideration. It would help the implementation of Slovakia's euro adoption strategy, enhance fiscal credibility in an ERM2 context, foster counter-cyclicality, and could assist in stemming appreciation pressures. It would also pave the way to a structural budgetary position of close to balance or in surplus and to attain a sufficient safety margin against breaching the 3% of GDP Treaty reference value for the deficit criterion with normal macroeconomic fluctuations.

The risks to the budgetary projections in the programme appear broadly balanced for the programme horizon as a whole. On the basis of the given macroeconomic assumptions, there seems to be an upside risk on the revenue side throughout the considered period. Balanced uncertainties exist with respect to the impact of the pension reform. The use of EU-funds (and of co-payments) is likely to be lower than budgeted in 2004 to 2006 as the absorption capacity still develops. However, it could exceed the budgeted amount in 2007 if sufficient catch-up in the implementation of postponed spending takes place. And finally, the parliamentary elections scheduled in 2006 lead to uncertainties, in particular on the extent to which further expenditure retrenchments will be implemented in 2007. The latter could fall short of or exceed the current plans. In view of this risk assessment, the budgetary stance in the programme seems sufficient to reduce the deficit to 3% of GDP by 2007, which is the end-year of the programme, but does not provide for any safety margin.

The programme projects an increase of the debt-to-GDP ratio between 2004 and 2007 by 2½ percentage points to 45½%. The dynamics of the debt-to-GDP ratio reflect the back-loaded deficit reduction and are much less influenced by stock-flow adjustments and exceptional factors than in the past, although projected cash/accrual deviations and privatisation proceeds remain significant until 2006.

The update focuses on recent structural reforms that improve the quality of public finances and are likely to enhance growth – similar to earlier far-reaching reforms (including major tax reforms), which already took effect in 2004. The recent reforms are basically a second tranche of healthcare reforms and the introduction of a funded pension pillar, both effective from the beginning of 2005.

Slovakia presents some risks with regard to long-term sustainability of the public finances. These risks are importantly driven by the projected budgetary cost of an ageing population. Even assuming the achievement of the planned deficit reduction over the medium-term, long-term sustainability is not fully ensured, although the structural reform measures enacted and planned, in particular the pension and health reforms, contribute to the achievement of a sustainable position over the long term. Their full

implementation is a key condition, in addition to the achievement of the planned budgetary consolidation path over the programme period.

Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, Slovakia is on track to correct its excessive deficit by the deadline set by the Council.

In view of the above assessment and in light of the recommendations made by the Council under Article 104(7), it would be appropriate for Slovakia to (i) seize every opportunity for an accelerated deficit reduction, including through the use of better-than-expected revenues and of savings on the expenditure side, in particular in 2005; (ii) make the medium-term expenditure ceilings more binding; (iii) be vigilant that second-round effects from the high inflation in 2004 do not affect the inflation convergence path envisaged in the programme.

Table: Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	**CP Nov. 2004**	**5.0**	**4.5**	**5.1**	**5.4**
	COM Oct.2004	4.9	4.5	5.2	n.a.
	CP May 2004	4.1	4.3	5.0	4.7
HICP inflation (%)	**CP Nov. 2004**	**7.8**	**3.3**	**2.8**	**2.5**
	COM Oct.2004	7.7	3.9	3.0	n.a.
	CP May 2004	8.1	4.0	2.9	2.5
General government balance (% of GDP) /1	**CP Nov. 2004**	**-3.8**	**-3.8**	**-3.9**	**-3.0**
	COM Oct.2004	-3.9	-4.0	-4.1	n.a.
	CP May 2004	-4.0	-3.9	-3.9	-3.0
Primary balance (% of GDP) /1	**CP Nov. 2004**	**-1.5**	**-1.4**	**-1.6**	**-0.7**
	COM Oct.2004	-1.6	-1.6	-1.8	n.a.
	CP May 2004	-1.4	-1.1	-1.2	-0.4
Government gross debt (% of GDP)	**CP Nov. 2004**	**43.0**	**44.2**	**45.3**	**45.5**
	COM Oct.2004	44.2	45.2	45.9	n.a.
	CP May 2004	45.1	46.4	46.1	45.5

/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 0.4% of GDP in 2005; 1.0% of GDP in 2006; and 1.1% of GDP in 2007).

Sources:

Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM);

1. INTRODUCTION

Slovakia submitted its update of the convergence programme on 30 November 2004. The update covers the period 2004 to 2007 and, in addition, provides indicative projections until 2010. The document was adopted by the government. It is in line with the budget 2005, which the parliament passed on 9 December 2004, and the government's multi-annual budgetary framework 2005-2007, which the parliament took into account.

The programme is very well presented and complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".[3]

2. MACROECONOMIC DEVELOPMENTS

The programme uses plausible growth assumptions and projects real GDP expansion at an average rate of 5% over the period 2004 to 2007. An expected temporary slowdown to 4½% in 2005 results mainly from a drop in the external contribution, including due to higher investment-related imports. Thereafter, the external growth contribution is assumed to rebound and to replace domestic demand as the main driver of economic expansion in 2007. A stronger external contribution is plausible because, by then, higher export capacity will have come on stream, notably as a consequence of already pledged FDI in the automobile sector.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	4.9	5.0	4.5	4.5	5.2	5.1	5.4
Contributions:							
- Final domestic demand	3.7	2.6	4.3	4.3	4.1	3.9	3.1
- Change in inventories	0.9	1.1	0.4	0.4	0.0	-0.2	-1.8
- External balance on g&s	0.3	1.2	-0.2	-0.1	1.1	1.3	4.1
Employment (% change)	-0.1	0.0	0.6	0.6	0.9	0.6	0.9
Unemployment rate (%)	18.4	18.5	17.9	17.9	17.2	17.3	16.5
HICP inflation (%)	7.7	7.8	3.9	3.3	3.0	2.8	2.5
GDP deflator (% change)	4.0	5.1	2.3	2.0	1.6	1.7	1.7
Current account (% of GDP)	-2.9	-2.2	-3.3	-2.8	-3.0	-2.1	0.3

Sources:
Commission services autumn 2004 forecasts (COM); convergence programme update (CP)

Covering the period until 2006, the Commission services autumn 2004 forecasts broadly confirm the growth projections of the programme as well as the development of the

[3] *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. The programme provides not only the required but, with a few exceptions, also the optional information indicated in the code. It furnishes a broad array of supplementary data, thus facilitating the analysis. While not hampering the assessment, there remain (relatively small) differences with the Statistical Office as regards the consolidated expenditure- and revenue-to-GDP ratios for 2003 and, furthermore, concerning the classification of components of general government consumption; notably social transfers in kind are not provided as separate category. The other optional data missing are the nominal effective exchange rates for the years 2006 and 2007. Furthermore, in part of the programme update, the general government primary balance is calculated on the basis of net interest payments.

underlying composition of growth. For 2007, the growth assumption of almost 5½% exceeds Commission services calculations of potential growth (according to the commonly agreed methodology and based on the figures in the update) by a significant margin. However, these calculations are still surrounded by a large degree of uncertainty, including with respect to the effect of the forthcoming FDI on total factor productivity.[4] The programme projections are based on the assumption of robust GDP- and import-growth of Slovakia's major trading partners. The external assumptions of the macroeconomic scenario are largely in line with the Commission services autumn 2004 forecast.[5]

Table 2: Sources of potential output growth

	2004		2005		2006		2007
	COM	**CP[3]**	**COM**	**CP[3]**	**COM**	**CP[3]**	**CP[3]**
Potential GDP growth[1]	4.3	4.4	4.5	4.7	4.6	4.9	4.8
Contributions:							
- Labour	0.6	0.6	0.7	0.7	0.7	0.8	0.7
- Capital accumulation	1.7	1.6	1.8	1.7	1.8	1.7	1.7
- TFP	1.9	2.1	2.0	2.2	2.1	2.3	2.4
Output gap[1,2]	0.7	0.4	0.6	0.2	1.2	0.4	0.9

Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme (CP)

Sources:
Commission services autumn 2004 forecasts (COM); convergence programme (CP); Commission services calculations

Efforts to tackle the structural shortcomings in the labour market have been stepped up since 2003 but seem to bear fruit only gradually as economic restructuring, which has been underpinning Slovakia's growth performance, continues. Accordingly, the programme anticipates a drop of the unemployment rate (in labour force survey terms) of only 2 percentage points by 2007 (from around 18½% in 2004). Employment growth stalled in 2004 but is projected at 0.6% in both 2005/2006 and at 1% in 2007 (on the back of accelerated GDP expansion).[6]

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[4] Indeed, the Slovak authorities base their own calculations of potential growth in 2007, and of the underlying productivity effect of forthcoming FDI in the automobile industry, on their experience with previous FDI by a major car producer. Based on this, they arrive at a potential growth figure of slightly above 5%.

[5] However, there are the following deviations: (1) the assumed short-term euro-area interest rates are lower; (2) the assumptions on US interest rates and the nominal US dollar/euro exchange rate diverge slightly; (3) the assumed oil price in 2005 is lower. Furthermore, the nominal exchange rate of the Slovak crown against the euro is assumed to appreciate moderately against the euro (2.5% between 2004 and 2007), whereas the technical assumptions of the Commission Autumn forecasts lead to a basically constant rate over the forecast period.

[6] Furthermore, referring to the May 2004 convergence programme, the update elaborates on the impact on its macroeconomic projections of the following deviations from the underlying assumptions: (1) a higher than assumed appreciation of the Slovak crown in 2004; (2) a lower than assumed growth performance of Slovakia's trading partners; and (3) higher than assumed labour productivity growth. It also points to the risks associated with the development of energy prices.

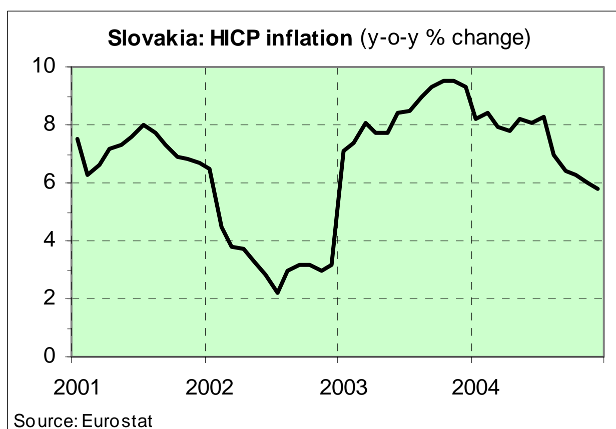
Inflation is forecast to decrease rapidly in 2005 to 3.3% (from an actual outcome of 7½% in 2004) as increases in administered prices and indirect taxes taper off. This prediction is only realistic if the authorities succeed in strictly containing second-round effects. The latter will in particular depend on the authorities' ability to counteract potentially backward-looking tendencies in wage-setting, including by limiting wage increases in the public sector and thus avoiding undesirable demonstration effects.

The programme projects a widening of the current account deficit from its 2003 level of less than 1% of GDP to levels between 2 and 3% of GDP in 2004 to 2006 (which includes a pick-up in investment-related imports in 2005). The current account balance for 2007 is predicted as slightly positive, reflecting the by then established new export capacity.

Given the planned development of the fiscal deficit, the programme projections for the current account balance 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 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 fiscal policy.

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

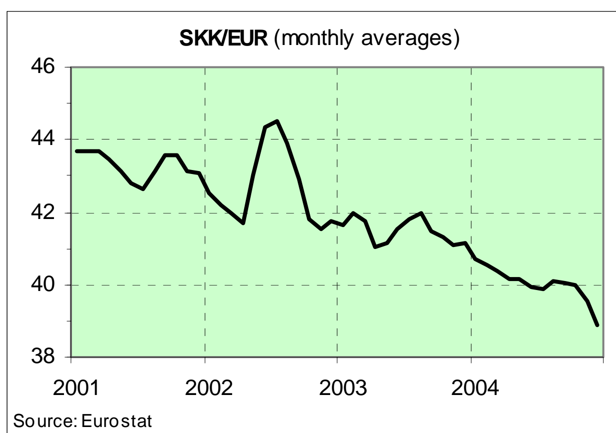


Source: Eurostat

Slovakia recently switched from implicit to explicit inflation targets but continues with a managed float of the exchange rate. By its monetary policy decisions, the National Bank of Slovakia (NBS) reacts to the risk for headline inflation to deviate from the level expected in the NBS annual monetary programmes. The exchange rate is understood to play an important role in the transmission mechanism and is managed by the central bank to reduce excessive

volatility and to offset exchange rate pressures that are deemed inconsistent with economic fundamentals. The update of the convergence programme confirms the intention of Slovakia to be ready to join the euro area in 2009 and states that Slovakia is likely to enter ERM II no later than in the first half of 2006. These targets are consistent with the detailed update of the official strategy for preparation of euro area membership adopted by the government on 8 September 2004.

In recent years, the NBS has implemented its monetary policy in the context of relatively high and volatile inflation mostly reflecting adjustments of regulated prices and indirect taxes. In 2004, these factors added 5.7 percentage points to a CPI headline inflation of 7.5%. Including as a consequence of the disappearance of base effects of August 2003 excise tax increases, the year-on-year monthly CPI inflation has fallen from 8.5% in July 2004 to 5.9% in December 2004. Markets seem relatively confident about the disinflation path predicted for the coming years, as also suggested by a remarkable stability of long term interest rates in the last two years, when the spread towards the euro area has constantly moved at or below 100 basis points.



On the backdrop of the expected decline in headline inflation, the central bank has continued to ease monetary policy in 2004 and brought the repurchase rate from over 8% in the first half of 2002 to 4% by the end of November 2004. The interest rate cuts delivered in 2004 have principally aimed at stemming currency appreciation considered as being too fast in view of the development of fundamentals and of the moderate appreciation anticipated, including in the convergence programme. The rate cuts helped to stabilise the currency in the first half of the year, but the appreciation has recently resumed. In 2004, the koruna has gained almost 6% against the euro.

4. BUDGETARY IMPLEMENTATION IN 2004

Major parts of the government's structural public finance reform agenda for the current legislative period went into force in 2004 and were reflected in the budget for that year, i.e. notably comprehensive reforms in the taxation and social policy area.[7] In spite of the forecast uncertainties associated with these reforms, the government is likely to have comfortably reached the general government deficit target of 4.0% of GDP stipulated in the budget for 2004 and communicated in the May 2004 programme. Indeed, the actual outcome may be closer to or even lower than the figure of 3.8% of GDP estimated in the update.[8]

On the basis of thus far available information, revenues are not likely to have come in significantly better than envisaged in the 2004 budget and May 2004 programme – in spite of the prospectively much higher actual GDP growth than envisaged in the May programme (around 5% instead of 4.1%, in real terms). This seems to be mainly a consequence of the underperformance of value-added taxes and social contributions, which was roughly compensated by higher-than-budgeted other revenues, in particular corporate income taxes.

On the expenditure side, the information available to date suggests considerable savings in several spending areas, including transfers and subsidies and interest outlays and in particular related to co-payments for EU funds (i.e. spending postponements into future years due to a lack of absorption capacity). However, realised savings were to a considerable extent used up by overspending in other areas, including due to discretionary decisions on extra-spending during the budget year.

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

5.1. Evolution of budgetary targets in successive programmes

Similar to the May 2004 convergence programme, the update targets a reduction of the general government deficit to 3.0% of GDP by 2007.[9] The reduction path in the

[7] For more details, see section 7 of this assessment as well as the Commission's assessment of the May 2004 convergence programme.

[8] However, a major one-off increase of the 2004 deficit could result from a decision by the International Centre for the Settlement of Investment Disputes (ICSID) on 29 December 2004 in a case related to the restructuring of CSOB (Ceskoslovenska Obchodni Banka) in 1993. If the decision is not (or unsuccessfully) appealed, the government would have to pay around 25 billion SKK to CSOB (some 1.9% of GDP). The timing of the ESA95 deficit impact of this one-off event would have to be determined in the context of the March 2005 notification, but the impact may well fall into the year 2004. The event is unlikely to endanger the overall fiscal adjustment strategy – *inter alia* because the payment is planned to be primarily financed from existing liquid state assets and from forthcoming privatisation revenues.

[9] The comparison in this section as well as the discussion in the following sections is based on general government deficit and revenue figures that include the effect of the introduction of a funded pension

November 2004 update is almost completely in line with the May 2004 programme. Only the projected deficit outcome for 2004 and the target for 2005 are marginally lower. The deficit reduction path is also close to the one in 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.[10]

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007
General government balance /1 (% of GDP)	**CP November 2004**	**-3.7**	**-3.8**	**-3.8**	**-3.9**	**-3.0**
	CP May 2004	-3.6	-4.0	-3.9	-3.9	-3.0
	PEP August 2003	*-5.0*	*-3.9*	*-3.9*	*-3.8*	*n.a.*
General government expenditure /2 (% of GDP)	**CP November 2004**	**40.0**	**39.1**	**40.4**	**39.8**	**38.8**
	CP May 2004	40.9	41.5	41.8	40.9	39.6
General government revenues /1 /2 (% of GDP)	**CP November 2004**	**36.3**	**35.3**	**36.7**	**35.9**	**35.8**
	CP May 2004	37.4	37.4	37.9	36.9	36.6
Real GDP (% change)	**CP November 2004**	**4.2**	**5.0**	**4.5**	**5.1**	**5.4**
	CP May 2004)	4.2	4.1	4.3	5.0	4.7
	PEP August 2003	*4.0*	*4.1*	*4.4*	*4.8*	*n.a.*

/1 Including the effect of the introduction of a funded pension pillar at the beginning of 2005 (for the magnitude of this effect, see table 4).
/2 Methodological changes since the May 2004 convergence programme regarding the delimitation of general government (in particular exclusion of health care facilities) led to a corresponding downward shift in the revenue- and expenditure-to-GDP ratios in the update.

Sources:
Convergence programmes (CP); Pre-accession economic programme (PEP)

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pillar at the beginning of 2005, i.e. an estimated revenue decrease of 0.4% of GDP in 2005 and of some 1% of GDP in 2006 and 2007 due to the redirection of pension contributions to this pillar (for more details, see in particular table 4 in section 5.2 and box 4 in section 7). This is in line with the Eurostat decision of 2 March 2004 (Eurostat News Release 30/2004), which requires the classification of defined-contribution funded pension schemes outside of general government. In spite of this decision, the authorities inform in footnote 1 of the update that "given the fact that the introduction of the second pillar purely converts a portion of the implicit debt to the explicit one and, as such, does not increase demand, Slovakia will request that this fact be taken into consideration when evaluating compliance with the Maastricht criteria." The Slovak authorities also signalled that, when defining their budgetary plans for 2005 and 2006, they would like to opt for the transitional period (expiring in March 2007) granted by Eurostat for the implementation of its decision (Eurostat News Release 117/2004 of 23 September 2004). The authorities argue, *inter alia,* that this would facilitate budgetary planning for these years, in light of the uncertainties related to the rate of participation in the funded pension pillar.

[10] For details on the 2003 budget outcome, see the Commission's assessment of the May 2004 convergence programme.

Box 1: The excessive deficit procedure for Slovakia

On the basis of a general government deficit of 3.6% of GDP in 2003, above the 3% of GDP reference value, the Council decided on 5 July 2004 that Slovakia had an excessive deficit and recommended that this be corrected by 2007 at the latest. In particular, Slovakia was recommended to take effective action by 5 November 2004 to achieve the 2005 deficit target, to implement with vigour the measures envisaged in the May 2004 programme, and to accelerate the fiscal adjustment if the implemented structural reforms result in higher growth than expected in the programme, in particular by dedicating any higher-than-budgeted revenues primarily to faster deficit reduction.

A Commission communication of 22 December 2004 concluded that, on current information and on the basis of the measures detailed in the 2005 budget, it appeared that the Slovak government had taken effective action to achieve the 2005 deficit target, by the deadline of 5 November, in response to the Council recommendation under Article 104(7) to correct the excessive deficit by 2007 at the latest.

Furthermore, the communication assessed that, as regards the additional recommendations given under Article 104(7), the Slovak authorities had implemented the measures envisaged. With respect to the recommended acceleration of the fiscal adjustment, it seemed that the authorities would have had some additional opportunities.

5.2. Budgetary targets in the updated programme

The reduction of the deficit to the 3% of GDP reference value in 2007[11], in line with the Council recommendation under Article 104(7), is underpinned by a back-loaded reduction path of both the headline and primary general government deficit. The update foresees that both stay basically constant at, respectively, around 3.8% and 1.5% of GDP until 2006 and that their planned overall adjustment by 0.8% of GDP takes place in 2007 (together with the revision of a small deficit increase of 0.1% of GDP in 2006). Even net of the impact resulting from the introduction of a funded pension pillar at the beginning of 2005, the adjustment mostly takes place in the last two years and remains back-loaded.[12]

The composition of the overall adjustment of the headline deficit of 0.8% of GDP is based on an increase of the revenue-to-GDP ratio by 0.5 percentage points and a fall in the expenditure-to-GDP ratio by 0.3 percentage points. This contrasts with the May 2004 programme, which based the adjustment exclusively on expenditure cuts. Both revenue- and expenditure-to-GDP ratios rise significantly between 2004 and 2005 and fall continuously thereafter. The increase in 2005 is to a large extent related to the assumed time profile of transfers from the EU on the revenue side and to the associated spending (including co-financing) and the contributions to the EU budget on the expenditure side.

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[11] Including the pension reform effect on revenues and deficit (see footnote 8 above).

[12] This can be seen from the last lines of table 4, which show that, abstracting from the pension reform effect on revenues and, *ceteris paribus,* on the deficit (estimated at 0.4% of GDP in 2005 and some 1% of GDP in 2006 and 2007), the overall adjustment over the update horizon would amount to almost 2 percentage points of GDP, of which around 1/2 percentage point is planned for the election year 2006 and another 1 percentage point for 2007.

The envisaged increase in the GDP-share of revenues by 0.5 percentage points over the full horizon of the update results from an increase in EU-transfers (included in "other revenues"), which more than compensates for the predicted fall in the GDP-share of taxes and social contributions by a total of 0.5 percentage points. After the major tax reforms effective since 2004, future plans for changes in the tax legislation are rather marginal.[13] Although the update seems to rule out any further reduction of the relatively high total social contribution rates over the programme horizon[14], the introduction of a funded pension pillar in 2005 will lead to a redirection of pension contribution of 9% of gross wages or, by 2007, of an estimated 1.1% of GDP. Even after taking this effect into account, the GDP-share of social security contributions flowing to general government is still planned to fall only slightly by 0.2 percentage points over the programme horizon. An intermittent increase in the GDP-share for 2005 rests partly on the assumption of improved contribution compliance.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	Change: 2007-2004
Revenues	36.3	35.3	36.7	35.9	35.8	**+0.5**
(net of pension reform)	*36.3*	*35.3*	*37.1*	*36.9*	*36.9*	*+1.6*
of which:						
- Taxes	18.2	17.6	17.4	17.3	17.3	**-0.3**
- Social security contributions	13.9	12.5	13.1	12.5	12.3	**-0.2**
(net of pension reform)	*13.9*	*12.5*	*13.5*	*13.5*	*13.4*	*+0.9*
- Other (residual)	4.2	5.2	6.2	6.1	6.2	**+1.0**
Expenditure	40.0	39.1	40.4	39.8	38.8	**-0.3**
of which:						
- Primary expenditure	37.4	36.8	38.0	37.5	36.5	**-0.3**
of which:						
Gross fixed capital formation	2.5	2.6	2.6	2.5	2.3	**-0.3**
Consumption /1	12.6	12.3	12.4	12.3	12.0	**-0.3**
Transfers & subsidies	19.9	18.5	18.9	18.8	18.4	**-0.1**
Other (residual)	2.5	3.4	4.1	3.9	3.8	**+0.4**
- Interest payments	2.6	2.3	2.4	2.3	2.3	**0.0**
Budget balance	**-3.7**	**-3.8**	**-3.8**	**-3.9**	**-3.0**	**+0.8**
(net of pension reform)	*-3.7*	*-3.8*	*-3.4*	*-2.9*	*-1.9*	*+1.9*
Primary balance	**-1.1**	**-1.5**	**-1.4**	**-1.6**	**-0.7**	**+0.8**
(net of pension reform)	*-1.1*	*-1.5*	*-1.0*	*-0.6*	*+0.4*	*+1.9*

/1 outlays for wages and goods and services.

Sources:
Convergence programme; Commission services calculations

[13] The planned future changes include: a slightly higher income tax bonus for children and alterations in real estate taxes in 2005; and an increase in tobacco excise taxes in 2007 (in line with the *acquis communautaire).*

[14] The update mentions on page 20 that "the responsible approach to the issue of future costs of population ageing, …, rules out any dramatic reduction of social contributions, even in the long run." However, it also mentions that "potential restructuring of taxes and contributions within the existing burden cannot be ruled out." At the beginning of 2004, the contribution rate for employers was lowered by 3% of gross wages (but still amounts to almost 3/4 of the overall contribution rate of approximately 48% of gross wages), while the contribution rate for employees was increased by 0.6% of gross wages. Furthermore, the maximum assessment bases were increased.

The GDP-share of total and primary expenditure is foreseen to fall by 0.3 percentage points over the full horizon of the update. Until 2007, the government's wage bill is supposed to decrease by 0.2 percentage points of GDP and the outlays for goods and services by 0.1 percentage points. The GDP-share of transfers and subsidies is assumed to stay basically constant over the programme horizon: on the one hand, an increase in 2005 by almost ½ percentage point is caused largely by higher expenditures by health insurance companies, with the GDP-share of these expenditures staying basically constant thereafter; on the other hand, compensating savings are realized through a gradual fall in the GDP-share of social assistance over the full horizon as well as through slight reductions in 2007 of the GDP-shares of agricultural and rail transport subsidies (which remain nevertheless high) and of old-age and disability pensions. Gross fixed capital formation is supposed to fall by 0.3% of GDP over the last two years. "Other expenditures", which include contributions to the EU-budget, increase by 0.4 percentage points over the whole update horizon.[15]

Box 3: The budget for 2005

The main reform measures of the current government's reform agenda were already implemented in 2004 and encompass far-reaching tax reforms and comprehensive reforms in the social area (for details, see the Commission's assessment of the May 2004 programme).

The remaining parts of the government's reform agenda, which are included in the budget 2005, are the introduction of a funded-pension pillar with an estimated redirection of revenues of 0.4% of GDP in 2005 (for details see Box 4 in section 7) and a second tranche of health care reforms, which lead to an upfront increase of the GDP-share of expenditures by health insurance companies in 2005 but a stable share thereafter (for details see again section 7). The GDP-share of health insurance contributions is planned to increase in 2005 as well, including due to improved contribution compliance.

The risks to the budgetary projections in the programme appear broadly balanced for the programme horizon as a whole. On the basis of the given macroeconomic assumptions, there seems to be an upside risk on the revenue side: specifically, downside risks with respect to social contributions and VAT revenues seem to be overcompensated by upside risks regarding other revenues, in particular corporate income tax. Balanced uncertainties exist with respect to the revenue impact of the pension reform, i.e. to the rate of participation in the funded pillar and to the exact timing of the switching decision by

[15] Slovakia's first contribution to the EU budget is foreseen at 0.6% of GDP in 2004 and is planned at 0.9% of GDP in the following years. Transfers from the EU flowing to the general government sector are estimated at 1.2% of GDP in 2004 and increase to a budgeted 2½% of GDP in 2007. Nevertheless, the update seems to follow the line of argumentation of the May 2004 programme and states that "despite the fact that the accession to the European Union is expected to have a positive impact on economic development, its net effect on general government finance will be negative in the medium term contrary to the country's net financial position". This statement and the related analysis provided in the May 2004 programme tend to convey a spurious impression of the extent to which the presented "EU-related" expenditures (and their alleged deficit-increasing effect) are pre-determined or automatic. In reality, these expenditures depend, to a large degree, 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 other expenditures in the budget or to what extent they draw on EU-funds, which require co-payments, at all.

potential participants between the beginning of 2005 and mid-2006 (see Box 4 in section 7). The use of EU funds (and of co-payments) is likely to be lower than budgeted in 2004 to 2006 as the absorption capacity still develops. However, it could exceed the budgeted amount in 2007 if sufficiently improved absorption capacity combines with the catch-up in the implementation of spending postponed in 2004 to 2006. And finally, the parliamentary elections scheduled in 2006 lead to uncertainties, regarding pre-election spending as well as the extent to which further expenditure retrenchments (falling short or exceeding the current plans) will be implemented in 2007.

Table 5: Budgetary targets and output gaps

	2003		2004		2005		2006		2007	Change: 2007-2004
	COM	CP	COM	CP	COM	CP	COM	CP	CP	CP
Budget balance[2]	-3.7	-3.7	-3.9	-3.8	-4.0	-3.8	-4.1	-3.9	-3.0	+0.8
Output gap[1,3]	0.1	0.2	0.7	0.4	0.6	0.2	1.2	0.4	0.9	+0.8

Notes:
[1]Commission services calculations on the basis of the information in the convergence programme (CP)
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services autumn 2004 forecasts (COM); Commission services calculations

To conclude, Slovakia is on track to correct its excessive deficit by the deadline set by the Council. It conforms to the deficit reduction path specified by the Council and broadly complies with the related BEPGs in the area of public finance. Nevertheless, against the changed growth outlook, which is more favourable than in the May 2004 programme, the fiscal consolidation path in the update looks less ambitious, even if one takes the achieved consolidation at the beginning of the current legislative period and the revenue effect of the introduction of a funded pension pillar into account.

For this reason, the possibility of accelerating the deficit reduction in the early years of the programme horizon, in line with the Council Recommendation under Article 104 (7), becomes an even more important consideration. The Council recommendation does not only refer to the revenue side of the budget but also to the expenditure side as additional expenditure cuts are easier to implement in a very favourable growth environment, i.e. in "good times". An accelerated deficit reduction would create a buffer against the potential realisation of downside risks and increase the probability that the general government deficit will be below 3.0% of GDP in 2007 and, hence, that Slovakia's euro adoption strategy can be implemented as foreseen. It would also further underpin the credibility of Slovakia's fiscal adjustment strategy with a view to the start of its ERM2 participation envisaged in the first half of 2006, when the general government deficit is currently planned to be still close to 4% of GDP. In addition, it would help to ensure the counter-cyclicality of fiscal policy (in particular in 2005 when, net of pension reform and EU transfers, fiscal policy seems to be slightly pro-cyclical) and could assist in stemming appreciation pressures resulting from potentially surging capital inflows. And finally, it would pave the way to achieve 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.[16]

[16]The update does not include a sensitivity analysis. However, the May 2004 programme very briefly discussed the effects on public finances of the three deviations from the assumptions of the macroeconomic scenario presented in footnote 5. The reported effects on the general government

6. EVOLUTION OF THE DEBT RATIO

The programme projects an increase of the debt-to-GDP ratio between 2004 and 2007 by 2½ percentage points, i.e. to somewhat over 45% of GDP in 2006 (broadly in line with the Commission projections) and to 45½% in 2007. The actual debt ratio in 2004 is likely to be by around 2 percentage points of GDP lower than foreseen in the May 2004 programme (mainly due to growth effects, lower interest outlays and lower cash/accrual adjustments). 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, although projected cash/accrual divergences and privatisation proceeds remain significant until 2006.[17] The contribution of the primary deficit (including the pension reform effect) stays around 1½ percentage points until 2006 and drops significantly only in 2007. The contribution of interest outlays stays constant. Real GDP growth and inflation have a substantial debt ratio-reducing effect throughout the period.

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio	**46.1**	**44.2**	**43.0**	**45.2**	**44.2**	**45.9**	**45.3**	**45.5**
Change in debt ratio (1 = 2+3+4)	-1.1	1.6	0.4	0.9	1.2	0.7	1.1	0.2
Contributions:								
- **Primary deficit** (2)	**3.4**	**1.6**	**1.5**	**1.6**	**1.4**	**1.8**	**1.6**	**0.7**
- **"Snow-ball" effect** (3)	**-0.4**	**-1.3**	**-1.5**	**-0.5**	**-0.3**	**-0.6**	**-0.5**	**-0.7**
- Interest expenditure	3.6	2.3	2.3	2.4	2.4	2.3	2.3	2.3
- Real GDP growth	-1.6	-1.9	-1.9	-1.9	-1.8	-2.2	-2.1	-2.3
- Inflation (GDP deflator)	-2.4	-1.7	-1.9	-1.0	-0.9	-0.7	-0.7	-0.7
- **Stock-flow adjustment** (4)	**-4.1**	**1.3**	**0.4**	**-0.2**	**0.1**	**-0.5**	**0.0**	**0.2**
- Cash/accruals	-0.1							
- Accumulation of financial assets	-3.5							
of which: Privatisation proceeds	-5.7							
- Valuation effects & residual adj.	-0.5							

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Sources:
Convergence programme update (CP); Commission services autumn 2004 forecasts (COM);

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deficit are small, i.e. in the range between 0.1 and 0.3 percentage points, and mostly favourable. In the case of lower euro-area imports, the deficit target of 3.0% by 2007 would be missed (by 0.2 percentage points).

[17] Major stock-flow adjustments in the past were related to bank restructuring, debt assumptions in connection with government guarantees, and privatisation operations. The privatisation process in Slovakia is largely completed. The government still owns major stakes in public utilities (without management rights), the electricity sector (where privatisation is ongoing), and the Slovak Railway companies. The government is committed to use privatisation receipts primarily for debt reduction.

Commission services 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. The programme mentions litigation risks[18] and debt relief in the health sector as factors which could influence debt developments unfavourably. Downside risks could also arise from fiscal decentralization, in particular as some of the foreseen mechanisms to control the indebtedness of the non-central government level remain untested. Higher-than-expected privatisation proceeds constitute an upside risk. Further downside risks could be connected with the government's borrowing in foreign currency. In addition to imparting risks on the public sector, this could, at least to some extent, lead to the perception by market participants that, in the authorities' belief, the Slovak crown can only move in one direction, i.e. appreciate. It could thus motivate unhedged foreign currency borrowing by the private sector.[19]

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

The update focuses on structural public finance reforms, which were adopted since the May 2004 programme and basically complete the current government's reform agenda. It refers to that programme for a review of earlier far-reaching reforms, which took place both on the revenue side (flat income tax and uniform VAT rate, both at 19%) and the expenditure side (predominantly in the social area) and became effective mostly in 2004. The reforms improve the quality of public finances and have a potential to enhance growth.

Recent reforms regard mainly the healthcare system and the introduction of a funded pension pillar (see Box 4) and went into force at the beginning of 2005. Major elements of the recent tranche of healthcare reforms are: the introduction of individual health insurance in addition to the public health insurance; more competition and harder budget constraints; adjustments in the assessment base for health insurance contributions; the creation of a better basis for the streamlining of the health care benefit package; and better incentives for health care providers. Furthermore, increased funds are foreseen for active labour market policies, an area were close monitoring of effectiveness and efficiency seem to be particularly important.

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[18] On litigation risks, see in particular section 4 (footnote 7) above.

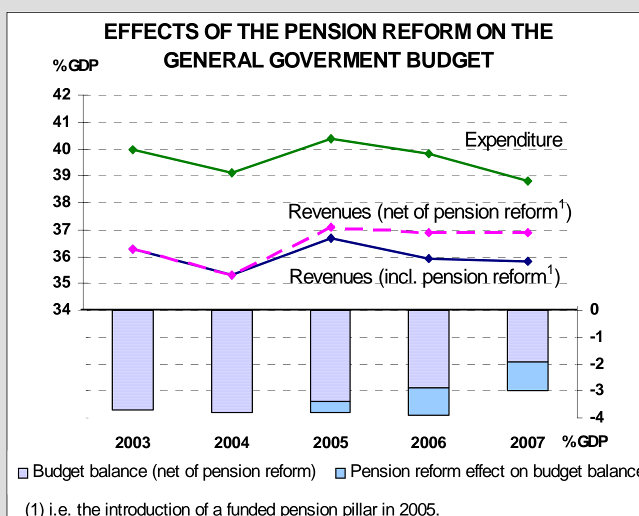
[19] The May 2004 programme indicated that around 30% of the general government gross debt was denominated in foreign currency and that the authorities planned to issue an increasing share of their debt in euro, while considering the associated exchange rate risk as limited and assuming that the Slovak crown would remain stable or appreciate against the euro until euro adoption. Similar to the May 2004 programme, the update reports on a stress-test on interest outlays of moderate exchange rate and interest rate shocks but only identifies minor deviations (close to 0.1 percentage point of GDP) from the baseline in this case. Further work on this and similar stress tests would be useful.

Box 4: Pension reform in Slovakia

Slovakia has reformed its pension system in mainly two steps: In a first step, it introduced several changes to the parameters of the pay-as-you-go pillar that became effective in 2004. These parametric changes reduced the scope of entitlements and, hence, the (implicit) debt of the pillar. They thereby prepared the ground for the second (systemic) reform step, i.e. the introduction of a funded pension pillar ("2nd pillar") at the beginning of 2005. Furthermore and in parallel to these reforms, the possibilities for voluntary old-age provisions ("3rd pillar") have been expanded.

The main parametric changes to the pay-as-you-go pillar were the following: (1) an annual stepwise increase of the retirement age by 9 months to 62 for both men (to be completed by 2006) and women (to be completed by 2012) from 60 for men and 53 to 57 for women (depending on the number of children); (2) introduction of a close link between contribution history and pension benefits; (3) and the institution of an automatic indexation mechanism for benefits, with the adjustment based half on inflation and half on the average nominal wage increase in the previous year.

The funded pension pillar introduced at the beginning of 2005 is sizeable and receives contributions of 9% of gross wages. Further pension-related social contributions consist of 9% (of gross wages) for old-age pensions from the PAYG-pillar, 6% for disability pensions, and 4.75% for a reserve fund which is envisaged to cover potential shortfalls in the public pension system. Roughly ¾ of the contribution total are paid by employers.



(1) i.e. the introduction of a funded pension pillar in 2005.

The programme update estimates the revenue flow to the new funded pillar at 0.4% of GDP in the first year, at 0.9% of GDP in 2006 and at 1.1% in 2007 (for the effects on the general government budget, see the above graph in combination with table 4). The risks attached to these estimates seem to be largely balanced. Specific uncertainties relate to the share of incumbent workers who will actually opt to switch to the new system and the exact timing of the switching (as the decision can be taken during a period spanning from the beginning of 2005 to mid-2006).

The pension reforms implemented to date considerably improve the long-term sustainability of the system. In addition, the reforms diversify the risk for beneficiaries and are likely to foster contribution compliance and to enhance work incentives. The introduction of a funded pillar may also have a favourable effect on financial market development. Nevertheless, sustainability considerations suggest that further reforms should be considered in the medium-term (see section 8). As mentioned in the programme, these include additional increases in the retirement age and further changes in the indexation mechanism.

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. A new act on budgetary rules was adopted in September 2004 and includes the changes necessary because of EU accession and because of the fiscal decentralisation, which reaches its final stage in 2005. The rules include limits for the deficit and debt of sub-national governments. Starting with the budget year 2005, the budget planning process has been expanded to a multi-annual, i.e. three-years, budgetary framework.

Altogether, the effective implementation of the adopted structural public finance reforms will go a long way into the direction of the country-specific BEPGs 2003-2005, although there remains in particular scope for increasing the binding character of the multi-annual budgetary framework.

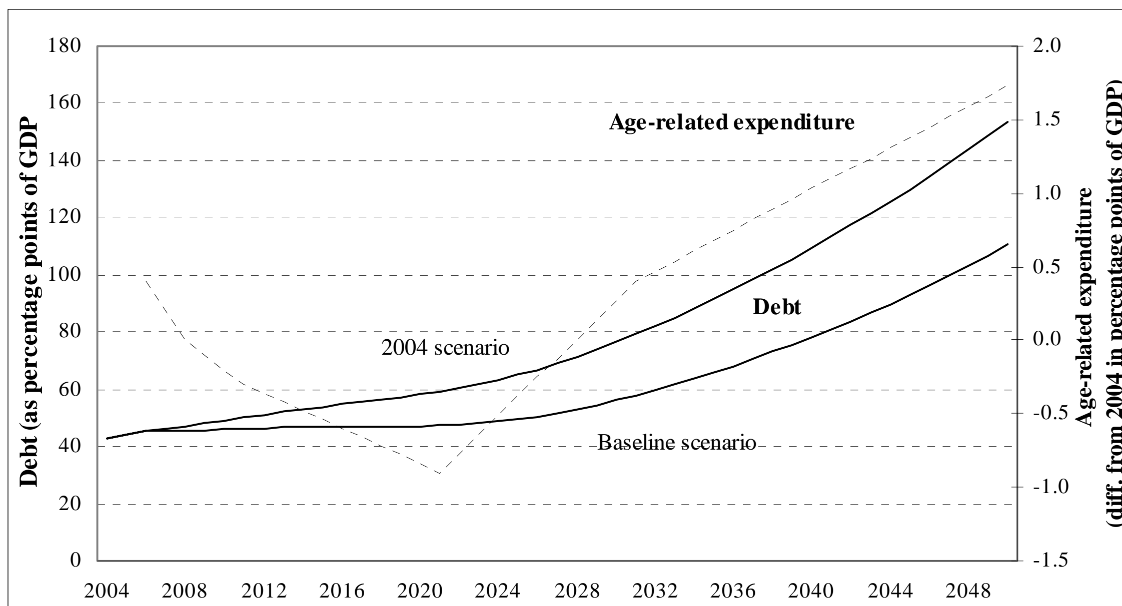
8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The sustainability assessment is based on an overall judgement on quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios so as to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme, age-related expenditures are foreseen to increase by 1.9% of GDP between 2008 and 2050 (see Annex 2 for a breakdown of different age-related expenditures). Gross debt is projected to remain fairly stable up to 2020, at slightly below 50% of GDP, as a consequence of declining age-related expenditures, in particular pension expenditures. Thereafter, the gross debt ratio starts to rise, influenced by the rise in age-related expenditures, and an explosive path may emerge[20].

[20] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	1.0	2.3	2.0
2004 scenario	1.8	3.2	2.0

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.

** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: -13.8%

*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050)[21]. S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, i.e. the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, Slovakia should increase its tax ratio permanently by about 2 percentage points, compared with the one projected at the end of the programme period, and considerably more if it fails to consolidate as planned in the medium-term[22]. This would lead to a sustainable debt ratio

[21] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

[22] The projections include the effect of the introduction of a defined-contribution funded pension scheme in 2005 on the general government budgetary position (see footnote 8), estimated at 0.4% of GDP in 2005, 1.1% of GDP in 2007, and 2% of GDP in 2050. Net of the pension reform effect, the S2 indicator would be 1.2.

of around -14% of GDP by the middle of the century[23]. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of 2% of GDP on average, about 2.5 percentage point higher than the one projected for the last year of the programme period.

In interpreting these results, several factors need to be taken into account: First, the relatively limited rise in age-related expenditure over the next 50 years is in part due to favourable demographic developments over the coming decades. The current fertility rate is much lower and the current old-age dependency ratio 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, as well as a rapid rise in life expectancy. These two assumptions, taken together, would appear to be somewhat tilted towards the optimistic side. Second, the relatively small increase of pension expenditures results from the recently adopted pension reforms (see Box 4), which are currently being implemented, but it is also predicated on the adoption of further reform steps, in particular a further increase in the retirement age (to 65) after the currently ongoing increase is completed and a change to a pure inflation-indexation of benefits from 2010 onwards.[24] Third, the health care reform measures, which came into force at the beginning of 2005, institute mechanisms that are conducive to cost containment in the future. Experience will show to what extent these mechanisms will prove sufficient and whether further reform steps will be necessary to rein in health care cost. Already in the authorities' baseline scenario, the latter are the main driver of the increase in age-related expenditures.

Slovakia presents some risks with regard to long-term sustainability of the public finances, of which the projected budgetary costs of an ageing population are an important element. A significant budgetary gap still arises for the currently projected path of age-related expenditure if the country wants to fully ensure sustainability over time (even assuming the achievement of the planned deficit reduction over the medium-term), although the structural reform measures enacted and planned, in particular the pension and health reforms, contribute to the achievement of a sustainable position over the long term. The strategy outlined in the programme is broad-based and consists of further gross debt consolidation and structural reforms. However, a full implementation of these measures is a key condition, in addition to the achievement of the planned budgetary consolidation path over the programme period.

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[23] The debt ratio of around -14% in 2050 in the baseline scenario illustrates that the tax gap according to the S2 indicator is higher (compared with the S1 indicator) so as to ensure a sustainable evolution of gross debt beyond 2050. In other words, a lower tax increase is compatible with the 60% reference value in 2050.

[24] See May 2004 convergence programme and the Commission's assessment thereof.

Annex 1: Summary tables from the convergence programme update

Table 1. Growth and associated factors

	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	4.2	5.0	4.5	5.1	5.4
GDP *level* at *current* market prices, SKK bn.	1,195.8	1,319.9	1407.4	1503.8	1611.3
GDP deflator	4.7	5.1	2.0	1.7	1.7
HICP change	8.5	7.8	3.3	2.8	2.5
Employment growth [1]	1.8	0.0	0.6	0.6	0.9
Labour productivity growth [2]	3.4	5.0	3.8	4.4	4.4
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	-0.4	3.0	4.1	3.9	4.0
2. Government consumption expenditure	2.9	0.9	1.5	2.2	1.5
3. Gross fixed capital formation	-1.2	3.3	7.5	6.0	3.3
4. Changes in inventories and net acquisition of valuables as a % of GDP [3]	-0.7	0.4	0.8	0.6	-1.1
5. Exports of goods and services	22.6	12.4	10.5	13.9	12.8
6. Imports of goods and services	13.8	11.8	11.1	13.0	9.6
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	0.1	2.6	4.3	3.9	3.1
8. Change in inventories and net acquisition of valuables (=4) [3]	-2.3	1.1	0.4	-0.2	-1.8
9. External balance of goods and services (5-6)	6.4	1.2	-0.1	1.3	4.1

(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	-3.7	-3.8	-3.4	-2.9	-1.9
2. Central government	-4.2	-3.4	-3.9	-3.5	-3.1
3. State government	0.0	0.0	0.0	0.0	0.0
4. Local government	-0.1	-0.1	0.0	0.0	0.0
5. Social security funds	0.5	-0.3	0.5	0.5	1.2
General government					
6. Total receipts	36.3	35.3	37.1	36.9	36.9
7. Total expenditures	40.0	39.1	40.4	39.8	38.8
8. Budget balance	-3.7	-3.8	-3.4	-2.9	-1.9
9. Net interest payments	-1.8	-1.9	-2.0	-1.9	-2.0
10. Primary balance	-1.9	-1.9	-1.4	-1.0	0.1
Components of revenues					
11. Taxes	18.2	17.6	17.4	17.3	17.3
12. Social contributions	13.9	12.5	13.5	13.5	13.4
13. Interest income	0.7	0.4	0.4	0.3	0.3
14. Other	3.5	4.8	5.8	5.8	5.8
15. Total receipts	36.3	35.3	37.1	36.9	36.9
Components of expenditures					
16. "Public consumption"	12.6	12.3	12.4	12.3	12.0
17. Social transfers in kind					
18. Social transfers other than in kind	18.4	16.8	17.2	17.1	16.8
19. Interest payments	2.6	2.3	2.4	2.3	2.3
20. Subsidies	1.5	1.7	1.7	1.7	1.6
21. Gross fixed capital formation	2.5	2.6	2.6	2.5	2.3
22. Other	2.6	3.5	4.1	4.0	3.9
23. Total expenditures	40.0	39.1	40.4	39.8	38.8

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	42.8	43.0	44.2	45.3	45.5
Change in gross debt	-0.6	0.2	1.2	1.1	0.1
Contributions to change in gross debt					
Primary balance	1.2	1.5	1.4	1.7	0.7
Interest payments	2.5	2.3	2.4	2.3	2.3
Nominal GDP growth	-3.6	-4.0	-2.7	-2.9	-3.0
Other factors influencing the debt ratio	-0.7	0.4	0.1	0.0	0.1
Of which: Privatisation receipts	--	--	--	--	--
p.m. implicit interest rate on debt	6.4	5.9	5.8	5.5	5.5

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	4.2	5.0	4.5	5.1	5.4
2. Actual balance	-3.7	-3.8	-3.4	-2.9	-1.9
3. Interest payments	-1.8	-1.9	-2.0	-1.9	-2.0
4. Potential GDP growth	4.3	5.1	4.6	4.8	5.1
5. Output gap	0.0	-0.1	-0.2	0.1	0.3
6. Cyclical budgetary component	0.0	0.0	0.0	0.0	0.1
7. Cyclically-adjusted balance (2-6)	-3.7	-3.8	-3.4	-2.9	-2.0
8. Cyclically-adjusted primary balance (7-3)	-1.9	-1.9	-1.4	-1.0	0.0

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	4.2	4.1	4.3	5.0	4.7
Latest update	4.2	5.0	4.5	5.1	5.4
Difference	0.0	0.9	0.2	0.1	0.7
Actual budget balance					
Previous update	-3.6	-4.0	-3.4	-3.0	-2.0
Latest update	-3.7	-3.8	-3.4	-2.9	-1.9
Difference	-0.1	0.2	0.0	0.1	0.1
Gross debt levels					
Previous update	42.8	45.1	46.4	46.1	45.5
Latest update	42.8	43.0	44.2	45.3	45.5
Difference	0.0	-2.1	-2.2	-0.8	0.0

Table 6. Long-term sustainability of public finances

% of GDP	2004	2005	2010	2020	2030	2050
Total expenditure	39.1	40.4	36.3	34.5	35.2	37.3
Old age pensions	7.2	7.2	6.6	5.8	6.6	7.4
Health care (including care for the elderly)	4.5	4.9	5.1	5.5	6.0	6.6
Interest payments	2.3	2.4	2.1	0.8	0.3	1.0
Total revenues	35.3	37.1	36.9	36.9	36.9	36.9
Of which: from pension contributions	12.5	13.5	13.4	13.4	13.4	13.4
National pension fund assets (if any)						
Assumptions						
Labour productivity growth	5.0	4.0	3.4	3.4	2.5	2.3
Real GDP growth	5.0	4.5	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	18.5	17.9	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	2.1	2.7	3.5
Long-term interest rate (annual average)	4.1	4.2	4.7	5.0	5.3
United States: short-term (three-month money market)	1.2	1.5	2.8	3.8	4.2
United States: long term (10-year government bonds)	4.0	4.3	4.6	5.6	5.6
USD/€exchange rate (annual average)	1.13	1.22	1.23	1.2	1.2
Nominal effective exchange rate (euro area)	10.9	2.8	0.6		
Nominal effective exchange rate (EU)	12.5	5.9	0.8		
SKK/€exchange rate (annual average)	41.5	40.0	39.4	39.0	39.0
World GDP growth, excluding EU	4.2	5.7	4.8	4.6	4.6
United States, GDP growth	3.1	4.4	3.0	2.9	2.9
Japan, GDP growth	2.4	4.2	2.1	2.3	2.3
EU-25 GDP growth	1.0	2.5	2.3	2.4	2.4
GDP growth of relevant foreign markets	1.2	2.1	2.7	2.7	2.7
Import growth of relevant foreign markets	4.0	6.6	8.0	7.8	7.4
World import volumes, excluding EU	10.3	11.6	8.8	8.3	8.3
World import prices (goods, in USD)	8.8	10.4	3.7	0.5	0.5
Oil prices (Brent, USD/barrel)	28.5	39.3	40.0	40.0	40.0
Non-oil commodity prices (in USD)	6.3	12.9	-2.9	-0.5	0.0

Annex 2: Long-term sustainability of public finances in Slovakia – quantitative scenarios

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	16.1	15.9	15.3	16.6	17.3	18.0	1.9
Pensions	6.9	6.6	5.8	6.6	7.0	7.4	0.5
Health care	5.0	5.1	5.5	6.0	6.4	6.6	1.6
Education	3.4	3.4	3.4	3.4	3.4	3.4	0.0
Unemployment benefits	0.2	0.2	0.1	0.1	0.1	0.1	-0.1
Child allowance	0.6	0.6	0.5	0.5	0.4	0.5	-0.1
*Total primary non age-related spending**	20.3						
*Total revenues**	35.8						

* constant

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Baseline scenario							
Gross debt	45.6	46.0	47.1	56.2	78.3	110.6	65.0
i + 0.5*	45.8	46.7	50.1	62.0	88.5	127.3	81.5
2004 scenario							
Gross debt	47.0	49.0	57.4	76.5	109.4	153.8	106.8
i + 0.5*	47.2	49.7	61.5	83.5	122.2	175.5	128.3

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.