



EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 25 January 2006
ECFIN/B/(2006)REP/116-EN

DECEMBER 2005 UPDATE
OF THE CONVERGENCE PROGRAMME OF SLOVAKIA
(2005-2008)
AN ASSESSMENT

(Note for the Economic and Financial Committee)

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SUMMARY AND CONCLUSIONS¹

Slovakia submitted its convergence programme on 1 December 2005. It covers the period 2005 to 2008 and, in addition, provides indicative projections until 2010. The document was adopted by the government on 30 November 2005. It incorporates the 2006 budget, which the parliament approved on 13 December 2005, and the government's multi-annual budgetary framework 2006-2008, which the government adopted on 12 October 2005. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct.² The programme has gaps in the compulsory and optional data prescribed by the new code of conduct.³

On 5 July 2004 the Council decided that Slovakia had an excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit has to be corrected by 2007. In its opinion of 17 February 2005 on the previous update of the Slovakia's convergence programme covering the period 2004-2007, the Council invited 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."

Slovak real GDP growth averaged 4.3% between 1994 and 2004 almost two percentage points above the EU25 average of 2.4%. The labour market situation remains the country's major problem. As a consequence of accelerated enterprise restructuring in the late 1990s, the unemployment rate increased from 13.7% in 1994 to 18.2% in 2004 while total employment decreased by two percentage points over the same period. The programme projects real GDP growth at an average rate of 5.6% over the programme period and, starting with a negative output gap in 2005, implies a marked swing in cyclical conditions. GDP growth is expected to increase from 5.1% in 2005 to 5.4% in 2006 and 6.1% in 2007, with net exports providing an increasing contribution to GDP growth and complement a strong positive contribution of domestic demand. Strong domestic demand should be sustained thanks to positive wage and labour market developments as well as an attractive business environment and growing public

¹This technical analysis, which is based on information available up to 23 December 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 11 January 2006. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Anton Jevcak (Anton.Jevcak@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct (Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines for the period 2005-2008.

² However, sections on growth implications of "major structural reforms" and on sensitivity of budgetary projections to different scenarios and assumptions are missing. The chapter on institutional features of public finances is divided into different sections than the model structure.

³ Note, however, that compulsory data on nominal effective exchange rate are missing in order to avoid pre-empting the setting of the euro conversion rate. The data on FISIM, differences between cash and accruals and general government expenditure by function for 2008 are also missing.

investment supported by EU funds. Covering the period until 2007, the Commission services autumn 2005 forecast broadly confirms the growth projections of the programme as well as the development of the underlying composition of growth. For 2008, the growth assumption of almost 5½% exceeds the Commission services' estimate of potential output growth. The programme expects inflation to rise to 3.6% in 2006 due to increases in administered prices induced by higher oil and natural gas prices. As these effects fade out, inflation is projected to ease to 2.0% in 2007 and 2008. The inflation projections presented in the programme seem plausible although recently announced further upward adjustments of some regulated prices represent an upside risk.

After a depreciation in March-April 2005, the koruna slowly appreciated until its ERM II entry on 28 November 2005. Following this move, the koruna initially further strengthened by about 1.5 percent and subsequently stabilized at between 1 and 2 percent above the central rate during the first weeks of ERM II participation. Since early 2005 long-term interest rates remained close to the euro area level compared to a spread of around 100 basis points in 2003 and 2004. As the recent increase in Slovak long-term interest rates outpaced that of the euro area, the spread widened again somewhat in the last quarter of 2005. Since 1 January 2005 the National Bank of Slovakia has defined the conduct of its monetary policy as “inflation targeting in the conditions of ERM II”.

The general government deficit for 2005 is estimated, based on the Commission services' forecast, at 4.1% of GDP but a comparison with previous convergence programmes is not straightforward because it includes a cancellation of some developing countries' debt amounting to about 0.8% of GDP. Without the debt cancellation the deficit is estimated at around 3.3% of GDP which is slightly lower than foreseen in the previous update (3.4% of GDP). This positive development is, however, mainly driven by lower-than-expected interest expenditure.

The programme aims at reducing the deficit to below the 3% of GDP reference value in 2007 (including the costs of the pension reform), in line with the Council recommendation under Article 104(7) from 5 July 2004. The general government deficit (net of the pension reform costs) is projected to decrease from 4.1% of GDP (including debt cancellations amounting to 0.8 % of GDP) in 2005 to 2.9% in 2006, then decline sharply to 1.6% of GDP in 2007 and afterwards to fall to 1.3% of GDP in 2008. The budgetary adjustment is mainly expenditure based. The expenditure-to-GDP ratio is projected to decrease by 3.4 percentage points between 2005 and 2008 (by 2.6 percentage points excluding debt cancellations of 0.8% of GDP in 2005). General government revenues are estimated to remain broadly stable until 2007 and then decrease by 0.7% of GDP in 2008. The budgetary impact of the classification of the funded second-pillar pension scheme outside the general government sector (which has to be implemented by the time of the spring 2007 fiscal notification) is estimated at 0.8%, 1.3%, 1.4% and 1.4% of GDP in 2005, 2006, 2007 and 2008 respectively. The planned fiscal consolidation is back-loaded, mainly concentrated in 2007. Compared to the previous convergence programme the back-loading of the fiscal consolidation effort required to reach the 2007 deficit target of 3.0% of GDP has grown stronger in view of higher estimates of the costs of the pension reform. The 2006 deficit target remained unchanged. Overall, the new update broadly confirms the planned adjustment in the previous programme against the background of a more favourable macroeconomic outlook. The budgetary effect of stronger economic growth projections is largely offset by an upward revision of the costs of the pension reform.

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance would improve from around -2¾% of GDP in 2005 to about -1½% of GDP in 2008. The fiscal effort planned in the programme is mainly concentrated in 2007, when the output gap implied by the macroeconomic scenario of the programme is estimated to be close to zero but with cyclical conditions clearly expected to improve compared to the previous year. The programme identifies a medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact of a structural balance of -0.9% of GDP, which it aims to achieve by 2010. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2¼% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

According to this update the medium-term budgetary framework approved by the government is exclusively based on current legislation and on government approved legislative changes. However, it is not very explicit about the measures that would ensure the achievement of the 2007 deficit target. So far the government has overachieved the budgetary targets set in the previous programmes: after a lower-than-expected 2004 deficit a better-than-planned result is also projected for 2005 (excluding debt cancellations of 0.8 % of GDP). Nevertheless, some of the financial resources that were freed by lower-than-expected interest expenditure in 2005 were used to cover other unbudgeted public expenditures highlighting the need for more binding ceilings for expenditure items. Overall, the risks to the predictions appear broadly balanced and the budgetary projections presented in the programme thus seem plausible.

Taking into account the balance of risks Slovakia is on track to correct its excessive deficit by the deadline set by the Council. An increase in the deficit projection for 2005 results from the one-off effect of debt cancellations amounting to 0.8% of GDP. However, the budgetary strategy outlined in the programme may not be sufficient to ensure that the programme's MTO (-0.9% of GDP) will be reached in 2010. Including the budgetary impact of the Eurostat decision of 2 March 2004 on the classification of the funded second-pillar pension schemes (which has to be implemented by the time of the spring 2007 notification) the structural balance based on the Commission services' calculations on the basis of the programme is estimated at -2.9% of GDP in 2008 (-1.5% of GDP net of the costs of the pension reform). Substantial additional consolidation measures would thus be needed to reach the programme's MTO by 2010. The planned improvement in the structural balance of around ¼% of GDP in 2008 is below the 0.5% of GDP benchmark set in the Stability and Growth Pact, when the cyclical conditions may qualify as good economic times.

The debt ratio is expected to fall quite significantly by nearly 9 percentage points to 33.7% of GDP in 2005. This large fall - even larger than expected in the Commission services' forecasts - is mainly because of a reduction in liquidities (deposits) managed by a new agency responsible for managing government debt (ARDAL). The reduction in liquid assets is recorded as a component of the stock-flow adjustment. The debt ratio is then expected to hover around 35 to 36% of GDP (35.5% in 2006, 35.2% in 2007 and 36.2% in 2008), as a result of a small primary balance, a debt-decreasing snow-ball effect (as the effective interest rate is below GDP growth). The stock-flow adjustment is

expected to remain positive over the programme horizon in spite of some privatisation receipts expected in 2006.

With regard to the sustainability of public finances, Slovakia appears to be at medium risk in view of the projected budgetary costs of ageing populations. The level of the debt is significantly below the 60% reference value and should remain so under the assumption of unchanged policies for the coming two decades. Slovakia has recently enacted a two-step pension reform, which has contained future increase in public expenditure. However, the currently high structural deficit will prevent the reduction of the debt/GDP ratio, which increases the risk to long-term sustainability. Implementing rigorously the planned consolidation of public finances over the medium-term is necessary in order to reduce risks to long-term sustainability.

The planned measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. Slovakia is on track to correct its excessive deficit by the deadline set by the Council.

The National Reform Programme of Slovakia, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) information society; (ii) R&D and innovations; and (iii) education and employment. The budgetary implications of the actions outlined in the National Reform Programme are fully reflected in the budgetary projections of the convergence programme. The convergence programme describes the already adopted reforms of the tax and the pension system. The 2006 budget as well as the 2006-2008 budgetary framework foresee significant increases in expenditure on education and research and development and thus reflect priorities set in the National Reform Programme.

In view of the above assessment and in the light of the recommendations under Article 104(7), the Council is of the opinion that Slovakia should:

(i) strengthen the effort in the structural budgetary adjustment, in the absence of any margin with respect to the reference value targeted for 2007 (which is the deadline for the correction of the excessive deficit) and in order to fully take advantage of the upward revision of growth prospects compared to those underlying the Council recommendations;

(ii) reinforce the binding character of the medium-term expenditure ceilings for central government.

Comparison of key macroeconomic and budgetary projections¹

		2004	2005	2006	2007	2008
Real GDP (% change)	CP Dec 2005	5.5	5.1	5.4	6.1	5.6
	COM Nov 2005	5.5	5.1	5.5	6.3	n.a.
	CP Nov 2004	5.0	4.5	5.1	5.4	n.a.
HICP inflation (%)	CP Dec 2005	7.5	2.9	3.6	2.0	2.0
	COM Nov 2005	7.5	2.9	3.6	2.1	n.a.
	CP Nov 2004	7.8	3.3	2.8	2.5	n.a.
Output gap (% of potential GDP)	CP Dec 2005²	-1.9	-1.6	-1.1	0.1	0.8
	COM Nov 2005 ⁶	-1.5	-1.3	-0.9	0.2	n.a.
	CP Nov 2004 ²	0.4	0.2	0.4	0.9	n.a.
General government balance (% of GDP)	CP Dec 2005²	-3.2	-4.1	-2.9	-1.6	-1.3
	COM Nov 2005	-3.1	-4.1	-3.0	-2.5	n.a.
	CP Nov 2004	-3.8	-3.4	-2.9	-1.9	n.a.
Primary balance (% of GDP)	CP Dec 2005	-1.0	-2.3	-1.0	0.4	0.7
	COM Nov 2005	-0.9	-1.9	-0.8	-0.2	n.a.
	CP Nov 2004	-1.5	-1.0	-0.6	0.4	n.a.
Cyclically-adjusted balance (% of GDP)	CP Dec 2005²	-2.6	-3.6	-2.6	-1.6	-1.5
	COM Nov 2005	-2.7	-3.8	-2.7	-2.5	n.a.
	CP Nov 2004 ²	n.a.	n.a.	n.a.	n.a.	n.a.
Structural balance ³ (% of GDP)	CP Dec 2005⁴	-2.6	-2.8	-2.6	-1.7	-1.5
	COM Nov 2005 ⁵	-2.7	-3.0	-2.7	-2.5	n.a.
	CP Nov 2004	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt ⁷ (% of GDP)	CP Dec 2005	42.6	33.7	35.5	35.2	36.2
	COM Nov 2005	42.6	36.7	38.2	38.5	n.a.
	CP Nov 2004	43.0	44.2	45.3	45.5	n.a.

Notes:

¹The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated programme would be -3.2% of GDP in 2004, -4.9% in 2005, -4.2% in 2006, -3.0% in 2007 and -2.7% in 2008.

²Commission services calculations on the basis of the information in the programme

³Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

⁴One-off and other temporary measures taken from the programme (0.8% of GDP in 2005, deficit-increasing and 0.1% in 2007, deficit-reducing)

⁵One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (0.8% of GDP in 2005, deficit-increasing)

⁶Based on estimated potential growth of 4.9%, 4.8%, 5.1% and 5.1% respectively in the period 2004-2007.

⁷The debt projections (in contrast with deficit projections) in the programme have been prepared taking into account the Eurostat decision of 2 March 2004 on the classification of funded pension schemes.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

Slovakia submitted its convergence programme on 1 December 2005.⁴ It covers the period 2005 to 2008 and, in addition, provides indicative projections until 2010. The document was adopted by the government on 30 November 2005. It is in line with the 2006 budget, which the parliament approved on 13 December 2005, and the government's multi-annual budgetary framework 2006-2008, which the government passed on 12 October 2005 and the parliament took into account.

The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct.⁵ The programme has gaps in the compulsory and optional data prescribed by the new code of conduct.⁶ Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC OUTLOOK

Slovak real GDP growth averaged 4.3% between 1994 and 2004 almost two percentage points above the EU25 average of 2.4%. After a period of strong economic expansion, real GDP growth fell to 1.5% in 1999. Fiscal and monetary stabilisation, which became necessary after Slovakia recorded large external imbalances raising issues of sustainability, contributed to the slowdown. Thereafter, in parallel with a shift to market-oriented structural reforms, growth gradually accelerated to 5.5% in 2004. Per capita income in purchasing power standards reached 51.4% of the EU25 average in 2004. HICP inflation has remained high, at 7.5% on average, over the last decade, reflecting mainly gradual increases in administered prices, but it is forecast to drop significantly in 2005. The labour market situation remains the country's major problem. As a consequence of accelerated enterprise restructuring in the late 1990s, the unemployment rate increased from 13.7% in 1994 to 18.2% in 2004 while total employment decreased by two percentage points over the same period. Also, the employment rates of young and elderly people (26.3% and 26.8% in 2004 respectively) are far below the EU 25 averages (36.8% and 41% in 2004 respectively).

The programme's macroeconomic scenario appears plausible. The programme projects real GDP growth at an average rate of 5.6% over the period 2005 to 2008. The programme foresees a gradual closing of the negative output gap (as recalculated by Commission services on the basis of the information provided in the programme according to the agreed methodology) which should turn positive in 2007 and stand at 0.8% of GDP in 2008. GDP growth is expected to increase from 5.1% in 2005 to 5.4% in 2006 and 6.1% in 2007, as net exports would provide an increasing impetus to GDP

⁴ The English version was submitted on 21 December 2005.

⁵ However, sections on growth implications of "major structural reforms" and on sensitivity of budgetary projections to different scenarios and assumptions are missing. The chapter on institutional features of public finances is divided into different sections than the model structure.

⁶ Note, however, that compulsory data on nominal effective exchange rate are missing in order to avoid pre-empting the setting of the euro conversion rate. The data on FISIM, differences between cash and accruals and general government expenditure by function for 2008 are also missing.

growth and complement a strong positive contribution of domestic demand. A stronger contribution to growth of the external sector seems plausible since new export capacities, created mainly by foreign direct investment (FDI) in the automobile sector, are planned to come on stream in 2006 and 2007. Strong domestic demand should be sustained thanks to positive wage and labour market developments as well as an attractive business environment and growing public investment supported by EU funds.

Covering the period until 2007, the Commission services' autumn 2005 forecast broadly confirms the growth projections of the programme as well as the underlying composition of growth. For 2008, the growth forecast of 5.6% exceeds both the estimate of potential output growth consistent with the programme's macroeconomic scenario (as recalculated by Commission services on the basis of the information provided in the programme according to the agreed methodology) and the Commission services' estimate for 2007, the last year of the forecast period.

The most important external assumptions underlying the programme's macroeconomic scenario include the exchange rate between USD and EUR, the development of oil prices, GDP growth in the EU-25 and growth of the main foreign markets. The external assumptions are broadly in line with the Commission services' forecast.

The programme predicts that the unemployment rate will drop by 1.8 percentage points to 16.2% in 2005 while employment should increase by 1.5%. Apart from strong employment growth, the exceptional reduction in the unemployment rate can be attributed to a decrease in the participation rate resulting from temporarily increased interest in early-retirement schemes associated with the pension reform introduced in 2005. Gradual increases in the retirement age should lead to a growing participation rate in the subsequent years. As a result, in the next three years the unemployment rate is projected to fall on average by 0.3 percentage points to 15.2% in 2008, while average annual employment growth is projected at 0.8% on the back of strong economic growth.

The programme forecasts real wage growth broadly in line with productivity growth over the programme horizon. Due to the backward-looking wage indexation real wage growth is estimated to be 1.6 percentage points above productivity growth in 2005 while it should remain below productivity growth for the rest of the programme period. HICP inflation is expected to increase to 3.6% in 2006 due to increases in administered prices induced by higher oil and natural gas prices. As these effects fade out inflation is projected to decrease to 2.0% in both 2007 and 2008, despite a forecasted positive output gap in those years. Part of the benign inflation outlook is due to a further nominal appreciation of the koruna expected by the authorities. However, compared to the Commission services' forecast, the programme expects higher oil prices (65USD/barrel in 2006 and 62.5USD/barrel in 2007 compared to 61.4USD/barrel in 2006 and 60.3USD/barrel in 2007). As inflation already fell from 8.4% in July 2004 to 2.1% in August 2005 due to the fading-out of increases in administered prices the Slovak economy seems to be able to withstand potential second-round effects. The programme's inflation projections thus seem plausible although the recently announced further upward adjustments of some regulated prices of energy at the beginning of 2006 represent an upside risk.

The estimate of potential output growth consistent with the programme's macroeconomic scenario (as recalculated by Commission services on the basis of the information provided in the programme according to the agreed methodology) is broadly in line with

the Commission service's estimate based on the autumn 2005 forecast. The largest contribution is expected from total factor productivity.

The new update projects net borrowing vis-à-vis the rest of the world to increase to 4.8% in 2005 due to the deterioration in the trade balance as well as in the balance of primary incomes and transfers driven by increased borrowing of the private sector. The deterioration in the trade deficit is partly caused by imports of investment goods linked to FDI. The new production capacities should enhance Slovakia's export performance and thus lead to a gradual improvement in the external balance throughout the programme period. The downside risks are related to the uncertainty about the import intensity of the new production facilities.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	5.1	5.1	5.5	5.4	6.3	6.1	5.6
<i>Contributions:</i>							
- Final domestic demand	5.3	5.1	5.1	5.0	4.4	4.9	3.8
- Change in inventories	0.5	0.3	-0.6	-0.2	-1.5	-2.2	0.4
- External balance on g&s	-0.7	-0.2	0.9	0.6	3.4	3.3	1.4
Output gap ¹	-1.3	-1.6	-0.9	-1.1	0.2	0.1	0.8
Employment (% change)	1.8	1.5	0.9	0.8	0.8	0.7	0.8
Unemployment rate (%)	16.7	16.2	16.2	15.7	15.8	15.5	15.2
Labour productivity growth (%)	3.2	3.4	4.5	6.4	5.4	3.5	4.1
HICP inflation (%)	2.9	2.9	3.6	3.6	2.1	2.0	2.0
GDP deflator (% change)	2.7	2.8	3.1	2.8	2.8	1.6	1.2
Compensation of employees (% change)	10.2	8.2	7.5	6.0	6.8	6.5	6.7
External balance (% of GDP)	-6.2	-4.8	-5.7	-4.4	-3.3	-1.9	-1.3
<i>Note:</i>							
¹ In percent of potential GDP, with potential GDP growth as reported in Table 2 below.							
<i>Source:</i>							
Commission services' autumn 2005 economic forecasts (COM); convergence programme update (CP)							

Table 2: Sources of potential output growth

	2005		2006		2007		2008
	COM	CP ²	COM	CP ²	COM	CP ²	CP ²
Potential GDP growth ¹	4.8	4.8	5.1	4.8	5.1	4.9	4.8
<i>Contributions:</i>							
- Labour	0.5	0.3	0.5	0.2	0.5	0.2	0.2
- Capital accumulation	1.7	1.7	1.8	1.8	1.8	1.9	1.8
- TFP	2.8	2.8	2.9	2.8	3.0	2.8	2.8
<i>Notes:</i>							
¹ based on the production function method for calculating potential output growth							
² Commission services' calculations on the basis of the information in the programme							
<i>Source:</i>							
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations							

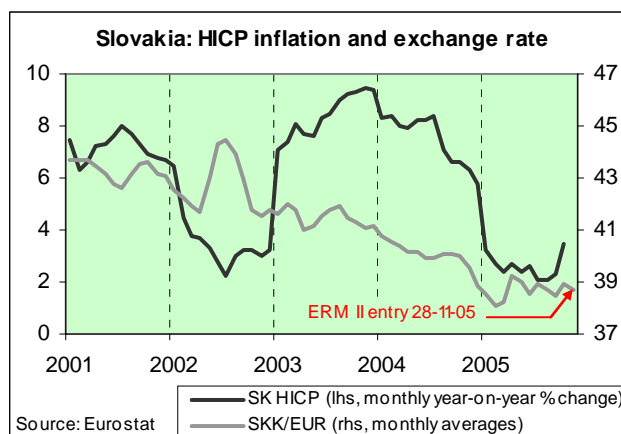
3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Since 1 January 2005 the National Bank of Slovakia has defined the conduct of its monetary policy as "inflation targeting in the conditions of ERM II". The new strategy based on binding inflation targets is intended to increase the transparency of monetary policy decisions and to contribute to a more forward-looking wage setting process. The

inflation targets are defined as an end-year annual rate of HICP inflation of 3.5 percent ± 0.5 percentage points in 2005; below 2.5 percent in 2006; and below 2 percent in 2007 and 2008.

The 2005 convergence programme confirmed 1 January 2009 as the Slovak target date for euro area entry. As of 28 November 2005, Slovakia started to participate in the ERM II mechanism with a central rate of 38.455 SKK/EUR and a standard fluctuation band of ± 15 percent.

2005 saw a quick fall in headline inflation rates, with average HICP inflation between January and October 2005 easing to 2.6 percent compared with 7.5 percent in 2004. The main reasons include a significantly lower adjustment of regulated prices at the beginning of the year and a continuous year-on-year nominal exchange rate appreciation, contributing to decreasing prices of non-energy



industrial goods and of processed food. Following an upward adjustment of regulated prices of energy, HICP growth accelerated again in October to 3.5 percent. The convergence programme expects the average 2005 HICP inflation rate to be 2.9 percent and end-year HICP year-on-year change for 2005 is forecast at 4.2 percent, slightly above the upper range of the inflation target.

Following a period of sustained appreciation between mid-2002 and February 2005 in which the koruna gained nearly 15 percent against the euro, the koruna depreciated in March-April 2005 by around 6 percent. This depreciation was triggered by a general trend movement across the central European region, which lasted until the beginning of May. The subsequent movements of the koruna were characterized by higher volatility alongside a very slow appreciation trend. Most recently, following ERM II entry on 28 November, the koruna strengthened by about 1.5 percent and stabilized at between 1 and 2 percent above the central rate during the first weeks of ERM II participation.

In the context of decreasing inflation coupled with nominal appreciation, the National Bank of Slovakia has continued to lower interest rates. Following a cumulative 200 basis points cut in 2004, the NBS cut the repurchase rate by another 100 basis points in February 2005 to the current level of 3 percent. Money market interest rates followed the policy rate cuts, although the spread to the corresponding three-month market rates in the euro area occasionally narrowed well below the 100 basis points spread on policy rates due to market expectations of further cuts and specific liquidity conditions. As expectations of further rate cuts were easing, spreads on market rates rebounded in mid-2005 and grew from a low of 15 basis points in March 2005 to around 80 basis points in November. At the end of November, the currency appreciation following ERM II entry led to a downward revision of markets' expectations of an imminent increase in policy rates. This, together with the ECB decision to increase euro area key policy rates, contributed to a recent decrease in the money market interest rate differential against the euro area.

Long-term interest rates significantly decreased at the end of 2004 and in the first half of 2005 and approached the level of long-term interest rates in the euro area compared to a spread of around 100 basis points in 2003 and 2004. Factors included falling headline inflation rates, policy rates cuts and an improving outlook as far as euro adoption is concerned. As the recent increase in Slovak long-term interest rates outpaced that of the euro area, the spread widened somewhat in the last quarter of 2005.

4. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous convergence programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

4.1. Targets in successive programmes and implementation in 2005

It should be noted that Slovakia uses the transition period for the implementation of the Eurostat decision of 2 March 2004 on the classification of funded second-pillar pension schemes. The new update of the convergence programme broadly confirms the adjustment path for the general government balance established in the previous programmes. The target for 2007 is somewhat more ambitious in order to reach the deficit target of 3.0% of GDP (including the costs of the pension reform) in the face of the higher-than-expected costs of the pension reform.

The general government deficit for 2005 is estimated at 4.1% of GDP (net of the pension reform costs) but a comparison with previous convergence programmes is not straightforward because it includes a cancellation of some developing countries' debt amounting to about 0.8% of GDP. Without the debt cancellation the deficit in the new update of the programme is estimated at around 3.3% of GDP which is slightly lower than foreseen in the previous update (3.4% of GDP). This positive development is, however, mainly driven by lower-than-expected interest expenditure. The primary deficit (1.5% of GDP excluding debt cancellation of 0.8 % of GDP) is estimated to be higher than projected in the previous programme (1.0% of GDP) as some of the financial resources that were freed are being used to cover other unbudgeted public expenditures like state aid to new investors in the automobile sector and increases in government infrastructure compensating for a lower absorption of EU funds.

Furthermore, real GDP growth in 2005 is according to the new update expected to be higher (5.1%) than in the previous programme (4.5%) suggesting additional room for deficit reduction. However, an over-estimation of social contributions in the previous programme (13.5% of GDP compared to 13.1% of GDP in the most recent update) offsets positive developments in other general government revenues. The estimates of social contributions have now been corrected for the whole programming period.

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008
General government balance (% of GDP)	CP Dec 2005	-3.2	-4.1	-2.9	-1.6	-1.3
	CP Nov 2004	-3.8	-3.4	-2.9	-1.9	n.a.
	<i>CP May 2004</i>	<i>-4.0</i>	<i>-3.4</i>	<i>-3.0</i>	<i>-2.0</i>	<i>n.a.</i>
	COM Nov 2005	-3.1	-4.1	-3.0	-2.5	n.a.
General government expenditure (% of GDP)	CP Dec 2005	38.9	41.1	39.8	38.8	37.7
	CP Nov 2004	39.1	40.4	39.8	38.8	n.a.
	<i>CP May 2004</i>	<i>41.5</i>	<i>41.8</i>	<i>40.9</i>	<i>39.6</i>	<i>n.a.</i>
	COM Nov 2005	40.5	41.2	39.3	38.3	n.a.
General government revenues (% of GDP)	CP Dec 2005	35.7	37.0	36.9	37.1	36.4
	CP Nov 2004	35.3	37.1	36.9	36.9	n.a.
	<i>CP May 2004</i>	<i>37.4</i>	<i>38.4</i>	<i>37.8</i>	<i>37.6</i>	<i>n.a.</i>
	COM Nov 2005	37.3	37.0	36.3	35.8	n.a.
Real GDP (% change)	CP Dec 2005	5.5	5.1	5.4	6.1	5.6
	CP Nov 2004	5.0	4.5	5.1	5.4	n.a.
	<i>CP May 2004</i>	<i>4.1</i>	<i>4.3</i>	<i>5.0</i>	<i>4.7</i>	<i>n.a.</i>
	COM Nov 2005	5.5	5.1	5.5	6.3	n.a.

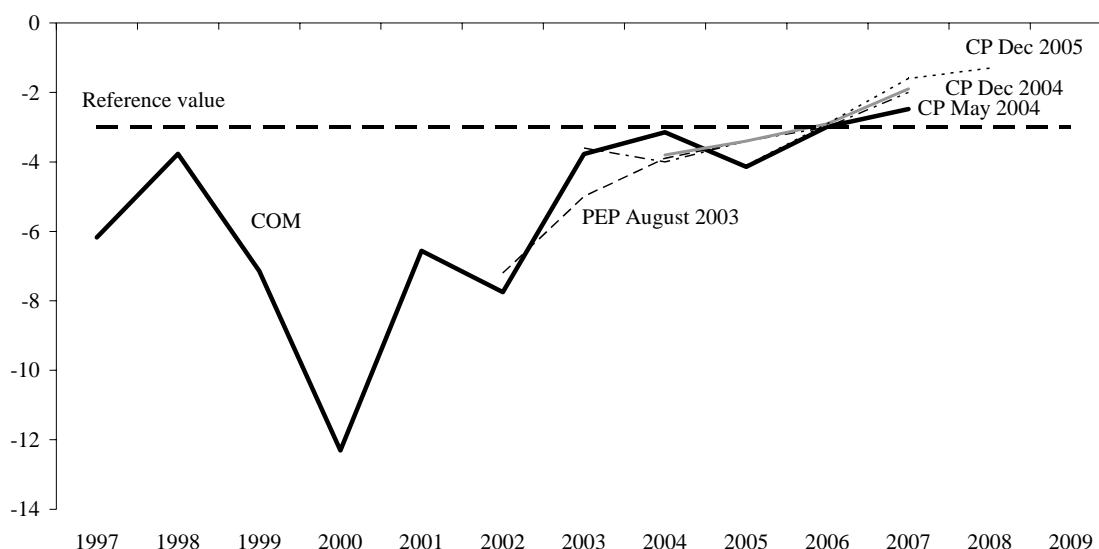
Note:

¹The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. See Table 4 for the quantification of this effect on the general government balance in the most recent update.

Source:

Convergence programmes (CP) and Commission services' autumn 2005 economic forecasts (COM)

Figure 1: General government balance projections in successive convergence programmes (% of GDP)¹



Source: Commission services' autumn 2005 forecast (COM) and successive convergence programmes

¹Excluding the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007

Box 1: The excessive deficit procedure for Slovakia

On 5 July 2004 the Council decided that an excessive deficit existed in Slovakia. At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007. 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, based on current information and 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.

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The programme firstly aims at reducing the deficit to below the 3% of GDP reference value by 2007 (including the costs of the pension reform), in line with the Council recommendation under Article 104(7) from 5 July 2004. Secondly, it aims at achieving a nominal deficit-to GDP ratio of 1.3% in 2008, the final year of the programme period. Thirdly, the medium-term objective of -0.9% of GDP is planned to be reached by 2010.

The planned fiscal consolidation is back-loaded, mainly concentrated in 2007. The back-loading of the fiscal consolidation required to reach the 2007 deficit target of 3.0% of GDP (including the costs of the pension reform) has grown stronger in view of higher estimates of pension reform costs. The deficit target for 2006 remained unchanged.

The general government deficit is projected to decrease from 3.3% of GDP (excluding debt cancellations amounting to 0.8 % of GDP) in 2005 to 2.9% in 2006, then decline sharply to 1.6% of GDP in 2007 and afterwards to fall to 1.3% of GDP in 2008. The profile of the primary balance is similar. It is planned to improve from -2.3% of GDP (-1.5% of GDP excluding debt cancellations amounting to 0.8 % of GDP) in 2005 to 0.7% of GDP in 2008.

A large effort will have to be made in the two years beyond the end of the programme period to reach the medium-term objective. As the costs of the pension reform are estimated at 1.4% of GDP in 2008 the budget deficit would have to be cut by around 1.8% of GDP between 2008 and 2010 to meet the medium-term objective (including the costs of the pension reform) of -0.9% of GDP in 2010 (assuming that the output gap is closed by 2010 and, in consequence, that the actual balance is equal to the MTO).

Compared with the previous programme, the new update broadly confirms the planned adjustment against a more favourable macroeconomic scenario. An upward revision in GDP growth estimates in the new update is counter-balanced by an upward revision of the costs of the pension reform. While the 2007 deficit target (net of the costs of the pension reform) has been adjusted downward to reflect these developments, the 2006 deficit target has remained unchanged despite an increase in the 2006 GDP growth estimate. The path of fiscal consolidation thus would seem to be somewhat less ambitious and more back-loaded vis-à-vis the previous programme.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	Change: 2008-2005
Revenues	35.7	37.0	36.9	37.1	36.4	-0.6
<i>of which:</i>						
- Taxes revenues	18.0	17.8	17.6	17.5	17.4	-0.4
- Social contributions	12.8	13.1	13.2	13.0	12.8	-0.3
- Other (residual)	4.9	6.1	6.1	6.6	6.2	0.1
Expenditure	38.9	41.1	39.8	38.8	37.7	-3.4
<i>of which:</i>						
- Primary expenditure	36.7	39.3	37.9	36.9	35.8	-3.5
<i>of which:</i>						
Consumption ¹	12.5	12.6	12.6	11.9	11.6	-1.0
Transfers & subsidies	20.9	21.7	21.1	20.9	20.4	-1.3
Gross fixed capital formation	2.7	2.7	2.0	1.5	1.3	-1.4
Other (residual)	0.6	2.3	2.2	2.6	2.5	0.2
- Interest expenditure	2.2	1.8	1.9	1.9	1.9	0.1
General government balance (GGB)	-3.2	-4.1	-2.9	-1.6	-1.3	2.8
- <i>excluding second-pillar pension scheme</i> ²	-3.2	-4.9	-4.2	-3.0	-2.7	1.2
Primary balance	-1.0	-2.3	-1.0	0.4	0.7	3.0
One-off and other temporary measures	0.0	0.8	0.0	-0.1	0.0	-0.8
GGB excl. one-off & other temporary measures	-3.2	-3.3	-2.9	-1.7	-1.3	2.0
Note:						
¹ Expenditure on wages and goods and services						
² This shows the general government balance as it will be after the Eurostat decision of 2 March 2004 on the classification of funded pension schemes has been implemented, which needs to be done by the time of the spring 2007 notification.						
<i>Source:</i>						
<i>Convergence programme update; Commission services' calculations.</i>						

4.2.2. The composition of the budgetary adjustment in the programme

In nominal terms, the fiscal adjustment is expected to be mainly achieved via a reduction of expenditure. The programme envisages general government expenditure to decrease by 3.4 percentage points between 2005 and 2008 (by 2.6 percentage points if the debt cancellations of 0.8% of GDP in 2005 are disregarded). Gross fixed capital formation is foreseen to decline by 1.4 percentage points, subsidies and transfers by 1.3 percentage points and government consumption by 1 percentage point. A decrease in the expenditure on gross fixed capital formation is accompanied by an increase in capital transfers (from 1.5% of GDP in 2005 excluding debt cancellations amounting to 0.8 % of GDP to 2.4% of GDP in 2008) and it is linked to the creation of the National Motorway Company on 1 February 2005 which is classified outside the general government sector.⁷

Net of debt cancellations, general government expenditures are projected to decrease by only 0.5% of GDP between 2005 and 2006 despite strong GDP growth. Spending increases will need to be resisted better in the following two years for the foreseen 2.1 percentage point decrease in general government expenditure to be realised.

General government revenues are estimated to remain broadly stable until 2007 and then to decrease by 0.7% of GDP in 2008 mostly due to a drop in other revenues. The

⁷ Judging from its business plan, the cash deficit of the National Motorway Company (covered through bank loans) could be around 0.4%, 0.4% and 0.2% of GDP in 2005, 2006 and 2007 respectively.

budgetary impact of the classification of the funded second-pillar pension scheme outside the general government sector (which has to be implemented by the time of the spring 2007 notification) is estimated at 0.8%, 1.3%, 1.4% and 1.4% of GDP in 2005, 2006, 2007 and 2008 respectively.

Box 2: The budget for 2006

The 2006 budget was approved by the parliament on 13 December 2005. The budget targets a nominal general government deficit of 2.9% of GDP.

Planned increases in public expenditure largely offset a favourable growth performance as well as declining interest payments, preventing a more significant fiscal consolidation. The highest spending increases are planned in the areas of environmental protection, education, research and development (i.e. the priority areas identified in the National Reform Programme) while only modest increases are foreseen for public transport, justice and interior affairs. On the revenue side, the main measures consist of the restriction of child tax allowances and increases in taxes on cigarettes and alcohol as well as of some administrative fees.

4.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The update sets an MTO of -0.9% of GDP, which it aims to achieve by 2010. Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance would improve from around -2¾% of GDP in 2005 to about -1½% of GDP in 2008. The structural balance is thus planned to improve on average by 0.4% of GDP per year. The consolidation effort is back-loaded. It is mainly concentrated in 2007 when the output gap implied by the macroeconomic outlook of the programme is estimated to be close to zero but with cyclical conditions clearly expected to improve compared to the previous year.

Table 5: Output gaps, cyclically-adjusted and structural balances

% of GDP	2004		2005		2006		2007		2008		Change: 2008-2005 CP ¹
	COM	CP ¹	COM	CP ¹	COM	CP ¹	COM	CP ¹	CP ¹		

Gen. gov't balance	-3.1	-3.2	-4.1	-4.1	-3.0	-2.9	-2.5	-1.6	-1.3	2.8
One-offs ²	0.0	0.0	-0.8	-0.8	0.0	0.0	0.0	0.1	0.0	-
Output gap ³	-1.5	-1.9	-1.3	-1.6	-0.9	-1.1	0.2	0.1	0.8	-
CAB ⁴	-2.7	-2.6	-3.8	-3.6	-2.7	-2.6	-2.5	-1.6	-1.5	2.1
change in CAB	0.4	0.5	-1.0	-1.0	1.0	1.0	0.2	1.0	0.1	-
CAPB ⁴	-0.4	-0.4	-1.5	-1.8	-0.5	-0.7	-0.3	0.3	0.4	2.2
Structural balance ⁵	-2.7	-2.6	-3.0	-2.8	-2.7	-2.6	-2.5	-1.7	-1.5	1.3
change in struct. bal.	0.4	0.5	-0.2	-0.2	0.2	0.2	0.2	0.9	0.2	-
Struct. prim. bal. ⁶	-0.4	-0.4	-0.7	-1.0	-0.5	-0.7	-0.3	0.2	0.4	1.4
Notes:										
¹ Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme										
² One-off and other temporary measures										
³ In percent of potential GDP. See Table 1 above.										
⁴ CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.										
⁵ CAB excluding one-off and other temporary measures										
⁶ Structural primary balance = CAPB excluding one-off and other temporary measures										
<i>Source:</i>										
<i>Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations</i>										

4.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

4.3.1. Appropriateness of the programme's medium-term objective

As the programme's MTO (-0.9% of GDP) is more demanding than the minimum benchmark, its achievement should fulfil the aim of providing a safety margin. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

4.3.2. Risks attached to the budgetary targets

As reported in Table 6, the observed elasticity of tax revenues to GDP in the programme for 2006 and 2007 is somewhat above both the OECD ex-ante elasticity and the observed elasticity in the Commission services' autumn 2005 forecast. The difference to the OECD ex-ante elasticity is however only marginal in 2007 while the higher elasticity in 2006 should reflect the measures included in the 2006 budget such as the restriction of child tax allowances and increases in taxes on cigarettes and alcohol as well as in some administration fees not fully reflected in the Commission services' forecast.

In 2007, the planned fiscal adjustment builds upon revenues from strong GDP growth coupled with the commitment announced in the medium-term budgetary framework to keep a tight rein on nominal expenditure increases. According to the update the medium-term budgetary framework approved by the government is exclusively based on current legislation and on government approved legislative changes. However, the programme is

not very explicit about the measures that would ensure the achievement of the 2007 deficit target.⁸

The current government has so far overachieved the budgetary targets set in the previous programmes: after a lower-than-expected 2004 deficit a better-than-planned result is also projected for 2005 (if debt cancellations of 0.8 % of GDP are excluded). With the parliamentary elections scheduled for autumn 2006 the question arises what will be the position of a future government towards these targets especially as the fiscal consolidation is back-loaded and concentrated in 2007. Overall, the risks to the budgetary targets of the programme appear broadly balanced.

Table 6: Assessment of tax projections

	2006		2007		2008	p.m.:
	COM	CP	COM ²	CP	CP	OECD ¹
Total taxes						
Change in tax-to-GDP ratio	-0.4	-0.1	-0.7	-0.2	-0.3	/
<i>Difference</i>		0.3		0.5	/	/
<i>of which³: - elasticity component</i>		0.6		0.2	/	/
<i>- composition component</i>		-0.2		0.3	/	/
p.m. Observed elasticity to GDP	0.8	1.0	0.7	0.9	0.8	0.88
Notes:						
¹ OECD ex-ante elasticity relative to GDP						
² On a no-policy change basis						
³ The decomposition is explained in Annex 4						
Source:						
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)						

4.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

Taking account of the balance of risks to the budgetary targets Slovakia is on track to correct its excessive deficit by the deadline set by the Council. It broadly conforms to the deficit reduction path specified by the Council. An increase in the deficit projection for 2005 results from the one-off effect of debt cancellations amounting to 0.8% of GDP. However, the budgetary strategy outlined in the programme may not be sufficient to ensure that the programme's MTO (-0.9% of GDP) will be reached in 2010. Including the impact of the Eurostat decision of 2 March 2004 on the classification of funded second-pillar pension schemes (which has to be implemented by the time of the spring 2007 notification) the structural balance based on the Commission services' calculations on the basis of the programme is estimated at -2.9% of GDP in 2008 (-1.5% of GDP if pension reform costs are excluded). As a result, a safety margin against breaching 3% of GDP deficit limit will not be provided within the programme period. Furthermore, substantial additional consolidation measures would be needed to reach the programme's MTO by 2010.

⁸ Only a 50% decrease in government expenditure on housing subsidies over the period 2002-2008 and an annual 3% decrease in the employment in the education sector are specifically mentioned.

The planned improvement in the structural balance of around ¼% of GDP in 2008 is below 0.5% of GDP benchmark set in the Stability and Growth Pact, when cyclical conditions, as measured by the output gap implied by the macroeconomic scenario of the programme, are expected to be rather favourable.

Table 7: Assessment of tax elasticities

	2006		2007	
	COM (observed)	ex-ante ¹	COM ² (observed)	ex-ante ¹
Total taxes				
Change in tax-to-GDP ratio	-0.4	-0.3	-0.7	-0.3
<i>Difference</i>				
<i>of which³: - elasticity component</i>		-0.1		-0.4
<i>- composition component</i>		-0.2		-0.1
		0.1		-0.2
p.m.: Elasticity to GDP	0.8	0.9	0.7	0.9
Notes:				
¹ Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD				
² On a no-policy change basis				
³ The decomposition is explained in Annex 4				
Source:				
<i>Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)</i>				

The strategy for the general government balance outlined in the programme is broadly consistent with the 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.

4.4. Sensitivity analysis

The sensitivity analysis provided in the programme is not explicit about the underlying assumptions on how revenues and expenditure are projected to react to variations in economic variables. The analysis only reports how the overall general government balance is expected to react under different external assumptions. Specifically, a nominal 5% appreciation of the currency, a 3% decline in foreign demand and a 10USD increase in the per barrel price of oil are in the period from 2006 to 2010 expected to result into an average annual increase in the government deficit of 0.1%, 0.4% and 0.3% of GDP respectively. A permanent positive productivity shock of 0.5 percentage point per year is projected to lead to a decline of the average annual government deficit by 0.1% of GDP between 2006 and 2010.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2008 period; (ii) trend output based on the HP-filter⁹ and (iii) no policy response (notably, the expenditure level is as in the central

⁹In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

scenario¹⁰), reveal that, by 2008, the cyclically-adjusted balance is 0.5 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around ½ percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.¹¹

5. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

5.1. Debt developments in the programme

The debt ratio is projected to fall quite significantly by 8.8 percentage points to 33.7% of GDP in 2005.¹² This large fall – even larger than expected in the Commission services' autumn 2005 forecast – is mainly because of a reduction in liquidities (deposits) managed by a new agency responsible for managing government debt (ARDAL). The reduction in liquid assets is recorded as a component of the stock-flow adjustment.¹³

The debt ratio is then expected to hover around 35 to 36% of GDP (35.5% in 2006, 35.2% in 2007 and 36.2% in 2008), as a result of a small primary balance and a debt-decreasing snow-ball effect (as the effective interest rate is below GDP growth). The stock-flow adjustment is expected to remain positive over the programme horizon in spite of some privatisation receipts expected for 2006.

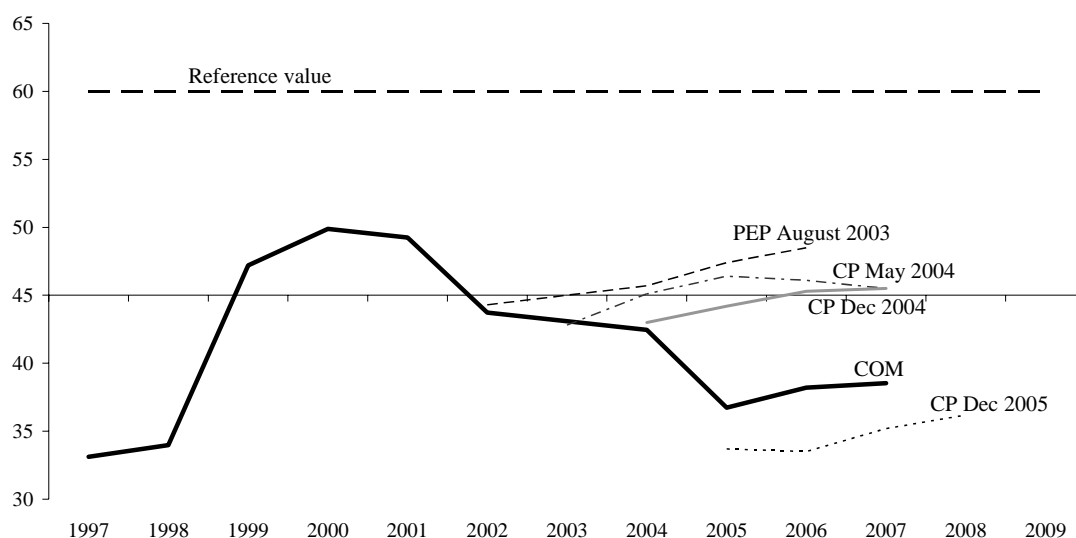
¹⁰The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

¹¹Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

¹² The programme presents the general government gross debt ratio including the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes. Therefore, deficit and debt data in the programme are somewhat inconsistent.

¹³ The government debt level may also decrease if the risk assessment of state guarantees already included in the debt improves due to privatisation of a state-owned company. Such transactions are estimated to have a debt-reducing impact of 0.8% of GDP in 2005.

Figure 2: Debt projections in successive convergence programmes (% of GDP)¹



Source: Commission services' autumn 2005 forecast (COM) and successive convergence programmes

¹ Including the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007

Table 8: Debt dynamics

	average	2005		2006		2007		2008
	2000-2004	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio²	45.8	36.7	33.7	38.2	35.5	38.5	35.2	36.2
Change in debt ratio (1 = 2+3+4)	-1.1	-5.7	-8.8	1.5	1.8	0.3	-0.3	1.0
<i>Contributions¹:</i>								
- Primary balance³ (2)	3.4	1.9	2.3	0.8	1.0	0.2	-0.3	-0.6
- “Snow-ball” effect (3)	-0.7	-0.8	-1.3	-0.7	-0.7	-1.0	-0.7	-0.3
- Interest expenditure	3.3	2.3	1.8	2.2	1.9	2.2	1.9	1.9
- Real GDP growth	-1.7	-2.0	-2.0	-1.9	-1.7	-2.2	-2.0	-1.8
- Inflation (GDP deflator)	-2.3	-1.0	-1.1	-1.1	-0.9	-1.0	-0.6	-0.4
- Stock-flow adjustment⁴ (4)	-3.8	-6.8	-9.8	1.4	1.5	1.1	0.7	1.9
- Cash/accruals	-0.1							
- Accumulation of financial assets	-3.3							
- of which: Privatisation proceeds	-4.6							
- Valuation effects & residual adj.	-0.4							

Notes:

¹The 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.

²This shows general government gross debt as it will be after the Eurostat decision of 2 March 2004 on the classification of funded pension schemes has been implemented, which needs to be done by the time of the spring 2007 notification.

³Contrary to Table 4 in Annex 1 the primary balance projections for 2007 and 2008 are presented here excluding the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification.

⁴From the factors affecting the stock-flow adjustment only privatisation proceeds of 2,0% of GDP in 2006 are explicitly stated in the programme. All the other factors are aggregated in the category “Valuation

effects & other”.

Source:

Convergence programme update (CP); Commission services’ autumn 2005 economic forecasts (COM); Commission services’ calculations

5.2. Assessment

The Commission services’ forecast projects the debt ratio to fall by 5.7 percentage points to 36.7% of GDP in 2005 and then to gradually increase to 38.5% of GDP by 2007. The difference with respect to the programme’s projections stems mainly from the different estimates of the reduction in liquid financial assets (a component of the stock-flow adjustment), especially in 2005. The divergent deficit projections for 2007 also explain the differences.

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. No new state guarantees have been granted since 2003. Higher-than-expected privatisation proceeds constitute an upside risk.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

A comprehensive reform of the tax system was introduced in 2004. The reform was not revenue neutral as it led to a revenue shortfall of 0.5% of GDP in that year in line with the projection of the 2004 budget (see Box 4). A positive effect on public finances is expected over the longer run as the tax reform should stimulate investment and improve incentives to work, and thus boost growth.

After the 2004 tax reform a pension reform was launched in 2005. This reform affects the distribution of social contributions by redirecting 9 % of gross wages from the first pillar to a funded (second) pension pillar. In the November 2004 update of the convergence programme the budget shortfall due to transfers to the second pillar was estimated at 0.4%, 1.0 % and 1.1% of GDP in 2005, 2006 and 2007 respectively. Due to a higher-than-expected appeal to the general public, the new update revises the projected revenue shortfall upward to 0.8% in 2005, 1.3% in 2006, and 1.4% in both 2007 and 2008.

The 2007 budget balance is expected to benefit from the abolition of anonymous saving accounts held by individuals in commercial banks, which will yield 0.1 % of GDP. The 2006 budget as well as the 2006-2008 budgetary framework foresee significant increases in spending on education and research and development, and thus reflect adequately the priorities set in the National Reform Programme submitted on 14 October 2005. The measures described above are also consistent with the broad economic policy guidelines in the area of public finances.

Box 3: The first year of the flat tax rate in Slovakia

The 2004 tax reform consisted of 5 key measures:

- introduction of the flat 19% personal¹⁴ and corporate income tax rate (previously, the corporate income tax rate was 25% and personal income tax rates ranged from 10 to 38%)
- unification of the VAT rates at 19% (previously 2 rates, 20% and 14%)
- abolition of the tax on dividends
- abolition of inheritance and gift taxes as well as of taxes on transfers of property estates
- elimination of almost all tax exemptions, deductions and special tax regimes.

The reform decreased direct taxes while it increased indirect taxes. When preparing the 2004 budget Ministry of Finance forecast correctly the direction of changes, but not the amounts. As shown in Table 1 direct tax revenues in 2004 were lower than in the case of no reform but they turned out to be higher than foreseen in the 2004 budget. The opposite result applies to indirect taxes. All in all, the tax reform was revenue neutral as it led to a revenue shortfall of 0.5% of GDP; this was correctly forecast in the budget 2004.

Table 1 – Impact of the tax reform on public finances, preliminary results for 2004

% of GDP ESA 95	Budget	Actual revenues	Potential revenues in case of no reform	Difference between reality and expectations	Difference between no reform and reform
	1	2	3	2-1	2-3
Individual income tax	2,1	2.6	3.5	0.6	-0.8
Corporate income tax	1,8	2.5	3.1	0.7	-0.6
Advanced tax payments	0.9	0.4	0.6	-0.5	-0.2
Value-added tax	8,8	7.9	7.1	-0.9	0.8
Consumption taxes	3,3	3.4	3	0	0.3
Property taxes	0,1	0.2	0.2	0.1	0
Local taxes	0,6	0.6	0.6	0	0
Other	0,3	0.3	0.3	0	0
Total	17,9	18.0	18.4	0*	-0.5*

*Discrepancy

s due to rounding

Source: Ministry of Finance

Overall actual tax revenues in 2004 were SK 6.4bn higher than foreseen in the budget but as nominal GDP was also SK 32.3bn higher than anticipated the tax revenues share of GDP turned out to be broadly in line with the budget.

It is still too early to assess the macroeconomic impact of the reform. Although the short term fiscal impact

¹⁴ As there is still a level of non-taxable income, even this flat tax is progressive.

the tax reform was negative (Table 1, bottom right corner), the Financial Policy Institute of the Slovak Ministry of Finance expects it to have a positive effect over the longer run as the reformed system should stimulate incentives to work and investment and thus boost growth.

7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Slovakia's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance¹⁵ remains unchanged at the 2005 level throughout programme period.

On the basis of information in the programme, age-related expenditure is foreseen to increase by 2.5 % of GDP between 2008 and 2050, to which public pension expenditures contribute 2.1 % of GDP (see table A2 in the Annex). The Commission's analysis is based on the set of government expenditure items covered by the common projections carried out by the Economic Policy Committee¹⁶. In addition to these expenditure items, Slovakia's programme includes a projected decrease in child benefits.

The gross debt ratio is projected to be on an explosive path in the "2005" scenario and would breach the 60% of GDP reference value in the late 2020s. If, however, the budgetary consolidation over the medium-term planned in the convergence programme materialises, the gross debt-to-GDP ratio would remain below the 60% of GDP reference value up to around mid-2030s¹⁷ (see Table A4 in the Annex).

In the "2005" scenario, the sustainability gap (S1) that assures maintaining debt at 60% of GDP in 2050 would be 2.1% of GDP. The sustainability gap (S2) would be higher, at 3.6% of GDP, to respect the inter-temporal budget constraint.

According to both sustainability gaps, the impact of ageing is limited, in particular, thanks to the two-step¹⁸ pension reform enacted in recent years. However, the large

¹⁵ The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out. Moreover, the revenue side is also corrected for the impact of the switch to funded second-pillar pensions (see Box 5 in Annex 5); it therefore differs from the structural balance published in the medium-term analysis.

¹⁶ Namely, government expenditure on pension, health-care, education and unemployment benefits. Long-term care projections are however not available in the programme. Revenues and expenditure items not covered by the AWG common exercise are assumed to remain constant as a share of GDP over the projection period.

¹⁷ 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 should not be taken at face value.

¹⁸ Slovakia has reformed its pension system in 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 for future entitlements. They thereby prepared the ground for the second reform

structural government deficit, close to the Treaty threshold in 2005, prevents a rapid reduction of the debt. The need to consolidate the current budgetary position is therefore a priority.

This is reflected in the programme that includes a budgetary consolidation of 1.3% of GDP between 2005 and 2008. If it materialises, it would appreciably reduce both sustainability gaps, underlying the importance of budgetary consolidation to face the challenge posed by ageing population. The sustainability gaps would increase by around 1/4 % of GDP if the (budgetary or structural) adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

The S2 indicator translates into a required primary balance (RPB) of about 2¼% of GDP, significantly higher than the structural primary balance of -1% of GDP of the last year of the programme period¹⁹.

Table: value of the indicators

Value (of which)	Sustainability indicators and RPB					
	2005 Scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
	2,1	3,6	2,3	1,3	2,8	2,3
<i>initial budgetary position</i>	2,0	2,3		1,2	1,5	
<i>debt requirement in 2050</i>	-0,4	:		-0,4	:	
<i>future changes in budgetary position</i>	0,5	1,3		0,5	1,3	

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio²⁰. Derived from the S2, the RPB measures the average primary balance over the first five years of the projection period that that would satisfy the government's inter-temporal budget constraint. See the European Commission ((2005), European Economy, 'Public finances in EMU – 2005, Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

The macroeconomic data used in long-term projections are taken from the AWG commonly agreed assumptions. Increases in expenditure as projected in the programme are broadly similar to those of the latest available AWG projections, even though the coverage slightly differs for education and unemployment benefits. Long-term care projections are however missing in the programme and could account for some further increase in the projected age-related expenditure.

step, i.e. the introduction of a funded pension pillar ("2nd pillar") at the beginning of 2005. On the second step of the reforms, see Box 5.

¹⁹ The structural primary balance includes, in the long-term analysis, the revenue-decreasing impact of the switch to the funded second-pillar pension schemes (see Box 5). It therefore differs from the government deficit in the programme which includes revenue from the funded second-pillar pension schemes and from the structural primary balance used in the assessment of the programme in the medium term.

²⁰ The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

By contrast, the programme includes national estimates for child benefits showing a decrease by 0.1 % GDP over the projection period. Moreover, the recently enacted health care reform may not lead to immediate expenditure savings but institute mechanisms that are conducive to cost containment in the future. Finally, the second step of the pension reform (switch to private pension schemes) has reduced long-term pressure on public expenditure although it entails a permanent decrease in revenue. The reform may not translate fully into the indicators (particularly S1) which may therefore underestimate the impact of the second step of the reform on long-term sustainability²¹.

* * *

²¹ According to the S2 indicator, the switch to funded second-pillar pension schemes should be broadly neutral with respect to the long-term sustainability of public finances when compared to the maintained decrease in revenue of 1.4% of GDP. It may however be the case that the new funded second-pillar pension scheme has not totally reached its steady state in 2050; cutting projections in 2050 could reduce the apparent impact of the reform as measured by S2.

The S1 indicator, which takes into account changes in the primary balance up to 2050, may not take fully into account the improvement of long-term sustainability; the S1 indicator may therefore underestimate the impact of the reform on long-term sustainability or, equivalently, overestimate the impact of ageing on long-term sustainability.

In addition to previous caveats, these calculations should be handled with care: because of the uncertainties regarding the share of incumbents that will actually opt for the new system which has been introduced in 2005, the impact on this reform on the revenue side presented in the programme may differ slightly with the coming results in EPC report.

Annex 1: Summary tables from the convergence programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	826.5	5.5	5.1	5.4	6.1	5.6
2. Nominal GDP	B1*g	1325.5	10.3	8.1	8.4	7.8	6.8
Components of real GDP							
3. Private consumption expenditure	P.3	416.4	3.5	5.2	4.5	4.8	4.4
4. Government consumption expenditure	P.3	158.8	1.1	1.8	4.2	2.9	3.0
5. Gross fixed capital formation	P.51	202.8	2.5	8.5	7.6	7.4	4.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	18.6	2.2	3.5	3.0	0.8	1.1
7. Exports of goods and services	P.6	806.3	11.4	7.5	9.6	16.0	10.5
8. Imports of goods and services	P.7	792.0	12.7	7.9	9.2	13.1	9.7
Contributions to real GDP growth							
9. Final domestic demand			2.7	5.1	5.0	4.9	3.8
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		3.6	0.3	-0.2	-2.2	0.4
11. External balance of goods and services	B.11		-0.8	-0.2	0.6	3.3	1.4

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008
		level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		1.604	4.6	2.8	2.8	1.6	1.2
2. Private consumption deflator		1.771	7.0	3.0	3.2	1.9	2.0
3. HICP		-	7.5	2.9	3.6	2.0	2.0
4. Public consumption deflator		1.623	6.4	4.1	3.3	1.7	1.8
5. Investment deflator		1.614	3.5	3.0	2.9	1.4	1.6
6. Export price deflator (goods and services)		1.263	-2.1	0.4	0.5	-0.2	0.1
7. Import price deflator (goods and services)		1.330	-1.7	1.5	0.3	-0.7	0.2

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons²²		2056	-0.3	1.5	0.8	0.7	0.8
2. Employment, hours worked ²³		3566895	1.9	1.6	-0.9	2.5	1.4
3. Unemployment rate (%)²⁴		18.0	0.6	-1.8	-0.5	-0.2	-0.3
4. Labour productivity, persons²⁵			5.9	3.5	4.6	5.3	4.7
5. Labour productivity, hours worked ²⁶			3.5	3.4	6.4	3.5	4.1
6. Compensation of employees	D.1	532111	7.7	8.2	6.0	6.5	6.7

²² Occupied population, domestic concept national accounts definition.

²³ National accounts definition.

²⁴ Harmonised definition, Eurostat; levels.

²⁵ Real GDP per person employed.

²⁶ Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-3.0	-4.8	-4.4	-1.9	-1.3
of which:						
- Balance on goods and services		-2.7	-3.8	-3.5	-1.0	-0.5
- Balance of primary incomes and transfers		-0.7	-1.4	-1.4	-1.3	-1.1
- Capital account		0.3	0.4	0.5	0.4	0.3
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	-3.2	-5.3	-4.9	-2.3	-1.6
3. Net lending/borrowing of general government	B.9	0.2	0.5	0.6	0.5	0.3
4. Statistical discrepancy		0.1	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-41776	-3.2	-4.1	-2.9	-1.6	-1.3
2. Central government	S.1311	-47477	-3.6	-4.0	-4.3	-3.1	-2.8
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	3185	0.2	-0.1	0.1	0.1	0.1
5. Social security funds	S.1314	2516	0.2	0.0	1.3	1.5	1.5
General government (S13)							
6. Total revenue	TR	495893	37.4	37.8	37.6	37.9	37.2
7. Total expenditure	TE ²⁷	537669	40.6	41.9	40.5	39.5	38.5
8. Net lending/borrowing	EDP B.9	-41776	-3.2	-4.1	-2.9	-1.6	-1.3
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	29607	2.2	1.8	1.9	1.9	1.9
pm: 9a. FISIM							
10. Primary balance	²⁸	-12169	-0.9	-2.3	-1.0	0.3	0.7
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		249529	18.8	18.6	18.3	18.3	18.2
11a. Taxes on production and imports	D.2	168110	12.7	12.8	12.6	12.4	12.2
11b. Current taxes on income, wealth, etc	D.5	81296	6.1	5.8	5.8	5.9	6.0
11c. Capital taxes	D.91	123	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	164550	12.4	11.9	12.0	11.9	11.7
13. Property income	D.4	21485	1.6	1.7	1.4	1.3	1.1
14. Other (14=15-(11+12+13))		60329	4.6	5.5	5.8	6.5	6.2
15=6. Total revenue	TR	495893	37.4	37.8	37.6	37.9	37.2
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) ²⁹		405409	30.6	29.9	29.8	29.5	29.3
Selected components of expenditure							
16. Collective consumption	P.32	184951	14.0	13.5	13.7	13.1	12.8
17. Total social transfers	D.62 + D.63	222583	16.8	17.0	16.8	16.4	16.1
17a. Social transfers in kind	P.31 = D.63	84072	6.3	6.4	6.3	6.3	6.2
17b. Social transfers other than in kind	D.62	138511	10.4	10.6	10.4	10.1	9.8
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	29607	2.2	1.8	1.9	1.9	1.9
19. Subsidies	D.3	29313	2.2	2.4	2.4	2.3	2.3
20. Gross fixed capital formation	P.51	33332	2.5	2.5	1.9	1.5	1.3
21. Other (21=22-(16+17+18+19+20))		37883	2.9	4.6	3.9	4.2	4.1
22=7. Total expenditure	TE ³⁰	537669	40.6	41.9	40.5	39.5	38.5
Pm: compensation of employees	D.1	118506	8.9	7.4	7.6	7.3	7.2

²⁷ Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

²⁸ The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

²⁹ Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

³⁰ Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2003	2008
1. General public services	1	5.2	
2. Defence	2	1.8	
3. Public order and safety	3	2.0	
4. Economic affairs	4	5.1	
5. Environmental protection	5	0.7	
6. Housing and community amenities	6	1.1	
7. Health	7	2.3	
8. Recreation, culture and religion	8	1.0	
9. Education	9	4.3	
10. Social protection	10	15.7	
11. Total expenditure (= item 7=26 in Table 2)	TE ³¹	39.2	

Table 4. General government debt developments

% of GDP	2004	2005	2006	2007	2008
1. Gross debt ³²	42.6	33.7	35.5	35.2	36.2
2. Change in gross debt ratio	-0.6	-8.9	1.9	-0.3	1.0
Contributions to changes in gross debt					
3. Primary balance ³³	0.9	2.3	1.0	1.1	0.8
4. Interest expenditure (incl. FISIM) ³⁴	2.2	1.8	1.9	1.9	1.9
5. Stock-flow adjustment	0.3	-9.9	1.2	-0.8	0.7
of which:					
- Differences between cash and accruals ³⁵					
- Net accumulation of financial assets ³⁶	-0.4	0.0	-2.0	0.0	0.0
<i>of which:</i>					
- privatisation proceeds	-0.4	0.0	-2.0	0.0	0.0
- Valuation effects and other ³⁷	0.7	-9.9	3.2	-0.8	0.7
p.m. implicit interest rate on debt ³⁸	5.7	4.6	6.2	5.8	5.9
Other relevant variables					
6. Liquid financial assets ³⁹	11.7	2.1	3.0	1.5	1.6
7. Net financial debt (7=1-6)	30.9	31.5	32.6	33.7	34.7

³¹ Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

³² As defined in Regulation 3605/93 (not an ESA concept).

³³ Cf. item 10 in Table 2.

³⁴ Cf. item 9 in Table 2.

³⁵ The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

³⁶ Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

³⁷ Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

³⁸ Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

³⁹ AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Real GDP growth (%)		5.5	5.1	5.4	6.1	5.6
2. Net lending of general government	EDP B.9	-3.2	-3.3	-2.9	-1.6	-1.2
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 + FISIM	-2.2	-1.8	-1.9	-1.9	-1.9
4. Potential GDP growth (%) (1)		5.4	5.1	5.0	6.2	5.8
contributions:						
- labour		0.5	0.5	0.5	0.5	0.5
- capital		0.7	0.9	1.2	1.3	1.5
- total factor productivity		4.2	3.7	3.3	4.4	3.8
5. Output gap		-0.1	-0.1	0.3	0.2	0.0
6. Cyclical budgetary component		0.0	0.0	0.1	0.0	0.0
7. Cyclically-adjusted balance (2-6)		-3.1	-3.3	-2.9	-1.6	-1.3
8. Cyclically-adjusted primary balance (7-3)		-0.9	-1.5	-1.0	0.3	0.7

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008
Real GDP growth (%)						
Previous update		5.0	4.5	5.1	5.4	
Current update		5.5	5.1	5.4	6.1	5.6
Difference		0.5	0.6	0.3	0.7	
General government net lending (% of GDP)	EDP B.9					
Previous update		-3.8	-3.4	-2.9	-1.9	
Current update		-3.2	-3.3	-2.9	-1.6	-1.3
Difference		0.6	0.1	0.0	0.3	
General government gross debt (% of GDP)						
Previous update		43.0	44.2	45.3	45.5	
Current update		42.6	33.7	35.5	35.2	36.2
Difference		-0.4	-10.5	-9.8	-10.3	

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
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Total expenditure		41.5	37.0	36.5	37.8	44.3
Of which: age-related expenditures		16.6	15.4	15.2	16.2	18.4
Pension expenditure		7.2	6.7	7.0	7.7	9.0
Social security pension		7.2	6.7	7.0	7.7	9.0
Old-age and early pensions		5.4	4.8	4.6	5.0	6.3
Other pensions (disability, survivors)		1.8	1.9	2.3	2.7	2.7
Occupational pensions (if in general government)		-	-	-	-	-
Health care		4.8	4.7	5.1	5.5	6.1
Long-term care (<i>this was earlier included in the health care</i>)		-	-	-	-	-
Education expenditure		3.9	3.3	2.6	2.6	2.7
Other age-related expenditures		0.8	0.7	0.5	0.4	0.6
Interest expenditure		1.8	1.8	1.5	1.8	6.1
Total revenue		37.3	36.4	36.4	36.4	36.4
Of which: property income		1.7	1.3	1.3	1.3	1.3
<i>of which: from pensions contributions (or social contributions if appropriate)</i>		12.3	11.2	11.0	10.9	10.8
Pension reserve fund assets		0.8	7.0	18.9	31.5	58.0
Of which: consolidated public pension fund assets (assets other than government liabilities)		0.0	0.0	0.0	0.0	0.0
Assumptions						
Labour productivity growth		3.1	4.2	3.3	2.7	1.7
Real GDP growth		5.1	5.3	3.3	2.0	0.3
Participation rate males (aged 20-64)		77.6	79.6	82.1	82.3	78.7
Participation rates females (aged 20-64)		64.7	67.1	73.5	73.8	69.1
Total participation rates (aged 20-64)		71.1	73.3	77.8	78.0	73.9
Unemployment rate		16.4	15.2	9.7	7.0	7.0
Population aged 65+ over total population		11.6	12.3	16.3	20.8	29.3

Table 8. Basic assumptions

	2004	2005	2006	2007	2008
Short-term interest rate^{40,41} (annual average)	2.1	2.1	2.4	2.9	3.6
Long-term interest rate (annual average)	4.1	3.3	3.4	3.8	4.8
USD/€exchange rate (annual average) (euro area and ERM II countries)	1.2	1.3	1.2	1.2	1.2
Nominal effective exchange rate					
(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)	-	-	-	-	-
World excluding EU, GDP growth	5.9	5.2	5.0	4.7	4.5
EU GDP growth	2.4	1.5	2.1	2.4	2.3
Growth of relevant foreign markets	2.4	2.1	2.6	3.1	2.8
World import volumes, excluding EU	14.0	8.8	8.8	8.4	8.2
Oil prices, (Brent, USD/barrel)	37.8	57.3	65.0	62.5	60.0

⁴⁰ If necessary, purely technical assumptions.

⁴¹ Short-term and long-term interest rate projections for the euro-zone.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the “format” requirements of the code, whereas point (iv) refers to its “content” requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December ¹ .	X		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		However, sections on growth implications of “major structural reforms” and on sensitivity of budgetary projections to different scenarios and assumptions are missing. Ch.7 – different subsections
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.		X ⁴²	
The programme provides all optional information in these tables.		X	<i>Table 3 - General government expenditure by function for 2008</i> <i>Table 4 - Differences between cash and accruals</i>
The concepts used are in line with the European system of accounts (ESA).	X		

⁴² Note, however, that compulsory data on nominal effective exchange rate are missing in order to avoid pre-empting the setting of the euro conversion rate. The data on FISIM are also missing.

Guidelines in the new code of conduct	Yes	No	Comments
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.	X		
b. Economic outlook			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.			<i>not applicable</i>
Significant divergences between the national and the Commission services’ economic forecasts are explained ¹² .		X	
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		
c. Monetary/exchange rate policy			
The <u>convergence</u> programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			<i>not applicable</i>
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.	X		
e. “Major structural reforms”			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible ‘major structural reforms’ over time.			<i>not applicable</i>
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			<i>not applicable</i>
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of:		X	

Guidelines in the new code of conduct	Yes	No	Comments
a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.			
In case of such “major structural reforms”, the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			<i>not applicable</i>
<i>g. Broad economic policy guidelines</i>			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
<i>h. Quality of public finances</i>			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
<i>i. Long-term sustainability</i>			
The programme outlines the country’s strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (...) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
<i>j. Other information (optional)</i>			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
<p>Notes:</p> <p>¹The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on “budget day”, i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.</p> <p>²To the extent possible, bearing in mind the typically short time period between the publication of the Commission services’ autumn forecast and the submission of the programme.</p>			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it ¹ .		X	
– Member States should avoid pro-cyclical fiscal policies ² .			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits ³ .	X		
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.			X
2. To safeguard economic and fiscal sustainability			
In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.			X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (...)	X		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X		
Notes: ¹ As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. ² As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”. ³ As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)⁴³. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i*-th tax $\frac{T_i}{Y}$ can be written

as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY} \frac{Y}{T_i} - 1\right) \frac{T_i}{Y} = \left(\frac{dT_i}{dB_i} \frac{B_i}{T_i} \frac{dB_i}{dY} \frac{Y}{B_i} - 1\right) \frac{T_i}{Y} = (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y}$$

where ε_{T_i, B_i} and $\varepsilon_{B_i, Y}$ denote the elasticity of the *i*-th tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i, B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity⁴⁴. By contrast, if ε_{T_i, B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i, Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i*-th tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_i \eta_i \frac{dY}{Y}$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

⁴³Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

⁴⁴The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i, B_i, ex\,ante} \frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i, B_i, ex\,post} \frac{dB_i}{B_i}$.

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) = \left[(\varepsilon_{T_i, B_i}' - \varepsilon_{B_i, Y}') - 1 \right] \frac{T_i}{Y} - \left[(\varepsilon_{T_i, B_i} - \varepsilon_{B_i, Y} - 1) \right] \frac{T_i}{Y} \frac{dY}{Y} .$$

If $(\varepsilon_{T_i, B_i}' - \varepsilon_{T_i, B_i}) = \alpha_i$; $(\varepsilon_{B_i, Y}' - \varepsilon_{B_i, Y}) = \beta_i$,

$$\text{then } d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) = \left[(\alpha_i \varepsilon_{B_i, Y} + \beta_i \varepsilon_{T_i, B_i} + \alpha_i \beta_i) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

where $\alpha_i \varepsilon_{B_i, Y} \frac{T_i}{Y} \frac{dY}{Y}$ determines the elasticity component and $\beta_i \varepsilon_{T_i, B_i} \frac{T_i}{Y} \frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i \beta_i \frac{T_i}{Y} \frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i \varepsilon_{T_i, B_i} \varepsilon_{B_i, Y}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

Assessment of tax projections by major tax category

	2006		2007		2008	p.m.: OECD ¹
	COM	CP	COM ²	CP	CP	
Taxes on production and imports:						
Change in tax-to-GDP ratio	-0.2	-0.2	-0.4	-0.2	-0.2	/
<i>Difference</i>	0.0		0.2		/	/
<i>of which</i> ³ : - elasticity component	0.0		0.0		/	/
- composition component	0.0		0.1		/	/
p.m.: Observed elasticity:						
- of taxes to tax base ⁴	0.8	0.9	0.9	0.9	0.8	1.00
- of tax base ⁴ to GDP	0.9	0.9	0.7	0.9	0.9	1.00
Social contributions:						
Change in tax-to-GDP ratio	-0.2	0.1	-0.3	-0.1	-0.2	/
<i>Difference</i>	0.3		0.2		/	/
<i>of which</i> ³ : - elasticity component	0.5		0.1		/	/
- composition component	-0.2		0.1		/	/
p.m.: Observed elasticity:						
- of taxes to tax base ⁵	1.0	1.6	1.0	1.1	0.7	1.00
- of tax base ⁵ to GDP	0.9	0.7	0.7	0.8	1.0	0.70
Personal income tax⁶:						
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.1	0.1	/
<i>Difference</i>	0.0		0.1		/	/
<i>of which</i> ³ : - elasticity component	0.1		0.0		/	/
- composition component	0.0		0.0		/	/
p.m.: Observed elasticity:						
- of taxes to tax base ⁵	1.1	1.4	1.3	1.5	1.3	1.00
- of tax base ⁵ to GDP	0.9	0.7	0.7	0.8	1.0	0.70
Corporate income tax⁶:						
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.1	0.1	/
<i>Difference</i>	0.0		0.1		/	/
<i>of which</i> ³ : - elasticity component	0.0		0.1		/	/
- composition component	0.0		0.0		/	/
p.m.: Observed elasticity:						
- of taxes to tax base ⁷	0.9	0.8	0.8	1.1	1.3	1.00
- of tax base ⁷ to GDP	1.1	1.2	1.2	1.1	1.0	1.32
Notes:						
¹ OECD ex-ante elasticities						
² On a no-policy change basis						
³ The decomposition is explained in the text above						
⁴ Tax base = private consumption expenditure						
⁵ Tax base = compensation of employees						
⁶ Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period						
⁷ Tax base = gross operating surplus						
Source:						
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)						

Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	ex-ante ¹	COM ² (observed)	ex-ante ¹
Taxes on production and imports:				
Change in tax-to-GDP ratio	-0.2	0.0	-0.4	0.0
<i>Difference</i>	-0.2		-0.4	
<i>of which</i> ³ : - elasticity component	-0.2		-0.1	
- composition component	-0.1		-0.3	
p.m.: Observed elasticity:				
- of taxes to tax base ⁴	0.8	1.0	0.9	1.0
- of tax base ⁴ to GDP	0.9	1.0	0.7	1.0
Social contributions:				
Change in tax-to-GDP ratio	-0.2	-0.3	-0.3	-0.3
<i>Difference</i>	0.2		0.0	
<i>of which</i> ³ : - elasticity component	0.0		0.0	
- composition component	0.2		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base ⁵	1.0	1.0	1.0	1.0
- of tax base ⁵ to GDP	0.9	0.7	0.7	0.7
Personal income tax⁶:				
Change in tax-to-GDP ratio	0.0	-0.1	0.0	-0.1
<i>Difference</i>	0.1		0.1	
<i>of which</i> ³ : - elasticity component	0.0		0.1	
- composition component	0.1		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base ⁵	1.1	1.0	1.3	1.0
- of tax base ⁵ to GDP	0.9	0.7	0.7	0.7
Corporate income tax⁶:				
Change in tax-to-GDP ratio	0.0	0.1	0.0	0.1
<i>Difference</i>	-0.1		-0.1	
<i>of which</i> ³ : - elasticity component	0.0		-0.1	
- composition component	-0.1		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base ⁷	0.9	1.0	0.8	1.0
- of tax base ⁷ to GDP	1.1	1.3	1.2	1.3
Notes:	¹ Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD ² On a no-policy change basis ³ The decomposition is explained in the text above ⁴ Tax base = private consumption expenditure ⁵ Tax base = compensation of employees ⁶ Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period ⁷ Tax base = gross operating surplus			
Source:	<i>Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)</i>			

Annex 5: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	4,2	4,2	3,3	3,3	2,7	2,7	1,7	1,7
Real GDP growth	5,3	5,3	3,3	3,3	2,0	2	0,3	0,3
Participation rate males (aged 20-64)	79,6	79,6	82,1	82,1	82,3	82,3	78,7	78,7
Participation rates females (aged 20-64)	67,1	67,1	73,5	73,5	73,8	73,8	69,1	69,1
Total participation rates (aged 20-64)	73,3	73,3	77,8	77,8	78,0	78	73,9	73,9
Unemployment rate	15,2	15,2	9,7	9,7	7,0	7	7,0	7
Population aged 65+ over total population	12,3	12,3	16,3	16,3	20,8	20,8	29,3	29,3

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes	Impact on S2
<i>Total age-related spending</i>	15,4	14,9	14,8	15,9	16,9	17,9	2,5	1,3
Pensions	6,9	6,7	7,0	7,7	8,4	9,0	2,1	1,3
Health care	4,7	4,7	5,1	5,5	5,8	6,1	1,4	0,9
Education	3,5	3,3	2,6	2,6	2,7	2,7	-0,8	-0,8
Unemployment benefits	0,2	0,2	0,1	0,1	0,1	0,1	-0,1	-0,1
<i>Total primary non age-related spending</i>	20,4	20,4	20,4	20,4	20,4	20,4	0,0	0,0
<i>Adjusted total revenues</i>	34,8	34,8	34,8	34,8	34,8	34,8	0,0	0,0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

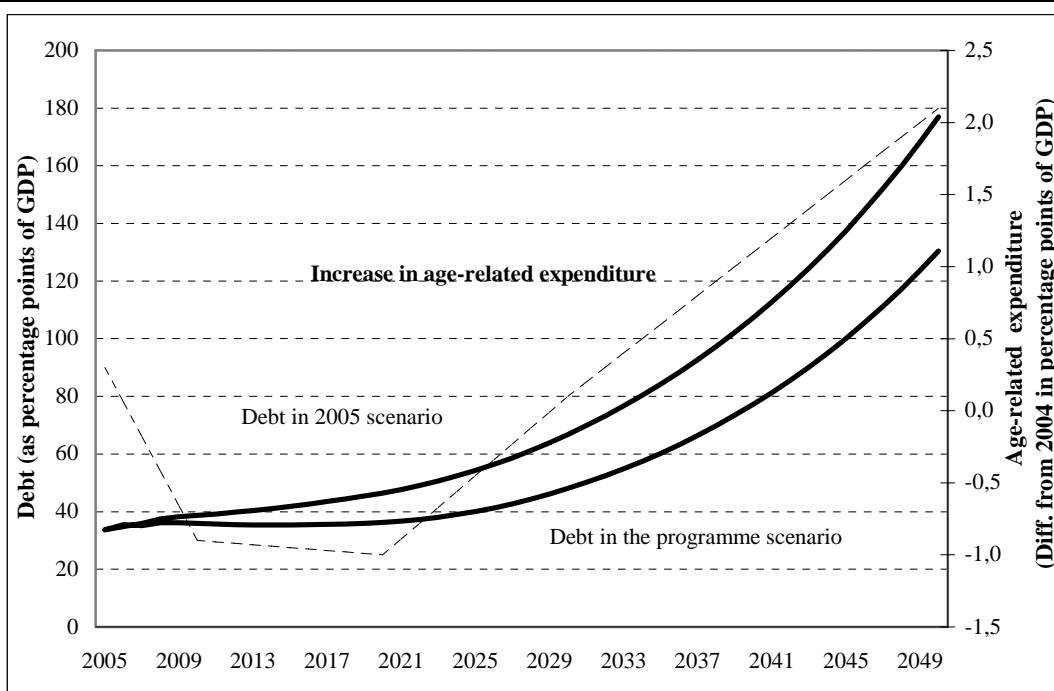
	S1	S2
2005 scenario	0,3	0,3
Programme scenario	0,2	0,2

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
<i>Programme scenario</i>							
Gross debt	36,2	35,9	36,3	48,1	77,2	130,4	94,2
<i>Gross debt, i + I****</i>	36,2	36,6	40,3	56,7	94,6	165,3	129,1
<i>Gross debt, i - I****</i>	36,2	35,3	32,7	40,9	63,8	105,0	68,8
Adjusted gross debt	36,2	35,9	36,3	48,1	77,2	130,4	94,2
<i>2005 Scenario</i>							
Gross debt	37,5	38,7	46,5	66,8	107,3	176,9	139,5
<i>Gross debt, i + I****</i>	38,4	40,4	52,0	78,6	131,2	224,8	186,4
<i>Gross debt, i - I****</i>	36,5	37,1	41,5	57,1	88,9	142,1	105,6
Adjusted gross debt	37,5	38,7	46,5	66,8	107,3	176,9	139,5

Slovakia: Projected developments of gross debt and age-related expenditures



Source: Country SCP 2005, Commission services calculations.

Box 5: Eurostat's decision concerning funded defined-contribution pension schemes

A number of Member States have switched a part of their pension schemes into funded defined-contribution schemes. According to the decision of Eurostat (2 March 2004) those schemes should be recorded in the private sector in the national accounts. The rationale underlying the decision is that these schemes' assets, even when run by government, should be considered as owned by the pension beneficiaries, who are the ultimate economic owners, i.e., those bearing most of the risk, associated mainly with financial market developments. Member States are required to implement the Eurostat decision, by classifying funded, defined-contribution schemes outside the government sector, by spring 2007 at the latest. Slovakia currently benefits from this transitional period for the classification of pension schemes.

The classification of the funded defined-contribution pension schemes may significantly change short-term general government revenue and therefore decrease the current general government balance, while changes in expenditure will only materialize in the long term. Therefore, such a reform would improve long-term government balances but would increase the short-term deficit. Reducing both current revenue and long-term expenditure should be, neutral or positive in terms of long-term sustainability and, theoretically, S2 should remain stable or decrease if revenue and expenditure data were available in the very long-run. It might be the case that the new pension scheme has not reached its steady state in 2050 (i.e. the private pension/GDP ratio may still be increasing after 2050), which would imply that the calculated S2 may overestimate the risk to long-term sustainability (see footnote 21).

Long-term pension projections included in the Slovakia's convergence programme have been prepared assuming that the funded defined-contribution pension schemes are classified in a sector other than government. To be consistent, for the purpose of sustainability analysis, the government balance projections for 2005 to 2008 of the programme have been adjusted by the cost of the pension reform (reduction in

government revenue by 0.8% of GDP in 2005, 1.3% of GDP in 2006 and 1.4% of GDP in 2007 and 2008).