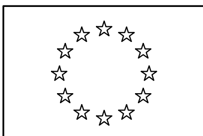


EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 27/02/2007
ECFIN/G3(2007)REP/50577-EN

ECONOMIC ASSESSMENT OF THE CONVERGENCE PROGRAMME OF SLOVAKIA (UPDATE OF DECEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Slovakia's convergence programme was submitted on 1 December 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 27 February 2007. Comments should be sent to Anton Jevcak (Anton.JEVCAK@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

* * *

All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

Table of contents

SUMMARY AND CONCLUSIONS....4
1. INTRODUCTION....8
2. ECONOMIC TRENDS AND POLICY CHALLENGES....8
2.1. Economic performance....8
2.2. Anatomy of medium-term growth....11
2.3. Macro-policies against the backdrop of the economic cycle....13
2.4. Public finances....14
2.5. Medium and long-term policy challenges for public finances....15
3. MACROECONOMIC OUTLOOK....27
3.1. External assumptions....27
3.2. Economic activity....27
3.3. Potential growth and its determinants....28
3.4. Labour market developments....29
3.5. Costs and price developments....29
3.6. Sectoral balances....29
3.7. Assessment....30
3.7.1. Plausibility of the macroeconomic scenario....30
3.7.2. Economic good vs. bad times....30
4. GENERAL GOVERNMENT BALANCE....30
4.1. Budgetary implementation in 2006....30
4.2. The programme's medium-term budgetary strategy....31
4.2.1. The main goal of the programme's budgetary strategy....31
4.2.2. The composition of the budgetary adjustment....33
4.2.3. The medium-term objective (MTO) and the structural adjustment....34
4.3. Risk assessment....36
4.4. Assessment of the fiscal stance and budgetary strategy....39
5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY....40
5.1. Recent debt developments and medium-term prospects....41
5.1.1. Debt projections in the programme....41
5.1.2. Assessment....42
5.2. Long-term debt projections and the sustainability of public finances....42
5.2.1. Sustainability indicators and long-term debt projections....43
5.2.2. Additional factors....46
5.2.3. Assessment....46
6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES....47
7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES....47

Annex 1: Glossary....50
Annex 2: Summary tables from the programme update....54
Annex 3: Compliance with the code of conduct....63
Annex 4: Key economic indicators of past economic performance....66
Annex 5: Assessment of tax projections....69

SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Slovakia, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2006-2009, was submitted on 1 December 2006. Under the corrective arm of the Pact, Slovakia was placed in excessive deficit by the Council in July 2004. The deadline for correcting the excessive deficit is 2007.

Slovakia enjoyed strong growth for most of the last ten years. However, neither the labour market situation nor regional disparities have improved. Although the labour market performance finally started to improve in 2005, the employment rate of 54.2% was still far below the Lisbon target of 70%. The unemployment rate remained the second highest in the EU at 16.3% in 2005, particularly hitting young people. No reversal of regional disparities has yet been established. Energy prices continue to have a relatively strong effect on Slovak HICP inflation and thus might endanger the country's inflation convergence vis-à-vis the euro area, especially given the uncertain outlook for oil prices. Thanks to the pension reform implemented since 2005 the age-related pressure on the long-term sustainability of public finances is mitigated.

In the light of this assessment, the following key medium- and long-term challenges in the area of public finances seem relevant for Slovakia. First, in the area of stabilisation, significant fiscal consolidation since 2003 helped to create the right macroeconomic conditions for a sustainable economic expansion. Persisting structural deficits in a context of a closing negative output gap and strong growth highlight the need to create the room for fiscal policy to react to future cyclical downturns and to support the disinflation process. Second, regarding efficiency, increased FDI inflows in the last years resulted in an acceleration of total-factor productivity growth and should further improve the country's export performance in the coming years. In order to ensure the country's attractiveness for FDI inflows with nominal wage levels growing towards the EU25-average, public policies and finances in areas which are beneficial for the country's long-term competitiveness, such as education, R&D and innovation as well as business environment, come to the forefront.

The macroeconomic scenario underlying the updated convergence programme envisages that real GDP growth will increase from 6.6% in 2006 to 7.1% in 2007 and then decrease to 5.5% and 5.1% in 2008 and 2009, respectively. Assessed against currently available information, this scenario appears to be based on cautious growth assumptions for 2006 and plausible growth assumptions for the rest of the programme period. The programme’s projections for inflation also appear realistic. The labour content of GDP growth assumed by the programme is broadly in line with the Commission services’ autumn forecast and also reflects the positive impact of structural reforms implemented in the last years as well as expected employment-generating FDI inflows. The programme expects the net borrowing from the rest of the world to decrease gradually from 6.4% of GDP in 2006 to 2.0% of GDP in 2009 thanks to continuously falling public

[1]The analysis takes into account (i) the Commission services’ autumn 2006 forecast, (ii) the code of conduct (“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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

and private borrowing. This is in line with the trend indicated in the Commission services' autumn forecast. As the negative output gap is expected to be closing rapidly in 2006, should turn positive in 2007 and then increase further in 2008, Slovakia is likely to be in economic good times from 2007 until the end of the programme period.

For 2006, the general government deficit is estimated at 3.4% of GDP in the Commission services' autumn 2006 forecast, against a target of 4.2% of GDP set in the previous update of the convergence programme. The better outturn is due to much stronger GDP and employment growth and lower interest expenditure and pension reform costs than expected. However, some of the additional revenues owing to the growth surprise were spent rather than devoted to faster deficit reduction.

As in the previous update, the main goal of the new programme's medium-term budgetary strategy is to achieve long-term sustainability of public finances in 2010, notably by reaching the medium-term objective (MTO) for the budgetary position of a structural balance (i.e. cyclically-adjusted balance net of one-off and other temporary measures) of -0.9% of GDP. According to the programme the headline deficit should gradually decline from 3.7% of GDP in 2006 to 1.9% of GDP in 2009 and the primary deficit from 1.9% of GDP in 2006 to 0.2% of GDP in 2009. The envisaged fiscal consolidation relies on expenditure restraint with respect to both current and capital expenditure (decline in the expenditure ratio by around 3¼ percentage points of GDP), which is less than fully offset by a decline in the revenue ratio (1½ percentage point). Compared with the previous update, the new programme broadly confirms the planned adjustment against a more favourable macroeconomic scenario.

The structural balance calculated according to the commonly agreed methodology is planned to improve from around -3½% of GDP in 2006 to some -2½% of GDP in 2009. As in the previous update, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of just below 1% of GDP, which the programme does not aim to achieve within the programme period but by 2010. The MTO is in line with the Pact.

The risks to the budgetary projections in the programme appear broadly balanced. The risks from the macroeconomic scenario are broadly neutral, while tax projections seem on the whole based on prudent assumptions. The envisaged fiscal consolidation in the programme relies heavily on expenditure restraint, but the programme does not provide sufficient information on the measures supporting this (after 2007) nor is there a binding medium-term expenditure framework. On the other hand, Slovakia has built up a good track-record in recent years, although achieving the budgetary targets was facilitated by higher-than-expected growth and lower-than-expected absorption of EU funds.

In view of this risk assessment, the budgetary stance in the programme seems broadly consistent with a correction of the excessive deficit by 2007 as recommended by the Council. However, the adjustment path in structural terms during the correction period should be strengthened given the upward revision of growth prospects and the good economic times. In the following years the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. Moreover, it seems insufficient to ensure that the MTO is achieved in 2010, as envisaged in the programme. In the years following the correction of the excessive deficit, the pace of the adjustment towards the MTO implied by the programme should be strengthened to be in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the

annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times. In particular, an improvement in the structural balance of only around ¾% of GDP is anticipated between 2007 and 2009 when good times are expected to occur. The favourable economic situation offers an opportunity for fiscal policy to ensure a safety margin against future cyclical downturns and to support the disinflation process.

The long-term budgetary impact of ageing in Slovakia is lower than the EU average, with pension expenditure influenced by the recent pension reform showing a more limited increase than in many other countries. The initial budgetary position constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Consolidating the public finances would therefore contribute to reducing risks to sustainability. Overall, Slovakia appears to be at medium risk with regard to the sustainability of public finances.

The Implementation Report of the National Reform Programme of Slovakia, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 13 October 2006. Slovakia's National Reform Programme identifies as key challenges/priorities: developing the information society; increasing R&D and innovation; improving the business environment; improving education and raising employment. The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Slovakia is making progress in the implementation of its National Reform Programme. However, important challenges and the need for further measures remain, particularly in the microeconomic and employment fields. Against the background of strengths and weaknesses identified, Slovakia was recommended to take action in the areas of: R&D and innovation; lifelong learning and education reform; and active labour market policies for the most vulnerable groups. However, the convergence and the national reform programme do not seem well-integrated. In particular, apart from education, expenditure priorities listed in the convergence programme are different from the key challenges identified in the national reform programme. Moreover, the significant support for education indicated in the national reform programme is not evident in the 2007 budget or in the convergence programme.

The overall conclusion is that the updated convergence programme is consistent with a correction of the excessive deficit by 2007 but envisages limited progress towards the MTO thereafter. The expected good economic times are not planned to be fully exploited to ensure a safety margin against future cyclical downturns and to speed up the progress towards the MTO. Moreover, the programme's expenditure priorities are not fully in line with the areas identified in the national reform programme as beneficial for the country's long-term competitiveness.

[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

Comparison of key macro economic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Dec 2006**	**6.1**	**6.6**	**7.1**	**5.5**	**5.1**
	COM Nov 2006	6.0	6.7	7.2	5.7	n.a.
	CP Dec 2005	*5.1*	*5.4*	*6.1*	*5.6*	*n.a.*
HICP inflation (%)	**CP Dec 2006**	**2.8**	**4.4**	**3.1**	**2.0**	**2.4**
	COM Nov 2006	2.8	4.5	3.4	2.5	n.a.
	CP Dec 2005	*2.2*	*1.5*	*2.2*	*2.5*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2006[1]**	**-2.2**	**-0.9**	**1.0**	**1.6**	**1.9**
	COM Nov 2006[5]	-2.0	-0.7	1.1	1.6	n.a.
	CP Dec 2005 [1]	*-1.6*	*-1.1*	*0.1*	*0.8*	*n.a.*
General government balance[6] (% of GDP)	**CP Dec 2006**	**-3.1**	**-3.7**	**-2.9**	**-2.4**	**-1.9**
	COM Nov 2006	-3.1	-3.4	-3.0	-2.9	n.a.
	CP Dec 2005	*-4.9*	*-4.2*	*-3.0*	*-2.7*	*n.a.*
Primary balance[6] (% of GDP)	**CP Dec 2006**	**-1.4**	**-1.9**	**-0.9**	**-0.6**	**-0.2**
	COM Nov 2006	-1.4	-1.7	-1.1	-0.9	n.a.
	CP Dec 2005	*-3.1*	*-2.3*	*-1.1*	*-0.8*	*n.a.*
Cyclically-adjusted balance[6] (% of GDP)	**CP Dec 2006[1]**	**-2.4**	**-3.4**	**-3.2**	**-2.9**	**-2.5**
	COM Nov 2006	-2.5	-3.2	-3.3	-3.3	n.a.
	CP Dec 2005 [1]	*-4.4*	*-3.9*	*-3.0*	*-2.9*	*n.a.*
Structural balance[2 6] (% of GDP)	**CP Dec 2006[3]**	**-1.6**	**-3.5**	**-3.2**	**-2.9**	**-2.5**
	COM Nov 2006[4]	-1.7	-3.3	-3.3	-3.3	n.a.
	CP Dec 2005	*-3.6*	*-3.9*	*-3.1*	*-2.9*	*n.a.*
Government gross debt[6] (% of GDP)	**CP Dec 2006**	**34.5**	**33.1**	**31.8**	**31.0**	**29.7**
	COM Nov 2006	34.5	33.0	31.6	31.0	n.a.
	CP Dec 2005	*33.7*	*35.5*	*35.2*	*36.2*	*n.a.*

Notes:

[1]Commission services calculations on the basis of the information in the programme.

[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

[3]One-off and other temporary measures taken from the programme
(0.8% of GDP in 2005 - deficit-increasing; 0.1% in 2006 - deficit-reducing).

[4]One-off and other temporary measures taken from the Commission services' autumn 2006 forecast
(0.9% of GDP in 2005 - deficit-increasing; 0.1% in 2006 - deficit-reducing).

[5]Based on estimated potential growth of 5.2%, 5.3%, 5.3% and 5.2% respectively in the period 2005-2008.

[6]Since October 2006, Slovakia has implemented the Eurostat decision of 2 March 2004 on the classification of the second pillar funded pension schemes. The general government data from the previous update have been adjusted accordingly so as to facilitate comparison with the new update and the Commission services' autumn 2006 forecast.

Source:

Convergence programme; Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

Slovakia submitted its convergence programme on 1 December 2006[3]. It covers the period 2006 to 2009 and, in addition, provides indicative projections until 2010. The document was adopted by the government on 29 November 2006. It incorporates the 2007 budget and the government's multi-annual budgetary framework 2007-2009, which the government adopted on 11 October 2006 and the parliament took into account. The programme broadly follows the model structure for stability and convergence programmes specified in the code of conduct. The programme provides all compulsory and most of the optional data prescribed by the code of conduct.[4] Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

This section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second part presents the results of a growth accounting exercise and tries to identify the main drivers of the Slovak growth performance vis-à-vis the EU-10 average. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. The fifth part then identifies major economic challenges with implications for public finances.

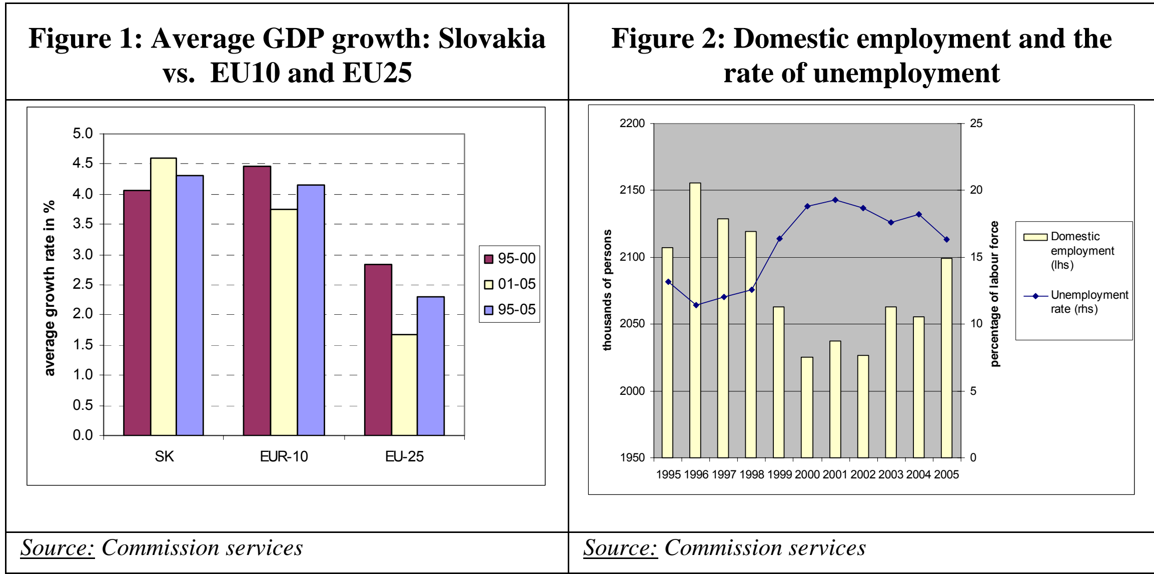
2.1. Economic performance

Real economic growth in Slovakia in the period 1995-2005 was more than twice as high as in the EU12 and it also slightly exceeded real growth in the EU10. Whereas economic growth slowed down both in the EU10 and the EU12 in the period 2001-2005 it accelerated by 0.8 percentage points in Slovakia. As a result, per-capita GDP vis-à-vis the EU25 in purchasing power standard (PPS) increased from around 44% in 1995 to some 55% in 2005.

Up to 2005, strong economic growth did not have much of an effect on the labour market. The accelerated enterprise restructuring process in 1999 induced a sharp decline in the employment level, while the unemployment rate peaked at 19.3% in 2001. Subsequently, the labour code and social protection system were reformed in 2003. The reforms introduced non-standard labour contracts (limited-period contracts), increased the employer's flexibility to terminate labour contracts and strengthened the incentives to work. Furthermore, since 2004, some large FDI projects have been launched. As a result, labour market performance improved significantly in 2005 with domestic employment increasing by 1.4% and the unemployment rate falling by almost 2 p.p. to 16.3%, which was, nevertheless, still the second highest in the EU.

[3] The English version of the programme was submitted on 14 December 2006.

[4] In particular, the data on general government expenditure by function for 2009 are missing.

Figure 1: Average GDP growth: Slovakia vs. EU10 and EU25	**Figure 2: Domestic employment and the rate of unemployment**
	
Source: *Commission services*	*Source:* *Commission services*

Apart from high unemployment, a large regional disparity remains a significant problem in Slovakia. Whereas 2003 per-capita GDP in PPS reached 115.9% of the EU25 average in Bratislava making it the second richest NUTS2 region in the EU10 it remained below 50% of the EU25 average in the other 3 regions harbouring 89% of Slovak population.

Box 1: Monetary policy and exchange rate regimes of SLOVAKIA	
Fixed peg *(1993-1998)*	Following the split of Czechoslovakia and the introduction of the Slovak koruna, Slovakia inherited a system of a fixed peg, based on a basket of five currencies, within a +/-0.5% band. In 1994, there was a switch in the reference basket from five to two currencies (40% USD, 60% DEM). In 1996, a widening of the fluctuation band to +/- 5% took place. The following year, the fluctuation band was widened further to +/- 7%.
Combination of implicit inflation targeting and managed float (October 1998-December 2004)	The currency peg was abandoned and replaced by managed floating combined with implicit inflation targeting which took form of announcement of yearly implicit inflation objectives in the form of annual forecast (often revised in the middle of the year). In 1999, the euro became the the reference currency. In 2001, the Law on the National Bank of Slovakia was amended in the process of harmonisation of legislation with EU *acquis* in that price stability became the primary objective of monetary policy.

Combination of explicit inflation targeting and managed float *(December 2004-November 2005)*	Since December 2004, the implicit inflation targeting was replaced by explicit and binding inflation targets. The main monetary policy instruments became policy interest rates.
ERM II entry (*November 2005*)	With ERM II entry, Slovakia switched to a fixed peg with a central rate vis-à-vis the euro at 38.455 SKK/EUR and a fluctuation band of +/-15%. The National Bank of Slovakia defined its monetary regime as "inflation targeting in the conditions of ERM II".

Harmonised consumer price inflation (HICP) averaged 7.2% between 1997 and 2005 and it was mainly driven by service and energy price inflation which contributed 2.4 and 2.3 percentage points respectively to the average inflation in that period. While up to 2004, adjustments in administered prices were necessary for the energy prices to reach market price levels, from 2005 onwards, changes in administered prices should only reflect changing costs. As the weight of energy prices in Slovak HICP in the period 2001-2005 was around 7.5 percentage points above the EU-25 average of 8.6%, the energy price developments have a much stronger impact on HICP inflation in Slovakia than on average in the EU25.

Nominal unit labour costs have been continuously on the rise over the last decade as increases in nominal compensation per employee exceeded labour productivity growth in each year. As a result, the real effective exchange rate vis-à-vis the rest of EU25 based on unit labour costs (ULC) has also been appreciating since 2001. However, real unit labour costs have been falling since 1998 as the liberalisation of product markets, especially in the energy sector, permitted prices to increase so that profitability of firms could be maintained. Slovakia's export performance has been relatively good as it increased its specialisation in faster-growing sectors.

Development of the Balassa index[5] comparing the degree of specialisation of Slovakia's and the OECD's manufacturing exports, reveals that Slovakia's relative export specialisation in high and medium-high technology manufactures seems to increase while its specialisation in low and medium-low technology manufactures seems to decrease. The specialisation index was still highest for the medium-low technology manufactures in 2004 but Slovakia was already also relatively more specialised in medium-high technology manufactures than the OECD as a whole. The good performance in the medium-high technology sector can be attributed to Slovakia's increasing specialisation in the manufacturing of motor vehicles which are classified in this sector. Based on the production capacities of factories currently being built or entering production, the passenger car production in Slovakia should increase from around 220,000 in 2004 to somewhere between 800,000 and 1.1 million by 2009/2010. A further rapidly accelerating specialisation in medium-high technology manufacturing sector can thus be expected.

[5] The Balassa index is defined as the ratio of a country's share in global exports of a given sector and the country's share in global exports of the economy as a whole.

Balassa index	1997	1998	1999	2000	2001	2002	2003	2004
High-technology manufactures	0.23	0.23	0.23	0.19	0.22	0.21	0.23	0.32
Medium-high technology manufactures	0.90	1.06	1.08	1.11	1.06	1.07	1.19	1.11
Medium-low technology manufactures	2.22	1.97	1.93	1.97	1.96	1.90	1.62	1.70
Low technology manufactures	1.10	1.03	1.10	1.11	1.16	1.18	1.03	1.00

Source: OECD

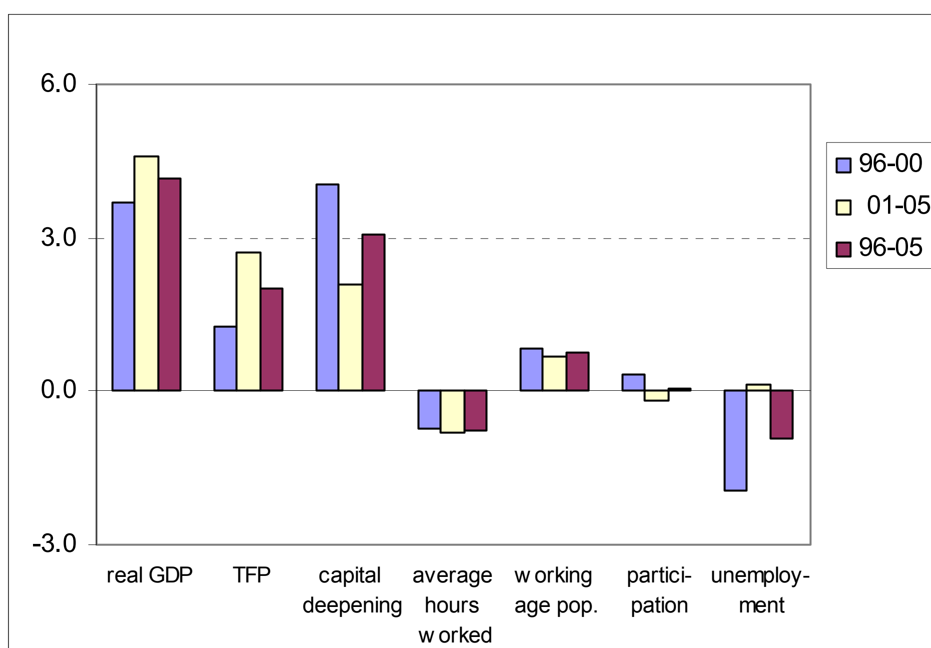
Compared to the EU10 average, Slovakia has been less successful in attracting FDI in the period 1996-2000 as a whole. However, it has been more successful in the last 5 years. Although some big privatisation projects significantly affected the inflows in 2001 and 2002, an improved investment environment including a simplified tax system, a more flexible labour code and relatively generous state aid should have a long-term positive impact on the country's attractiveness as a target for FDI inflows.

Improved growth and labour market performance resulted in a rapid acceleration of households borrowing over the last 3 years with credits to households growing by 41% in 2005 leading to an outstanding stock of 11.2% of GDP (according to the National Bank of Slovakia). Since only 12.5% of domestic credits was denominated in foreign currency in 2005, the exposure to exchange rate risks is limited.

2.2. Anatomy of medium-term growth

The growth accounting exercise carried out on the basis of the Cobb-Douglas production function indicates that real growth in the last 10 years was mainly driven by total factor productivity growth and capital deepening with the labour contribution being relatively less significant. While capital deepening was the main growth driver in the period from 1996 to 2000, increases in TFP represented the strongest growth contribution in the period from 2001 to 2005. However, whereas capital deepening between 1996 and 2000 was accompanied by deterioration in the unemployment situation suggesting a substitution between capital and labour, the increased TFP growth between 2001 and 2005 was accompanied by a decrease in the unemployment rate. The acceleration of TFP growth and improvement in the labour market situation between 2001 and 2005 can be attributed to increased FDI inflows accompanying the major structural reforms in the areas of tax, social and labour market policies implemented in this period.

Figure 3: Real GDP growth and its components



Note:
Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP*, L employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1-ur)$ where *WP* stands for working age population, *PART* denotes the participation ratio as a share of *WP* and *ur* the rate of unemployment. In terms of growth rates *g* this is:

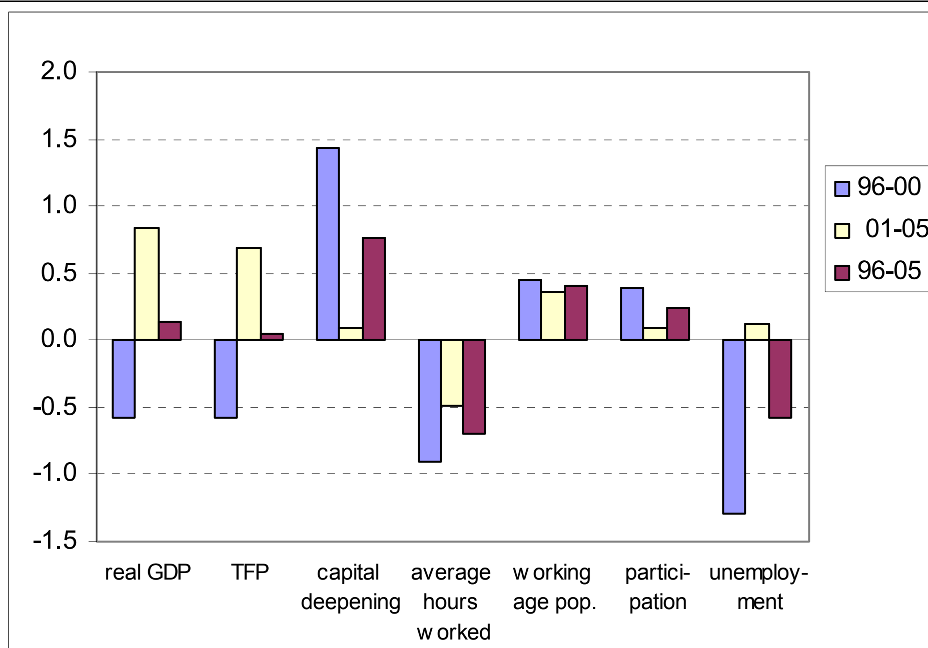
$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source:
Commission services

A slightly better per capita GDP growth performance vis-à-vis the EU10 average over the last decade can be attributed mainly to capital deepening in the period 1996-2000 and to TFP growth in the period 2001-2005. Capital deepening in the period 1996-2000 was largely driven by substantial public investment which resulted in large public deficits. As a result, such growth composition was not sustainable. A relative acceleration in TFP growth was primarily induced by know-how and technology transfers related to increased FDI inflows between 2001 and 2005. These resulted in the increasing relative export specialisation in high and medium-high technology manufactures (as shown by the development of the Balassa index).

Figure 4: Real GDP growth and its components: Difference vis-à-vis the EU10 average



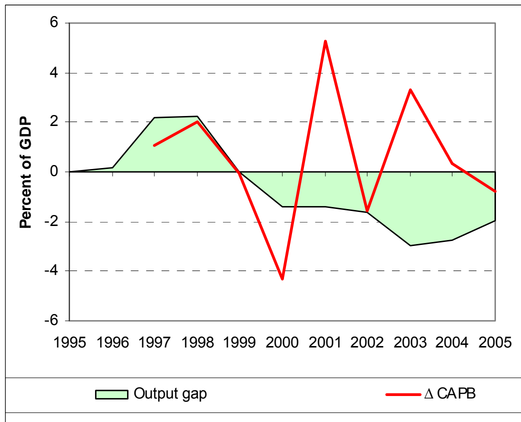
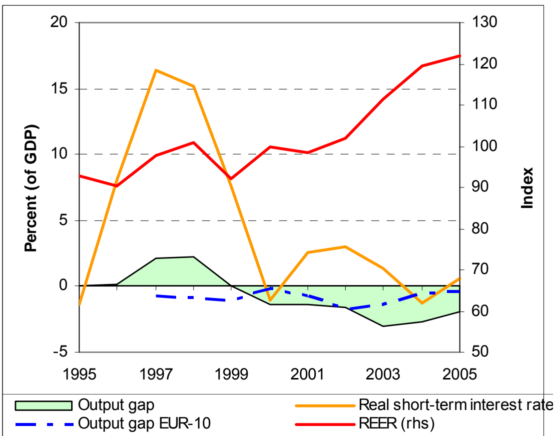
Note:
See note of Figure 3

Source:
Commission services

2.3. Macro-policies against the backdrop of the economic cycle

Up to 1997 the economic expansion was mainly driven by public spending. Actual growth was above potential growth and the unsustainable public finance policy pushed up real short-term interest rates. In 1997 and especially in 1998 a restrictive counter-cyclical fiscal stance was adopted. Restructuring of large state- and private-owned enterprises, particularly in the financial sector, became unavoidable in 1999 and the output gap thus entered negative territory. In order to enable a smooth revitalisation of the banking sector, the government decided to take over its debts which significantly contributed to a temporary deterioration in public finances in the period 1999-2002. The fiscal stance in this period seemed rather expansionary (apart for 2001), but the evolution of cyclically adjusted primary balances (CAPBs) was affected by significant restructuring-related one-offs. Successful restructuring and privatisation accompanied by significant FDI inflows followed by a subsequent fiscal consolidation allowed for the real effective exchange rate to appreciate and for interest rates to come down. This created a favourable macroeconomic environment for the negative output gap to start closing in 2005.

The business cycle seems to have become more synchronised with the rest of the EU10 countries in recent years but the economic expansion is still predominantly driven by the catching-up process presently accelerating thanks to significant FDI inflows.

Figure 5: Output gap and fiscal stance	Figure 6: Output gap and monetary stance
	
Note: ΔCAPB denotes the change in the cyclically-adjusted primary budget balance *Source:* *Commission services*	*Source:* *Commission services*

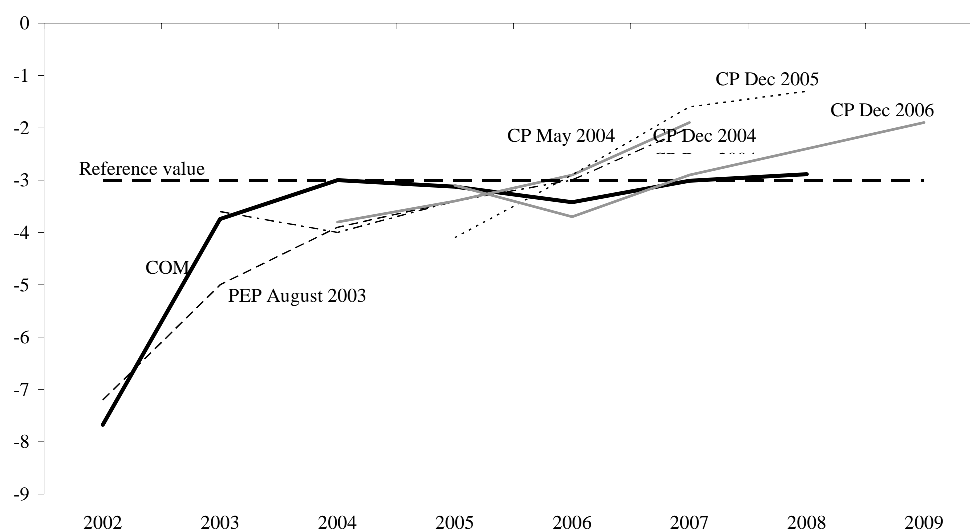
2.4. Public finances

The general government budget deficit exceeded 6% of GDP in each but one year between 1996 and 2002. Significant consolidation of public finances has been achieved since 2002. The fiscal adjustment was expenditure based with both current and capital expenditure cuts contributing to the overall consolidation. This permitted to decrease general government revenues from 35.7% of GDP in 2002 to 33.9% of GDP in 2005. Capital expenditure decreased considerably over the last years, but from "artificially" high levels as capital expenditure up to 2002 was partly induced by debt assumptions related to large state-enterprise restructuring and cancellations of some developing countries' debts. These were one-off measures which did not directly influence current domestic investment levels.

In 2004 Slovakia introduced a comprehensive tax reform simplifying the whole tax system. As part of the reform, direct taxes were decreased while indirect taxes increased. The tax reform was not revenue neutral as it led to a revenue shortfall of 0.5 percent of GDP. After the 2004 tax reform, a pension reform was launched in 2005, affecting social contributions by redirecting 9 percent of gross wages to a funded (second) pension pillar. Although putting additional pressure on public finances in the short-run the reform should improve the sustainability of public finances in the medium/long-run.

Gross public debt increased sharply at the end of the 1990s as the government took over liabilities from some large state-owned enterprises to enable their restructuring and privatisation. The creation of a public debt and liquidity management agency ARDAL allowed that the spare liquidity held by public institutions at the state treasury was used to pay off in 2005 some of the country's debts. A part of the 2005 debt reduction was also financed by privatisation revenues from previous years.

Figure 7: : General government balance projections in successive convergence programmes (% of GDP)



<u>Note:</u>
General government deficit projection excluding pension reform costs
PEP – Pre-accession economic programme
<u>Source</u>:
Commission services and national convergence programmes

2.5. Medium and long-term policy challenges for public finances

Slovakia enjoyed strong growth for most of the last ten years. However, neither the labour market situation nor regional disparities have improved. Although the labour market performance finally started to improve in 2005, the employment rate of 54.2% was still far below the Lisbon target of 70%. The unemployment rate remained the second highest in the EU at 16.3% in 2005, particularly hitting young people. No reversal of regional disparities has yet been established. Energy prices continue to have a relatively strong effect on Slovak HICP inflation and thus might endanger the country's inflation convergence vis-à-vis the euro area, especially given the uncertain outlook for oil prices. Thanks to the pension reform implemented since 2005 the age-related pressure on the long-term sustainability of public finances is mitigated.

In the light of this assessment, the following key medium- and long-term challenges in the area of public finances seem relevant for Slovakia:

<u>Stabilisation:</u> Significant fiscal consolidation since 2003 helped to create the right macroeconomic conditions for a sustainable economic expansion. Persisting structural deficits in a context of a closing negative output gap and strong growth highlight the need to create the room for fiscal policy to react to future cyclical downturns and to support the disinflation process.

<u>Efficiency:</u> Increased FDI inflows in the last years resulted in an acceleration of total-factor productivity growth and should further improve the country's export performance in the coming years. In order to ensure the country's attractiveness for FDI inflows with

nominal wage levels growing towards the EU25-average, public policies and finances in areas which are beneficial for the country's long-term competitiveness, such as education, R&D and innovation as well as business environment, come to the forefront.

Table 1: Key economic indicators

	Slovakia						EU10					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96–'05	'96–'00	'01–'05				'96–'05	'96–'00	'01–'05			
Economic activity												
Real GDP (% change)	4.1	3.7	4.6	4.2	5.4	6.0	4.0	4.3	3.7	4.0	5.1	4.6
Contributions to real GDP growth:												
Domestic demand	4.9	4.6	5.3	-1.3	6.3	8.8	4.3	5.3	3.4	4.0	5.6	3.0
Net exports	-0.8	-0.9	-0.7	5.5	-0.9	-2.8	-0.3	-1.0	0.4	0.0	-0.5	1.6
Prices, costs and labour market												
HICP inflation (% change)	7.0	8.2	5.9	8.4	7.5	2.8	n.a.	n.a.	3.3	1.9	4.1	2.5
Labour productivity (% change)	4.2	4.5	4.0	2.3	5.8	4.6	4.2	4.6	3.7	4.3	4.5	2.9
Real unit labour costs (% change)	-0.5	0.1	-1.1	0.8	-2.7	-1.8	-0.8	-0.6	-1.0	-0.7	-2.5	-1.8
Employment (% change)	0.3	-0.4	1.1	1.8	0.3	2.1	-0.1	-0.3	0.0	-0.2	0.6	1.7
Unemployment rate (% of labour force)	16.1	14.2	18.0	17.6	18.2	16.3	12.8	11.3	14.2	14.3	14.2	13.4
Competitiveness and external position												
Real effective exchange rate (% change) (1)	2.8	1.5	4.1	9.5	7.1	2.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	2.2	0.1	4.4	10.0	-1.7	7.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	-6.3	-7.6	-5.0	-1.9	-2.7	-5.1	-3.4	-4.2	-2.6	-2.9	-2.6	-1.3
Public finances												
General government balance (% of GDP)	-6.2	-7.7	-4.8	-3.7	-3.0	-3.1	n.a.	n.a.	-4.2	-5.1	-3.7	-3.3
General government debt (% of GDP)	40.7	39.3	42.2	42.7	41.6	34.5	37.9	35.8	40.1	39.9	43.4	41.3
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-2.4	-2.2	-1.7	n.a.	n.a.	n.a.	-4.5	-3.4	-3.0
Financial indicators (4)												
Long term real interest rate (%) (5)	n.a.	n.a.	1.1	0.2	-0.9	1.1	n.a.	n.a.	n.a.	3.5	2.2	2.2
Household debt (% of GDP) (6)	5.5	3.6	7.5	7.0	8.6	11.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	5.7	5.1	6.2	6.1	6.6	7.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:
Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output growth, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

3.1. External assumptions

The programme's external assumptions are in line with those underlying the Commission services' autumn 2006 forecast. However, contrary to the Commission services' assumption of a nominal exchange rate at the ERM II central parity level the programme implicitly assumes an appreciating koruna.

3.2. Economic activity

The programme expects real GDP growth to increase from 6.6% in 2006 to 7.1% in 2007 and then to decrease to 5.5% and 5.1% in 2008 and 2009 respectively. Growth contributions of both final domestic and external demand are projected to remain positive over the whole programme period. The decelerating investment boom in the automotive sector should lead to a slowdown in import growth while newly built production capacities are likely to ensure that export performance remains relatively strong. Slower employment and wage growth is expected to reduce private consumption growth. Implied cyclical conditions, as measured by the output gaps recalculated by the Commission services based on the information in the programme, indicate that the output gap should turn positive in 2007 and then continue widening up to 2009.

The programme's real GDP growth projections until 2008 are in line with the Commission services' forecast. However, in the light of recently released data showing significantly higher-than-expected growth for the third quarter of 2006 (9.8% year-on-year), the annual average for 2006 growth is likely to be significantly higher than both the programme's and the Commission services' estimate. The growth projection for 2009 is slightly below the estimate of average potential growth in the Commission services' autumn 2006 forecast for the period 2006-2008.

According to the programme, growth of both nominal private consumption and compensation of employees should decelerate gradually from above 10% in 2006 to some 7% in 2008. This is in line with the Commission services' forecast.

As regards cyclical conditions, the recalculated output gaps implied by the programme up until 2008 are broadly in line with output gap estimates of the Commission services' forecast. The widening positive output gap from 2007 onward is plausible, as growth is projected to remain above potential in spite of slowing down. The assessment of cyclical conditions has become more positive since the December 2005 update as growth projections for 2006 and 2007 have been revised upwards.

In the course of 2006, as demand-driven inflationary pressures emerged and exchange rate appreciation slowed down, the NBS reacted by raising its main policy rate by cumulative 175 basis points. Higher interest rates should contribute to the slowdown in domestic demand growth projected by the programme. However, in order to stabilise

exchange rate movements, fiscal policy seems to have become the preferable instrument for confining the domestic demand growth now.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	6.7	6.6	7.2	7.1	5.7	5.5	5.1
Private consumption (% change)	5.8	5.6	5.3	5.3	4.4	4.4	4.2
Gross fixed capital formation (% change)	9.6	8.2	6.5	6.0	5.2	5.0	5.0
Exports of goods and services (% change)	13.8	17.6	14.6	14.2	10.3	8.5	7.3
Imports of goods and services (% change)	12.3	15.2	11.3	11.2	8.2	7.3	6.4
Contributions:							
- Final domestic demand	6.6	6.1	5.4	4.9	4.3	4.3	4.1
- Change in inventories	-0.4	-0.8	-0.3	-0.8	-0.3	0.0	-0.1
- External balance on g&s	0.5	1.5	2.1	2.7	1.7	1.2	1.1
Output gap[1]	-0.7	-0.9	1.1	1.0	1.6	1.6	1.9
Employment (% change)	2.6	2.0	1.5	1.5	0.9	0.8	0.8
Unemployment rate (%)	14.3	13.8	13.3	13.2	12.9	12.9	12.4
Labour productivity growth (%)	4.0	4.5	5.6	5.5	4.8	4.6	4.2
HICP inflation (%)	4.5	4.4	3.4	3.1	2.5	2.0	2.4
GDP deflator (% change)	4.2	3.5	3.5	2.8	2.0	1.3	1.6
Comp. of employees (% change)	10.5	10.3	8.6	8.7	6.9	6.9	7.1
Real unit labour costs (% change)	-0.5	-2.0	-1.9	-2.9	-0.6	-0.9	-0.9
External balance (% of GDP)	-7.5	-6.4	-4.5	-3.1	-3.1	-2.5	-2.0

Note:

[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below.

Source :

Commission services' autumn 2006 economic forecasts (COM); Convergence programme

Table 3: Output gap estimates in successive Commission services' forecasts and convergence programmes

	2006		2007		2008	
	COM	CP	COM	CP	COM	CP
CP Dec 2006	-	-0.9	-	1.0	-	1.6
Autumn 2006	-0.7	-	1.1	-	1.6	-
Spring 2006	-0.8	-	0.2	-	-	-
CP Dec 2005	-	-1.1	-	0.1	-	0.8
Autumn 2005	-0.9	-	0.2	-	-	-
Spring 2005	1.3	-	-	-	-	-
CP Dec. 2004	-	0.4	-	0.9	-	-

Note: Commission services' calculations according to the the commonly agreed method based on the figures of the programme

Source: Commission services' forecasts and national Convergence programme

3.3. Potential growth and its determinants

Based on the information provided in the programme, potential growth is projected at around 5% over the programme period. Up to 2008, these estimates and their determinants are broadly in line with the Commission services' autumn 2006 forecast. They are above the average growth of the past ten years as structural reforms and technology transfer related to recent significant FDI inflows are likely to have had a positive effect on TFP growth.

Table 4: Sources of potential output growth

	2006		2007		2008		2009
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Potential GDP growth[1]	5.3	5.1	5.3	5.1	5.2	4.9	4.8
Contributions:							
- Labour	0.3	0.4	0.3	0.4	0.3	0.4	0.3
- Capital accumulation	2.2	2.0	2.2	2.0	2.1	2.0	2.0
- TFP	2.7	2.6	2.7	2.6	2.7	2.5	2.4

Notes:

[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

Source :

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

3.4. Labour market developments

According to the programme, employment growth should peak in 2006 before falling gradually to 0.8% in 2008 and remaining at this level up to 2009. The labour content of GDP growth is broadly in line with the Commission services' autumn forecast and also reflects the positive impact of structural reforms implemented in the last years as well as expected employment-generating FDI inflows. The unemployment rate is projected to continue falling throughout the programme period by an annual average of almost 0.5 percentage points.

The decline in the unemployment rate is consistent with a widening positive output gap (as recalculated by Commission services on the basis of the programme).

3.5. Costs and price developments

The programme expects HICP inflation to decline to 3.1% in 2007 and then to drop further to 2.0% in 2008 mainly due to the anticipated lower contribution of administered energy prices compared to 2006. The positive inflation outlook in the programme is partly induced by expected nominal exchange rate appreciation. Assuming that the nominal exchange rate depreciates back to the ERM II central parity rate between 2006 and 2007 and then remains constant in 2008, the Commission services' autumn forecast projects HICP inflation at 3.4% and 2.5% in 2007 and 2008 respectively.

Similarly to the Commission services' autumn 2006 forecast, the programme assumes that the disinflation trend will go along with a slowdown in the nominal wage growth in 2007 and 2008 which should, nevertheless, remain above the productivity growth. Resulting increasing nominal unit labour costs may hamper the country's relative cost competitiveness in the longer run.

3.6. Sectoral balances

The programme expects the net borrowing from the rest of the world to decrease gradually from 6.4% of GDP in 2006 to 2.0% of GDP in 2009 thanks to continuously falling public and private borrowing. The trade balance should improve from -3.7% of GDP in 2006 to 0.1% of GDP in 2009. This is in line with the trend indicated in the Commission services' autumn forecast.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic 'good' or 'bad' times.

3.7.1. Plausibility of the macroeconomic scenario

The programme's macroeconomic outlook for the period 2006-2008 is in line with the Commission services' autumn 2006 forecast and the programme's growth projection for 2009 is broadly in line with the Commission services' estimate of average potential GDP growth for the period 2006-2008. There are also no major differences concerning the composition of growth. However, latest data indicate that both forecasts are likely to be too conservative regarding the real GDP growth in 2006. The programme's more favourable HICP inflation forecast can be attributed to the different assumption concerning exchange rate developments. The programme thus builds on cautious macroeconomic assumptions for 2006 and on plausible macroeconomic assumptions for the rest of the programme period.

3.7.2. Economic good vs. bad times

According to the Commission services' autumn 2006 forecast the negative output gap is expected to be closing rapidly in 2006, should turn positive in 2007 and then increase further in 2008. The growing positive output gap will be accompanied by rising employment and continuously falling unemployment. As a result, Slovakia is likely to be in economic good times from 2007 until the end of the programme period. The high growth rate of nominal GDP provides additional opportunities for fiscal consolidation.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme's medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The target for the 2006 general government deficit set in the programme (3.7% of GDP) is below the targets set in the previous programmes but it is above the Commission services' autumn 2006 forecast (3.4% of GDP). Much stronger GDP and employment growth and lower-than-expected interest expenditure and pension reforms costs allowed for a better outturn. On the other hand, some of the additional revenues generated by higher-than-expected growth were spent as state expenditure in 2006 was increased by the maximum allowed 1% compared to the level foreseen in the 2006 budget.

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009
General government balance[1] (% of GDP)	**CP Dec 2006**	**-3.1**	**-3.7**	**-2.9**	**-2.4**	**-1.9**
	CP Dec 2005	-4.9	-4.2	-3	-2.7	n.a.
	CP Dec 2004	*-3.8*	*-3.9*	*-3*	*n.a.*	*n.a.*
	COM Nov 2006	-3.1	-3.4	-3.0	-2.9	n.a.
General government expenditure (% of GDP)	**CP Dec 2006**	**37.1**	**36.3**	**34.6**	**33.6**	**33.1**
	CP Dec 2005[1]	41.9	40.5	39.5	38.5	n.a.
	CP Dec 2004	*40.4*	*39.8*	*38.8*	*n.a.*	*n.a.*
	COM Nov 2006	37.1	36.5	35.4	35.0	n.a.
General government revenues (% of GDP)	**CP Dec 2006**	**33.9**	**32.6**	**31.7**	**31.2**	**31.1**
	CP Dec 2005	37	36.3	36.5	35.8	n.a.
	CP Dec 2004	*36.7*	*35.9*	*35.8*	*n.a.*	*n.a.*
	COM Nov 2006	33.9	33.1	32.4	32.1	n.a.
Real GDP (% change)	**CP Dec 2006**	**6.1**	**6.6**	**7.1**	**5.5**	**5.1**
	CP Dec 2005	5.1	5.4	6.1	5.6	n.a.
	CP Dec 2004	*4.5*	*5.1*	*5.4*	*n.a.*	*n.a.*
	COM Nov 2006	6.0	6.7	7.2	5.7	n.a.

[1]Since October 2006, Slovakia has implemented the Eurostat decision of 2 March 2004 on the classification of the second pillar funded pension schemes. The general government data from the previous updates have been adjusted accordingly so as to facilitate comparison with the new update and the Commission services' autumn 2006 forecast.

Source:
Convergence programme; Commission services' autumn 2006 economic forecasts (COM)

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

As in the previous update, the main goal of the programme's medium-term budgetary strategy is to achieve long-term sustainability of public finances in 2010 by reaching a medium-term objective (MTO) for the budgetary position set as a structural balance of -0.9% of GDP (see also Section 4.2.3 below).

Box 2: The excessive deficit procedure for Slovakia

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 5 July 2004 the Council adopted a decision stating that Slovakia had an excessive deficit in accordance with Article 104(6). 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 resulted in higher growth than expected in the programme, in particular by dedicating any higher-than budgeted revenues primarily to faster deficit reduction.

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

In October 2006, Slovakia implemented the Eurostat decision on the classification of second-pillar funded pension schemes (see box 3). The general government data presented in the programme include the pension reform cost estimated at 1.1%, 1.1%, 1.2% and 1.2% of GDP in 2006, 2007, 2008 and 2009, respectively.

According to the programme the headline deficit should gradually decline from 3.7% of GDP in 2006 to 2.9%, 2.4% and 1.9% of GDP in 2007, 2008 and 2009 respectively. The primary deficit should decrease from 1.9% of GDP in 2006 to 0.9%, 0.6% and 0.2% of GDP in 2007, 2008 and 2009 respectively. The fiscal consolidation is concentrated in 2007 when the 3% of GDP-deficit criterion should be fulfilled.

Box 3: The classification of pension schemes

There are typically different pillars within a country's pension system, such as pay-as-you-go or unfunded systems and funded systems; furthermore, pension schemes can be of the defined-benefit (DB) or defined-contribution (DC) variety.

If a pension scheme is classified in the government sector, contributions collected and benefits paid by the scheme are government revenue and expenditure and contribute to the government balance. If a pension scheme is classified in a sector other than government, its contributions and benefits do not contribute to the government balance. The ESA95 accounting rules state that pension schemes classified within government are those which are "imposed, controlled and financed by government".

On 2 March 2004, Eurostat clarified that funded DC pension schemes do not fulfil these criteria because pensions paid by such schemes (i) depend primarily on financial market performance (i.e. not under government control) and (ii) are financed by reserves that are not economically owned by government. Even if they are mandatory or if they are managed by government (for example, managed by the same government agency in charge of the pay-as-you-go pillar) or if there is some government guarantee of a minimum pension, funded DC schemes should not be classified within government (*).

A transition period, expiring in spring 2007 (first EDP notification of 2007), has been granted to implement this decision (**). Slovakia used this transition period until October 2006.

(*) Eurostat News Release No 30/2004 of 2 March 2004.
(**) Eurostat News Release No 117/2004 of 23 September 2004.

Compared with the previous programme, the new update broadly confirms the planned adjustment against a more favourable macroeconomic scenario. The path for the headline deficit reduction has became somewhat more demanding, but given the significant improvement in the macroeconomic outlook, the foreseen pace of fiscal consolidation remains not very ambitious.

Table 6: Composition of the budgetary adjustment

(% of GDP)	2005	2006	2007	2008	2009	Change: 2009-2006
Revenues	33.9	32.6	31.7	31.2	31.1	**-1.5**
of which:						
- Taxes & social contributions	29.8	27.9	27.2	27.1	26.9	**-1.0**
- Other (residual)	4.1	4.7	4.5	4.1	4.2	**-0.5**
Expenditure	37.1	36.3	34.6	33.6	33.1	**-3.2**
of which:						
- Primary expenditure	35.4	34.5	32.6	31.7	31.3	**-3.2**
of which:						
Consumption	15.4	15.3	14.6	14.3	14.2	**-1.1**
Transfers other than in kind & subsidies	12.1	12.1	11.8	11.5	11.2	**-0.9**
Gross fixed capital formation	2.1	1.8	1.4	1.2	1.1	**-0.7**
Other (residual)	5.8	5.3	4.8	4.7	4.8	**-0.5**
- Interest expenditure	1.7	1.8	2.0	1.9	1.8	**0.0**
General government balance (GGB)	**-3.1**	**-3.7**	**-2.9**	**-2.4**	**-1.9**	**1.8**
Primary balance	**-1.4**	**-1.9**	**-0.9**	**-0.6**	**-0.2**	**1.7**
One-offs [1]	-0.8	0.1	0.0	0.0	0.0	-0.1
GGB excl. one-offs	**-2.3**	**-3.8**	**-2.9**	**-2.4**	**-1.9**	**1.9**

Note:
[1]One-off and other temporary measures.
Source :
Convergence programme update; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

The envisaged fiscal consolidation relies on expenditure restraint with respect to both current and capital expenditure.[6] As a result, general government expenditure is foreseen to fall from 36.3% of GDP in 2006 to 33.1% of GDP in 2009. Given the expected average nominal GDP growth of some 8% between 2006 and 2009 the envisaged reduction in the expenditure ratio is consistent with considerable expenditure growth both in nominal and in real terms.

The 2007 fiscal consolidation is supported by a budget and accompanying legislative changes both approved by the government (see also box 4). Adopted changes of the tax code (direct and indirect taxes) are expected to have a slight revenue-decreasing effect. However, the overall effect of the tax changes on public finances is too a large extent neutralised as decreases in revenues due to lower VAT on pharmaceutical and medical products should be partly offset by savings in public healthcare expenditure. In order to reach a deficit just below 3% of GDP the government is committed to a wide-ranging spending restraint with primary expenditure foreseen to drop by almost 2 percentage points. A planned increase in consumption taxes on cigarettes in January 2008 is expected to induce pre-stocking in 2007 and thus positively affect tax revenues in 2007 (and negatively in 2008). Up to a 20% reduction in public sector employment, to be realised in the course of 2007 should depending on the precise scale and method of the reduction result in some expenditure savings from 2008 onwards.

---

[6] The decrease in capital expenditure is partly enabled by creation of the National Motorway Company in 2005 which is classified outside the general government sector.

The programme acknowledges that for the MTO to be achieved in 2010 (i.e. one year beyond the programme period) further measures will have to be adopted. A lower indexation of pensions is suggested as a measure that could be implemented in order to improve the long-term sustainability of public finances. No one-off or other temporary measures are foreseen for the period 2007-2009.

Box 4: The budget for 2007

On 11 October 2006, the government approved the 2007 budget, targeting a general government deficit of 2.9% of GDP (including pension reform costs). The government decided to decrease the amount of financial resources attributed to the ministries of justice and interior affairs and to the Slovak Academy of Sciences while keeping increases in expenditure available to education and social affairs ministries below nominal GDP growth in order to attain a deficit below 3% of GDP. The tax reform introduced in 2004 has also been slightly modified by a re-introduction of a lower VAT rate (10%) on pharmaceutical and medical products and by decreasing the level of tax-free income for higher income groups.

Table: Main measures in the budget for 2007

Revenue measures*	**Expenditure measures****
o Lower VAT on pharmaceutical and medical products (-0.16% of GDP)	o Savings in health expenditure due to lower VAT (-0.13% of GDP)
o Various changes of direct taxes (0.07% of GDP)	o Increased health expenditure (0.12% of GDP)
	o Expenditure restraint (-0.3% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services and 2007 Budget.

4.2.3. The medium-term objective (MTO) and the structural adjustment

The programme sets the MTO defined in structural terms (cyclically-adjusted and net of one-off and other temporary measures) as a balance of -0.9% of GDP to be reached in 2010, which is the same goal as in the previous update.

Box 5: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific 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 MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct 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 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the

exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

The programme's MTO is more demanding than the minimum benchmark of around 2% of GDP which is the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value. The 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 run.

The structural balance as recalculated by Commission services on the basis of the information in the programme according to the commonly agreed methodology is projected to deteriorate from around -1½% of GDP in 2005 to some -3½% of GDP in 2006 before improving gradually to around -2½% in 2009.[7] Part of the initial deterioration is induced by pension reform costs increasing from 0.6% of GDP in 2005 to 1.1% of GDP in 2006. Nevertheless, the stance of fiscal policy seems expansionary in 2006 and the planned stance mildly restrictive for the rest of the programme period. The planned fiscal effort between 2006 and 2009 measured by the change in the structural balance as recalculated by the Commission services is around 1% of GDP or some 1/3% of GDP per year on average.

[7] There is, however, a significant difference between the programme's output gaps as recalculated by the Commission services on the one hand (-0.9%, 1.0%, 1.6% and 1.9% of potential output in 2006, 2007, 2008 and 2009 respectively) and the programme's output gaps as presented in the programme itself on the other hand (0.2%, 0.4%, 0.2% and 0.0% of potential output in 2006, 2007, 2008 and 2009 respectively).

Table 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	Change: 2009-2006
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Gen. gov't balance	-3.1	-3.1	-3.4	-3.7	-3.0	-2.9	-2.9	-2.4	-1.9	1.8
One-offs[2]	-0.9	-0.8	0.1	0.1	0.0	0.0	0.0	0.0	0.0	-0.1
Output gap[3]	-2.0	-2.2	-0.7	-0.9	1.1	1.0	1.6	1.6	1.9	2.8
CAB[4]	-2.5	-2.4	-3.2	-3.4	-3.3	-3.2	-3.3	-2.9	-2.5	1.0
change in CAB	-0.4	:	-0.7	-1.0	-0.1	0.2	0.0	0.3	0.4	:
CAPB[4]	-0.8	-0.7	-1.5	-1.6	-1.4	-1.2	-1.3	-1.0	-0.7	1.0
Structural balance[5]	-1.7	-1.6	-3.3	-3.5	-3.3	-3.2	-3.3	-2.9	-2.5	1.1
change in struct. bal.	0.5	:	-1.6	-1.9	0.0	0.3	0.0	0.3	0.4	:
Struct. prim. bal.[6]	0.1	0.1	-1.6	-1.7	-1.4	-1.2	-1.3	-1.0	-0.7	1.1

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. See Table 6 above.

[3]In percent of potential GDP. See Table 2 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

Source:

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

4.3. Risk assessment

The Commission services' autumn 2006 forecast indicates that the 2007 target is broadly plausible; for 2008, the Commission services' no-policy change forecast is 0.5 percentage point of GDP above the convergence programme target (2.9% versus 2.4% of GDP). The possibility to carry-over unspent resources assigned for capital expenditure and co- financing to the next budgetary year continues to represent a risk for the fiscal consolidation process. Both the Commission services' and the programme's projections are based on the assumption that the size of the carry-overs in the coming years will be similar to the amount carried over from 2005 to 2006 (some 0.8% of GDP).

The risks stemming from the macroeconomic scenario are broadly neutral, although there is scope for a better-than-estimated outturn for 2006.

The programme's tax revenue projections seem to embody plausible assumptions about the tax intensity of economic activity. Taxes on production and imports will in 2007 be negatively affected by a lower VAT on pharmaceutical and medical products. This effect should, however, be outweighed by a positive evolution of consumption taxes on cigarettes and alcohol in 2007. This stems from two effects. First, taxes on alcohol and cigarettes were increased in 2006 but due to considerable pre-stocking of cigarettes and alcohol by both consumers and retailers in 2005, actually, the tax increase had a negative impact on tax revenues in 2006 because spending on cigarettes and alcohol was low. It is expected that this will be reversed in 2007, generating increased tax revenues. Second, another increase in consumption taxes on cigarettes is planned for 2008 which is likely to induce another pre-stocking in 2007. This should further positively affect tax revenues in 2007 (and negatively in 2008). Social contributions will continue to be negatively affected by the fact that all new labour-market-entrants are automatically joining the second funded pension pillar.

The programme assumes a slightly more favourable composition of GDP growth with respect to tax revenues than the Commission services' autumn 2006 forecast which is, however, for 2007 more conservative than the OECD ex-ante estimate of the composition component. On the other hand, the programme's estimate of the overall impact of discretionary measures in 2007 is more conservative than the Commission's estimate. Taken together, tax revenues in the programme seem prudently forecast.

The envisaged fiscal consolidation relies predominantly on expenditure restraint, which, in the absence of sufficient information on the envisaged measures, constitutes a risk of higher-than-targeted budgetary outcomes in the years beyond 2007. While Slovakia has so far respected its budgetary targets, the good track-record in recent years was facilitated by higher-than-expected growth and lower-than-expected absorption of EU funds.

The overall assessment is that the balance of risks looks broadly neutral for the entire programme period.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009
		COM	CP	COM	CP	COM[1]	CP	CP
Revenues	33.9	33.1	32.6	32.4	31.7	32.1	31.2	31.1
of which:								
- Taxes & social contributions	29.2	28.9	27.9	28.3	27.2	28.1	27.1	26.9
- Other (residual)	4.7	4.2	4.7	4.1	4.5	4.0	4.1	4.2
Expenditure	37.1	36.5	36.3	35.4	34.6	35.0	33.6	33.1
of which:								
- Primary expenditure	35.3	34.8	34.5	33.5	32.6	33.0	31.7	31.3
of which:								
Consumption	18.5	18.1	15.3	17.4	14.6	17.1	14.3	14.2
Transfers other than in kind & subsidies	12.1	12.7	12.1	12.4	11.8	12.2	11.5	11.2
Gross fixed capital formation	2.1	1.9	1.8	1.6	1.4	1.3	1.2	1.1
Other (residual)	2.6	2.1	5.3	2.1	4.8	2.3	4.7	4.8
- Interest expenditure	1.7	1.7	1.8	2.0	2.0	2.0	1.9	1.8
GGB[2]	-3.1	-3.4	-3.7	-3.0	-2.9	-2.9	-2.4	-1.9
Primary balance	-1.4	-1.7	-1.9	-1.1	-0.9	-0.9	-0.6	-0.2
One-offs	-0.9	0.1	0.1	0.0	0.0	0.0	0.0	0.0
GGB[2] excl. one-off	-2.3	-3.5	-3.8	-3.0	-2.9	-2.9	-2.4	-1.9

Notes:

[1]On a no-policy change basis.

[2]General government balance

Source :

Commission services' autumn 2006 economic forecast (COM); stability/convergence programme update; Commission services' calculations

Table 9: Assessment of tax projections

	2007			2008			2009
	CP	COM	OECD[3]	CP	COM[1]	OECD[3]	CP
Change in tax-to-GDP ratio (total taxes)	-0.8	-0.6	-0.3	-0.1	-0.3	0.0	-0.2
Difference (CP – COM)	-0.2		/	0.2		/	/
of which [2] :							
- discretionary and elasticity component	-0.3		/	0.0		/	/
- composition component	0.1		/	0.1		/	/
Difference (COM - OECD)	/	-0.3		/	-0.1		/
of which [2] :							
- discretionary and elasticity component	/	-0.1		/	-0.1		/
- composition component	/	-0.2		/	0.0		/
p.m.: Elasticity to GDP	0.7	0.8	0.9	0.9	0.9	0.9	0.9

Notes:

[1]On a no-policy change basis.

[2]The decomposition is explained in Annex 5.

[3]OECD ex-ante elasticity relative to GDP.

Source :

Commission services' autumn 2006 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)

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 10: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Consistency with correction of excessive deficit by 2007 deadline	yes	broadly structural adjustment should be strengthened
b. Safety margin against breaching 3% of GDP deficit limit[1]	not within programme period	not within programme period
c. Achievement of the MTO	not within programme period (2010)	not within programme period
d. Adjustment towards MTO in line with the Pact[2]?	should be strengthened	should be strengthened

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 2% of GDP for Slovakia). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

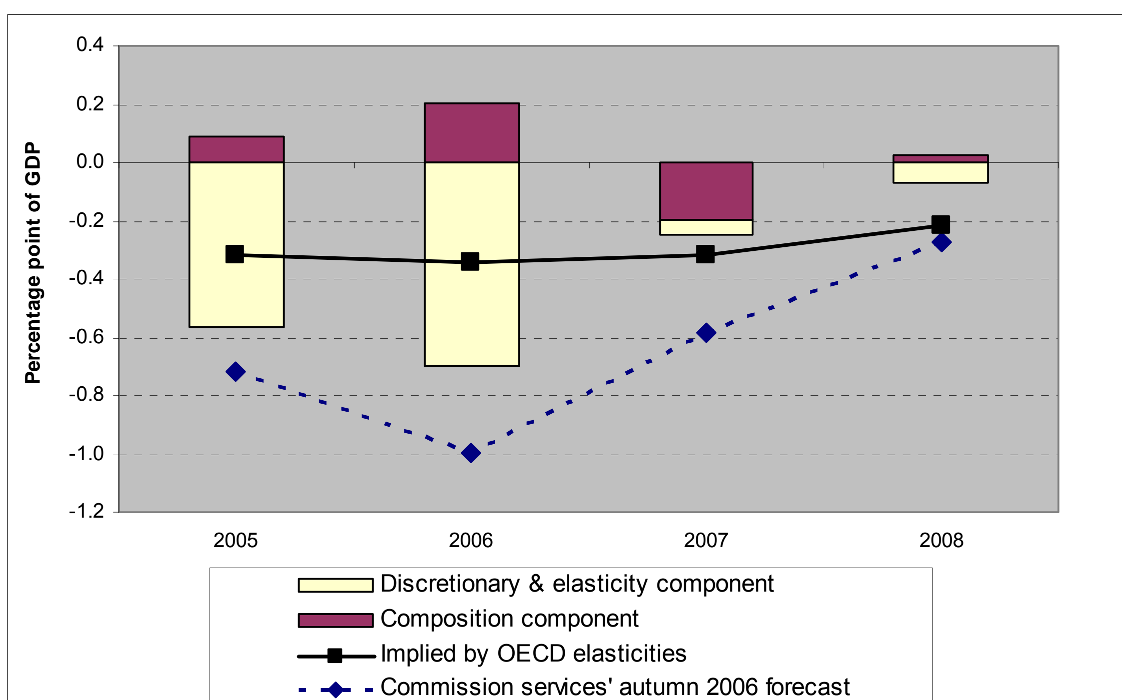
The budgetary stance in the programme seems broadly consistent with a correction of the excessive deficit by 2007 as recommended by the Council if the budget measures are fully and effectively implemented. Nevertheless, in line with the Council opinion on the previous programme, the considerably improved macroeconomic scenario pleads for a more ambitious consolidation in structural terms both during and after the correction of the excessive deficit.

The planned change in the structural balance as recalculated by Commission services is around 1% of GDP over the period 2006-2009 or some 1/3% of GDP per year on average. The Commission services' autumn 2006 forecast and the programme's macroeconomic scenario implies that Slovakia will be in economic "good times" from 2007 until 2009. This is not contradicted by the analysis of tax elasticities which indicate growth composition component broadly in line with the OECD ex-ante estimate. As a result, the average annual structural improvement implied by the programme of around 1/3% of GDP between 2006 and 2009 is insufficient when compared with the 0.5% of GDP benchmark for euro area and ERM II countries (and the requirement in the Pact to do more in good times) and should therefore be strengthened.

The 2009 structural balance as recalculated by the Commission services on the basis of the information in the programme according to the commonly agreed methodology is foreseen at around -2.5% of GDP. The budgetary stance in the programme thus does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations over the whole programme period.

The programme envisages that the MTO will be achieved by 2010, that is, beyond the programme period. However, given the size of the structural deficit at the end of the programme period, a very significant structural improvement in 2010 will be needed for the MTO of -0.9% of GDP to be achieved. This seems quite ambitious in the light of the relatively modest fiscal effort planned between 2006 and 2009.

Figure 8: Changes in the tax-to-GDP ratio: actual/projected changes vs. changes implied by OECD elasticity



Note:
The dashed line displays the change in the tax ratio in the Commission services' autumn 2006 forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

5. Government debt and long-term sustainability

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial

assets and other adjustments may also play a role.[8] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

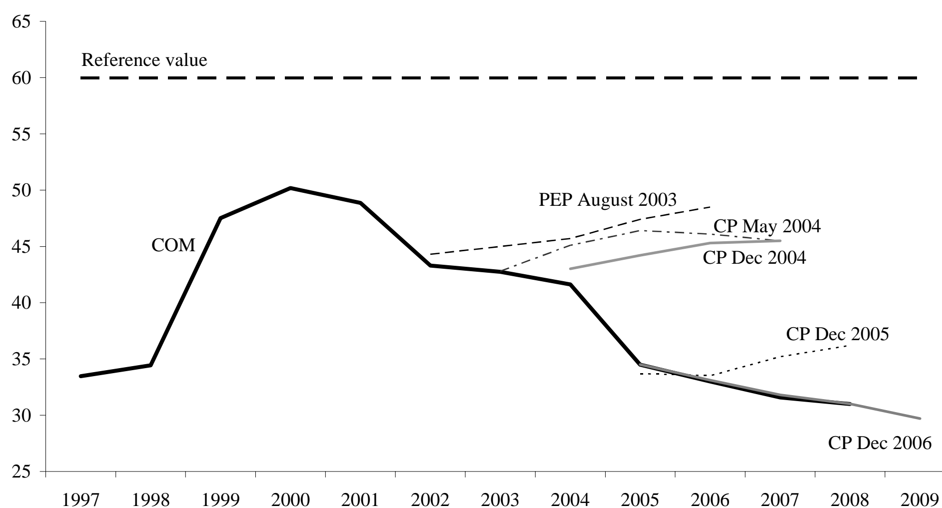
This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the convergence programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

Debt dropped substantially in 2005 (see section 2.4) and is expected to decrease further over the programme horizon, albeit more slowly. The programme estimates the 2006 debt ratio at 33.1% of GDP which is virtually the same as the Commission services' autumn 2006 forecast of 33% of GDP. According to the programme the debt ratio is expected to decrease gradually to 29.7% in 2009. Part of this decline will again be enabled by better liquidity management causing a decrease in liquid financial assets (see section 2.4). This debt reduction path is significantly below the one set in the previous update. The improvement in debt projections results mainly from higher nominal growth projections and a more ambitious fiscal consolidation path.

Figure 9: Debt projections in successive convergence programmes (% of GDP)



<u>*Source:*</u>
Commission services and national convergence programmes

8 On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

Table 11: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**41.6**	**34.5**	**33.0**	**33.1**	**31.6**	**31.8**	**31.0**	**31.0**	**29.7**
Change in the ratio	-1.2	-7.1	-1.5	-1.4	-1.4	-1.3	-0.6	-0.8	-1.3
Contributions [2] *:*									
Primary balance	3.4	1.4	1.7	1.9	1.1	0.9	0.9	0.5	0.1
"Snow-ball" effect	-0.8	-1.5	-1.8	-1.4	-1.3	-1.0	-0.3	-0.2	-0.2
Of which:									
Interest expenditure	3.3	1.7	1.7	1.8	2.0	2.0	2.0	1.9	1.8
Growth effect	-1.5	-2.3	-2.1	-2.1	-2.1	-2.1	-1.7	-1.6	-1.5
Inflation	-2.6	-1.0	-1.4	-1.2	-1.1	-0.9	-0.6	-0.4	-0.5
Stock-flow adjustment	-3.7	-7.0	-1.5	-1.9	-1.2	-1.2	-1.2	-1.1	-1.2
Of which:									
Cash/accruals diff.	0.1	0.3	n.a.	0.1	n.a.	-0.1	n.a.	0.2	0.3
Acc. financial assets	-3.3	-7.2	n.a.	-1.2	n.a.	-1.1	n.a.	-1.2	-1.2
Privatisation	-4.7	0.0	n.a.	0.0	n.a.	0.0	n.a.	0.0	0.0
Val. effect & residual	-0.5	-0.1	n.a.	-0.7	n.a.	0.0	n.a.	-0.2	-0.4

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

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

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Convergence programme update (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The programme's debt projections are broadly in line with the Commission services' autumn 2006 forecast. 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.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[9]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing

[9] For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (see box 6), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2009, the final year of the convergence programme; it is called the "2006 scenario". Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2009 provided in the convergence programme will be fully respected. This is the "programme scenario". Debt and primary balance projections in this scenario start in 2010. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections[10]. Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	16.2	15.4	15.3	16.5	17.7	19.1	2.9
Pensions	7.2	6.7	7.0	7.7	8.2	9.0	1.8
Healthcare	4.4	4.7	5.2	5.7	6.0	6.3	1.9
Long-term care	0.7	0.8	0.7	0.9	1.1	1.3	0.6
Education	3.7	3.0	2.2	2.2	2.3	2.4	-1.3
Unemployment benefits	0.3	0.2	0.1	0.1	0.1	0.1	-0.2
Source: Economic Policy Committee and Commission services.							

The projected increase in age-related spending in Slovakia is below the average of the EU, rising by 2.9% points of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be relatively limited in Slovakia, rising by 1.8% points, due to the pension reform enacted in 2005. The increase in health-care expenditure is projected to be 1.9% points of GDP, slightly above the average in the EU. For long-term care, the projected increase of 0.6% points up to 2050 coincides with the average in the EU.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

[10] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1 (hereinafter Ageing Report).

Table 13: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	2.4	4.1	2.8	1.5	3.2	2.8
of which:						
Initial budgetary position	1.9	2.2	-	1.0	1.2	-
Debt requirement in 2050	-0.5	-	-	-0.5	-	-
Future changes in budgetary position	1.0	2.0	-	1.0	2.0	-

Source: Commission services.

Box 6 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) **initial budgetary position (IBP)**; and, (ii) l**ong-term change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2010-2014) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, the S1 indicator is additionally decomposed into a third factor, the distance to a debt/GDP ratio of 60% of GDP in 2050 is an additional; the debt requirement in 2050 (DR).

In the “2006 scenario”, the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 2.4% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be 4.1% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are larger in the present assessment, by about 1 p.p. of GDP. This is mainly due to a lower structural primary balance in 2006 (at -1.7% of GDP), compared with the structural primary balance in 2005 estimated in the Commission services’ spring 2006 forecast (at -0.4% of GDP) that

was used in the Sustainability Report.[11] The revenue diverted to the new fully-funded defined contribution pension scheme introduced in 2004 and classified outside the general government is indeed significantly larger in 2006 (1.1% of GDP) than in 2005 (0.6% of GDP).

The initial budgetary position constitutes a risk to the sustainability of public finances even before considering the long-term budgetary impact of ageing. The budgetary plans in the programme imply a strengthening of the structural primary balance, of around 1 p.p. of GDP, between 2006 and 2009. If achieved, such consolidation would reduce risks to long-term sustainability of public finances, reducing the sustainability gap S2 by about 1% of GDP ("programme scenario"). The difference between the initial budgetary position in the 2006 scenario and the programme scenario illustrates how the full respect of the convergence programme targets, will contribute to tackling the budgetary challenges raised by the demographic developments, although Slovakia would still have a structural primary deficit in 2009. According to both sustainability gaps, the long-term budgetary impact of ageing is relatively limited in particular thanks to the pension reform measures enacted in recent years.

The required primary balance (RPB) is almost 3% of GDP, higher than the structural primary deficit of 0.8% of GDP in the last year of the programme's period.

Moreover, the sustainability gap indicators would increase by up to ½% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 10.

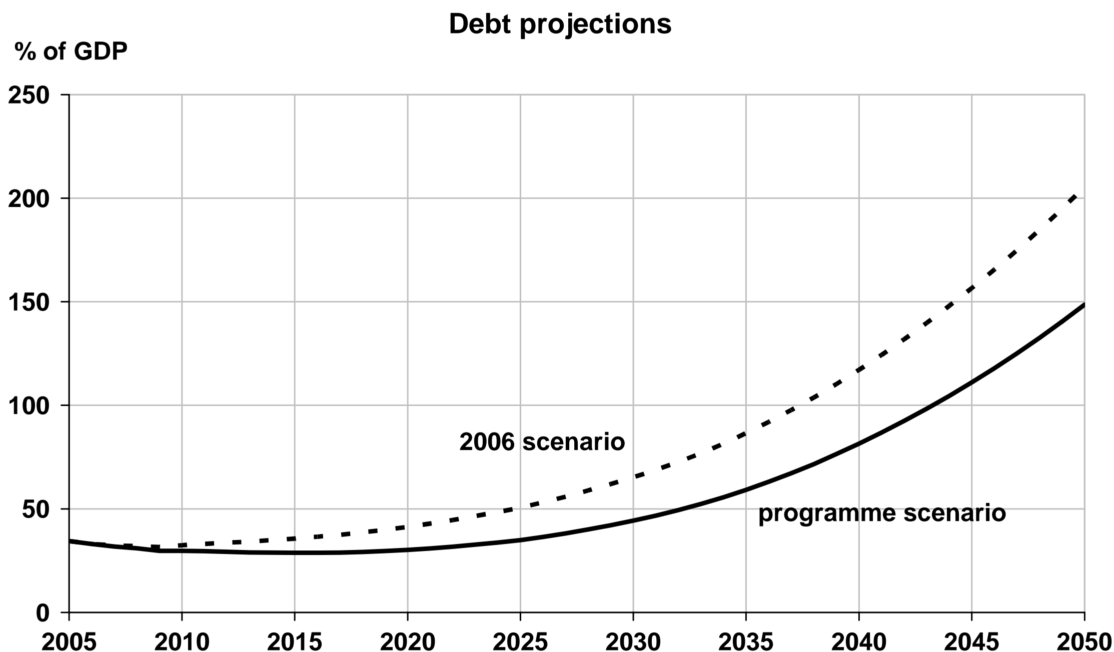
The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at close to 33% of GDP in 2006. According to the "2006 scenario", the debt ratio is projected to start increasing in the 2010s as the impact of ageing takes hold; in the late 2020s it will be higher than 60% of GDP. In the "programme scenario" the projected increase in the debt ratio will start somewhat later, since the budgetary position in 2009 is stronger than in 2006.[12]

---

[11] Both figures include the revenue-reducing impact of classifying funded defined-contribution pension schemes outside the general government sector.

[12] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

Figure 10: Long-term projections for the government debt ratio



Source: Commission's services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, the benefit ratio in Slovakia is projected to decrease relatively markedly, by almost 20% in the period to 2050.[13] Employment rates of older workers are currently lower in Slovakia (25%) than on average in the EU (40%) and are projected to remain so up to 2050, although the gap is projected to narrow considerably. A further increase in the employment rate of older workers than assumed in the projections would contribute to reduce the projected relatively marked decrease in the benefit ratio. Indeed, a large increase in employment rates for older workers would foster GDP growth and ensure that workers can accumulate enough pension rights to limit the decrease in the benefit ratio, which would reduce the risks of possible pressures on the public finance emerging in the future.

Second, property income in Slovakia amounted to 2% of GDP in 2005. As shown in Chapter IV of the Sustainability Report (2006), risks to public finance sustainability might be underestimated by around half of this amount, i.e. 1% of GDP. This suggests that the risks to public finance sustainability could be slightly underestimated.

5.2.3. Assessment

The long-term budgetary impact of ageing in Slovakia is lower than the EU average, with pension expenditure influenced by the recent pension reform showing a more limited

---

[13] If the pensions from the private funded scheme are not considered, the reduction in the benefit ratio is even larger, by 34%.

increase than in many other countries. However, current pension arrangements might come under pressure at some point if the projected decrease in the benefit ratio was to fully materialise and risks to the public finances in the future can not be excluded. Increasing the employment rates of older workers would improve workers' pensions in the future and contribute to the success of the pension reforms.

The initial budgetary position with a structural deficit constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Moreover, the large revenue-reducing impact of the pension reform is projected to increase over the medium-term. Consolidating the public finances would therefore contribute to reducing risks to the sustainability of public finances.

Overall, Slovakia appears to be at medium risk with regard to the sustainability of public finances.

6. Structural reform, the quality of public finances and institutional features

According to the programme, the planned fiscal consolidation relies predominantly on strong GDP growth. Apart from that, an up to 20% across-the-board reduction in public sector employment is being prepared for 2007 with the aim of increasing the efficiency of public expenditure. No details are provided on how this reduction should be achieved. The programme does not present other major structural reforms for the period 2006-2009.

However, some elements of the healthcare reform introduced since mid-2003, such as increased cost-sharing by patients were abolished in 2006. As a result, debt build-up in the healthcare system might accelerate again, having a negative impact on general government finances. On the other hand, a reduction of the healthcare provider network, which would lead to considerable cost-savings, is being considered.

The 2004 tax reform has also been modified through an introduction of a lower VAT rate (10%) on medical products and a lower tax-free income for higher income groups effective from 2007. Various adjustments to the pension reform launched in 2005 that would have a negative impact on the long-term sustainability of public finances, in particular a decrease in the size of the second funded pension pillar, are being considered, but no changes have yet been adopted. In addition, it is likely that transitory savings achieved by a smaller second pillar will be used for additional spending and not deficit reductions.

Moreover, the non-binding multi-annual budgetary framework has still not yet been complemented by more binding rules such as expenditure ceilings. As a result, part of the better-than-expected revenues in 2006 has been used for financing increased government spending.

7. Consistency with the National Reform Programme and with the broad economic policy guidelines

According to the programme, the new government has 3 priorities: healthcare, education and agriculture. Apart from education, these priorities are different from the key challenges identified in the NRP: information society; R&D and innovation; business

environment; and education and employment. Moreover, the significant support for education indicated in the NRP is not evident in the 2007 budget. On the other hand, expenditure on healthcare and agriculture is planned to increase considerably. The programme underscores that increasing the wages of teachers is its main goal in the area of education.

The convergence programme provides systematic information on the direct budgetary costs associated with the main reforms implemented in 2006, but does not provide such information with regard to the main reforms envisaged in the NRP for coming years. Moreover, it does not contain a qualitative assessment of the overall impact of the National Reform Programme within the medium term fiscal strategy. Nevertheless, the update confirms that implementation of the NRP will be consistent with the fiscal consolidation path envisaged in the programme.

Box 7: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme of Slovakia, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 13 October 2006. The Commission’s assessment of this report, which was adopted on 12December 2006 as part of its Annual Progress Report, can be summarised as follows.

Slovakia is making progress in the implementation of its National Reform Programme, which as key challenges identifies: developing the information society; increasing R&D and innovation; improving the business environment; improving education and raising employment. However, important challenges and the need for further measures remain, particularly in the microeconomic and employment fields.

Among the strengths of the National Reform Programme and its implementation are: policies to improve the business environment and create an information society are now beginning to pay off; employment growth has been strengthened by new tax incentives, mobility measures and some improvement in the service offered to certain disadvantaged groups; and progress in the reform of tertiary education alongside new measures to support ICT use and the integration of disadvantaged children into education system.

The policy areas in the Slovak National Reform Programme where weaknesses need to be tackled with the highest priority are: within the context of fiscal consolidation, redirecting more resources to R&D, innovation and education and developing clear strategies and priorities in these areas; reinforcing action on improving skills and lifelong learning; and additional efforts to reduce long-term unemployment, especially among vulnerable groups including the Roma minority. Against this background, it is recommended that Slovakia:

- reallocate expenditure towards R&D and education and complete the development of a coherent national R&D and innovation strategy, with strong interconnections between research institutions and business;

- adopt a lifelong learning strategy that addresses the needs of the labour market and improves qualification levels and skills, and complement the reform of tertiary education with reform of primary and secondary education;

- develop a comprehensive approach to tackling long-term unemployment, notably by developing targeted active labour market policies for the most vulnerable groups.

In addition, it will be important for Slovakia over the period of the National Reform Programme to focus on: continued efforts on ICT policies, especially on broadband infrastructure;

improvements in the better regulation system; addressing the gender pay gap; and developing an active ageing strategy to increase employment of older workers.

Overall, the budgetary strategy in the convergence programme is broadly consistent with the broad economic policy guidelines.

Table 14: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	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 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 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.

Source:
Commission services

* * *

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific 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, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a "safety margin" that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary

pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2005	2005	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	1178.8	6.1	6.6	7.1	5.5	5.1	5.0
2. Nominal GDP	B1*g	1472.1	8.6	10.3	10.1	7.0	6.8	6.9
Components of real GDP								
3. Private consumption expenditure	P.3	658.5	7.0	5.6	5.3	4.4	4.2	4.1
4. Government consumption expenditure	P.3	221.3	0.5	3.9	2.0	3.0	2.8	2.8
5. Gross fixed capital formation	P.51	320.2	13.8	8.2	6.0	5.0	5.0	5.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	28.6	2.4	1.6	0.7	0.7	0.6	0.6
7. Exports of goods and services	P.6	1049.8	13.5	17.6	14.2	8.5	7.3	6.9
8. Imports of goods and services	P.7	1099.5	15.5	15.2	11.2	7.3	6.4	6.3
Contributions to real GDP growth								
9. Final domestic demand		-	7.5	6.1	4.9	4.3	4.1	4.1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.7	-0.8	-0.8	0.0	-0.1	0.0
11. External balance of goods and services	B.11	-	-2.0	1.5	2.7	1.2	1.1	0.8

Table 1b. Price developments

	ESA Code	2005	2005	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		1249.0	2.4	3.5	2.8	1.3	1.6	1.9
2. Private consumption deflator		1282.0	2.6	4.9	2.8	2.0	2.4	2.6
3. HICP[1]		-	2.8	4.4	3.1	2.0	2.4	2.6
4. Public consumption deflator		1244.0	1.1	5.1	2.6	1.8	2.2	2.3
5. Investment deflator		1195.0	2.8	2.1	1.9	1.6	1.8	1.9
6. Export price deflator (goods and services)		1080.0	-1.9	3.2	1.1	0.2	0.4	1.0
7. Import price deflator (goods and services)		1091.0	-1.6	3.9	0.5	0.6	0.9	1.3

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2005	2005	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		2084	1.4	2.0	1.5	0.8	0.8	0.8
2. Employment, hours worked[2]		3623800	1.6	0.3	3.3	1.4	1.4	1.8
3. Unemployment rate (%)[3]		16.3	16.3	13.8	13.2	12.9	12.4	12.0
4. Labour productivity, persons[4]		-	4.7	4.5	5.5	4.6	4.2	4.1
5. Labour productivity, hours worked[5]		-	4.5	6.2	3.7	4.1	3.6	3.1
6. Compensation of employees	D.1	550739	6.6	10.3	8.7	6.9	7.1	7.2

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis rest of the world	B.9	-8.6	-6.4	-3.1	-2.5	-2.0	-1.6
of which: - Balance on goods and services		-4.5	-3.7	-0.8	-0.3	0.1	0.3
- Balance of primary incomes and transfers		-4.1	-3.2	-2.7	-2.5	-2.4	-2.2
- Capital account		0.0	0.5	0.4	0.3	0.3	0.3
2. Net lending/borrowing of the private sector	B.9	-5.5	-2.7	-0.2	-0.1	-0.1	
3. Net lending/borrowing of general government	EDP B.9	-3.1	-3.7	-2.9	-2.4	-1.9	
4. Statistical discrepancy							

Table 2. General government budgetary prospects

	ESA code	2005 Level	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-45995	-3.1	-3.7	-2.9	-2.4	-1.9
2. Central government	S.1311	-34188	-2.3	-3.6	-2.8	-2.3	-2.0
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-987	-0.1	-0.1	-0.1	0.0	0.0
5. Social security funds	S.1314	-10820	-0.7	0.0	-0.1	-0.1	0.1
General government (S13)							
6. Total revenue	TR	499271	33.9	32.6	31.7	31.2	31.1
7. Total expenditure	TE[1]	545266	37.1	36.3	34.6	33.6	33.1
8. Net lending/borrowing	EDP B.9	-45995	-3.1	-3.7	-2.9	-2.4	-1.9
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	25678	1.7	1.8	2.0	1.9	1.8
p.m.: 9a. FISIM		261	0.0	0.0	0.0	0.0	0.0
10. Primary balance	[2]	-20317	-1.4	-1.9	-0.9	-0.6	-0.2
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		276774	18.8	17.6	17.4	17.4	17.3
11a. Taxes on production and imports	D.2	187141	12.7	11.8	11.7	11.5	11.4
11b. Current taxes on income, wealth, etc	D.5	89608	6.1	5.8	5.8	5.8	5.8
11c. Capital taxes	D.91	25	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	161162	11.0	10.3	9.8	9.7	9.6
13. Property income	D.4	28783	2.0	1.8	1.7	1.5	1.4
14. Other (14=15-(11+12+13))		32552	2.2	3.0	2.8	2.6	2.8
15=6. Total revenue	TR	499271	33.9	32.6	31.7	31.2	31.1

p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[3]		429446	29.2	27.8	27.2	27.0	26.9

Selected components of expenditure

16. Collective consumption	P.32	160339	10.9	10.8	10.2	10.0	9.9
17. Total social transfers	D.62+D.63	224538	15.3	15.3	15.0	14.5	14.2
17a. Social transfers in kind	P.31=D.63	65975	4.5	4.5	4.4	4.3	4.3
17b. Social transfers other than in kind	D.62	158563	10.8	10.8	10.5	10.2	9.9
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	25678	1.7	1.8	2.0	1.9	1.8
19. Subsidies	D.3	19487	1.3	1.3	1.3	1.3	1.3
20. Gross fixed capital formation	P.51	31045	2.1	1.8	1.4	1.2	1.1
21. Other (21=22-(16+17+18+19+20))		84179	5.7	5.3	4.8	4.8	4.8
22=7. Total expenditure	TE[1]	545266	37.1	36.3	34.6	33.6	33.1
p.m.: Compensation of employees	D.1	107629	7.3	7.3	7.0	6.8	6.7

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

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

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

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2004**	**2009**
1. General public services	1	4.9	
2. Defence	2	1	
3. Public order and safety	3	1.3	
4. Economic affairs	4	6.5	
5. Environmental protection	5	0.5	
6. Housing and community amenities	6	1.2	
7. Health	7	4.1	
8. Recreation, culture and religion	8	1.2	
9. Education	9	3.6	
10. Social protection	10	15.5	
11. Total expenditure (=item 7=26 in Table 2)	TE[1]	**39.7**	

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

Table 4. General government debt developments

% of GDP		**2005**	**2006**	**2007**	**2008**	**2009**
1. Gross debt[1]		34.5	33.1	31.8	31.0	29.7
2. Change in gross debt ratio		-7.1	-1.4	-1.3	-0.8	-1.4
3. Primary balance[2]		1.4	1.9	0.9	0.6	0.2
4. Interest expenditure (incl. FISIM)[3]		1.7	1.8	2.0	1.9	1.8
5. Stock-flow adjustment		-7.0	-1.8	-1.2	-1.2	-1.3
of which: - Differences between cash and accruals[4]		0.9	0.1	-0.1	0.2	0.3
- Net accumulation of financial assets[5] *of which:*		-7.4	-1.2	-1.1	-1.2	-1.2
- privatisation proceeds		0.0	0.0	0.0	0.0	0.0
- Valuation effects and other[6]		-0.6	-0.7	0.0	-0.2	-0.4

p.m.: implicit interest rate on debt[7]		4.6	5.7	6.6	6.3	6.1
Other relevant variables						
6. Liquid financial assets[8]		5.1	5	2.7	1.3	0.3
7. Net financial debt (7=1-6)		29.4	28.1	29.2	29.7	29.4

[1]As defined in Regulation 3605/93 (not an ESA cncept).

[2]Cf. Item 10 in Table 2.

[3]Cf. Item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

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

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

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

[8]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	**2005**	**2006**	**2007**	**2008**	**2009**
1. Real GDP growth (%)		6.1	6.6	7.1	5.5	5.1
2. Net lending of general government	EDP B.9	-1.7	-2.6	-1.9	-1.3	-0.7
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 incl. FISIM	-1.8	-1.8	-2.0	-1.9	-1.8
4. Potential GDP growth (%)		5.8	6.5	6.9	5.6	5.4
contributions:						
- labour		0.4	0.5	0.5	0.4	0.4
- capital		1.5	1.6	1.6	1.7	1.7
- total factor productivity		3.9	4.4	4.8	3.5	3.2
5. Output gap		0.0	0.2	0.4	0.2	0.0
6. Cyclical budgetary component		0.0	0.0	0.1	0.0	0.0
7. Cyclically-adjusted balance (2-6)		-1.7	-2.7	-2.0	-1.4	-0.7
8. Cyclically-adjusted primary balance (7-3)		0.1	-0.9	0.0	0.5	1.0

Table 6. Divergence from previous update

	ESA Code	2005	2006	2007	2008	2009
Real GDP growth (%)						
Previous update		5.1	5.4	6.1	5.6	
Current update		6.1	6.6	7.1	5.5	5.1
Difference		1	1.2	1	-0.1	
General government net lending (% of GDP)	EDP B.9					
Previous update		-4.9	-4.2	-3.0	-2.7	
Current update		-3.1	-3.7	-2.9	-2.4	-1.9
Difference		1.8	0.5	0.1	0.3	
General government gross debt (% of GDP)						
Previous update		33.7	35.5	35.2	36.2	
Current update		34.5	33.1	31.8	31.0	29.7
Difference		0.8	-2.4	-3.4	-5.2	

Table 7. Long-term sustainability of public finances

% of GDP	2004	2010	2020	2030	2040	2050
Total expenditure	**38.0**	**36.4**	**36.2**	**38.0**	**40.9**	**45.3**
Of which: age-related expenditures	**16.2**	**15.4**	**15.3**	**16.5**	**17.7**	**19.1**
Pension expenditure[1]	7.2	6.7	7.0	7.7	8.2	9.0
Social security pension	7.2	6.7	7.0	7.7	8.2	9.0
Old-age and early pensions[2]	5.4	4.8	4.6	5.0	5.5	6.3
Other pensions (disability, survivors)	1.8	1.9	2.3	2.7	2.7	2.7
Occupational pensions (if in general government)	-	-	-	-	-	-
Health care[3]	4.4	4.7	5.2	5.7	6.0	6.3
Long-term care *(this was earlier included in health care)*	0.7	0.8	0.7	0.9	1.1	1.3
Education expenditure[4]	3.7	3.0	2.2	2.2	2.3	2.4
Other age-related expenditures[4]	0.3	0.2	0.1	0.1	0.1	0.1
Interest expenditure	2.2	1.5	1.4	2.0	3.7	6.7
Total revenue	35.0	33.0	32.8	32.7	32.7	32.6
Of which: property income	1.7	1.3	1.3	1.3	1.3	1.3
of which: from pensions contributions (or social contributions if appropriate)	12.8	11.2	11.0	10.9	10.9	10.8
Pension reserve fund assets	0.0	7.0	18.9	31.5	45.7	58.0
Of which: consolidated public pension fund assets (assets other than government liabilities)	0.0	0.0	0.0	0.0	0.0	0.0
Assumptions						
Labour productivity growth	5.2	4.2	3.3	2.7	1.9	1.7
Real GDP growth	5.5	5.3	3.3	2.0	0.4	0.3
Participation rate males (aged 15-64)[5]	77.3	79.6	82.1	82.3	79.4	78.7
Participation rates females (aged 15-64)[5]	64.1	67.1	73.5	73.8	70.0	69.1
Total participation rates (aged 15-64)[5]	70.7	73.3	77.8	78.0	74.7	73.9
Unemployment rate						
Population aged 65+ over total population						

[1] Including pension payments from other funds than Social Security Fund. Projection of the Ministry of Finance until 2010, projection of the EPC AWG afterwards, corrected with the effect of the stabilisation measures of 2006-2007.

[2] Including survivor pension paid after the retirement age and other pension-type benefits.

[3] 2005-2050: projection of the EPC AWG, 2000: OECD Health Data 2005.

[4] Projection of the EPC AWG.

[5] In the Code of conduct the age limits are 20-64

Table 8. Basic assumptions

	2005	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	2.1	2.1	3.0	3.7	3.6	4.0
Long-term interest rate (annual average)	4.1	3.3	3.3	4.1	4.2	5.3
for countries in euro area or ERM II: **USD/€exchange rate (annual average)**	1.2	1.3	1.3	1.3	1.3	1.3
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	5.7	5.2	5.2	4.5
EU GDP growth	2.4	1.5	2.8	2.4	2.4	2.1
Growth of relevant foreign markets	2.4	2.1	2.6	3.0	2.8	2.7
World import volumes, excluding EU	14.0	8.8	9.1	8.2	7.9	7.9
Oil prices (Brent, USD/barrel)	37.8	57.3	65.6	69.1	69.1	69.1

[1]If necessary, purely technical assumptions.

Annex 3: 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 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.

Guidelines in the 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		
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		
The programme provides all optional information in these tables.	X		Data on COFOG for 2009 are missing.
The concepts used are in line with the European system of accounts (ESA).	X		In some cases, concepts are not applied consistently across the whole time series.
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.	X		Different exchange rate assumption
Significant divergences between the national and the Commission services’ economic forecasts are explained[2].	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 convergence 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.	X		
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	X		Only for 2007

Guidelines in the code of conduct	Yes	No	Comments
measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.			
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.			not applicable
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.			not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			not applicable
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: 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.	X		
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			not applicable
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
h. Quality of public finances			
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. Long-term sustainability			
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		
j. Other information (optional)			
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		

Notes:

[1]The 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.

[2]To 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.

Source:

Guidelines in the code of conduct	Yes	No	Comments
Commission services			

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the EU10.

Slovakia - Key economic indicators

	Averages					
	1996 – 2005	1996 – 2000	2001 – 2005	2003	2004	2005
Economic activity						
Real GDP (% change)	4.1	3.7	4.6	4.2	5.4	6.0
Private consumption (% change)	4.5	4.7	4.3	0.2	4.2	7.0
Government consumption (% change)	2.9	2.7	3.1	3.9	2.0	-0.6
Investment (% change)	6.2	5.6	6.7	-2.3	5.0	17.5
Exports (% change)	9.7	9.6	9.8	15.9	7.9	13.8
Imports (% change)	10.4	10.5	10.2	7.6	8.8	16.6
Contributions to real GDP growth:						
Domestic demand	4.9	4.6	5.3	-1.3	6.3	8.8
Net exports	-0.8	-0.9	-0.7	5.5	-0.9	-2.8
Output gap (% of potential GDP)	-0.8	0.6	-2.1	-3.0	-2.7	-2.0
Prices and costs						
HICP inflation (% change)	7.0	8.2	5.9	8.4	7.5	2.8
Unit labour costs (% change)	4.8	6.2	3.5	5.6	3.2	0.5
Labour productivity (% change)	4.2	4.5	4.0	2.3	5.8	4.6
Real unit labour costs (% change)	-0.5	0.1	-1.1	0.8	-2.7	-1.8
Comparative price levels (EUR25=100)	45.4	42.3	48.5	48.1	52.3	54.9
Labour market						
Employment (% change)	0.3	-0.4	1.1	1.8	0.3	2.1
Employment (% of working age population)	58.1	59.3	56.9	56.9	56.7	57.6
Unemployment rate (% of labour force)	16.1	14.2	18.0	17.6	18.2	16.3
NAIRU (% of labour force)	15.8	14.4	17.2	17.0	15.7	14.8
Participation rate (% of working age population)	69.1	68.9	69.3	69.0	69.3	68.8
Working age population (% change)	0.8	0.8	0.7	0.7	0.7	0.5
Competitiveness and external position						
Real effective exchange rate (% change) (1)	2.8	1.5	4.1	9.5	7.1	2.2
Export performance (% change) (2)	2.2	0.1	4.4	10.0	-1.7	7.5
External balance of g & s (% of GDP)	-6.3	-7.6	-5.0	-1.9	-2.7	-5.1
External balance (% of GDP)	-6.4	-7.0	-5.9	-2.5	-2.3	-8.1
FDI inflow (% of GDP)	n.a.	n.a.	n.a.	2.2	2.0	4.5
Public finances						
Total expenditure (% of GDP)	44.7	49.1	40.4	39.4	38.9	37.1
Total revenue (% of GDP)	38.5	41.4	35.6	35.6	35.9	33.9
General government balance (% of GDP)	-6.2	-7.7	-4.8	-3.7	-3.0	-3.1
General government debt (% of GDP)	40.7	39.3	42.2	42.7	41.6	34.5
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-2.4	-2.2	-1.7
Financial indicators (4)						
Short term real interest rate (%) (5)	5.3	9.2	1.3	1.4	-1.3	0.5
Long term real interest rate (%) (5)	n.a.	n.a.	1.1	0.2	-0.9	1.1
Household debt (% change) (6)	27.2	23.7	30.8	38.8	37.1	41.4
Corporate sector debt (% change) (7)	-0.6	3.5	-4.7	3.8	-13.8	15.9
Household debt (% of GDP) (6)	5.5	3.6	7.5	7.0	8.6	11.2
Corporate sector debt (% of GDP) (7)	5.7	5.1	6.2	6.1	6.6	7.7

Notes:

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (= EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:

Commission services

EU10 - Key economic indicators

	Averages					
	1996 – 2005	1996 – 2000	2001 – 2005	2003	2004	2005
Economic activity						
Real GDP (% change)	4.0	4.3	3.7	4.0	5.1	4.6
Private consumption (% change)	4.2	4.7	3.8	3.9	4.1	3.7
Government consumption (% change)	2.5	1.9	3.1	5.0	1.8	2.0
Investment (% change)	5.6	8.4	2.9	1.7	7.2	6.2
Exports (% change)	10.0	11.0	9.0	9.1	14.5	10.3
Imports (% change)	10.2	12.7	7.8	8.5	14.6	6.9
Contributions to real GDP growth:						
Domestic demand	4.3	5.3	3.4	4.0	5.6	3.0
Net exports	-0.3	-1.0	0.4	0.0	-0.5	1.6
Output gap (% of potential GDP)	n.a.	n.a.	-1.0	-1.4	-0.5	-0.4
Prices and costs						
HICP inflation (% change)	n.a.	n.a.	3.3	1.9	4.1	2.5
Unit labour costs (% change)	5.7	9.2	2.3	1.3	1.4	0.7
Labour productivity (% change)	4.2	4.6	3.7	4.3	4.5	2.9
Real unit labour costs (% change)	-0.8	-0.6	-1.0	-0.7	-2.5	-1.8
Comparative price levels (EUR25=100)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour market						
Employment (% change)	-0.1	-0.3	0.0	-0.2	0.6	1.7
Employment (% of working age population)	58.0	59.4	56.6	56.1	56.2	57.0
Unemployment rate (% of labour force)	12.8	11.3	14.2	14.3	14.2	13.4
NAIRU (% of labour force)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate (% of working age population)	66.4	66.7	66.1	65.7	65.6	65.8
Working age population (% change)	0.3	0.4	0.3	0.4	0.4	0.3
Competitiveness and external position						
Real effective exchange rate (% change) (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s (% of GDP)	-3.4	-4.2	-2.6	-2.9	-2.6	-1.3
External balance (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances						
Total expenditure (% of GDP)	n.a.	n.a.	44.2	44.9	43.4	43.6
Total revenue (% of GDP)	n.a.	n.a.	40.0	39.9	39.6	40.3
General government balance (% of GDP)	n.a.	n.a.	-4.2	-5.1	-3.7	-3.3
General government debt (% of GDP)	37.9	35.8	40.1	39.9	43.4	41.3
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-4.5	-3.4	-3.0
Financial indicators (4)						
Short term real interest rate (%) (5)	n.a.	n.a.	3.5	3.3	1.8	1.8
Long term real interest rate (%) (5)	n.a.	n.a.	n.a.	3.5	2.2	2.2
Household debt (% change) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% change) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.
(5) Using GDP deflator.
(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.
(7) Non-financial corporate sector debt, defined as loans and securities other than shares.
Source:
Commission services

Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[14].

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 elasticity[15]. 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:

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

[14] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 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.

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

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

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

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.

Assessment of tax projections by major tax category

	2007			2008			2009
	CP	COM	OECD[1]	CP	COM[2]	OECD[1]	CP
Taxes on production and imports:							
Change in tax-to-GDP ratio	-0.2	-0.3	0.0	-0.1	-0.2	0.0	-0.1
Difference CP – COM	0.1			0.1			/
of which [3]*:*							
- discretionary & elasticity component	0.1			0.0			/
- composition component	0.0			0.0			/
Difference COM – OECD [1]	/	-0.3		/	-0.2		/
of which [3]*:*							
- discretionary & elasticity component	/	0.0		/	-0.1		/
- composition component	/	-0.3		/	-0.1		/
p.m.: Elasticity							
- of taxes to tax base[4]	1.1	1.0	1.0	0.9	0.9	1.0	0.9
- of tax base[4] to GDP	0.8	0.8	1.0	0.9	0.9	1.0	1.0
Social contributions:							
Change in tax-to-GDP ratio	-0.6	-0.3	-0.3	-0.1	-0.1	-0.2	-0.1
Difference CP – COM	-0.2		/	0.0		/	/
of which [3]*:*							
- discretionary & elasticity component	-0.3		/	-0.1		/	/
- composition component	0.1		/	0.1		/	/
Difference COM – OECD [1]	/	0.0		/	0.1		/
of which [3]*:*							
- discretionary & elasticity component	/	-0.1		/	0.0		/
- composition component	/	0.1		/	0.1		/
p.m.: Elasticity							
- of taxes to tax base[5]	0.5	0.9	1.0	0.9	0.9	1.0	0.8
- of tax base[5] to GDP	0.9	0.8	0.7	1.0	0.9	0.7	1.0
Personal income tax[6]**:**							
Change in tax-to-GDP ratio	0.0	0.0	-0.1	0.1	0.0	-0.1	0.0
Difference CP – COM	0.0		/	0.0		/	/
of which [3] *:*							
- discretionary & elasticity component	-0.1		/	0.0		/	/
- composition component	0.0		/	0.0		/	/
Difference COM – OECD [1]	/	0.1		/	0.1		/
of which [3] *:*							
- discretionary & elasticity component	/	0.1		/	0.0		/
- composition component	/	0.0		/	0.0		/
p.m.: Elasticity							
- of taxes to tax base[5]	1.1	1.2	1.0	1.3	1.3	1.0	1.0
- of tax base[5] to GDP	0.9	0.8	0.7	1.0	0.9	0.7	1.0
Corporate income tax[6] **:**							
Change in tax-to-GDP ratio	0.0	0.0	0.1	0.0	0.0	0.1	0.0
Difference CP – COM	0.0		/	0.0		/	/
of which [3] *:*							
- discretionary & elasticity component	0.0		/	0.0		/	/
- composition component	0.0		/	0.0		/	/
Difference COM – OECD [1]	/	-0.1		/	0.0		/
of which [3] *:*							
- discretionary & elasticity component	/	-0.1		/	0.0		/
- composition component	/	-0.1		/	-0.1		/
p.m.: Elasticity							
-of taxes to tax base[7]	0.8	0.9	1.0	1.2	1.0	1.0	1.0
-of tax base[7] to GDP	1.1	1.1	0.7	1.0	1.1	0.7	1.0

Notes:

[1] Based on 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 2006 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)