COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of Slovakia, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Slovakia was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Slovakia, submitted on 1 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme); and

(4) the Commission's assessment of the October 2006 national reform programme.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2.1. Recent economic and budgetary performance

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.

2.2. The excessive deficit procedure for Slovakia

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

2.3. The assessment in the Council opinion on the previous programme

On 24 January 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2008. The Council was of the opinion that "the programme follows the deficit adjustment path set by the Council recommendations under Article 104(7)". The Council invited Slovakia to "(i) strengthen, in the context of strong growth outcome and prospects, the effort in the structural budgetary adjustment, in order to speed up the attainment of the MTO; and (ii) reinforce the binding character of the medium-term expenditure ceilings for central government".

2.4. The Commission assessment of the October 2006 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. 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.

[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.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[3] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[4] "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.

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On the updated convergence programme of Slovakia, 2006-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated convergence programme of Slovakia, which covers the period 2006 to 2009.

(2) The macroeconomic scenario underlying the 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.

(3) 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.

5 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

(4) 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.

(5) 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. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(6) 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.

(7) 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.

(8) Government gross debt is estimated to have reached 33.1% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 3.4 percentage points over the programme period.

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

(10) The convergence programme does not contain a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. However, it provides some information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme do not seem to be fully consistent with those foreseen in the national reform programme. In particular, apart from education, expenditure priorities listed in the 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.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[6].

The overall conclusion is that the programme is consistent with a correction of the excessive deficit by 2007 but envisages limited progress towards the MTO thereafter.

In view of the above assessment and also in the light of the recommendation under Article 104(7) of 5 July 2004, Slovakia is invited to:

(i) exploit the strong growth prospects to strengthen the structural adjustment in order to ensure the correction of the excessive deficit in 2007 with a larger margin and to speed up the progress towards the MTO; and

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

[6] In particular, the data on general government expenditure by function for 2009 are not provided.

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