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**SLOVAKIA: MACRO FISCAL ASSESSMENT**  
**AN ANALYSIS**  
**OF THE NOVEMBER 2007 UPDATE OF THE CONVERGENCE PROGRAMME**

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 29 November 2007.

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 (DG ECFIN) of the European Commission, was finalised on 6 February 2008. Comments should be sent to Anton Jevcak (Anton.Jevcak@ec.europa.eu). The main aim of the 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.

The analysis takes into account (i) the Commission services’ autumn 2007 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. Technical issues are explained in an accompanying “methodological paper” prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 30 January 2008. The ECOFIN Council adopted its opinion on the programme on 12 February 2008.

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

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## Summary and conclusions

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 2007-2010, was submitted on 29 November 2007. Under the corrective arm of the Pact, was placed in excessive deficit by the Council in July 2004. The deadline for correcting the excessive deficit is 2007.

Slovakia is currently experiencing a period of strong growth induced by wide-range structural reforms introduced in previous years combined with substantial inflows of FDI, especially into the manufacturing sector. Although consequential to growth employment picked up as well and the unemployment rate fell substantially, certain segments of the population concentrated in eastern regions do not seem to take part in this economic expansion. Apart from constituting a drag on public finances and a social problem, the low employability of certain segments of the labour force limits the country's potential output growth and thus hampers the catching-up process. This unevenness in the distribution of economic activity across population groups and regions would call for an increase in the quality of public education and some reallocation of government expenditure to education, R&D and innovation and infrastructure development. Following a predominantly restrictive budgetary policy in previous years, the fiscal stance turned expansionary in 2006, while monetary conditions tightened on the back of increased policy rates and continued exchange rate appreciation which however, as testified by the strong growth in exports and falling current account deficit, does not seem to have affected external competitiveness of the Slovak economy. As a Member State with a derogation and an ERMII participant Slovakia should gear its macroeconomic and structural policies towards achieving sustainable convergence. Although inflation has decelerated markedly in 2007, it is expected to pick up again on the back of rising food and energy prices, strong growth, a tightening labour market and a fading effect of the strong exchange rate appreciation in 2006-07. In order to meet the inflation targets set out in the programme – which assumes euro area membership from 2009 – and to contain possible inflationary pressures after the disinflationary effect from past substantial exchange rate appreciation fades out, further structural reforms are necessary and the government should stand ready to adopt a tighter fiscal stance than that envisaged in the programme.

The macroeconomic scenario underlying the programme envisages that real GDP growth will drop from 8.8% in 2007 to 5.0% in 2010. Assessed against currently available information<sup>1</sup>, this scenario appears to be based on plausible growth assumptions until 2009 and cautious ones for 2010, as the exceptional export performance recorded in 2007 induced by the launch of new production capacities in the manufacturing sector is not expected to be repeated in the coming years. The programme's projections for inflation appear to be on the low side as they are based on more favourable external assumptions than the Commission services' autumn 2007 forecast and on a different assumption on the fading out of the effect of past exchange rate appreciation.

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<sup>1</sup> The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

For 2007, the general government deficit is estimated at 2.7% of GDP in the Commission services' autumn 2007 forecast, against a target of 2.9% of GDP set in the previous update of the convergence programme and of 2.5% of GDP in the current update. This improvement was enabled by a revenue over-performance outweighing higher-than-budgeted expenditure. Given that the estimated 2007 deficit outturn is lower (by 0.2% of GDP) than previously targeted both in nominal and structural (i.e. cyclically-adjusted net of one-off and other temporary measures) terms, the Slovak authorities have partly responded to the invitation in the Council opinion of 27 February 2007 on the previous update of the convergence programme<sup>2</sup> which called for a strengthening of the structural adjustment in order to ensure the correction of the excessive deficit in 2007 with a larger margin.

The main goal of the budgetary strategy is to reach the medium-term objective (MTO) for the budgetary position of a structural deficit of just below 1 % of GDP by 2010. The programme foresees the general government deficit to decrease from 2.5% of GDP in 2007 to 0.8% of GDP in 2010 in nominal terms, with the primary balance improving from a deficit of 1.0% of GDP in 2007 to a surplus of 0.5% of GDP in 2010. The adjustment in both structural and nominal terms is back-loaded towards the end of the programme period. Compared to the previous update, the new update broadly confirms the planned adjustment against a more favourable macroeconomic scenario. Fiscal consolidation is envisaged to be expenditure-based (especially cuts in social payments and compensation of public employees) as the expenditure ratio is planned to be reduced by 3 percentage points of GDP over the programme horizon while the revenue ratio would decline by half this amount.

The budgetary outcomes could be better in 2008 and worse in 2009 and 2010 than projected in the programme. In particular, strong growth prospects, already adopted revenue-increasing measures (broadening of the corporate tax base and increase in the maximum ceiling for social contribution foreseen to generate additional revenue of some 0.3% of GDP) and the likely outflow of participants from the second pension pillar<sup>3</sup> (positive impact estimated at about 0.2% of GDP) should allow for a better-than-foreseen deficit outcome in 2008 if expenditure growth is kept more in check than suggested by the programme as was the case in previous years. However, substantial risks exist for the planned fiscal consolidation back-loaded to 2009 and 2010. In particular, there are no binding expenditure ceilings, there is a lack of information on the measures that underpin the adjustment and there are potentially some risks to expenditure related to planned partnerships with the private sector notably as regards construction of motorways.

In view of this risk assessment, the budgetary stance in the programme seems broadly consistent with a durable correction of the excessive deficit by 2007 as recommended by the Council. A sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations (estimated around a structural deficit of 2% of GDP) would only be provided from 2010 onwards if the envisaged consolidation is strictly implemented. Moreover, the budgetary stance in the programme seems insufficient to ensure that the MTO is achieved by the end of the programme period, as envisaged in the programme. In 2008, only a slight improvement (¼% of

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<sup>2</sup> OJ C 72, 29.3.2007, p. 1.

<sup>3</sup> In the first half of 2008 the second pension pillar will be temporarily opened, allowing current participants to leave and new participants to join the scheme.

GDP) in the structural balance can be expected when good times are foreseen to occur. The pace of adjustment towards the MTO implied by the programme in 2008 should be therefore 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. Moreover, budgetary room needs to be created for the expected increase in inflows of EU funds in order to maintain the restrictive fiscal stance planned for 2009-10. The planned adjustment in the remaining years of the programme – in line with the Pact – should be strictly implemented and, if necessary, backed up with measures. Finally, should inflationary pressures emerge, a tighter fiscal stance than foreseen in the programme would be required.

Slovakia appears to be at medium risk with regard to the long-term sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, with pension expenditure showing a more limited increase than in many other countries, notably thanks to the 2005 pension reform. However, those projections hinge upon the assumption that a relatively low share of workers will leave the mixed pension system in the first half of 2008, during which they will have the opportunity to do so. The budgetary position in 2007 as estimated in the programme with a structural primary deficit constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Consolidating the public finances, as planned in the convergence programme, would therefore contribute to reducing risks to the sustainability of public finances.

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 assessment of progress in its December 2007 Strategic Report on the renewed Lisbon strategy for growth and jobs was that Slovakia has made some progress in implementing its national reform programme over the period 2005-2007. The convergence programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. It confirms that the government's expenditure priorities (healthcare, education and agriculture) continue to partly diverge from the key challenges identified in the NRP (information society; R&D and innovation; business environment; and education and employment). Moreover, it does not specify whether the national R&D expenditure target of 0.8% of GDP will be met by 2010 while education spending tends to increasingly rely on EU Structural Funds. The programme does not contain a qualitative assessment of the overall impact of the National Reform Programme within the medium term fiscal strategy but it provides systematic information on the direct budgetary costs associated with the main reforms envisaged in the NRP for 2008.

In terms of progress in implementing its ERM II commitments, the fiscal targets in successive convergence programmes have been consistently overachieved but the targets themselves have turned out not to be particularly ambitious given the better-than-originally-assumed initial fiscal position and stronger-than-expected economic performance. As regards income policies, collective bargaining agreements in the public sector have provided an important signal of wage moderation for the whole economy. With a view to containing credit growth, the National Bank of Slovakia has closely monitored risk management practices of banks and strengthened cooperation with home country supervisors of banks operating in Slovakia.

The overall conclusion is that the programme is consistent with a correction of the excessive deficit by 2007. Thereafter, it envisages back-loaded progress towards the

MTO in a context of strong growth prospects; in 2008, the envisaged structural improvement is not in line with the Pact and should be more ambitious. Given risks to the budgetary targets from 2009 onwards, the MTO may not be achieved by 2010 as planned in the programme and therefore additional efforts might be required. Moreover, should inflationary pressures emerge, a tighter fiscal stance than foreseen in the programme would be required along with further structural reforms to improve the labour market performance. As regards the long-term sustainability of public finances, Slovakia appears to be at medium risk. With respect to medium-term challenges, the programme does not envisage any progress in reallocating expenditure towards R&D and innovation while it states that education spending should increasingly rely on EU funds.

### Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	<b>CP Nov 2007</b>	<b>8.3</b>	<b>8.8</b>	<b>6.8</b>	<b>5.8</b>	<b>5.0</b>
	COM Nov 2007	8.3	8.7	7.0	6.2	n.a.
	CP Dec 2006	6.6	7.1	5.5	5.1	5.0
HICP inflation (%)	<b>CP Nov 2007</b>	<b>4.3</b>	<b>1.7</b>	<b>2.3</b>	<b>2.6</b>	<b>2.7</b>
	COM Nov 2007	4.3	1.7	2.5	3.0	n.a.
	CP Dec 2006	4.4	3.1	2.0	2.4	2.6
Output gap <sup>1</sup> (% of potential GDP)	<b>CP Nov 2007</b>	<b>-0.5</b>	<b>1.8</b>	<b>2.3</b>	<b>2.1</b>	<b>1.4</b>
	COM Nov 2007 <sup>2</sup>	-0.8	1.0	1.3	0.8	n.a.
	CP Dec 2006	-0.9	1.0	1.6	1.9	2.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	<b>CP Nov 2007</b>	<b>-8.4</b>	<b>-3.4</b>	<b>-1.9</b>	<b>-1.1</b>	<b>-0.4</b>
	COM Nov 2007	-7.8	-4.2	-2.7	-1.6	n.a.
	CP Dec 2006	-6.4	-3.1	-2.5	-2.0	-1.6
General government balance (% of GDP)	<b>CP Nov 2007</b>	<b>-3.7</b>	<b>-2.5</b>	<b>-2.3</b>	<b>-1.8</b>	<b>-0.8</b>
	COM Nov 2007	-3.7	-2.7	-2.3	-2.4	n.a.
	CP Dec 2006	-3.7	-2.9	-2.4	-1.9	n.a.
Primary balance (% of GDP)	<b>CP Nov 2007</b>	<b>-2.2</b>	<b>-1.0</b>	<b>-0.9</b>	<b>-0.3</b>	<b>0.5</b>
	COM Nov 2007	-2.2	-1.2	-0.8	-0.9	n.a.
	CP Dec 2006	-1.9	-0.9	-0.6	-0.2	n.a.
Cyclically-adjusted balance <sup>1</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-3.5</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-2.4</b>	<b>-1.2</b>
	COM Nov 2007	-3.4	-3.0	-2.7	-2.6	n.a.
	CP Dec 2006	-3.4	-3.2	-2.9	-2.5	n.a.
Structural balance <sup>3</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-3.1</b>	<b>-3.0</b>	<b>-3.1</b>	<b>-2.4</b>	<b>-1.2</b>
	COM Nov 2007	-3.4	-3.0	-2.7	-2.6	n.a.
	CP Dec 2006	-3.5	-3.2	-2.9	-2.5	n.a.
Government gross debt (% of GDP)	<b>CP Nov 2007</b>	<b>30.4</b>	<b>30.6</b>	<b>30.8</b>	<b>30.5</b>	<b>29.5</b>
	COM Nov 2007	30.4	30.8	30.7	30.6	n.a.
	CP Dec 2006	33.1	31.8	31.0	29.7	n.a.

Notes:

<sup>1</sup>Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

<sup>2</sup>Based on estimated potential growth of 6.4%, 6.7%, 6.7% and 6.7% respectively in the period 2006-2009.

<sup>3</sup>Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.4% of GDP in 2006 - deficit-increasing and 0.1% of GDP in 2008 - deficit-reducing according to the most recent update of the programme. There are no one-off measures in the Commission services' forecast.

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

## **1. INTRODUCTION**

The November 2007 update of the Convergence Programme was submitted on 29 November 2007. It covers the period from 2007 to 2010. The programme was approved by the Slovak government on 21 November 2007 and it will be presented to the parliament.

This assessment is further structured as follows. Section 2 discusses the key challenges for public finances in Slovakia, with a particular focus on the role of fiscal policy in creating favourable conditions for sustained and rapid catching-up. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 3.3 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the National Reform Programme and its implementation reports and with the broad economic policy guidelines. Section 8 reviews progress in implementing Slovakia's ERM II commitments. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

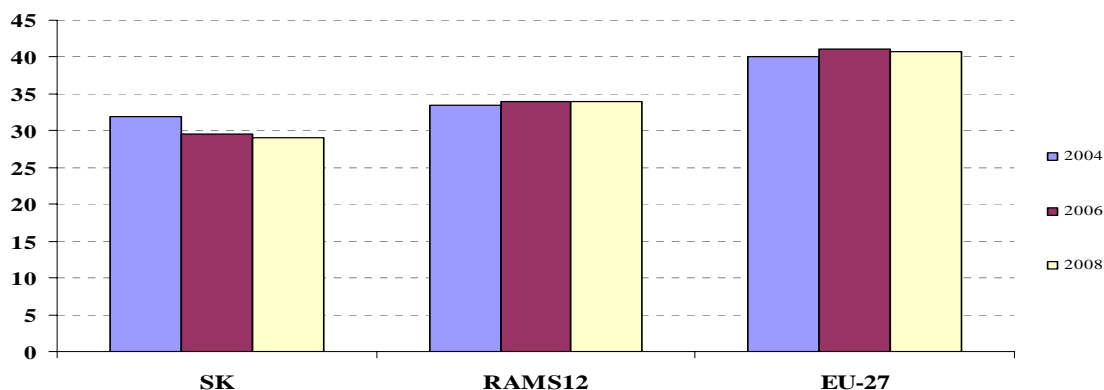
## **2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON THE ROLE OF FISCAL POLICY IN CREATING FAVOURABLE CONDITIONS FOR SUSTAINED AND RAPID CATCHING-UP**

In the period 1999-2006 some major structural reforms were introduced in Slovakia. The labour regulations were made more flexible, the social benefit system became less generous and more targeted, the tax code was simplified, a second funded pension pillar was established and state ownership including in major energy providers was reduced. These reforms were intended to increase incentives to work, to employ and to invest and thus promote growth. Indeed, Slovakia has in recent years attracted some large green-field investment projects in the automotive and electronics sector which have offered new employment opportunities and boosted growth to levels above 8%.

At the same time, the total tax burden decreased from 31.9% of GDP in 2004 to 29.5% of GDP in 2006, the second lowest level among the recently acceded Member States (RAMS12) and far below the EU27 average of 41.1%. Moreover, it is expected to decrease further to 29% of GDP in 2008.



**Figure 1: Total Tax Burden (% of GDP)**



*Source: AMECO*

The relatively lower share of resources at the disposal of the public sector implies a higher pressure for increasing the quality of public finances and especially, the efficiency of public expenditure. This was also pointed out in section 2 of the technical assessment of the previous update of the Slovak Convergence Programme which concluded that: "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."

Although consequential to growth, employment picked up as well and the unemployment rate fell substantially, certain segments of the population and certain regions do not seem to participate in this economic expansion. Apart from constituting a drag on public finances and a social problem, the low employability of certain segments of the labour force concentrated in eastern regions limits the country's potential output growth and thus hampers the catch-up process. In order to ensure that the whole labour force is able to contribute to economic expansion and that high rates of growth are preserved in the coming years some public sector intervention seems necessary.

This section looks specifically at fiscal expenditure categories which could alleviate structural problems in the labour market and increase the growth potential over a longer term horizon. Short-term measures aimed at increasing demand for low-skilled labour like active labour market policies (ALMP) or in-work benefits, are not analysed here.

In the following, first, the labour market is reviewed in more detail and the reasons for high youth unemployment are analysed. Second, given the observed low employability of low- and middle-skilled unemployed, the Slovak education system is evaluated, the role of education in shifting production structure more towards R&D and innovation is pointed out and the regional dimension of the unemployment situation is highlighted. Finally, this section concludes by highlighting some qualitative and quantitative adjustments of the public expenditure structure which could positively affect the long-term growth potential of the economy.

## **2.1. Labour market situation**

Although the overall unemployment level has decreased by almost 5 percentage points between 2004 and 2006, the long-term unemployment rate only decreased by 1½ percentage point and the very long-term unemployment only marginally by ¼ percentage

point in this period. As a result, the long-term unemployed represented 76.3% of all unemployed in 2006, which is by far the highest share of long-term unemployment in the EU27, leading to a relatively high NAWRU.

Moreover, while gradual increases in their retirement age have a clear positive impact on employment and activity rates of elderly (55-66 years) young people seem to continue to face serious problems on the labour market. Even though youth (15-24 years) unemployment decreased by 6.5 percentage points between 2004 and 2006, the youth employment rate stagnates at almost 26%. Hence, a prolonged period of strong economic growth has so far failed to generate more jobs for young labour market entrants, part of which probably used the 2004 EU entry to exploit employment opportunities in other EU countries causing a significant decline in the activity rate for this age group.

**Table 1: Labour Market Statistics (LFS adjusted series)**

	2002	2003	2004	2005	2006
Unemployment rate (total)	18.7	17.6	18.2	16.3	13.4
Unemployment rate (15 to 24 years)	37.7	33.4	33.1	30.1	26.6***
Long-term unemployment*	12.2	11.4	11.8	11.7	10.2****
Very long-term unemployment**	7.5	7.6	8.2	8.4	7.9****
Employment rate (15 to 64 years)	56.8	57.7	57.0	57.7	59.4
Employment rate (15 to 24 years)	27.0	27.4	26.3	25.6	25.9
Employment rate (55 to 64 years)	22.8	24.6	26.8	30.3	33.1
Activity rate (15 to 64 years)	69.9	70.0	69.7	68.9	68.6
Activity rate (15 to 24 years)	43.4	41.1	39.3	36.6	35.3
Activity rate (55 to 64 years)	26.9	28.5	31.7	35.0	36.7
Note: * More than 12 months ** More than 24 months *** The second highest in the EU **** The highest in the EU Source: Eurostat					

Disaggregating by education levels, the unemployment rate for young Slovaks with only pre-primary, primary and lower secondary education amounted to 74% in 2006 and was thus some 3.5 times higher than the EU27 average. The unemployment rate for young having achieved upper secondary and post-secondary non-tertiary education was much lower, 21.4%, albeit still above the EU27 average of 15.6%. A positive element is that the percentage of the population aged 20 to 24 having completed at least upper secondary education amounted to 91.8% in Slovakia in 2005 and was thus the highest in the EU27.

**Table 2: Youth unemployment rate by educational attainment (LFS)**

	Pre-primary, primary and lower secondary education				Upper secondary and post-secondary non-tertiary education			
	2003	2004	2005	2006	2003	2004	2005	2006
EU27	20.4	21.3	21.8	21.2	17.8	18.0	17.4	15.6
EU15	19.3	20.0	20.9	20.4	13.2	13.9	14.2	13.4
SK	69.6	73.7	76.8	74.0	30.6	28.6	25.2	21.4
Source: Eurostat								

Moreover, if instead of entering the labour market young Slovaks manage to successfully complete university studies, their chances of eventually finding employment increase dramatically, as the overall unemployment rate among people with tertiary education decreased to 3.3% in 2006 and was thus below the EU27 average of 4.6%.

**Table 3: Total unemployment rate by educational attainment (LFS)**

	Pre-primary, primary and lower secondary education			Upper secondary and post-secondary non-tertiary			Tertiary education		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
EU27	12	11.9	11.5	9.6	9.2	8.2	5.1	5	4.6
EU15	11.2	11.2	11	8.1	8	7.5	5.1	5	4.6
SK	52.1	53.3	48.4	16.9	14.4	11.8	5.9	5.1	3.3

*Source: Eurostat*

However, the share of Slovaks aged 25-39 having attained tertiary education level only grew by 4.5 percentage points between 2001 and 2006. With 16%, it is thus increasingly lagging behind the EU27 average and may also lack the right skill mix (see section 2.2).

**Table 4: Population (aged 25 to 39 years) by highest level of education attained (% of total) (LFS)**

	Pre-primary, primary and lower secondary education		Upper secondary and post-secondary non-tertiary education		Tertiary education	
	2001	2006	2001	2006	2001	2006
EU27	26.3	22.6	49.8	49.7	22.4	27.5
EU15	29.9	25.5	43.7	44.8	24.5	29.4
SK	7.3	6.5	81.2	77.6	11.5	16.0

*Source: Eurostat*

Hence, although only a relatively small fraction of young Slovaks does not attain at least an upper secondary school education these young people face great difficulties in the labour market. While performing better, upper secondary school graduates also suffer from relatively high unemployment rates. The Slovak education sector thus needs to improve its performance in terms of providing an adequate skill mix at all education levels.

## 2.2. Underlying policy areas

The next section looks at public expenditure areas which are crucial in alleviating structural problems in labour supply and can increase the country's growth potential over a longer time horizon.

### 2.2.1. Primary and secondary education

The public sector in Slovakia does not seem to ensure an equal access to education of the same quality for everybody while providing on average a lower quality of education compared to the OECD as a whole. According to the 2003 OECD PISA study assessing 15-year-olds in 41 countries, Slovak students' overall results were below the OECD average. This was confirmed by the 2007 study which showed that Slovak students' performance has further deteriorated. At the same time, student performances were more

sensitive to their socio-economic background (represented by the occupational status of parents) than in most other countries (OECD, 2007).

**Table 5: Mean scores in the 2003 and 2006 OECD PISA study**

	Mathematics		Science		Reading		Overall	
	2003	2006	2003	2006	2003	2006	2003	2006
OECD Average	500.0	497.7	499.6	500.0	494.2	491.8	497.9	496.5
Czech Republic	516.5	509.9	523.3	512.9	488.5	482.7	509.4	501.8
Latvia	483.4	486.2	489.1	489.5	490.6	479.5	487.7	485.1
Poland	490.2	495.4	497.8	497.8	496.6	507.6	494.9	500.3
Slovakia	498.2	492.1	494.9	488.4	469.2	466.3	487.4	482.3
Ireland	502.8	501.5	505.4	508.3	515.5	517.3	507.9	509.0
Portugal	466.0	466.2	467.7	474.3	477.6	472.3	470.4	470.9

*Source: OECD*

Public expenditure on education in Slovakia amounted on average to 4.2% of GDP in the period 2000-04 and was thus almost 1 percentage point below both the EU27 average and the recently-acceded Member States' (RAMS12) average.

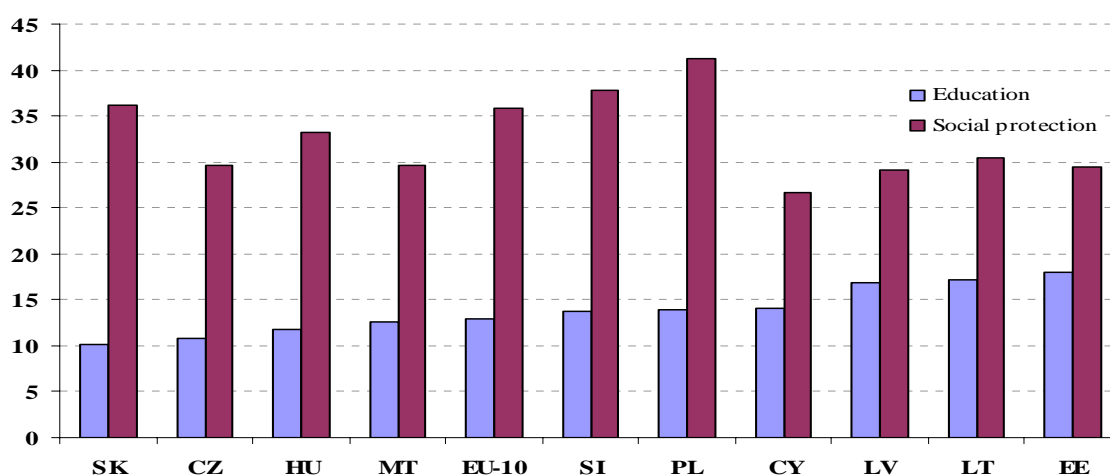
**Table 6: Total public expenditure on education (% of GDP)**

	2000	2001	2002	2003	2004	00-04 average
EU27	5.0	5.0	5.1	5.2	5.1	5.1
RAMS12	4.7	5.0	5.1	5.2	5.0	5.0
SK	4.2	4.0	4.3	4.3	4.2	4.2

*Source: Eurostat*

Moreover, the share of education expenditure in total Slovak public expenditure hovered around 10% in the years 2003-2005 and was thus below the RAMS10 (RAMS12 without Bulgaria and Romania) average of 13%. On the other hand, more than 36% of total public expenditure was in this period dedicated to social protection which was the third highest share among the RAMS10.

**Figure 2: Education and social protection expenditure (% of total expenditure of GG in 2003-05)**



*Source: AMECO*

The ratio of students to teachers in primary and secondary education has been somewhat above both the EU27 and the RAMS12 average in the period 1999-2005 but this should not be the main reason for below-the-average educational outcomes. In any case, there does not seem to be an over-employment in the education sector.

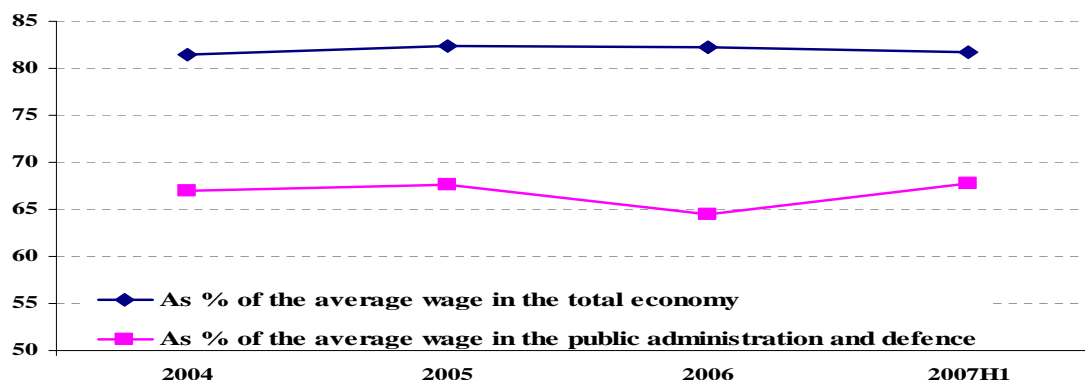
**Figure 3: Ratio of students to teachers in primary and secondary education (ISCED 1-3)**



*Source: Eurostat*

However, according to Eurostat, the age composition of teaching staff is evolving unfavourably. The share of teachers and academic staff over 50 years increased from 26.5% in the secondary and 24.4% in the tertiary education in 2000 to 37.3% and 45.1% in 2005 respectively. This is caused by the fact that working in the education sector is financially unattractive as average monthly wages in this sector only slightly exceeded 80% of the average wage in the total economy and have not even reached 70% of the average wage in public administration and defence in the period 2004-2007. In order to equalise wages in the education sector with average wages in the total economy or in public administration and thus make teaching more attractive for young well-educated graduates, annual public expenditure would have to increase by some 0.4% or 0.6% of GDP respectively.

**Figure 4: Average monthly wages in the education sector**



*Source: Statistical Office of the Slovak Republic*

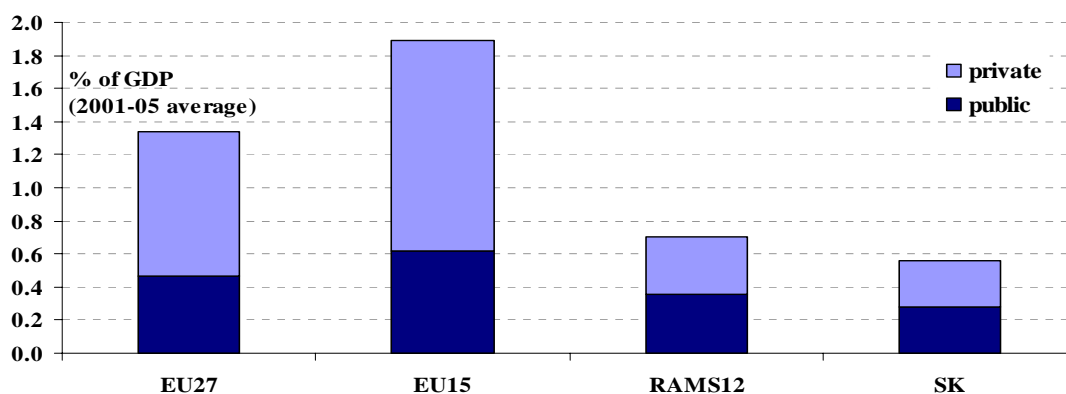
It is clear that higher education expenditure does not automatically guarantee better educational outcomes and thus higher employability of young labour-market entrants.<sup>4</sup> Hence, apart from reprioritising public expenditure toward education, Slovakia should also try to improve the efficiency of public education spending through curriculum and education methodology reforms and the restructuring of the public school network.

### 2.2.2. Tertiary education, R&D and innovation

Since, as pointed out above, the availability of relatively skilled workers decreased in recent years while their wages continued to converge to the EU27 average, the 2005 FDI-financed investment boom in the automobile and electronics sectors, generating a significant increase in the growth contribution of net export in the period 2006-2008, is not likely to be repeated at a similar scale. Hence, apart from enabling young people to succeed in the labour market, the public sector should also consider increasing its involvement in stimulating R&D and innovation which may be necessary for ensuring long-term growth in Slovakia by expanding into the production of higher value-added products.

Gross domestic expenditure on R&D in Slovakia amounted on average to 0.56% of GDP in the period 2001-2005 and was thus below both the RAMS12 average of 0.71% of GDP and the EU27 averages of 1.34% of GDP. At the same time, average public expenditure on R&D in Slovakia of some 0.3% of GDP was also below the RAMS12 and the EU27 averages of 0.4% and 0.5% of GDP respectively. Moreover, the GDP share of gross domestic R&D expenditure has been falling from 0.65% of GDP in 2000 to 0.51% of GDP in 2005. The current Slovak government set an annual R&D investment target of 0.8% of GDP to be reached at the end of its 4-year term in 2010 but it has so far not planned any increases in public R&D spending.

**Figure 5: Average gross domestic expenditure on R&D by source of funds**



*Source: Eurostat*

<sup>4</sup> For example, public expenditure on education was relatively higher in Portugal (6.3% of GDP) than in Ireland (4.7% of GDP) in the period 1990-2004. However, according to the 2003 OECD PISA study Irish 15-year-old pupils' overall score (506) was much better than the average result of Portuguese pupils (470), while youth unemployment reached on average 8.7% in Ireland and 14.8% in Portugal in the period 2002-2006.

It is possible that the large foreign investors which established production capacities in Slovakia in recent years will also gradually move more of their R&D and innovation activities there. However, the supply of university graduates familiar with state-of-the-art technologies and research will affect the size of this potential relocation. Although the share of tertiary graduates in science and technology among the population aged 20-29 increased from 0.75% in 2000 to 1.02% in 2005 and thus slightly exceeded the RAMS12 average of 0.93% it was still lagging behind the EU27 average of 1.29%. Hence, the improvement of education outcomes in terms of providing the right skill mix is also crucial in encouraging a production shift towards more high-tech goods.

**Table 7: Tertiary graduates in science and technology (% of population aged 20-29)**

	2001	2002	2003	2004	2005	01-05 average
EU27	1.08	1.13	1.23	1.25	1.29	1.20
EU12	0.68	0.75	0.80	0.90	0.93	0.81
SK	0.75	0.78	0.83	0.92	1.02	0.86

*Source: Eurostat*

Moreover, according to the World Bank's Knowledge Index (KI) measuring countries' ability to generate, adopt and diffuse knowledge and its Knowledge Economy Index (KEI) indicating whether the environment in a country is conducive for knowledge to be used effectively for economic development, Slovakia lags the EU27 in its knowledge economy readiness while being broadly in line with other RAMS. While Slovakia received performance scores clearly above the RAMS12 average for its economic incentive system and ICT, its education system was ranked well below the RAMS12 average.

**Table 8: Knowledge economy readiness in 2006**

	KEI*	KI**	Economic Incentive	Innovation	Education	ICT
EU27	7.8	7.9	7.6	7.7	7.9	8.0
RAMS12	7.1	7.2	6.8	6.7	7.6	7.3
SK	7.1	7.1	7.2	6.8	6.9	7.6

Note: \* Average of scores in all four pillars  
 \*\* Average of scores in three knowledge economy pillars (Innovation, Education and ICT)

*Source: World Bank*

### 2.2.3. Regional disparities

GDP per capita levels vary substantially across different NUTS2 regions in Slovakia. While GDP per capita already exceeded the EU27 average by almost 30% in Bratislava in 2004, it reached only around 42-53% of the EU27 average in the other 3 regions containing over 90% of the Slovak population. The regional variation of income seems to have been quite stable in the period 2000-2004 with Bratislava slightly improving its position as the richest Slovak region. Although households' disposable incomes are less dispersed, the 2004 household income in Bratislava was almost twice as high as in eastern Slovakia.

**Table 9: Regional per capita GDP as % of national average (households disposable income)**

	2000	2001	2002	2003	2004
Bratislava	217 (151)	220 (153)	226 (153)	225 (159)	228 (159)
Western Slovakia	95 (97)	93 (99)	91 (98)	93 (99)	93 (99)
Central Slovakia	82 (94)	84 (93)	84 (94)	83 (92)	82 (92)
Eastern Slovakia	75 (89)	77 (87)	76 (87)	74 (85)	75 (85)

*Source: Eurostat*

Unemployment levels also differed largely across regions. Moreover, although the unemployment level in Bratislava was already less than a half of the one in eastern Slovakia in 2002 it was also falling much faster in the period 2002-2006. In terms of unemployment, Bratislava and western regions thus have benefited more from the economic expansion than central and eastern regions thanks to better infrastructure and closeness to the core EU markets.

**Table 10: Regional unemployment rates (% of the national unemployment rate)**

	2002	2003	2004	2005	2006
Bratislava	47	40	46	33	34
Western Slovakia	94	90	78	77	73
Central Slovakia	114	116	121	120	122
Eastern Slovakia	119	124	133	142	143

*Source: Eurostat*

It is possible that with the progressive tightening of the labour market situation labour shortages will also induce significant decreases in the unemployment rate in eastern Slovakia. However, since the share of long-term unemployed there reached some 83% of total unemployment in 2006 and was thus clearly the highest in the whole county, the majority of unemployed in eastern Slovakia probably lacks sufficient skills to be employable.

**Table 11: Long-term unemployment rate (% total unemployment)**

	2002	2003	2004	2005	2006
Bratislava	53.3	46.9	46.7	39.1	55.1
Western Slovakia	69.8	66.3	68.5	69.6	72.8
Central Slovakia	61.9	63.4	58.6	69.8	73.3
Eastern Slovakia	65.7	68.4	69.6	78.5	83.2

*Source: Eurostat*

Hence, it is likely that considerable public sector intervention would be necessary if current regional disparities were to be alleviated, in particular in eastern Slovakia. Nevertheless, there is no short-term solution to the problem as it will in any case take at least 5 to 10 years to build transport infrastructure and to upgrade human capital skills in the eastern regions. Growing supply of EU funds is foreseen to play a crucial role in this context with some 30% of financial resources available under the 2007-13 financial framework (7% of 2006 Slovak GDP) allocated to the Operational Programme (OP) Transport and 8% allocated to OPs Employment and Education according to the National Strategic Reference Framework. However, it is also possible that with growing skills and



better transport possibilities, the most qualified labour would migrate to western regions, thus further disabling the growth potential in the eastern regions.

### **2.3. Conclusions**

Slovakia should ensure that sufficient resources are invested into the education system and R&D and innovation and that they are used efficiently. Otherwise, little employability of low-skilled unemployed located especially in the eastern regions and declining productivity growth may limit its potential output growth in the medium and long term and thus impede the catch-up process. This would require significant expenditure increases which should be achieved through budgetary reallocation in order not to endanger the foreseen fiscal consolidation path.

## **3. MACROECONOMIC OUTLOOK**

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail.

### **3.1. Economic activity**

The programme expects a gradual decrease in GDP growth from 8.8% in 2007 to 5% in 2010. GDP growth should be mainly driven by domestic demand but the external contribution is also expected to remain positive over the whole programme period.<sup>5</sup> Continuously falling growth contribution of net exports is likely as the exceptional export performance in 2007 was induced by the launch of production in some large new manufacturing capacities in the automotive and electronics sector. The country's manufacturing capacity is not expected to be further extended at the similar scale in the coming years, partly due to much lower availability of employable labour.

The output gap as recalculated by Commission services based on the information in the programme should become positive in 2007 and then increase further to 2.3% of potential output in 2008 before declining gradually to 1.4% of potential output in 2010. The average growth projection for the whole programme period is broadly in line with the average growth performance of the past five years.

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<sup>5</sup> The external outlook behind the programme's macroeconomic scenario is broadly in line with that in the Commission services' autumn 2007 forecast.

**Table 12: Comparison of macroeconomic developments and forecasts**

	2007		2008		2009		2010
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	8.7	8.8	7.0	6.8	6.2	5.8	5.0
Private consumption (% change)	6.9	6.7	6.2	6.0	5.6	4.7	4.1
Gross fixed capital formation (% change)	7.2	8.8	6.6	8.0	6.1	6.0	5.5
Exports of goods and services (% change)	19.9	21.1	12.6	12.8	9.1	8.9	6.8
Imports of goods and services (% change)	15.9	17.2	11.0	11.5	8.1	8.1	6.1
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	6.2	6.5	5.7	5.9	5.2	4.7	4.1
- Change in inventories	-0.3	-0.9	0.1	-0.9	0.1	0.0	-0.1
- Net exports	2.7	3.4	1.2	1.5	0.9	1.1	1.0
Output gap <sup>1</sup>	1.0	1.8	1.3	2.3	0.8	2.1	1.4
Employment (% change)	1.9	2.1	1.5	1.6	1.0	1.0	0.8
Unemployment rate (%)	11.2	11.0	9.7	10.1	9.0	9.7	9.4
Labour productivity (% change)	6.7	6.6	5.5	5.1	5.2	4.7	4.2
HICP inflation (%)	1.7	1.7	2.5	2.3	3.0	2.6	2.7
GDP deflator (% change)	2.5	2.4	2.6	2.2	3.0	1.8	1.8
Comp. of employees (per head, % change)	7.1	9.2	6.9	6.6	7.3	6.5	6.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-4.2	-3.4	-2.7	-1.9	-1.6	-1.1	-0.4
<u>Note:</u>							
<sup>1</sup> In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.							
<u>Source:</u>							
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)							

The GDP growth decrease from 8.8% in 2007 to 5.8% in 2009 projected by the programme is broadly in line with the Commission services' autumn 2007 forecast of a drop from 8.7% in 2007 to 6.2% in 2009. However, the programme's growth projection for 2010 is significantly below the estimate of potential growth in the autumn 2007 forecast for the period 2007-2009 of 6.7%.

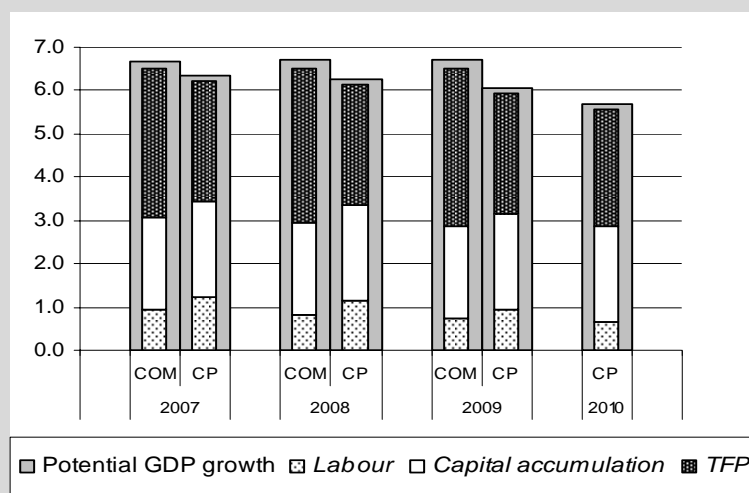
Private consumption and compensation of employees are according to the programme expected to grow on average by 5.8% and 9.1% respectively in years 2007-09. The programme's private consumption growth projection is thus slightly below the Commission services' autumn 2007 average forecast of 6.2% while its projection for growth in compensation of employees is slightly above the Commission services' forecast of 8.7%. The programme assumes that there is currently a significant stock of machinery included in inventories which will soon be turned into gross fixed capital formation and thus causes an equivalent reduction in inventories in 2007 and 2008. The Commission services' forecast assumes a much smoother evolution of GFCF and inventories.

Overall, the programme's macroeconomic outlook seems to be based on plausible growth assumptions for 2007-09 and cautious assumptions for 2010.

### Box 1: Potential growth and its determinants

Potential growth as recalculated by the Commission services using the commonly agreed methodology based on the information in the programme is estimated to peak at 6.3% in 2007 and in 2008 and then to decline gradually to 5.7% in 2010.

#### Potential growth and its determinants



Average potential growth over the whole programme period is above average growth in the past ten years as it benefits from strong investment growth which also contributes to higher TFP growth. The difference between potential growth estimates based on the programme's macroeconomic scenario and the Commission services' autumn 2007 forecast is mainly driven by the different forecast horizon with the strong GDP growth deceleration foreseen by the programme for 2010, negatively affecting the estimate of potential TFP growth in 2007-2010.

The positive output gaps for 2008 and 2009 as recalculated by the Commission services on the basis of the data provided in the programme using the commonly agreed method are around 1 and 1¼ percentage point higher than the output gaps indicated in the Commission services' autumn 2007 forecast.<sup>6</sup>

Although estimates for the years 2006-2008 varied considerably in successive Commission services' forecasts and convergence programmes (after being recalculated according to the commonly agreed method), a positive output gap has been consistently indicated for the years 2007-2008.

<sup>6</sup> Output gaps presented in the programme are much smaller: 0.3% of potential output in 2007, 0.1% in 2008 and 0% in 2009-10. However, the Slovak Ministry of Finance uses a different methodology for calculating output gaps, which, among other differences, also allows for adjusting trend TFP growth for productivity shocks.

**Table 13: Output gap estimates in successive Commission services' forecasts and convergence programme updates (% of potential GDP)**

	2006		2007		2008	
	COM	CP	COM	CP	COM	CP
<b>CP Nov 2007</b>		<b>-0.5</b>		<b>1.8</b>		<b>2.3</b>
Autumn 2007	-0.8		1.0		1.3	
Spring 2007	-0.4		1.7		1.8	
<b>CP Dec 2006</b>		<b>-0.9</b>		<b>1.0</b>		<b>1.6</b>
Autumn 2006	-0.7		1.1		1.6	
Spring 2006	-0.8		0.2		n.a.	
<b>CP Dec 2005</b>		<b>-1.1</b>		<b>0.1</b>		<b>0.1</b>
Autumn 2005	-0.9		0.2		n.a.	
Spring 2005	1.3		n.a.		n.a.	
<b>CP Nov 2004</b>		<b>n.a.</b>		<b>n.a.</b>		<b>n.a.</b>
<b>Minimum value</b>	-0.9	-1.1	0.2	0.1	1.3	0.1
<b>Maximum value</b>	1.3	-0.5	1.7	1.8	1.8	2.3
<b>Average output gap revision <sup>(1)</sup></b>	-0.6	-0.8	0.2	1.0	-0.4	1.3
<b>Standard deviation of revision <sup>(2)</sup></b>	0.9	0.3	0.7	0.9	0.1	1.1
<b>Percentage cases of change of sign w.r.t. latest estimate <sup>(3)</sup></b>	0.2	0.3	0.0	0.0	0.0	0.0
<i>Source:</i> Commission services' forecasts and convergence programme updates						
<i>Notes:</i> (1) average of the difference between the latest available estimate (Autumn 2007) and the previous vintages figures. (2) Standard deviation of the difference between the latest available estimate (Autumn 2007) and the previous vintages figures (3) Frequency of the change in the sign of output gap figures in different vintages compared to the sign of the latest estimate (Autumn 2007).						

### 3.2. Labour market and cost and price developments

The programme expects employment growth to decrease gradually from 2.1% in 2007 to 0.8% in 2010 while the unemployment rate should fall from 11% in 2007 to 9.4% in 2010. A projected slowdown in the improvement of labour market indicators is in line with the substantial drop in employable labour in Slovakia in recent years and broadly matches anticipated deceleration in GDP growth. Further improvements in the labour market conditions are in line with positive output gap estimates (as recalculated by Commission services).

According to the programme, HICP inflation is expected to increase from 1.7% in 2007 to 2.6% in 2009 and to 2.7% in 2010. For 2008 and 2009, the Commission services' inflation projections are 0.2 and 0.4 percentage points higher than the programme projections<sup>7</sup>. This is partly explained by slightly more favourable oil price assumptions in the programme (both in \$ and in euro terms) and a stronger SKK/euro exchange rate. Moreover, the programme seems to assume a higher persistence of the disinflationary effect of the recent strong exchange rate appreciation. Limited acceleration of HICP inflation over the programme period is in line with the flat profile of growth in nominal compensation per employee of some 6.5% in 2008-2010 which should, nevertheless, somewhat exceed strong but decelerating real productivity growth.

The inflation projection is subject to non-negligible risks related to rising food and oil prices, a tightening labour market and a fading effect of the strong exchange rate

<sup>7</sup> The 2009 inflation projection includes an inflationary impact of a changeover to the euro which is estimated by the Slovak authorities at 0.3 percentage points. Excluding this effect the programme's forecast is 0.7 pp below that of the Commission's autumn 2007 forecast.

appreciation in 2006-2007. In order to limit the risks to future inflation, in particular under the scenario of euro adoption in 2009, there is a need for further structural reforms, increased product market competition and an appropriately tight fiscal stance.

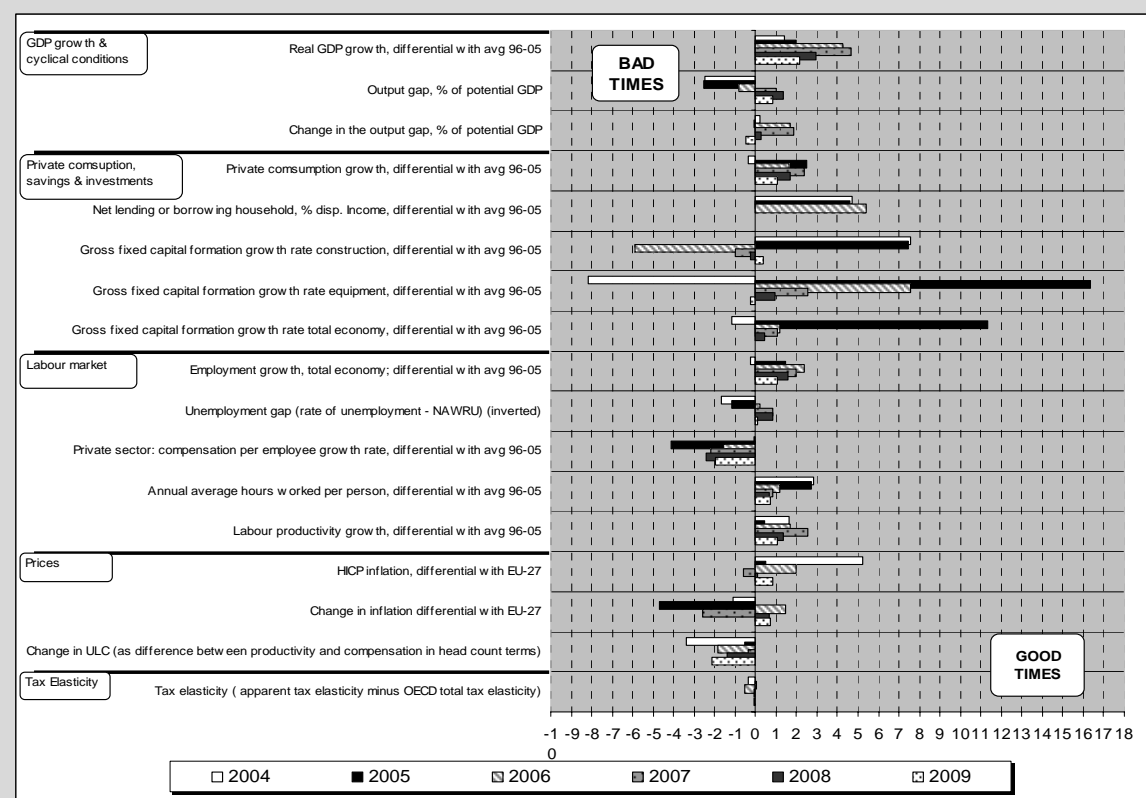
### Box 2: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times taking into account tax elasticities in the period 2007-2009.

Apart from the positive output gap estimates for 2007-09, the fact that growth rates of private consumption, gross fixed capital formation, employment and labour productivity are in these years also expected to exceed their 1996-2005 averages indicates that Slovakia is experiencing good economic times in this period. At the same time, the apparent tax elasticity is expected to be broadly in line with the OECD total tax elasticity in the years 2007-09.

Nevertheless, growth of compensation per employee in 2004-2009 is expected to be below its 1996-2005 average indicating a successful adjustment of wage growth to a lower inflationary environment. At the same time, a significant drop in the inflation differential vis-à-vis the EU27 in 2007 was induced by lower increases in regulated prices in the energy sector and a positive impact of exchange rate appreciation.

### Good versus bad times



### 3.3. Measures to ensure price stability

The programme outlines measures to ensure price stability after a possible euro adoption. Although welcome, these measures are at this stage only non-binding intentions.

Among the measures, the largest potential in terms of preserving price stability is seen in those fostering wage discipline and in structural measures aiming at enhanced flexibility

and competition in the labour and product markets. On the former, the planned agreement between the government, employers' organizations and labour unions mentioned in the update linking future wage developments, minimum wage adjustments and wage growth in the public sector to the productivity growth could help to contain possible wage-driven inflationary pressures, in particular if productivity in the sector in question is taken into account.

In view of a progressively tightening labour market with a high share of long-term unemployed (as discussed in section 2), wage policy should be accompanied by government policies supporting flexibility of the labour market. Within the framework of rather general measures listed in the update, public education and training policies are essential to enable acquisition of skills needed to succeed at the labour market. At the same time, incentives to find and provide employment should be strengthened, especially for low skilled workers.

Structural policies aiming at a stronger competitive environment would be welcome, however, they should not be limited to sanctions and regulatory actions. In the energy sector, diversification of energy import possibilities and increased domestic energy production capacities are crucial in generating effective competition necessary to enable favourable energy price developments on a sustainable basis. At the same time, increased energy efficiency would decrease the high role of energy prices in households' consumption.

#### **4. GENERAL GOVERNMENT BALANCE**

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

##### **4.1. Budgetary implementation in 2007**

Table 14 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect<sup>8</sup>:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions of the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than

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<sup>8</sup> A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).

- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

**Table 14: Budgetary implementation in 2007**

	2006		2007	
	Planned	Outcome	Planned	Outcome
	CP Dec 2006	COM	CP Dec 2006	COM
Revenue (% of GDP)	32.6	33.5	31.7	33.2
Expenditure (% of GDP)	36.3	37.2	34.6	35.9
Government balance (% of GDP)	-3.7	-3.7	-2.9	-2.7
Nominal GDP growth (%)			10.1	10.0
Nominal revenue growth (%)			7.1	9.1
Nominal expenditure growth (%)			4.9	6.3
<b>Revenue surprise compared to target (% of GDP)</b>			<b>1.5</b>	
<i>Of which</i> <sup>1</sup> : 1. Base effect			0.8	
2. GDP growth effect on the denominator			0.0	
3. Revenue growth effect			0.6	
<i>Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than</i> <sup>2</sup>			0.6	
<b>Expenditure surprise compared to target (% of GDP)</b>			<b>1.3</b>	
<i>Of which</i> <sup>1</sup> : 1. Base effect			0.8	
2. GDP growth effect on the denominator			0.0	
3. Expenditure growth effect			0.4	
<b>Government balance surprise compared to target (% of GDP)</b>			<b>0.2</b>	
<i>Of which:</i> 1. Base effect			0.0	
2. GDP growth effect on the denominator			0.0	
3. Revenue / expenditure growth effect			0.1	
<b>Notes:</b>				
<sup>1</sup> A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.				
<sup>2</sup> Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.				
<b>Source:</b> Commission services				

According to the Commission services' autumn 2007 forecast the general government deficit for 2007 is expected to reach 2.7% of GDP which is below the target of 2.9% of GDP set in the previous update of the Convergence Programme. This positive deviation is enabled by a substantial revenue growth surprise outweighing higher-than-expected expenditure. Apart from higher-than-expected growth of revenue and expenditure, the 2007 revenue- and expenditure-to-GDP ratios were to the same extent positively affected by a base effect.

Compared to the Commission services' forecast, the latest update of the Convergence Programme expects the 2007 deficit to reach only 2.5% of GDP. The difference in the 2007 deficit projections results mainly from the fact that the Commission services' forecast assumes some unbudgeted central government spending (like e.g. Christmas pension bonus) before the end of 2007 (in line with the experience from previous years) and a higher deficit contribution from local government balances. Given the latest

available information, it is possible that the 2007 deficit will be below the level expected by the Commission services' autumn 2007.

In its opinion of 27 February 2007 on the previous update of the convergence programme, the Council invited Slovakia to "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". As mentioned above, the 2007 general government deficit is according to the autumn 2007 forecast estimated to amount to 2.7% of GDP which is 0.2 percentage points below the target set in the previous update of the Convergence Programme while fiscal consolidation in structural terms is also marginally higher.

#### **4.2. The programme's medium-term budgetary strategy**

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

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

The main goal of the programme's medium-term budgetary strategy is to reach the medium-term objective of a structural deficit of just below 1 % of GDP by 2010. The programme thus confirms the target year for achieving the MTO set in the previous updates.

#### **Box 3: The excessive deficit procedure (EDP) 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 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.



**Table 15: Evolution of budgetary targets in successive programmes**

		2006	2007	2008	2009	2010
General government balance (% of GDP)	<b>CP Nov 2007</b>	<b>-3.7</b>	<b>-2.5</b>	<b>-2.3</b>	<b>-1.8</b>	<b>-0.8</b>
	<i>CP Dec 2006</i>	-3.7	-2.9	-2.4	-1.9	<i>n.a.</i>
	COM Nov 2007	-3.7	-2.7	-2.3	-2.4	n.a.
General government expenditure (% of GDP)	<b>CP Nov 2007</b>	<b>37.2</b>	<b>35.7</b>	<b>35.3</b>	<b>33.7</b>	<b>32.6</b>
	<i>CP Dec 2006</i>	36.3	34.6	33.6	33.1	<i>n.a.</i>
	COM Nov 2007	37.2	35.9	35.1	34.6	n.a.
General government revenue (% of GDP)	<b>CP Nov 2007</b>	<b>33.5</b>	<b>33.2</b>	<b>33.0</b>	<b>31.8</b>	<b>31.8</b>
	<i>CP Dec 2006</i>	32.6	31.7	31.2	31.1	<i>n.a.</i>
	COM Nov 2007	33.5	33.2	32.8	32.2	n.a.
Structural balance <sup>1</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-3.1</b>	<b>-3.0</b>	<b>-3.1</b>	<b>-2.4</b>	<b>-1.2</b>
	<i>CP Dec 2006</i>	-3.5	-3.2	-2.9	-2.5	<i>n.a.</i>
	COM Nov 2007	-3.4	-3.0	-2.7	-2.6	n.a.
Real GDP (% change)	<b>CP Nov 2007</b>	<b>8.3</b>	<b>8.8</b>	<b>6.8</b>	<b>5.8</b>	<b>5.0</b>
	<i>CP Dec 2006</i>	6.6	7.1	5.5	5.1	5.0
	COM Nov 2007	8.3	8.7	7.0	6.2	n.a.

Note:  
<sup>1</sup>Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.4% of GDP in 2006 - deficit-increasing and 0.1% of GDP in 2008 - deficit-reducing, according to the most recent programme and 0% of GDP in 2006-09 in the Commission services' autumn forecast.

Source:  
*Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)*

The programme foresees the general government deficit to decrease from 2.5% of GDP in 2007 to 0.8% of GDP in 2010, with the primary balance improving to a slightly lesser extent from -1.0% of GDP in 2007 to 0.5% of GDP in 2010. The structural deficit as recalculated by the Commission services according to the commonly agreed methodology based on the information provided in the programme is estimated to decrease from 3% of GDP in 2007 to 1.2% of GDP by 2010 but structural balances need to be interpreted with caution as there is considerable uncertainty about the precise size of the output gap.<sup>9</sup> The adjustment in both structural and nominal terms is back-loaded.

Nevertheless, the foreseen fiscal consolidation effort as measured by the change in the structural primary balance as recalculated by the Commission services is some 1½ percentage points between 2007 and 2010. The planned stance of fiscal policy seems to be broadly neutral in 2008 and restrictive in the years 2009 and 2010. However, the dampening impact on aggregate demand of the restrictive fiscal stance in 2009-10 might be fully offset by the expected increase in inflows of EU funds from 0.9% of GDP in 2008 to 2.7% of GDP in 2010.

Compared with the previous programme, the path for the nominal balance from 2008 onwards remains broadly unchanged while the planned fiscal consolidation in structural terms seems more back-loaded. At the same time, GDP growth projections have been

<sup>9</sup> As discussed in Section 3, there are significant differences between the output gap estimates according to the Commission services' forecast and the Commission services' recalculations based on the programme information.

revised upwards. The new update thus broadly confirms the planned adjustment against a more favourable macroeconomic scenario.

**Table 16: Composition of the budgetary adjustment**

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
<b>Revenue</b>	<b>33.5</b>	<b>33.2</b>	<b>33.0</b>	<b>31.8</b>	<b>31.8</b>	<b>-1.4</b>
<i>of which:</i>						
- Taxes on production and imports	11.3	11.4	11.0	10.8	10.8	<b>-0.6</b>
- Current taxes on income, wealth, etc.	6.0	6.1	6.2	6.3	6.2	<b>0.1</b>
- Social contributions	11.9	11.8	12.0	11.5	11.5	<b>-0.3</b>
- Other (residual)	4.3	3.9	3.8	3.2	3.3	<b>-0.6</b>
<b>Expenditure</b>	<b>37.2</b>	<b>35.7</b>	<b>35.3</b>	<b>33.7</b>	<b>32.6</b>	<b>-3.1</b>
<i>of which:</i>						
- Primary expenditure	35.7	34.2	33.9	32.2	31.3	<b>-2.9</b>
<i>of which:</i>						
Compensation of employees	7.4	7.4	7.0	6.7	6.6	<b>-0.8</b>
Intermediate consumption	5.7	4.7	4.9	5.2	4.9	<b>0.2</b>
Social payments	16.3	16.4	16.2	15.5	15.4	<b>-1.0</b>
Subsidies	1.3	1.3	1.2	1.0	0.9	<b>-0.4</b>
Gross fixed capital formation	2.2	1.6	1.8	1.4	1.3	<b>-0.3</b>
Other (residual)	2.8	2.7	2.8	2.4	2.2	<b>-0.5</b>
- Interest expenditure	1.5	1.5	1.4	1.5	1.3	<b>-0.2</b>
<b>General government balance (GGB)</b>	<b>-3.7</b>	<b>-2.5</b>	<b>-2.3</b>	<b>-1.8</b>	<b>-0.8</b>	<b>1.7</b>
<b>Primary balance</b>	<b>-2.2</b>	<b>-1.0</b>	<b>-0.9</b>	<b>-0.3</b>	<b>0.5</b>	<b>1.5</b>
One-off and other temporary measures	-0.4	0.0	0.1	0.0	0.0	<b>0.0</b>
<b>GGB excl. one-offs</b>	<b>-3.3</b>	<b>-2.5</b>	<b>-2.4</b>	<b>-1.8</b>	<b>-0.8</b>	<b>1.7</b>
Output gap <sup>1</sup>	-0.5	1.8	2.3	2.1	1.4	<b>-0.4</b>
Cyclically-adjusted balance <sup>1</sup>	-3.5	-3.0	-3.0	-2.4	-1.2	<b>1.8</b>
<b>Structural balance<sup>2</sup></b>	<b>-3.1</b>	<b>-3.0</b>	<b>-3.1</b>	<b>-2.4</b>	<b>-1.2</b>	<b>1.8</b>
<i>Change in structural balance</i>		<i>0.1</i>	<i>0.0</i>	<i>0.7</i>	<i>1.2</i>	
Structural primary balance <sup>2</sup>	-1.6	-1.5	-1.7	-0.9	0.1	<b>1.6</b>
<i>Change in structural primary balance</i>		<i>0.1</i>	<i>-0.1</i>	<i>0.8</i>	<i>1.0</i>	
<b>Notes:</b>						
<sup>1</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.						
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.						
<b>Source :</b>						
<i>Convergence programme; Commission services' calculations</i>						

#### 4.2.2. The composition of the budgetary adjustment

Fiscal consolidation as envisaged by the programme is achieved by an expenditure restraint with primary expenditure foreseen to decline by 2.9 percentage points of GDP and interest expenditure by 0.2 percentage points between 2007 and 2010. The only increasing expenditure components are intermediate consumption. Against the background of expected strong GDP growth, the foreseen decrease in the expenditure-to-GDP ratio is consistent with significantly positive expenditure growth in real terms.

Revenue-enhancing measures included in the 2008 budget, like a broadening of the corporate tax base and an increase in the maximum ceiling on social contributions are expected to generate additional revenue of some 0.3% of GDP. Moreover, contrary to the Commission services' autumn 2007 forecast (which was finalised before this measure was passed), the programme assumes that a temporary opening up of the second pension

pillar in the first half of 2008, allowing all current participants to leave and new participants to join, will result in an one-off revenue of around 0.12% of GDP in 2008 as savings accumulated in previous years in the second pillar will be transferred to the pay-as-you-go pillar if participants decide to leave. It also expects additional contributions to the pay-as-you-go pillar of some 0.06% of GDP by these returning participants.

However, diverging from the Commission services' autumn 2007 forecast which foresees a lower nominal expenditure growth, the programme assumes that all the revenue-enhancing measures will be outweighed by higher government expenditure resulting in a slight structural deterioration in 2008. A structural consolidation of some ¼% of GDP is projected by the Commission services' forecast for 2008.

On the other hand, the substantial fiscal consolidation foreseen for 2009 and 2010 is not supported by sufficiently binding measures like, for example, an expenditure ceiling for central government. In particular, although there is a 3-year general government budget (most recent for the period 2008-10) adopted by the government, this is routinely revised every year. In terms of measures, the main expenditure savings are planned to result from a 10% cut in central government employment, limited wage growth in the public sector and a reduction in farm subsidies to the minimum levels required by the EU. Moreover, the efficiency of public procurement is foreseen to increase significantly while low inflation and wage growth together with a gradually increasing retirement age should result in falling pension expenditure.

#### **Box 4: The budget for 2008**

The 2008 budget targeting a general government deficit of 2.3% of GDP was approved by parliament on 4 December 2007. Revenue-increasing measures adopted by the government should generate additional revenue of around ¼% of GDP. These measures include a broadening of the corporate and personal income tax base, an increase in the maximum ceiling on social contributions and the introduction of energy taxes. Moreover, current participants will be allowed to leave and new participants to join the second pension pillar in the first half of 2008 while pension eligibility criteria have been slightly tightened. On the expenditure side, a limited wage growth of 4% agreed in the public sector should ensure that compensation of employees falls in terms of GDP.

#### **Main measures in the budget for 2008**

<b>Revenue measures*</b>	<b>Expenditure measures**</b>
<ul style="list-style-type: none"> <li>○ broadening of corporate and personal income tax bases (0.2% of GDP)</li> <li>○ increase in the maximum ceiling on social contributions (0.1% of GDP)</li> <li>○ capital transfer from the second pension pillar (0.1% of GDP)</li> <li>○ increase in contributions to the first pension pillar (0.1% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>○ limited wage growth in the public sector (- 0.2% of GDP)</li> </ul>

\* Estimated impact on general government revenues.  
 \*\* Estimated impact on general government expenditure.  
 Sources: Commission services and the 2008 budget.

### 4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 17 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

**Table 17: Comparison of budgetary developments and projections**

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	CP	COM	CP	COM <sup>1</sup>	CP	CP
<b>Revenue</b>	<b>33.5</b>	<b>33.2</b>	<b>33.2</b>	<b>32.8</b>	<b>33.0</b>	<b>32.2</b>	<b>31.8</b>	<b>31.8</b>
<i>of which:</i>								
- Taxes on production and imports	11.3	11.4	11.4	11.3	11.0	11.1	10.8	10.8
- Current taxes on income, wealth, etc.	6.0	5.9	6.1	6.0	6.2	5.9	6.3	6.2
- Social contributions	11.9	11.7	11.8	11.4	12.0	11.2	11.5	11.5
- Other (residual)	4.3	4.2	3.9	4.2	3.8	4.0	3.2	3.3
<b>Expenditure</b>	<b>37.2</b>	<b>35.9</b>	<b>35.7</b>	<b>35.1</b>	<b>35.3</b>	<b>34.6</b>	<b>33.7</b>	<b>32.6</b>
<i>of which:</i>								
- Primary expenditure	35.7	34.4	34.2	33.7	33.9	33.1	32.2	31.3
<i>of which:</i>								
Compensation of employees	7.4	7.2	7.4	7.0	7.0	6.8	6.7	6.6
Intermediate consumption	5.7	5.3	4.7	5.2	4.9	5.2	5.2	4.9
Social payments	16.3	15.8	16.4	15.4	16.2	15.0	15.5	15.4
Subsidies	1.3	1.3	1.3	1.3	1.2	1.3	1.0	0.9
Gross fixed capital formation	2.2	2.1	1.6	2.1	1.8	2.1	1.4	1.3
Other (residual)	2.8	2.7	2.7	2.7	2.8	2.7	2.4	2.2
- Interest expenditure	1.5	1.5	1.5	1.5	1.4	1.5	1.5	1.3
<b>General government balance (GGB)</b>	<b>-3.7</b>	<b>-2.7</b>	<b>-2.5</b>	<b>-2.3</b>	<b>-2.3</b>	<b>-2.4</b>	<b>-1.8</b>	<b>-0.8</b>
<b>Primary balance</b>	<b>-2.2</b>	<b>-1.2</b>	<b>-1.0</b>	<b>-0.8</b>	<b>-0.9</b>	<b>-0.9</b>	<b>-0.3</b>	<b>0.5</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
<b>GGB excl. one-offs</b>	<b>-3.7</b>	<b>-2.7</b>	<b>-2.5</b>	<b>-2.3</b>	<b>-2.4</b>	<b>-2.4</b>	<b>-1.8</b>	<b>-0.8</b>
Output gap <sup>2</sup>	-0.8	1.0	1.8	1.3	2.3	0.8	2.1	1.4
Cyclically-adjusted balance <sup>2</sup>	-3.4	-3.0	-3.0	-2.7	-3.0	-2.6	-2.4	-1.2
<b>Structural balance<sup>3</sup></b>	<b>-3.4</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-2.7</b>	<b>-3.1</b>	<b>-2.6</b>	<b>-2.4</b>	<b>-1.2</b>
<i>Change in structural balance</i>		0.4	0.1	0.3	0.0	0.1	0.7	1.2
Structural primary balance <sup>3</sup>	-2.0	-1.5	-1.5	-1.3	-1.7	-1.2	-0.9	0.1
<i>Change in structural primary balance</i>		0.4	0.1	0.3	-0.1	0.1	0.8	1.0
<b>Notes:</b>								
<sup>1</sup> On a no-policy-change basis.								
<sup>2</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.								
<sup>3</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<b>Source:</b>								
Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations								

Strong growth prospects, a potential base effect, already adopted revenue increasing measures and the likely outflow of participants from the second pension pillar may generate enough resources allowing for even a better-than-foreseen deficit outcome in 2008. However, substantial risks exist for the planned fiscal consolidation back-loaded to 2009 and 2010, as there are no binding expenditure ceilings and there is a lack of information on the envisaged measures. Furthermore, parliamentary elections are scheduled for 2010 and there are potential negative risks to expenditure related to

planned partnerships with the private sector and a continuous accumulation of debt by some state-owned entities classified in the corporate sector.

For 2008, the programme assumes that a temporary opening up of the second pension pillar in the first half of 2008 will result in an one-off revenue of 0.12% of GDP in 2008 due to a transfer of accumulated savings from the second pension pillar not yet included in the Commission services' autumn 2007 forecast. Given the fact that the minimum period of participation in the second pillar was recently increased from 10 to 15 years (making the scheme less attractive for elderly workers) and the government's strong emphasis on potential uncertainties related to returns from private pension funds, the estimate of a net outflow from the second pillar provided in the programme (4% of participants) seems cautious.

Apart from the one-off capital transfer, a significant net outflow of participants from the second back to the first pillar assumed in the update implies a faster growth in social contributions in 2008 compared to both the Commission services' forecast and the growth implied by OECD ex-ante elasticity. On the other hand, after the temporary opening of the second pillar in 2008, participation in the second pillar is expected to start growing again in 2009 as new labour-market entrants are likely to be joining the second pillar. As a result, the apparent elasticities of social contributions and of overall tax revenues are likely to be below the OECD ex-ante elasticities in 2009-10.

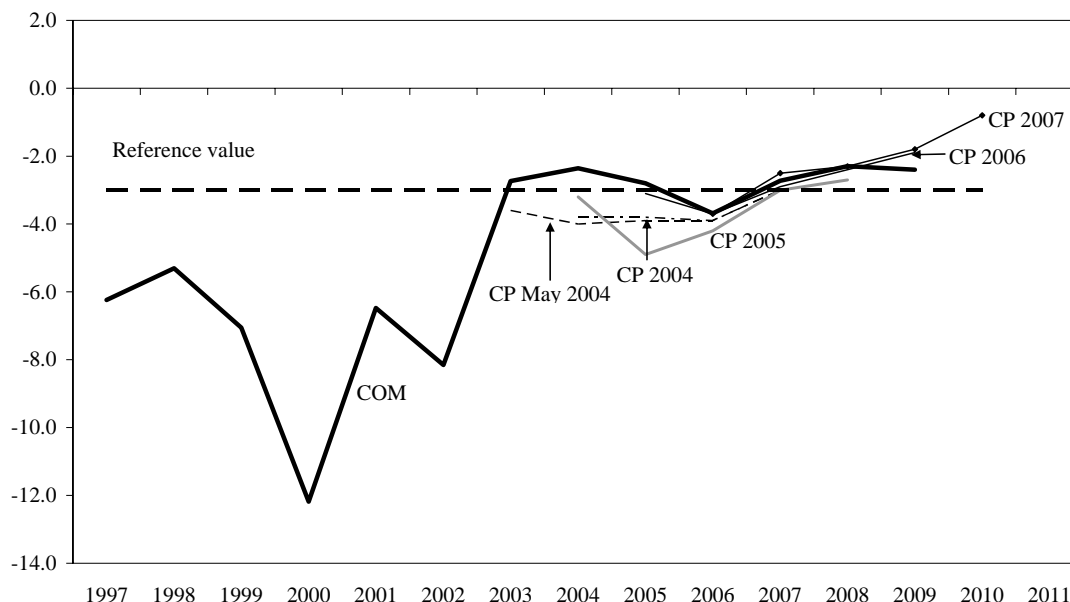
**Table 18: Assessment of tax projections**

	2008			2009			2010
	CP	COM	OECD <sup>3</sup>	CP	COM <sup>1</sup>	OECD <sup>3</sup>	CP
Change in tax-to-GDP ratio (total taxes)	-0.1	-0.3	-0.3	-0.6	-0.6	-0.3	-0.1
Difference (CP – COM)	0.2		/	-0.1		/	/
<i>of which</i> <sup>2</sup> :							
- discretionary and elasticity component	0.1		/	-0.2		/	/
- composition component	0.1		/	0.1		/	/
Difference (COM - OECD)	/	0.0		/	-0.3		/
<i>of which</i> <sup>2</sup> :							
- discretionary and elasticity component	/	-0.1		/	-0.4		/
- composition component	/	0.1		/	0.1		/
p.m.: Elasticity to GDP	1.0	0.9	0.9	0.7	0.8	0.9	0.9
<b>Notes:</b>							
<sup>1</sup> On a no-policy change basis.							
<sup>2</sup> 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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.							
<sup>3</sup> OECD ex-ante elasticity relative to GDP.							
<b>Source:</b>							
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).							

As fiscal consolidation is back-loaded towards the end of the programme period (with little information provided on the measures that underpin the envisaged consolidation) and 2010 is an election year, the fiscal outcome in 2009-2010 could be worse than planned, although it is possible that higher-than-expected growth will support fiscal consolidation given the cautious 2010 growth assumptions.

The envisaged consolidation relies on a high degree of expenditure restraint which is not supported by binding expenditure ceilings although it is outlined in a three-year general government budget. The latter is, however, updated every year. On the other hand, Slovakia has, so far, met all its deficit targets. Moreover, given strong growth prospects, the foreseen consolidation should be consistent with positive real expenditure growth.

**Figure 6: Government balance projections in successive programmes (% of GDP)**



*Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes*

The programme states that according to the proposal introduced by the Transport Ministry, 151km of motorways with a cost of 130bn SKK (7% of 2007 GDP) should be built through PPPs between 2008 and 2012. At the same time, it is emphasized that the key principle in the potential use of PPPs will be a clear definition of risks with an aim of transferring the larger part of risks to private partners. Nevertheless, a potential substantial accumulation of commitments in relation to partnerships with the private sector will clearly present a negative risk for future public expenditure.

In sum, the budgetary outcomes could be better in 2008 and worse in 2009 and 2010.

#### **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 and, second, the final assessment also taking into account risks.

**Table 19: Overview of compliance with the Stability and Growth Pact**

	<b>Based on programme<sup>3</sup></b> (with the targets taken at face value)	<b>Assessment</b> (taking into account risks to the targets)
a. Consistency with correction of excessive deficit by 2007 deadline	yes	yes
b. Safety margin against breaching 3% of GDP deficit limit <sup>1</sup>	in 2010	in 2010 only if sufficient measures are taken to back up the envisaged consolidation
c. Achievement of the MTO	not within programme period	not within programme period
d. Adjustment towards MTO in line with the Pact <sup>2</sup> ? (after the correction of the excessive deficit)	is insufficient and should be strengthened in 2008	is insufficient and should be strengthened in 2008 and, if necessary, backed up by more measures thereafter
<p><u>Notes:</u></p> <p><sup>1</sup>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 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.</p> <p><sup>2</sup>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.</p> <p><sup>3</sup>Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.</p> <p><u>Source:</u></p> <p><i>Commission services</i></p>		

The budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2007. However, structural balances as recalculated by the Commission services indicate fulfilment of a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations only in 2010 under the condition that the envisaged fiscal consolidation is strictly implemented and, if necessary, backed up by additional measures.

The 2010 structural balance as recalculated by the Commission services on the basis of the information in the programme according to the commonly agreed methodology is -1.2% of GDP. Considering that, in addition, there are negative risks to the achievement of the budgetary targets from 2009 onwards, the budgetary stance in the programme thus does not seem to be consistent with achieving the MTO of just below 1% of GDP by 2010.

According to the update the structural balance is planned to deteriorate marginally in 2008 and to improve by more than 0.5% of GDP per year thereafter. According to the Commission services' autumn 2007 forecast the structural balance is improving by around ¼% of GDP in 2008 but only marginally in 2009. Given the fact that Slovakia is enjoying good economic times, an annual improvement in the structural balance of more than 0.5% of GDP already in 2008 would be necessary to comply with the Pact.

## 5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

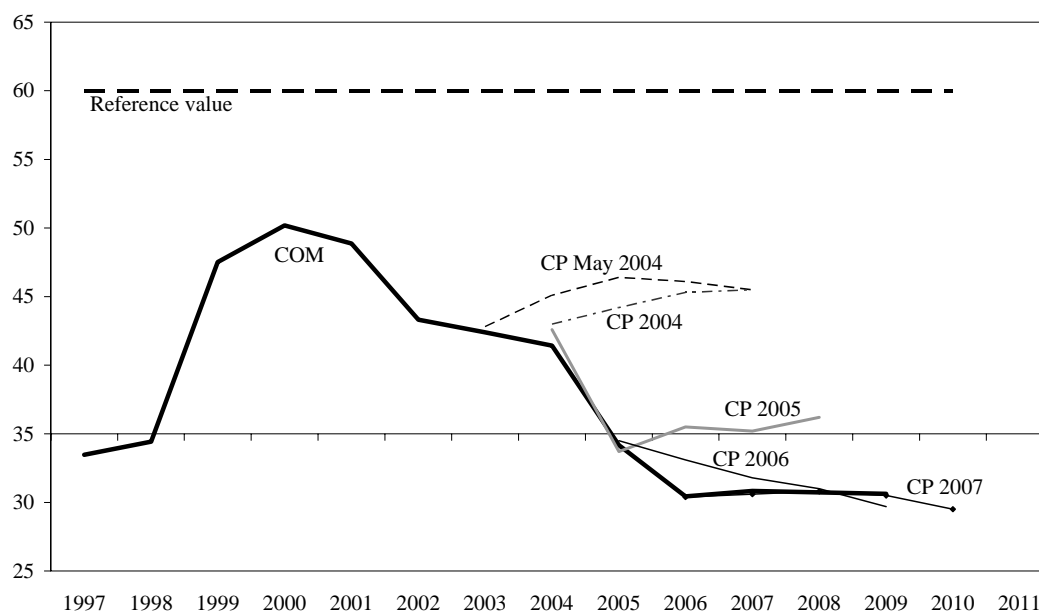
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

### 5.1. Recent debt developments and medium-term prospects

#### 5.1.1. Debt projections in the programme

The programme estimates the 2007 debt ratio at 30.6% of GDP which is in line with the Commission services' autumn 2007 forecast of 30.8% of GDP. According to the programme, the debt ratio is expected to decrease over the programme period to 29.5% in 2010 benefiting mainly from strong GDP growth and the consolidation of the primary balance.

**Figure 7: Debt projections in successive programmes (% of GDP)**



*Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes*



**Table 20: Debt dynamics**

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010
			COM	CP	COM	CP	COM	CP	CP
<b>Gross debt ratio<sup>1</sup></b>	<b>40.3</b>	<b>30.4</b>	<b>30.8</b>	<b>30.6</b>	<b>30.7</b>	<b>30.8</b>	<b>30.6</b>	<b>30.5</b>	<b>29.5</b>
Change in the ratio	-3.7	-3.7	0.4	0.2	-0.1	0.2	-0.1	-0.3	-1.0
<i>Contributions<sup>2</sup>:</i>									
<b>Primary balance</b>	<b>1.5</b>	<b>2.2</b>	<b>1.2</b>	<b>1.0</b>	<b>0.8</b>	<b>0.9</b>	<b>0.9</b>	<b>0.3</b>	<b>-0.5</b>
<b>“Snow-ball” effect</b>	<b>-1.3</b>	<b>-2.0</b>	<b>-1.3</b>	<b>-1.6</b>	<b>-1.2</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-0.7</b>	<b>-0.6</b>
<i>Of which:</i>									
Interest expenditure	2.5	1.5	1.5	1.5	1.5	1.4	1.5	1.5	1.3
Growth effect	-2.0	-2.5	-2.4	-2.4	-2.0	-1.9	-1.7	-1.7	-1.4
Inflation effect	-1.9	-1.0	-0.3	-0.7	-0.7	-0.6	-0.8	-0.5	-0.5
<b>Stock-flow adjustment</b>	<b>-3.8</b>	<b>-3.8</b>	<b>0.4</b>	<b>0.8</b>	<b>0.3</b>	<b>0.5</b>	<b>0.1</b>	<b>0.1</b>	<b>0.2</b>
<i>Of which:</i>									
Cash/accruals diff.	0.9	-0.8		0.2		-0.1		-0.2	-0.1
Acc. financial assets	-4.1	-2.2		0.0		0.0		0.0	0.0
<i>Privatisation</i>	-3.7	-1.9		<i>n.a.</i>		<i>n.a.</i>		<i>n.a.</i>	<i>n.a.</i>
Val. effect & residual	-0.4	-0.8		0.2		0.5		0.3	0.3

**Notes:**  
<sup>1</sup>End of period.  
<sup>2</sup>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 (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*

### 5.1.2. Assessment

The programme's debt projections are broadly in line with the Commission services' autumn 2007 forecast. All outstanding government guarantees have been risk-assessed by the authorities and thus most 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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

### 5.2.1. Sustainability indicators and long-term debt projections

Table 21 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 and property income received by general government according to an agreed

methodology.<sup>10</sup> Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

**Table 21: Long-term age-related expenditure: main projections**

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 50
<b>Total age-related spending</b>	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
Property income received	2.0	1.7	1.6	1.5	1.4	1.4	-0.5

*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 p.p. of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be relatively limited in Slovakia, rising by 1.8 p.p., thanks to the pension reform enacted in 2005.<sup>11</sup> The increase in health-care expenditure is projected to be 1.9 p.p. of GDP, slightly above the average in the EU. For long-term care, the projected increase of 0.6 p.p. of GDP up to 2050 coincides with the average in the EU.

**Table 22: Sustainability indicators and the required primary balance**

Value	2007 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
of which:	2.6	4.4	3.2	0.9	2.7	3.1
Initial budgetary position (IBP)	2.0	2.2	-	0.4	0.6	-
Debt requirement in 2050 (DR)	-0.5	-	-	-0.5	-	-
Long-term change in the primary balance (LTC)	1.1	2.1	-	1.1	2.1	-

*Source: Commission services.*

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 22 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained. In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 4.4 p.p. of GDP.<sup>12</sup> The sustainability gap in the present assessment is slightly higher to the sustainability gap calculated last year, essentially due to the inclusion of property income projections.

The initial budgetary position (with a structural primary deficit) is not sufficiently high to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances before considering the long-term budgetary impact of ageing.

According to both sustainability gaps, the long-term budgetary impact of ageing is limited in particular thanks to the pension reform measures enacted in recent years. The

<sup>10</sup> See the accompanying "methodological paper" for a description of the property income projections.

<sup>11</sup> The long-term projections do not include the most recent changes to the pension scheme (2007), see also 'additional factors'.

<sup>12</sup> The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 2.6% of GDP.

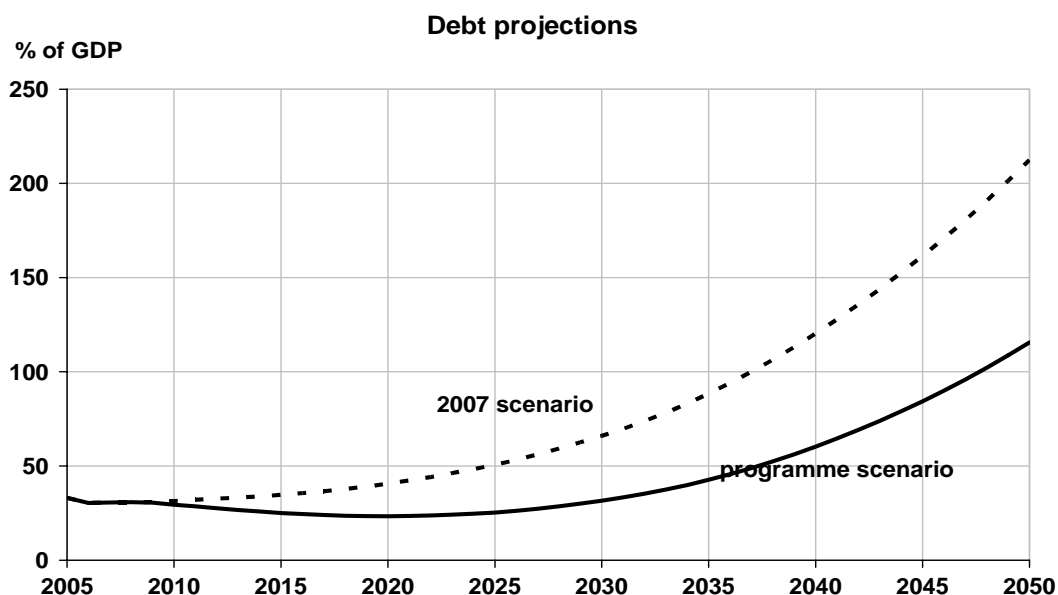
programme plans a structural primary budgetary consolidation of 1.6 p.p. of GDP between 2007 and 2010. If achieved, such a consolidation would appreciably reduce risks to the long-term sustainability of public finances by reducing the S2 sustainability gap to 2.7 p.p. of GDP (“programme scenario”). The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the convergence programme targets, would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is around 3 p.p. of GDP, significantly higher than the structural primary balance of about 0.0% of GDP in the last year of the programme’s period.

The sustainability gap indicators would increase by up to 0.4p.p. of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made 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 the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 9. The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at close to 30% of GDP in 2007. According to the “2007 scenario”, the debt ratio is projected to start increasing in the 2010s as the impact of ageing takes hold and would be higher than 60% of GDP in the late 2020s. In the “programme scenario” the projected increase in the debt ratio will start somewhat later, since the budgetary position in 2010 is stronger than in 2007.

**Figure 8: Long-term projections for the government debt ratio**



*Source: Commission services*

### 5.2.2. *Additional factors*

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, the government has enacted a pension reform consisting of several measures that could reduce pension expenditure over the long-term (slight tightening of the early retirement conditions, increase in the minimum period to be entitled to a pension from 10 years to 15 years).<sup>13</sup> The reform also allows, for a limited period of time (6 months), all current participants to leave the mixed system. This will lead to a permanent<sup>14</sup> increase in revenue for the general government (through higher contributions), at the expense of future higher public expenditure. According to the programme, only a limited share (4%) of second pillar participants are expected to leave the mix system. Under this assumption, the overall impact of the measures on pension expenditure over the long-term is limited. However, if a significantly higher share of workers currently in the mixed system were to opt out and if the resulting tax revenues were not used for debt reduction, it could significantly increase the risks to the long-term sustainability of public finances.

Second, the benefit ratio in Slovakia is projected to decrease relatively markedly, by almost 20% in the period to 2050.<sup>15</sup> 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. The recent measure aiming at tightening early retirement conditions should contribute to raising employment rates of older workers.

### 5.2.3. *Assessment*

The long-term budgetary impact of ageing in Slovakia is lower than the EU average, with pension expenditure showing a more limited increase than in many other countries. However, those projections hinge upon the assumption that a relatively low share of workers will leave the mixed pension system in the first half of 2008, during which they will have the opportunity to do so.

The initial budgetary position with a structural primary deficit constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of an

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<sup>13</sup> The increase in the maximum tax base for calculating social contributions from 3 times to 4 times the average wage will have a positive impact on revenue (of 0.09% of GDP); but this effect will materialize over the programme period and is therefore included in the medium term budgetary projections of revenue.

<sup>14</sup> The transfer of savings accumulated so far in the fully-funded pension scheme will also have a one-off impact on government receipts.

<sup>15</sup> If the pensions from the private funded scheme are not considered, the reduction in the benefit ratio is even larger, by 34%.

ageing population. Consolidating the public finances, as planned in the convergence programme, 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**

As discussed in section 2, Slovakia should ensure that sufficient resources are invested into the education system, R&D and innovation and that they are used efficiently. The programme, however, points out that reliable data allowing for a functional classification of general government expenditure are still not available. Nevertheless, the programme does not signal any reallocation of expenditure towards R&D and innovation while it states that education spending should increasingly rely on the EU funds.

The programme states that a reduction in central government employment of some 10% should be implemented in 2008 leading to an expenditure saving of around 0.1% of GDP per year. While this could free resources for alternative, more growth-enhancing uses it requires significant efficiency-gains in the central government administration in order to avoid a negative impact on its effectiveness.

Apart from the main revenue increasing measures mentioned in section 4, energy taxes will be introduced in 2008 and excise taxes on tobacco will increase both in 2008 and in 2009, while VAT on books and selected medical aid tools will be lowered from 2008 onwards. Taken together, these tax changes should have a marginally positive impact on public balances in 2008-2010 (already included in both the programme's and the Commission services' autumn 2007 forecast projections).

Accrual accounting according to the principles of the International Public Sector Accounting Standards (IPSAS) is planned to be gradually introduced in the public sector. For 2008, central and local governments will prepare individual financial statements according to the new accounting standards. The first consolidated financial statements for central government should be compiled in 2009 and for the entire general government sector in 2010.

However, the non-binding multi-annual budgetary framework has still not been complemented by more binding rules such as expenditure ceilings.

## **7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES**

The latest update of the Convergence Programme confirms that government's expenditure priorities (healthcare, education and agriculture) continue to partly diverge from the key challenges identified in the NRP (information society; R&D and innovation; business environment; and education and employment). The programme does not specify whether the national R&D expenditure target of 0.8% of GDP will be met by 2010 while it states that education spending should increasingly rely on EU funds.

The convergence programme provides systematic information on the direct budgetary costs associated with the main reforms envisaged in the NRP for 2008 and the budgetary projections in the programme seemingly take into account the public finance implications

of the reforms envisaged in the implementation report of the NRP. As a result, the two programmes seem to be consistent to some extent.

**Box 5: The Commission assessment of the October 2007 implementation report of the national reform programme**

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Slovakia's national reform programme<sup>16</sup> and is summarised as follows.

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 is that Slovakia has made some progress in implementing its National Reform Programme over the period 2005-2007.

Against the background of strengths and weaknesses identified, the Commission recommends that Slovakia is recommended to take action in the areas of: R&D and innovation; regulatory environment; lifelong learning and education reform.

Against the background of progress made, the Commission recommends that Slovakia is encouraged to also focus on the areas of: ICT policies; one-stop shops for start-up companies, entrepreneurship education, competition in power supply, gender pay and employment gap, active aging, and youth employment.

The table below provides an overview of whether the strategy and policy measures in the convergence programme are broadly consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs, in particular the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005.

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<sup>16</sup> Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

**Table 23: Consistency with the broad economic policy guidelines (integrated guidelines)**

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
<b>1. To secure economic stability</b>				
– 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 <sup>1</sup> .		X		
– Member States should avoid pro-cyclical fiscal policies <sup>2</sup> .				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits <sup>3</sup> .	X			
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.				X
<b>2. To safeguard economic and fiscal sustainability</b>				
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		
<b>3. To promote a growth- and employment-orientated and efficient allocation of resources</b>				
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		
<p><u>Notes:</u></p> <p><sup>1</sup>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.</p> <p><sup>2</sup>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”.</p> <p><sup>3</sup>As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.</p> <p><u>Source:</u> Commission services</p>				

## 8. PROGRESS IN IMPLEMENTING THE ERM II COMMITMENTS

On 28 November 2005, Slovakia joined ERM II, thus linking its currency to the euro. During the ERM II membership, the koruna continued its appreciation trend. The exchange rate appreciated by about 12% between July 2006 and March 2007, leading to a 8.5% revaluation of the ERM II central parity in March 2007. Since the revaluation, the koruna has traded 3-7% above the new central parity.

In order to ensure a smooth participation in ERM II, it undertook some commitments covering a broad range of areas, such as fiscal policy, financial supervision/credit growth and structural reforms (see box). Taking into account also the information provided in the most recent update of the convergence programme, this section assesses implementation of these commitments.

### **Box 6: ERM II commitments of Slovakia**

The agreement on participation of the Slovak koruna in ERM II is based on a firm commitment by the Slovak authorities to promote wage developments that are kept in line with productivity growth, thereby contributing to achieving price stability in a sustainable manner, and to pursue sound fiscal policies which are essential for preserving macroeconomic stability, including low inflation, and for ensuring the sustainability of the convergence process. The Slovak government's medium term fiscal consolidation strategy requires a high degree of budgetary discipline and needs to be implemented decisively through measures of a permanent nature. Strict monitoring of budget execution will be required, aimed at a timely detection and correction of slippages. The authorities, together with the responsible EU bodies, will closely monitor macroeconomic developments. The authorities commit to strengthen the fiscal stance if warranted. They will remain vigilant concerning risks of strong domestic credit growth. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms, reduce unemployment and maintain the overall competitiveness of the economy.

- **Fiscal policy**

Although the Slovak government has persistently overachieved the fiscal targets set out in its convergence programmes, the targets themselves turned out not to be particularly ambitious given the better-than-originally-assumed initial fiscal position and stronger-than-expected economic performance. Moreover, while the original deficit targets (together with the conservative growth assumptions) implied a planned improvement in structural terms, given the better-than-expected performance in 2004 and 2005, the nominal deficit of 3.7% of GDP reached in 2006 implied a significant structural deterioration. Hence, following a predominantly restrictive fiscal stance in previous years, the fiscal stance turned expansionary in 2006, while monetary conditions tightened on the back of increased policy rates and continued exchange rate appreciation. Nevertheless, as discussed in section 4.1., according to the Commission services' autumn 2007 forecast the general government deficit for 2007 is expected to reach 2.7% of GDP which is below the target of 2.9% of GDP set in the December 2006 update of the Convergence Programme. However, the most recent update of the convergence programme foresees a marginal increase in structural deficit in 2008.

- **Promoting wage developments in line with productivity growth**

Collective bargaining agreements in the public sector implying a wage growth of 5-8% for 2006 and 4-7% for 2007 have been intended to signal wage moderation for the whole economy. They were on average below both the actual increase in nominal compensation per employee of 7.7% in 2006 and the anticipated increase of 7.1% in 2007, which nevertheless have not induced any substantial increase in nominal unit labour costs as labour productivity growth is expected to increase from 5.8% in 2006 to 6.7% in 2007. The strong growth in exports and falling current account deficit in 2007 testify to the fact that the external competitiveness of the Slovak economy has so far been preserved.

- **Structural reforms and other measures**

After a string of structural reforms that ended with the introduction of a second funded pension pillar at the beginning of 2005, no further major structural reforms have been implemented in Slovakia. A reform of labour regulations, which appears to slightly hamper labour market flexibility, entered into force in September 2007. As pointed out in section 7, the government expenditure priorities (healthcare, education and agriculture) continue to partly diverge from the key challenges identified in the NRP (information society; R&D and innovation; business environment; and education and employment). Furthermore, while the significant support for education indicated in the NRP was not



evident in the 2007 budget, expenditure on healthcare and farming subsidies increased considerably.

- **Vigilance concerning risks of strong domestic credit growth**

Starting from a low level, domestic credit to the private sector has expanded rapidly during ERM II period, with annual rates increasing from around 6% in 2004 to 27 % in the first half of 2006. On account of a sharp rise in interest rates in 2006, credit growth has eased to 22% in August 2007. The private sector credit to GDP ratio stood at around 40% in 2006. Foreign-currency exposure seems less of a risk than in other ERM II countries, with the share of foreign-currency borrowing in total credit stable since 2004 at around 20%. Not perceiving credit growth as an imminent risk, the National Bank of Slovakia has not taken any particular measures to contain credit growth. The NBS has closely monitored risk managements practices of banks and strengthened cooperation with home country supervisors of banks operating in Slovakia. Also, the supervision of the entire financial sector has been unified as the risk-based approach of supervision has been extended to non-bank financial institutions.

**Conclusion:** Although the Slovak government has persistently overachieved the fiscal targets set out in its Convergence Programmes, the targets themselves turned out not to be particularly ambitious given the better-than-originally-assumed initial fiscal position and stronger-than-expected economic performance. As regards income policies, collective bargaining agreements in the public sector have provided an important signal of wage moderation for the whole economy. With a view to contain credit growth, the National Bank of Slovakia has closely monitored risk managements practices of banks and strengthened cooperation with home country supervisors of banks operating in Slovakia.

As a Member State with a derogation and an ERMII participant Slovakia should gear its fiscal and monetary policy towards achieving sustainable convergence. In particular, once the disinflationary effect of the exchange rate appreciation fades out, fiscal policy, supported by further structural reforms aiming at higher flexibility and competition in market competition, will have to play a greater role in containing inflationary pressures.

\* \* \*

## Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

### (i) Model structure

The update adheres to the code of conduct as far as its table of contents is concerned.

### (ii) Data requirements

The programme provides all compulsory data. From the optional data, only COFOG data for 2010 is missing. The absence of reliable data on functional classification of government expenditure makes it harder to assess the quality of public finances.

The tables on the following pages show the data presented in the November 2007 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

### (iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP...	Yes	No	Comments
<i>a. Involvement of parliament</i>			
... mentions status vis-à-vis national parliament.	X		
... indicates whether Council opinion on previous programme has been presented to national parliament.		X	
<i>b. Economic outlook</i>			
... (for euro area and ERM II Member States) uses “common external assumptions” on main extra-EU variables.	X		<i>Broadly in line with common external assumptions</i>
... explains significant divergences with Commission services’ forecasts <sup>1</sup> .	X		
... bears out possible upside/downside risks to economic outlook.	X		
... analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
<i>c. Monetary/exchange rate policy</i>			
... (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
<i>d. Budgetary strategy</i>			
... presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
... (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			<i>not applicable</i>
... (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).			<i>not applicable</i>
... backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
... specifies state of implementation of measures.	X		
<i>e. “Major structural reforms”</i>			
... (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible ‘major structural reforms’ over time.			<i>not applicable</i>
... includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			<i>not applicable</i>
<i>f. Sensitivity analysis</i>			

<b>The SCP...</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
... includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		<i>But a scenario with different exchange rate assumptions missing</i>
... (in case of “major structural reforms”) analyses how changes in assumptions would affect budget and potential growth.			<i>not applicable</i>
<i>g. Broad economic policy guidelines</i>			
... provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.		X	
<i>h. Quality of public finances</i>			
... describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
<i>i. Long-term sustainability</i>			
... outlines strategies to ensure sustainability.	X		
... includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
<i>j. Other information (optional)</i>			
... includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		
<p><u>Notes:</u> SCP = stability/convergence programme; CP = convergence programme  <sup>1</sup>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.</p> <p><u>Source:</u>  <i>Commission services</i></p>			

**Table 1a. Macroeconomic prospects**

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	1275.3	8.3	8.8	6.8	5.8	5.0
<b>2. Nominal GDP</b>	B1*g	1636.3	11.2	11.4	9.1	7.7	6.9
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	P.3	698.9	6.1	6.7	6.0	4.7	4.1
<b>4. Government consumption expenditure</b>	P.3	227.8	4.1	2.0	3.0	2.8	2.8
<b>5. Gross fixed capital formation</b>	P.51	355	7.3	8.8	8.0	6.0	5.5
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	33.1	2.6	1.6	0.6	0.6	0.5
<b>7. Exports of goods and services</b>	P.6	1270.5	20.7	21.1	12.8	8.9	6.8
<b>8. Imports of goods and services</b>	P.7	1308.2	17.8	17.2	11.5	8.1	6.1
<b>Contributions to real GDP growth</b>							
<b>9. Final domestic demand</b>		-	6.2	6.5	5.9	4.7	4.1
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	-	0.4	-0.9	-0.9	0.0	-0.1
<b>11. External balance of goods and services</b>	B.11	-	1.7	3.4	1.5	1.1	1.0

**Table 1b. Price developments**

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>		1.283	2.7	2.4	2.2	1.8	1.8
<b>2. Private consumption deflator</b>		1.348	5.1	2.2	2.1	2.4	2.4
<b>3. HICP<sup>1</sup></b>		n.a.	4.3	1.7	2.3	2.6	2.7
<b>4. Public consumption deflator</b>		1.306	5.0	2.6	1.8	2.2	2.3
<b>5. Investment deflator</b>		1.217	2.0	2.0	1.7	1.6	1.7
<b>6. Export price deflator (goods and services)</b>		1.104	2.2	-0.5	-0.1	0.0	1.1
<b>7. Import price deflator (goods and services)</b>		1.13	3.6	-1.3	-0.4	0.3	1.4

<sup>1</sup> Optional for stability programmes.

**Table 1c. Labour market developments**

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons<sup>1</sup></b>		2132	2.3	2.1	1.6	1.0	0.8
2. Employment, hours worked <sup>2</sup>		3728616	2.7	4.2	2.2	1.6	1.9
<b>3. Unemployment rate (%)<sup>3</sup></b>		13.4	13.4	11.0	10.1	9.7	9.4
<b>4. Labour productivity, persons<sup>4</sup></b>		n.a.	5.8	6.6	5.1	4.7	4.2
5. Labour productivity, hours worked <sup>5</sup>		n.a.	5.4	4.5	4.5	4.1	3.1
<b>6. Compensation of employees</b>	D.1	601883	10.2	11.5	8.3	7.6	7.4
<b>7. Compensation per employee</b>		251.3	7.7	9.2	6.6	6.5	6.5

<sup>1</sup>Occupied population, domestic concept national accounts definition.

<sup>2</sup>National accounts definition.

<sup>3</sup>Harmonised definition, Eurostat; levels.

<sup>4</sup>Real GDP per person employed.

<sup>5</sup>Real GDP per hour worked.

**Table 1d. Sectoral balances**

% of GDP	ESA Code	2006	2007	2008	2009	2010
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	-8.4	-3.4	-1.9	-1.1	-0.4
<i>of which:</i>						
- Balance on goods and services		-4.4	-1.2	0.3	0.7	1.3
- Balance of primary incomes and transfers		-3.9	-2.8	-2.8	-2.6	-2.5
- Capital account		-0.1	0.6	0.6	0.8	0.8
2. Net lending/borrowing of the private sector	B.9	-4.7	-0.9	0.4	0.7	0.4
3. Net lending/borrowing of general government	EDP B.9	-3.7	-2.5	-2.3	-1.8	-0.8
<b>4. Statistical discrepancy</b>		n.a.	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>							
<b>1. General government</b>	S.13	-61214	-3.7	-2.5	-2.3	-1.8	-0.8
<b>2. Central government</b>	S.1311	-57541	-3.5	-2.3	-2.3	-1.9	-0.9
<b>3. State government</b>	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>4. Local government</b>	S.1313	-4894	-0.3	-0.1	-0.1	0.0	0.0
<b>5. Social security funds</b>	S.1314	1221	0.1	-0.1	0.1	0.1	0.1
<b>General government (S13)</b>							
<b>6. Total revenue</b>	TR	555334	33.5	33.2	33.0	31.8	31.8
<b>7. Total expenditure</b>	TE <sup>1</sup>	616548	37.2	35.7	35.3	33.7	32.6
<b>8. Net lending/borrowing</b>	EDP B.9	-61214	-3.7	-2.5	-2.3	-1.8	-0.8
<b>9. Interest expenditure</b>	EDP D.41	24225	1.5	1.5	1.4	1.5	1.3
<b>10. Primary balance<sup>2</sup></b>		-36989	-2.2	-1.0	-0.9	-0.3	0.5
<b>11. One-off and other temporary measures<sup>3</sup></b>		-6253	-0.4	0.0	0.1	0.0	0.0
<b>Selected components of revenue</b>							
<b>12. Total taxes (12=12a+12b+12c)</b>		287099	17.3	17.5	17.3	17.1	17.1
<b>12a. Taxes on production and imports</b>	D.2	187731	11.3	11.4	11.0	10.8	10.8
<b>12b. Current taxes on income, wealth, etc</b>	D.5	99360	6.0	6.1	6.2	6.3	6.2
<b>12c. Capital taxes</b>	D.91	8	0.0	0.0	0.0	0.0	0.0
<b>13. Social contributions</b>	D.61	197406	11.9	11.8	12.0	11.5	11.5
<b>14. Property income</b>	D.4	25778	1.6	1.6	1.7	1.2	1.1
<b>15. Other<sup>4</sup></b>		45051	2.7	2.3	2.0	2.0	2.2
<b>16=6. Total revenue</b>	TR	555334	33.5	33.2	33.0	31.8	31.8
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)<sup>5</sup></b>			29.5	29.6	29.6	28.9	28.8
<b>Selected components of expenditure</b>							
<b>17. Compensation of employees + intermediate consumption</b>	D.1+P.2	217611	13.1	12.1	11.9	11.9	11.5
<b>17a. Compensation of employees</b>	D.1	122817	7.4	7.4	7.0	6.7	6.6
<b>17b. Intermediate consumption</b>	P.2	94794	5.7	4.7	4.9	5.2	4.9
<b>18. Social payments (18=18a+18b)</b>		270250	16.3	16.4	16.2	15.5	15.4
<b>18a. Social transfers in kind supplied via market producers</b>	D.6311, D.63121, D.63131	73094	4.4	4.6	4.6	4.5	4.5
<b>18b. Social transfers other than in kind</b>	D.62	197156	11.9	11.8	11.6	11.0	10.9
<b>19=9. Interest expenditure</b>	EDP D.41	24225	1.5	1.5	1.4	1.5	1.3
<b>20. Subsidies</b>	D.3	22134	1.3	1.3	1.2	1.0	0.9
<b>21. Gross fixed capital formation</b>	P.51	36310	2.2	1.6	1.8	1.4	1.3
<b>22. Other<sup>6</sup></b>		46018	2.8	2.7	2.8	2.4	2.2
<b>23=7. Total expenditure</b>	TE <sup>1</sup>	616548	37.2	35.7	35.3	33.7	32.6
<b>p.m.: Government consumption (nominal)</b>	P.3	318497	19.2	18.4	18.2	18.0	17.6

<sup>1</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>2</sup> The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

<sup>3</sup> A plus sign means deficit-reducing one-off measures.

<sup>4</sup> P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

<sup>5</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

<sup>6</sup> D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	2005	2010
1. General public services	1	6.4	n.a.
2. Defence	2	1.6	n.a.
3. Public order and safety	3	2.0	n.a.
4. Economic affairs	4	3.8	n.a.
5. Environmental protection	5	0.7	n.a.
6. Housing and community amenities	6	0.8	n.a.
7. Health	7	5.0	n.a.
8. Recreation, culture and religion	8	0.9	n.a.
9. Education	9	4.0	n.a.
10. Social protection	10	11.6	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE <sup>1</sup>	36.7	n.a.

<sup>1</sup>Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 4. General government debt developments**

% of GDP	ESA Code	2006	2007	2008	2009	2010
<b>1. Gross debt<sup>1</sup></b>		30.4	30.6	30.8	30.5	29.5
<b>2. Change in gross debt ratio</b>		-3.7	0.2	0.2	-0.3	-1.0
<b>Contributions to changes in gross debt</b>						
<b>3. Primary balance<sup>2</sup></b>		2.2	1.0	0.9	0.3	-0.5
<b>4. Interest expenditure<sup>3</sup></b>	EDP D.41	1.5	1.5	1.4	1.5	1.3
<b>5. Stock-flow adjustment</b>		-3.8	0.4	0.4	0.1	0.2
<i>of which:</i>						
- Differences between cash and accruals <sup>4</sup>		-0.6	0.2	-0.1	-0.2	-0.1
- Net accumulation of financial assets <sup>5</sup>		-2.3	0.0	0.0	0.0	0.0
<i>of which:</i>						
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other <sup>6</sup>		-0.9	0.2	0.5	0.3	0.3
<b>p.m.: Implicit interest rate on debt<sup>7</sup></b>		4.8	5.3	5.1	5.2	4.5
<b>Other relevant variables</b>						
6. Liquid financial assets <sup>8</sup>		4.8	4.1	4.1	4.0	3.9
7. Net financial debt (7=1-6)		25.7	26.5	26.7	26.6	25.7

<sup>1</sup>As defined in Regulation 3605/93 (not an ESA concept).

<sup>2</sup>Cf. item 10 in Table 2.

<sup>3</sup>Cf. item 9 in Table 2.

<sup>4</sup>The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

<sup>5</sup>Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

<sup>6</sup>Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

<sup>7</sup>Proxied by interest expenditure divided by the debt level of the previous year.

<sup>8</sup>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	2006	2007	2008	2009	2010
<b>1. Real GDP growth (%)</b>		8.3	8.8	6.8	5.8	5.0
<b>2. Net lending of general government</b>	EDP B.9	-3.7	-2.5	-2.3	-1.8	-0.8
<b>3. Interest expenditure</b>	EDP D.41	1.5	1.5	1.4	1.5	1.3
<b>4. One-off and other temporary measures<sup>1</sup></b>		-0.4	0.0	0.1	0.0	0.0
5. Potential GDP growth (%)		7.3	8.5	7.1	5.8	5.1
contributions:						
- labour		0.7	0.7	0.6	0.5	0.4
- capital		1.7	1.8	2.0	2.1	2.1
- total factor productivity		4.9	6.0	4.6	3.3	2.6
6. Output gap		0.0	0.3	0.1	0.0	0.0
7. Cyclical budgetary component		0.0	0.1	0.0	0.0	0.0
8. Cyclically-adjusted balance (2 - 7)		-3.7	-2.6	-2.4	-1.8	-0.8
9. Cyclically-adjusted primary balance (8 + 3)		-2.2	-1.1	-0.9	-0.4	0.5
10. Structural balance (8 - 4)		-3.3	-2.6	-2.5	-1.8	-0.8

<sup>1</sup>A plus sign means deficit-reducing one-off measures.

**Table 6. Divergence from previous update**

	ESA Code	2006	2007	2008	2009	2010
<b>Real GDP growth (%)</b>						
<b>Previous update</b>		6.6	7.1	5.5	5.1	5.0
<b>Current update</b>		8.3	8.8	6.8	5.8	5.0
<b>Difference</b>		1.7	1.7	1.3	0.7	0.1
<b>General government net lending (% of GDP)</b>	EDP B.9					
<b>Previous update</b>		-3.7	-2.9	-2.4	-1.9	-0.9
<b>Current update</b>		-3.7	-2.5	-2.3	-1.8	-0.8
<b>Difference</b>		0.0	0.4	0.1	0.1	0.1
<b>General government gross debt (% of GDP)</b>						
<b>Previous update</b>		33.1	31.8	31.0	29.7	n.a.
<b>Current update</b>		30.4	30.6	30.8	30.5	29.5
<b>Difference</b>		-2.7	-1.2	-0.2	0.8	n.a.



**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	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	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)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	4.4	4.7	5.2	5.7	6.0	6.3
Long-term care ( <i>this was earlier included in the health care</i> )	0.7	0.8	0.7	0.9	1.1	1.3
Education expenditure	3.7	3.0	2.2	2.2	2.3	2.4
Other age-related expenditures	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	31.8	31.6	31.5	31.4	31.2
Of which: property income	1.7	1.1	1.1	1.1	1.1	1.1
<i>Of which</i> : from pensions contributions (or social contributions if appropriate)	12.8	11.5	11.3	11.2	11.1	10.9
Pension reserve fund assets	0.0	7.0	18.9	31.5	45.7	58.0
<i>Of which</i> : consolidated public pension fund assets (assets other than government liabilities)	0.0	0.0	0.0	0.0	0.0	0.0
<b>Assumptions</b>						
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 20-64)	77.3	79.6	82.1	82.3	79.4	78.7
Participation rates females (aged 20-64)	64.1	67.1	73.5	73.8	70.0	69.1
Total participation rates (aged 20-64)	70.7	73.3	77.8	78.0	74.7	73.9
Unemployment rate	18.1	15.2	9.7	7.0	7.0	7.0
Population aged 65+ over total population	11.5	12.3	16.3	20.8	24.1	29.3

**Table 8. Basic assumptions**

	2006	2007	2008	2009	2010
Short-term interest rate <sup>1</sup> (annual average)	3.1	4.3	4.2	4.1	3.9
Long-term interest rate (annual average)	3.8	4.2	4.2	4.3	4.4
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.26	1.35	1.39	1.39	1.39
Nominal effective exchange rate	n.a.	n.a.	n.a.	n.a.	n.a.
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	5.8	5.6	5.3	5.5	5.5
EU GDP growth	3.0	2.8	2.4	2.4	1.9
Growth of relevant foreign markets	3.7	3.4	3.1	2.6	2.5
World import volumes, excluding EU	8.4	7.5	6.8	7.5	7.5
Oil prices (Brent, USD/barrel)	66.2	69.5	74.9	72.7	73.2

<sup>1</sup>If necessary, purely technical assumptions.

## Annex 2: Key indicators of past economic performance

This annex displays key indicators that summarise the past economic performance of Slovakia. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the recently acceded Member States (EU12).

**Table: Key economic indicators**

	Slovakia						Recently acceded Member States					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
<b>Economic activity</b>												
Real GDP (% change)	4.0	3.5	4.6	6.0	8.3	8.7	3.8	3.6	4.1	4.8	6.3	6.0
<i>Contributions to real GDP growth:</i>												
<i>Domestic demand</i>	4.9	4.5	5.3	8.8	6.5	6.0	4.4	4.6	4.1	4.1	7.3	7.8
<i>Net exports</i>	-0.9	-1.0	-0.7	-2.8	1.7	2.7	-0.5	-1.0	-0.1	0.8	-0.9	-1.8
Real GDP per capita (PPS; EU27 = 100)	52	51	54	58	62	65	47	45	49	52	54	56
Real GDP per capita (% change)	4.0	3.3	4.6	5.9	8.2	8.6	4.1	3.8	4.4	4.9	6.4	6.1
<b>Prices, costs and labour market</b>												
HICP inflation (%)	7.0	8.2	5.9	2.8	4.3	1.7	7.8	12.9	5.7	3.8	3.4	4.0
Labour productivity (% change)	4.1	4.3	4.0	4.6	5.8	6.7	4.2	4.3	4.1	3.3	3.6	3.5
Real unit labour costs (% change)	-0.5	0.1	-1.1	-1.8	-1.0	-2.1	-1.3	-1.4	-1.3	-0.6	-1.5	0.4
Employment (% change)	-0.1	-0.8	0.6	1.4	2.3	1.9	-0.3	-0.6	0.0	1.4	2.6	2.4
Unemployment rate (% of labour force)	16.1	14.3	18.0	16.3	13.4	11.2	11.3	9.7	12.9	11.9	9.9	7.8
<b>Competitiveness and external position</b>												
Real effective exchange rate (% change)	3.0	1.9	4.1	2.1	4.6	8.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) <sup>1</sup>	2.2	-0.1	4.4	7.4	9.4	11.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-6.4	-7.0	-5.8	-8.1	-7.8	-4.2	-4.5	-4.8	-4.3	-4.3	-5.0	-6.1
<b>Public finances</b>												
General government balance (% of GDP)	-6.3	-8.1	-4.5	-2.8	-3.7	-2.7	-4.2	-3.8	-4.4	-3.5	-3.3	-2.7
General government gross debt (% of GDP)	40.7	39.3	42.0	34.2	30.4	30.8	37.7	35.4	39.0	39.6	38.8	37.9
Structural balance (% of GDP) <sup>2</sup>	n.a.	n.a.	-1.4	-1.1	-3.4	-3.0	n.a.	n.a.	-3.8	-3.3	-3.6	-3.0
<b>Financial indicators</b>												
Short-term real interest rate (%) <sup>3</sup>	5.1	9.0	1.3	0.5	1.6	1.7	3.9	6.3	2.9	1.4	1.0	0.5
Long-term real interest rate (%) <sup>3</sup>	0.7	-1.2	1.1	1.1	1.6	1.9	n.a.	n.a.	n.a.	n.a.	1.6	1.1
Notes:												
<sup>1</sup> Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.												
<sup>2</sup> Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.												
<sup>3</sup> Using GDP deflator.												
<i>Source:</i>												
<i>Commission services</i>												