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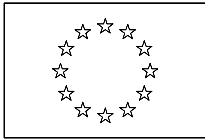

EUROPEAN COMMISSION

Brussels, 17.3.2010
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Recommendation for a

COUNCIL OPINION

on the updated stability programme of Slovakia, 2009-2012

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

In accordance with the Regulation, the Council delivered an opinion on the first stability programme of Slovakia on 7 July 2009 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the Regulation foresees that these are assessed by the Commission and examined by the Committee mentioned above and, following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Slovakia, submitted on 29 January 2010, and has adopted a recommendation for a Council Opinion on it.

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

(1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");

(2) the conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy";

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

(4) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council Opinion on the previous update of the stability programme).

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global crisis that hit financial markets and the world economy in 2008-2009, the European Commission called for a European Economic Recovery Plan (EERP)[2]. The plan proposed a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan called for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability (or room for manoeuvre) of government finances and competitive positions. In particular, for Member States with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008.

2.2. The conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy"

Following the halt of the sharp decline in economic activity and first signs of a recovery from the crisis, the stabilisation of financial markets and the improvement in confidence, the Council concluded on 20 October 2009 that, while in view of the fragility of the recovery it was not yet time to withdraw the support governments provided to the economy and the financial sector, preparing a coordinated strategy for exiting from the broad-based policies of stimulus was needed. Such a strategy should strike a balance between stabilisation and sustainability concerns, take into account the interaction between the different policy instruments, as well as the discussion at global level. Early design and communication of such a strategy would contribute to underpinning confidence in medium-term policies and anchor expectations. Beyond the withdrawal of the stimulus measures of the European Economic Recovery Plan, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Increasing the efficiency and effectiveness of public finances and the intensification of structural reform were desirable even in the short term as they would contribute to fostering potential output growth and debt reductions.

The Council agreed on the following principles of the fiscal exit strategy: (i) the strategy should be coordinated across countries in the framework of a consistent implementation of the Stability and Growth Pact; (ii) taking country-specific circumstances into account, timely withdrawal of fiscal stimulus was needed; provided that the Commission forecasts continued to indicate that the recovery was strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest; (iii) in view of the challenges, the pace of consolidation should be ambitious, in most countries going well beyond the benchmark of 0.5% of GDP per annum in structural terms; and (iv) important flanking policies to the fiscal exit would include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term

[2] Communication from the Commission to the European Council of 26 November 2008.

fiscal sustainability; in addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. The Council agreed that these elements should be reflected in the stability and convergence programmes, to be transmitted by Member States to the Commission by the end of January 2010.

2.3. The excessive deficit procedure for Slovakia

On 2 December 2009 the Council adopted a decision stating that Slovakia had an excessive deficit in accordance with Article 126(6) of the Treaty on the Functioning of the European Union (TFEU). At the same time, the Council addressed a recommendation under 126(7) TFEU specifying that the excessive deficit had to be corrected by 2013.

In particular, Slovakia was recommended to implement the deficit reducing measures in 2010 as planned in the budget for 2010-2012, ensure an average annual fiscal effort of 1% of GDP over the period 2010-2013, and specify the necessary measures for achieving the correction of the excessive deficit by 2013, cyclical conditions permitting. The Council also recommended to accelerate the reduction of the deficit if economic or budgetary conditions turn out better than expected. In addition, to limit risks to the adjustment, Slovakia was recommended to strengthen the enforceability of its medium-term budgetary framework as well as improve the monitoring of the budget execution throughout the year, in particular to avoid expenditure overruns compared to budget plans. The Council established the deadline of 2 June 2010 for the Slovak government to take effective action to implement the deficit reducing measures in 2010 as planned in the draft budget for 2010-2012 and to outline in some detail the consolidation strategy that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast. The Slovak authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the stability programmes prepared between 2010 and 2013.

2.4. The assessment in the Council Opinion on the previous update

In its opinion of 7 July 2009, the Council summarised its assessment of the previous update of the stability programme, covering the period 2008-2012, as follows. The Council considers that "the budgetary projections presented in the stability programme are based on markedly favourable macroeconomic assumptions. The risks to the budgetary targets are clearly negative. The expansionary fiscal stance in 2009, including the limited stimulus measures, appears appropriate given the competitiveness challenge and is therefore in line with the EERP. However, achieving medium-term budgetary targets will require more significant structural consolidation after 2009 than envisaged in the programme. The consolidation effort needs to be backed up by concrete expenditure measures. In addition, the deterioration of public finances presents a risk also for long-term sustainability. In this context, it is crucial to continue reforming the PAYG pillar of the pension system and to avoid undermining the stability of the fully-funded pension pillar." In view of the assessment the Council invited Slovakia to: "(i) implement the anti-crisis measures in line with the EERP as planned and within the framework of the SGP; (ii) ensure consolidation in 2010 as the economy recovers and beyond. The budgetary strategy and consolidation path should be backed up with specific measures for reducing expenditure from 2010 onwards, which should be supported by the introduction of legally binding expenditure ceilings for the general government to ensure fiscal discipline in a less buoyant revenue scenario; (iii) continue reforming the PAYG pillar of the pension system and avoid undermining the stability of the fully-funded pension pillar, given the upcoming challenges of an ageing population, in order to improve the long-term sustainability of public finance".

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [22 April 2010] the Council examined the updated stability programme of Slovakia, which covers the period 2009 to 2012.

(2) With an average real GDP growth rate of over 7% over the period 2003-2008, Slovakia was one of the best performing EU countries during the boom phase. Sound macroeconomic policies over that period allowed avoiding large macroeconomic imbalances, which enabled Slovakia to adopt the euro in January 2009. However, given its large trade openness, the Slovak economy was strongly affected by the crisis. Real GDP is estimated to have fallen by more than 5% in 2009, and the depreciation of neighbouring countries' currencies implied a further appreciation of Slovakia's real effective exchange rate. To contain the effects of the crisis, the authorities allowed a full operation of automatic stabilisers and, in line with the European Economic Recovery Plan, adopted anti-crisis measures in November 2008 and February 2009 (½% of GDP for both 2009 and 2010). With the government deficit expected at some 6% of GDP in 2009, on 2 December 2009 the Council decided on the existence of an excessive deficit and recommended its correction by 2013. Considering the weakening of Slovakia's external competitiveness due to temporary depreciation of neighbouring countries' currencies and widening fiscal imbalances during the crisis, a credible and sustainable reduction of the government deficit should be a key element of the authorities' strategy for the coming years.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In

[3] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Slovakia it is important to undertake reforms to reduce regulation and administrative burdens on businesses, to improve the functioning of the labour market, and to improve cost competitiveness position relative to trade partners, including through wage moderation.

(4) The macroeconomic scenario underlying the programme projects real GDP growth at 1.9% in 2010, 4.1% in 2011 and 5.4% in 2012. Assessed against currently available information[4], this scenario appears to be based on plausible growth assumptions in 2010 and favourable assumptions in 2011 and 2012. The projections for the outer years of the programme may not reflect the degree of prudence that should underpin fiscal consolidation strategies, especially given the unusually high uncertainties in the current post-crisis environment. Consistent with the assumed recovery, the programme projection for inflation is higher by about 1 pp. in 2011 than in the Commission services' autumn 2009 forecast, and the unemployment rate is projected to decline more rapidly.

(5) The programme estimates the government deficit in 2009 at 6.3% of GDP, up from 2.3% of GDP in 2008. The full operation of automatic stabilisers in 2009 triggered a marked decline in revenue and a sizeable increase in social spending. Stimulus measures adopted by the government in the context of the European Economic Recovery Plan (EERP) did not affect the deficit as they were financed by reallocations of spending within the budget. Some of the anti-crisis measures will remain in place in 2010. Nevertheless, in line with the exit strategy advocated by the Council, and with a view to correcting the excessive deficit and bringing the fiscal position to more sustainable levels, the government plans a front-loaded consolidation of public finances over the programme period starting in 2010.

(6) For 2010, the programme targets a general government deficit of 5.5% of GDP. The expenditure to GDP ratio is expected to fall by 1.1 percentage point of GDP, reflecting savings in goods and services expenditure, a moderate increase in public wages, and cuts in public investment. The revenue to GDP ratio is projected to decline by 0.3 percentage point of GDP, reflecting a temporary increase of tax allowances and in-work benefits, and a decline in dividends from public companies. The planned measures are expected to lower the general government deficit by about 1 percentage point of GDP. The fiscal target for 2010 implies a sizable improvement of the structural balance (i.e. cyclically-adjusted balance net of one-off and other temporary measures), by about 1¼ percentage points of GDP, which is in line with the Council recommendation under the excessive deficit procedure.

(7) The main aim of the programme's budgetary strategy is to reduce the general government deficit to 3% of GDP in 2012, i.e. one year earlier than recommended by the Council under the excessive deficit procedure. The headline deficit is expected to

[4] The assessment notably takes into account the Commission services' Autumn 2009 forecast, but also other information that has become available since then.

fall from 5.5% of GDP in 2010 to 4.2% and 3.0% of GDP in 2011 and 2012, respectively. Two thirds of the reduction of the deficit between 2010 and 2012 would reflect a frontloaded structural improvement (as measured according to the commonly agreed methodology applied to the information provided in the programme); the remaining third would result from favourable cyclical developments. The main drivers of the structural improvement are significant planned cuts in government consumption and capital expenditures. According to the programme, the annual average fiscal consolidation effort in the years 2010-2012, recalculated according to the commonly agreed method, would amount to around 1% of GDP, which is in line with the Council recommendation under the excessive deficit procedure. Consolidation is planned to continue in the years after 2012 with a view to progressing towards the medium-term budgetary objective (MTO), which is a balanced budget in structural terms. In view of the new methodology and given the most recent projections and debt level, the MTO more than adequately reflects the objectives of the Pact[5]. However, the programme does not envisage achieving it within the programme period.

(8) The budgetary outcomes in 2010 could turn out somewhat worse than projected in the programme. There are, in particular, uncertainties on the expenditure side, where some measures may not yield the expected savings (e.g. reduction of spending in goods and services). Moreover, the projection for the balance of local governments seems optimistic in view of the assumed impact of crisis on revenues of these entities in 2010. Uncertainties to fiscal targets are larger for the outer years. In particular, the programme is based on favourable macroeconomic assumptions in 2011 and 2012, implying that negative revenue surprises are possible. Furthermore the envisaged measures on the expenditure side, especially those related to the reduction of government consumption, will have to be specified in more details to enhance credibility of the consolidation plan.

(9) According to the stability programme government gross debt increased from 27.7% of GDP in 2008 to 37.1% of GDP in 2009. The increase reflects the high deficit and the significant contraction of real GDP in 2009. While remaining well below the Treaty reference value, the debt ratio is projected to increase further in 2010 and 2011, when it would reach 42.5% of GDP, and to slightly decline in 2012, to 42.2% of GDP. The evolution of the debt ratio is likely to be less favourable than projected in the programme, especially after 2010, in view of the risks identified for budgetary consolidation compounded by the possibility of less favourable real GDP growth than assumed in the programme.

(10) The long-term budgetary impact of ageing population is slightly higher than the EU average, due to a relatively high increase in pension expenditure during the coming decades. In addition, the budgetary position in 2009 compounds the budgetary impact of population ageing on the sustainability gap. Achieving higher primary surpluses over the medium term together with structural reforms, as foreseen in the programme, and reforming the pension system, would contribute to reducing the risks to the

[5] The country-specific MTOs should take into account three components: i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure.

sustainability of public finances which were assessed in the Commission 2009 Sustainability Report[6] as high. Medium-term debt projections that assume GDP growth rates to only gradually recover to the values projected before the crisis and tax ratios to return to pre-crisis levels show that the budgetary strategy envisaged in the programme, taken at face value, would not be enough to stabilise the debt-to-GDP ration by 2020.

(11) Slovakia's fiscal policy is based on a well-defined and detailed three-year fiscal framework. Nevertheless, medium-term expenditure targets are largely indicative and typically subject to large revisions, which over time undermines their credibility. The 2010 update of the stability programme proposes to strengthen the framework by introducing multiannual expenditure ceilings, which would cover a large share of government finances. Escape clauses would be foreseen in case of negative economic shocks. The programme also proposes to introduce an upper limit on government debt in a constitutional law and improvements in monitoring of budget execution during the year. These efforts to strengthen the institutional set-up for public finances are welcome and should be encouraged. However, as the proposals are only at a very initial stage they should be seen as complementary efforts rather than driving forces of the fiscal consolidation strategy.

(12) There is scope to improve the composition of government spending in Slovakia. The share of government investment in total government expenditure is low compared to neighbouring countries (2% of GDP). Spending in R&D, education and environment protection is also low by EU standards and compared to regional peers. Against this background, the projected reduction of spending on capital formation over the programme horizon is a source of concern. It may not be sustainable, and desirable, in a catching-up economy like Slovakia. The programme envisages several measures to enhance the efficiency of the government including reorganization of the central administration through merger of ministries, centralisation of public procurements and management of state property, and better use of information technologies in public services. While still at an early stage, these measures go in the right direction.

(13) Overall, in 2010 the budgetary strategy set out in the programme is consistent with the Council recommendations under Art. 126(7). From 2011 on, there are risks that the ambitious consolidation path described in the programme will not be achieved, and the budgetary strategy may not be fully consistent with the Council recommendations under Art. 126(7). The programme presents an ambitious plan to bring the government deficit from 6.3% of GDP in 2009 to 3.0% of GDP in 2012, one year before the deadline of 2013 set by the Council. Achievement of the fiscal target for 2010 would imply an improvement of the structural balance by about 1¼ percentage points of GDP. The projected average annual structural effort of around 1% of GDP over 2010-2012 is in line with the Council recommendation under the excessive deficit procedure. However, both revenue and expenditure targets are subject to risks, especially in 2011 and 2012, when macroeconomic assumptions seem to be on the

6 In the Council Conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

high side. In addition, further details of measures included in the programme will have to be specified to enhance the credibility of the consolidation plan.

(14) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[7]. In its recommendations under Article 126(7) of 2 December 2009 with a view to bringing the excessive deficit situation to an end, the Council also invited Slovakia to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the stability programmes. The programme complies with this recommendation.

The overall conclusion is that the fiscal strategy presented in the programme is broadly in line with the Council recommendation under the excessive deficit procedure. It envisages a sizeable, frontloaded fiscal consolidation with a view to bringing the deficit below 3% of GDP by 2012, one year before the deadline set by the Council. The budgetary projections are however subject to risks due to favourable growth assumptions for the outer years and might need more specific measures to achieve the planned savings on the expenditure side. Intentions to strengthen the fiscal framework are welcome but need to be followed by concrete actions.

In view of the above assessment and also in the light of the recommendation under Article 126 TFEU of 2 December 2009, Slovakia is invited to:

(i) implement the deficit reducing measures in 2010 as planned in the budget, and back up the consolidation path for the following years with specific measures to secure the correction of the excessive deficit by 2013 at the latest;

(ii) continue reforms of the pension system with a view to ensuring the sustainability of government finances;

(iii) implement the envisaged measures to further strengthen the fiscal framework, in particular the introduction of enforceable multiannual expenditure ceilings.

[7] In particular, the data on changes in inventories and net acquisition of valuables are not provided.

Comparison of key macro-economic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	**SP Jan 2010**	**6.4**	**-5.7**	**1.9**	**4.1**	**5.4**
	COM Nov 2009	6.4	-5.8	1.9	2.6	n.a.
	CP Apr 2009	*6.4*	*2.4*	*3.6*	*4.5*	*n.a.*
HICP inflation (%)	**SP Jan 2010**	**3.9**	**1.2**	**2.6**	**3.7**	**4.1**
	COM Nov 2009	3.9	1.1	1.9	2.5	n.a.
	CP Apr 2009	*3.9*	*2.2*	*3.6*	*4.1*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Jan 2010**	**8.9**	**-1.1**	**-2.9**	**-3.0**	**-1.0**
	COM Nov 2009[2]	9.2	-0.8	-2.1	-3.0	n.a.
	CP Apr 2009	*6.5*	*3.5*	*1.7*	*1.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Jan 2010**	**-5.3**	**-4.2**	**-3.2**	**-2.7**	**-1.9**
	COM Nov 2009	-5.6	-4.8	-4.3	-4.2	n.a.
	CP Apr 2009	*-5.8*	*-4.2*	*-2.9*	*-2.6*	*n.a.*
General government revenue (% of GDP)	**SP Jan 2010**	**32.5**	**32.8**	**32.5**	**32.3**	**31.7**
	COM Nov 2009	32.5	31.3	31.4	31.4	n.a.
	CP Apr 2009	*33.4*	*32.1*	*31.6*	*31.8*	*n.a.*
General government expenditure (% of GDP)	**SP Jan 2010**	**34.8**	**39.1**	**38.0**	**36.5**	**34.7**
	COM Nov 2009	34.8	37.5	37.5	36.9	n.a.
	CP Apr 2009	*35.6*	*35.1*	*34.5*	*34.1*	*n.a.*
General government balance (% of GDP)	**SP Jan 2010**	**-2.3**	**-6.3**	**-5.5**	**-4.2**	**-3.0**
	COM Nov 2009	-2.3	-6.3	-6.0	-5.5	n.a.
	CP Apr 2009	*-2.2*	*-3.0*	*-2.9*	*-2.2*	*n.a.*
Primary balance (% of GDP)	**SP Jan 2010**	**-1.1**	**-4.5**	**-3.6**	**-2.3**	**-1.1**
	COM Nov 2009	-1.1	-5.0	-4.7	-4.1	n.a.
	CP Apr 2009	*-0.9*	*-1.7*	*-1.7*	*-1.0*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Jan 2010**	**-4.9**	**-6.0**	**-4.7**	**-3.3**	**-2.7**
	COM Nov 2009	-5.0	-6.0	-5.4	-4.6	n.a.
	CP Apr 2009	*-4.1*	*-4.0*	*-3.4*	*-2.5*	*n.a.*
Structural balance[3] (% of GDP)	**SP Jan 2010**	**-4.2**	**-6.0**	**-4.7**	**-3.3**	**-2.7**
	COM Nov 2009	-5.2	-6.2	-5.4	-4.6	n.a.
	CP Apr 2009	*-3.8*	*-4.4*	*-3.5*	*-2.6*	*n.a.*
Government gross debt (% of GDP)	**SP Jan 2010**	**27.7**	**37.1**	**40.8**	**42.5**	**42.2**
	COM Nov 2009	27.7	34.6	39.2	42.7	n.a.
	CP Apr 2009	*27.6*	*31.4*	*32.7*	*32.7*	*n.a.*

Notes:

[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 4.7%, 3.6%, 3.2% and 3.6% respectively in the period 2008-2011

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.7% of GDP in 2008, deficit-increasing, according to the most recent programme and 0.2% of GDP in both 2008 and 2009, both deficit-reducing, in the Commission services' autumn 2009 forecast.

Source:

Stability programme (SP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations