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Fiscal adjustment from the Slovak perspective

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Slovak economy severely hit by crisis, now rebounding strongly on exports

Macroeconomic indicators	2008	2009	2010E	2011E	2012E	2013E
GDP growth	6.2	-4.7	4.0	3.3	4.5	4.7
Export (real growth)	3.2	-16.5	13.2	5.5	7.0	8.6
Investments (real growth)	1.8	-10.5	3.0	2.8	6.5	4.0
Employment (average growth. ESA95)	2.8	-2.4	-1.4	0.6	1.2	1.3
Unemployment rate (%)	9.6	12.1	14.4	13.6	13.2	12.4
Nominal monthly wages (growth)	8.1	3.0	2.7	3.7	5.8	6.1
Inflation (HICP)	3.9	0.9	1.0	3.5	3.4	3.7
General government deficit (% of GDP)	2.1	7.9	7.8	4.9	3.8	2.9
General government debt (% of GDP)	27.8	35.4	43.4	45.6	46.9	45.5

Medium-term fiscal targets

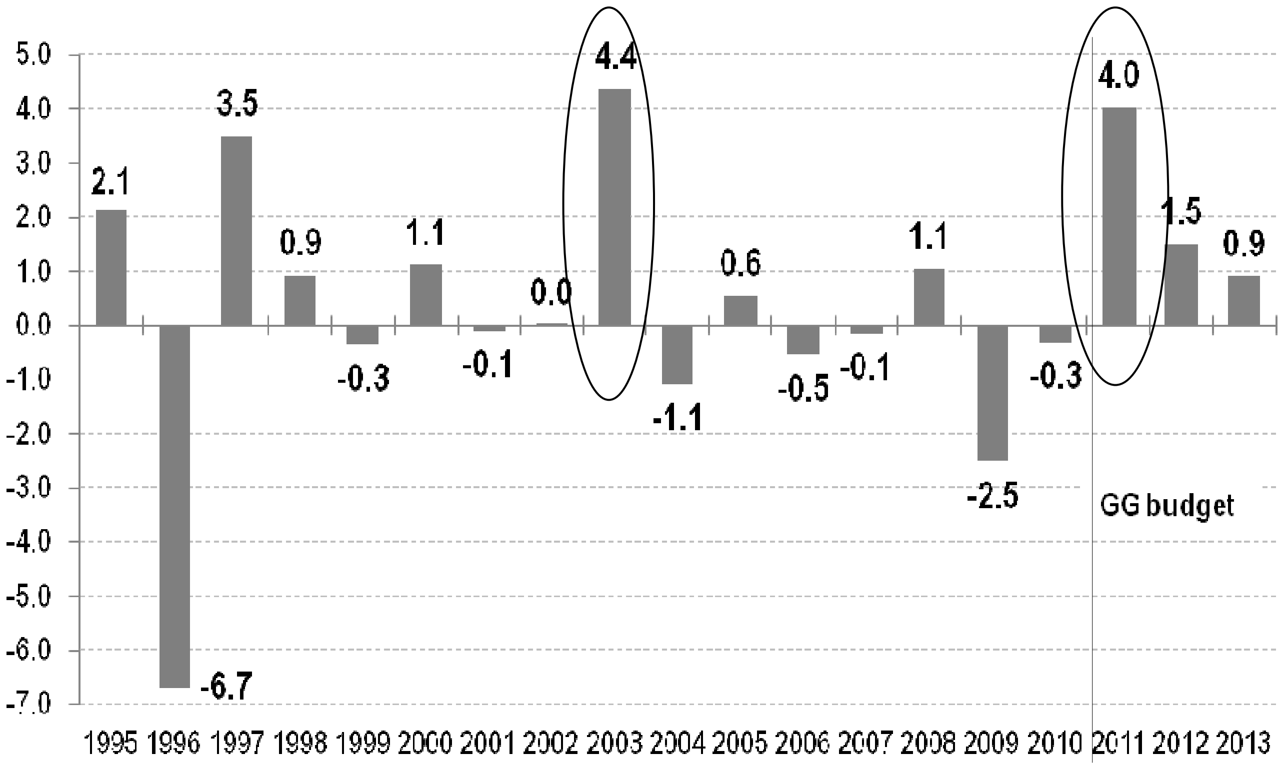
GG balance and debt (ESA 95, % of GDP)	2008	2009	2010E	2011B	2012B	2013B
GG balance	-2.1	-7.9	-7.8	-4.9	-3.8	-2.9
Gross GG debt	27.8	35.4	43.4	45.6	46.9	45.5

Note: E – estimate, B – budget

Source: Ministry of Finance

- Above average recession in 2009 when the economy was expected to post a 6% growth based on new capacities in industry
- This translates into sizeable lost potential output, pushing the structural deficit by 1% a year between 2008-2010, resulting in the cumulative pressure on structural deficit of 3.3% of GDP by 2010
- In addition, the government relaxed fiscal policy by a 2.5% of GDP in 2009
- This results into one of the highest primary deficits of 6.4% of GDP in 2010
- Strong need to front-load consolidation (measures amounting to 2.5% of GDP in 2011) to keep the credibility high and debt service costs contained
- Commitment to cut the deficit to below 3% by 2013 (ie, primary deficit of 0.9% of GDP)

Planned Consolidation effort (1)



The new government similar in structure compared to 2003-2006 period

Methodology

GG balance net of:

- Cyclical component
- One-offs
- Fully-funded pension pillar
- Interest payments
- Impact of crisis on structural balance
- PPP projects

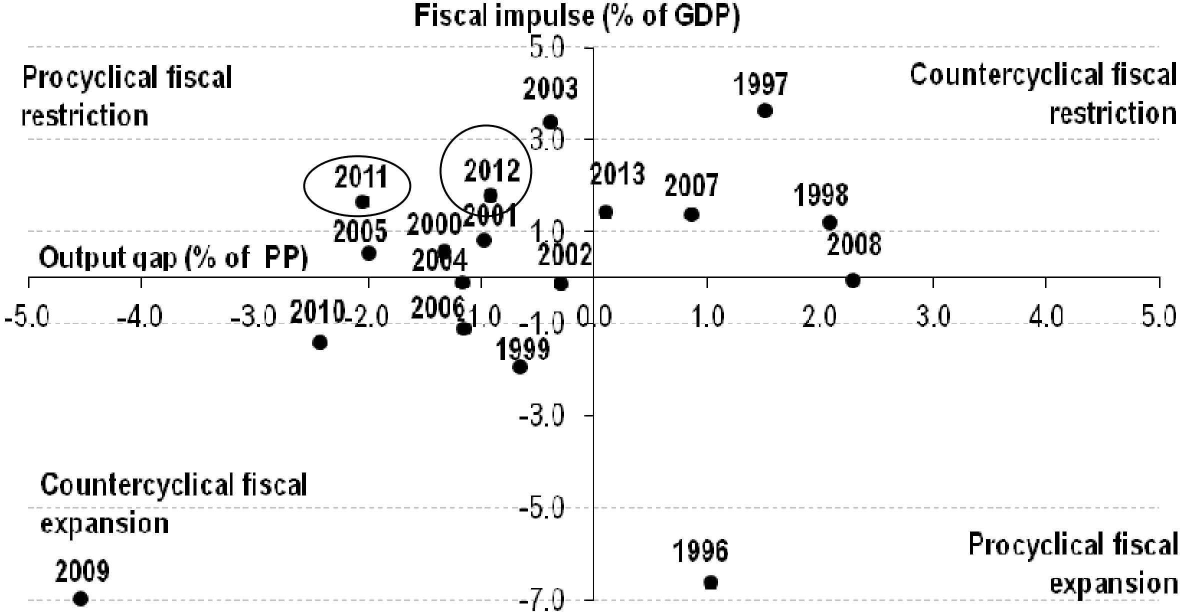
Consolidation effort in retrospect (2)

Consolidation effort of governments (cumulative, % of GDP)	
Period	**(+) restriction, (-) expansion**
1995-1998	-0.1 (-0.1)
1999-2002	0.7 (0.7)
2003-2006	3.3 (3.3)
2007-2010	-1.9 (-4.4)
2011-2013 (planned)*	6.4 (4.5)

*Note: *The general government budget is prepared for the period of 2011 to 2013*

- The magnitude of planned consolidation (2011-2013) can be viewed in light of the cumulative consolidation effort of previous governments – plans envisage the most ambitious consolidation in history

Slovakia pushed by the high deficit to have pro-cyclical fiscal restriction during 2011-2012



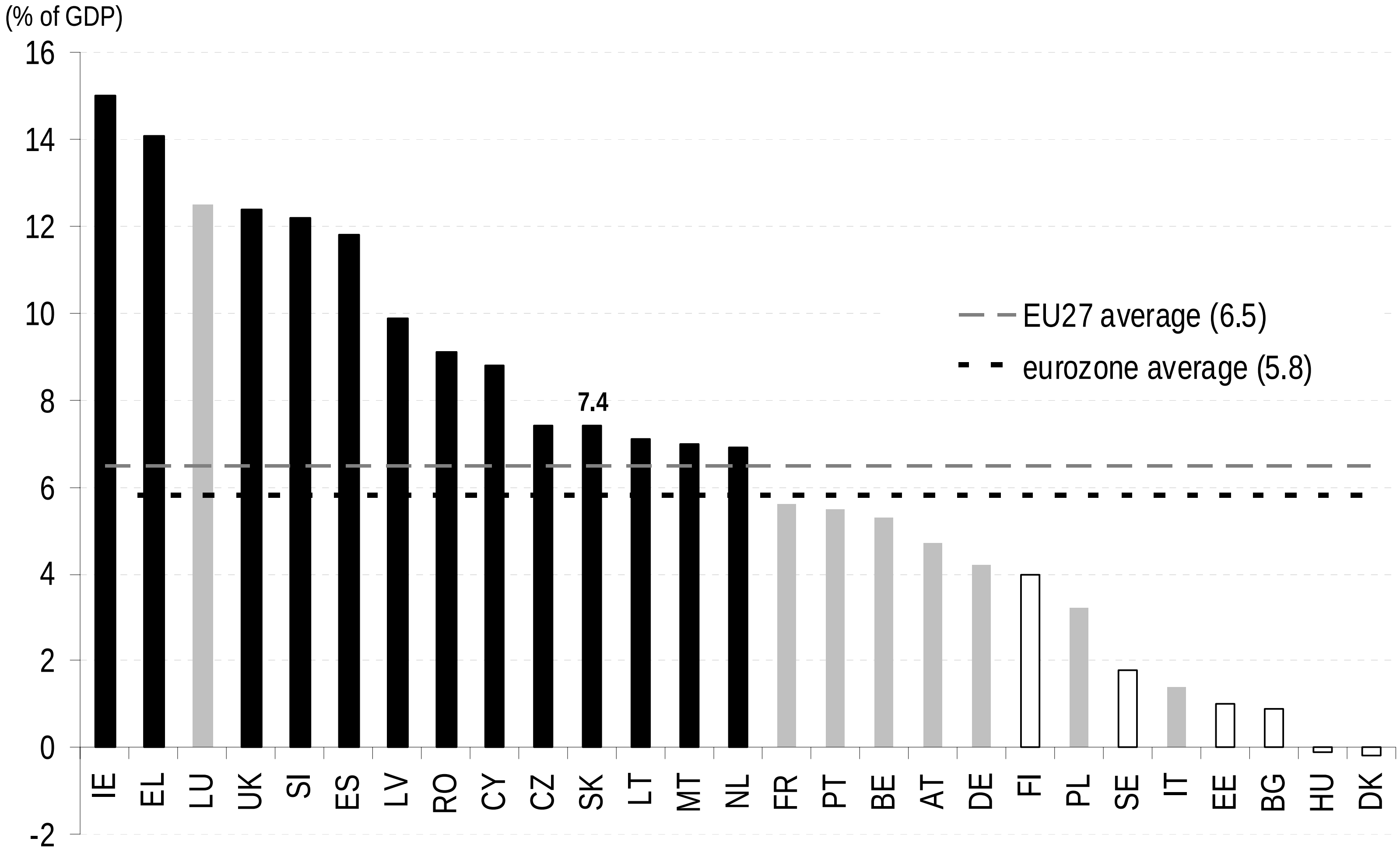
- Impact of fiscal restriction in 2011 hopefully partly compensated with expansionary effects of EU funds

Methodology

GG balance net of:

- One-offs
- Fully-funded pension pillar
- Interest payments to non-residents
- PPP projects
- Links to the EU budget

Long-term sustainability of public finance (1)



Sustainability risk : *black – high, grey – medium , white – low*

Long-term sustainability of public finance (2)

- Sustainability report 2009 : S2 indicator and 2009 scenario used by the EC for assessing EU countries
- **S2 indicator –** represents permanent change in the current structural primary balance (% of GDP), that would ensure public finance sustainability over infinite horizon
- **Main assumption** - the same fiscal position (in structural terms) over the whole horizon as in year 2009, with the exception of increase in expenditures affected by demographic changes
- Sustainability assessment deterioration from medium to high risk in year 2009 mainly due to unfavorable actual fiscal position - the calculation does not take into account expected consolidation goals
- Long-term sustainability will be improved by the consolidation of public finance (deficit below 3% of GDP in 2013) as well as other adjustments to the pension system and reforms in healthcare and education.

Strengthening fiscal institutions

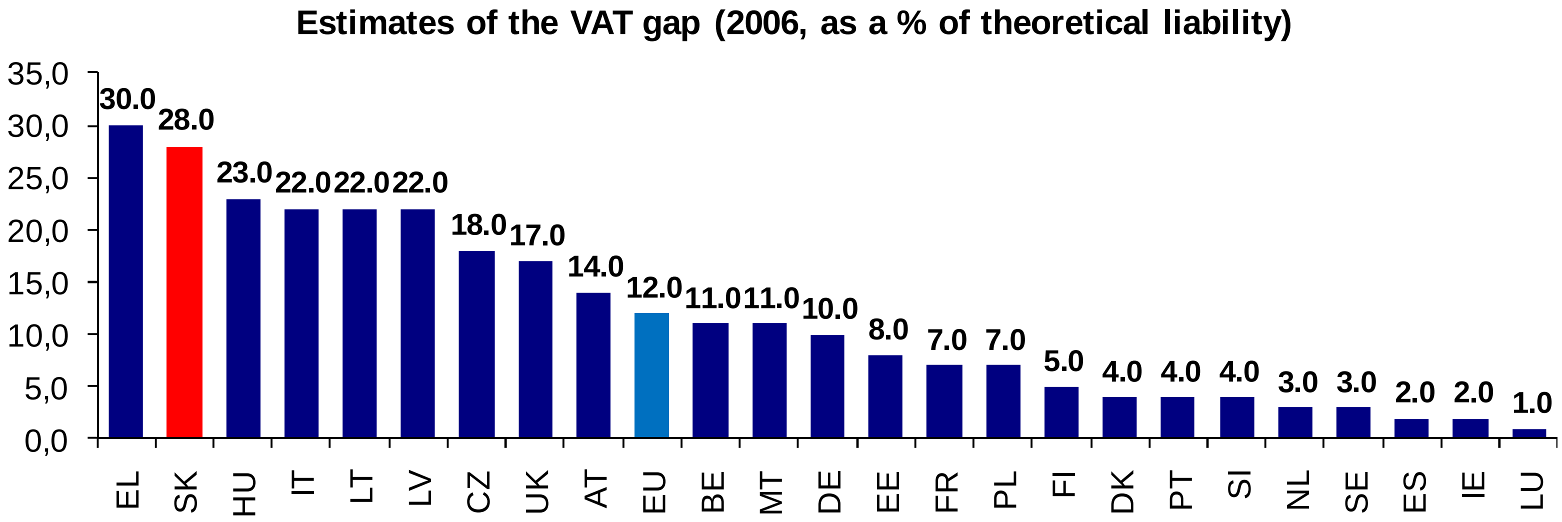
Planned Fiscal Responsibility Act:

- **Constitutional debt limit**; possibly below the Maastricht threshold
- **Nominal 4-year expenditure ceiling**
- Modification of fiscal rules for municipalities
- Pre-defined data dissemination standards
- **Council for Fiscal Responsibility** (to monitor and support "net wealth" concept for the fiscal policy)

Inefficiencies in the tax and SSC system

- The share of refunded taxes to total tax revenues is one of the highest among OECD countries, possibly related to inflated VAT refund claims
- The share of unpaid taxes relative to annual tax revenues is the highest among OECD countries and has been increasing from 2005 to 2007, suggesting weak effectiveness of debt collection
- The number of verification activities is lower than in many other OECD countries, but the value of completed verification actions is relatively high, indicating that the return to verification activities could be large

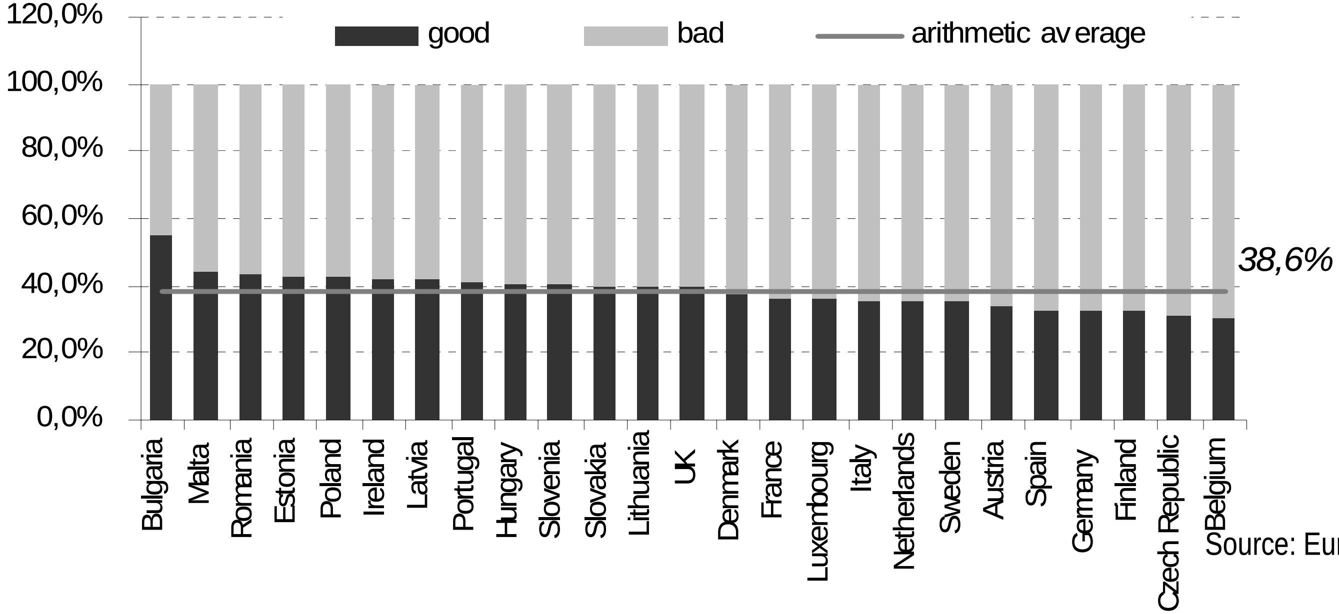
Low efficiency in VAT collection



Note: EU means average of EU-25 countries except Cyprus *Source: Reckon (2009)*

- Decreasing the **VAT** gap to EU 25 average would increase VAT revenues by more than **1% of GDP**

„Good and bad taxes“



Source: Eurostat, 2007

- Good taxes – the least harmfull taxes on economic growth according OECD (consumption, property, fees)
- **Slovakia ranks in a better half, but still room for improvement** (eg, by financing healthcare via broad tax base and not by taking labour, property taxes at ¼ of OECD average)

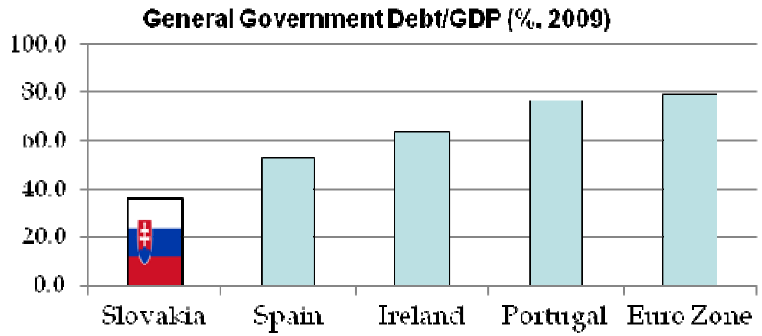
Project UNITAS

- Simplifying tax administration
  - Revenue agency (merger of tax, custom and social and health contributions administration)
  - Decrease of administrative burden for businesses
  - E – government
  - Should increase the efficiency of tax collection
- Unifying tax bases
  - To make the system more transparent
  - To increase fairness of tax system and prevent tax avoidance (broaden the bases, abolition of exemptions in health and social security contributions)

Why Slovakia might be Less Vulnerable to unexpected negative events?

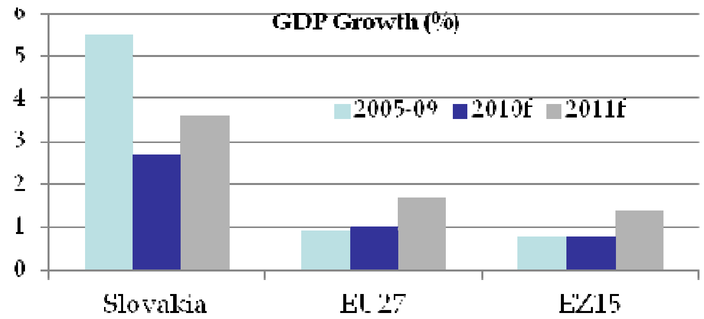
Crisis symptom # 1: High debt levels

- **Public debt much lower** compared to other EU countries at a given state of development (35.7% of GDP vs. a calculated average of 51.9% of GDP). **Private debt much lower** compared to other EU countries at a given state of development (47.7% of GDP vs. a calculated average of 97% of GDP) – 2009 data



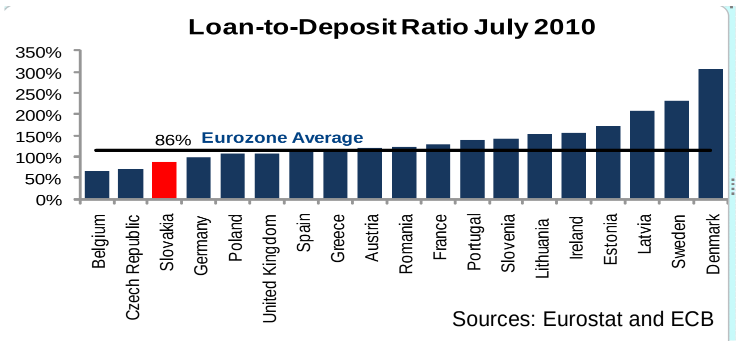
Crisis symptom # 2: Poor growth prospects

- ✓ Cheap Slovakia could hopefully benefit from **production outsourcing** out of more expensive EU countries (supply adjustment might happen more heavily in other countries)



Crisis symptom # 3: Costly bank bailouts

- ✓ Slovakia has already bank bailouts costs in fiscal numbers since 2000. **L/D ratio is one of the smallest in EU**



Thank you for your attention