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**Assessment of the 2016 Stability Programme for
Slovakia**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Slovakia's 2016 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 29 April 2016 and covers the period 2016-2019. It was approved by the government and presented to the national parliament for a debate without a vote.

The Stability Programme presents a 'no-policy-change' scenario and a fully-fledged central scenario. With the exception of 2016, headline deficit targets are aligned with the projection of the central scenario.

Slovakia is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its medium-term objective (MTO).

This document complements the Country Report published on 26 February 2016 and updates it with the information included in the Stability Programme. Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2016 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability programme. In particular, it includes an overview of the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on the Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview of long term sustainability risks and section 6 covers recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Slovakia's real GDP grew by 3.6 % in 2015, on the back of a surge in investment activity and robust private consumption. Booming investment reflected substantial use of EU funds, as the possibility to draw on funds available under the 2007-2013 programming period ended in December 2015. According to the Stability Programme, the economy is forecast to expand by 3.2 % in 2016. The expected slowdown in overall investment growth and the decline in government consumption expenditure are set to be largely offset by accelerating private consumption and a strongly positive contribution from net exports. In 2017, real GDP growth is forecast to pick up to 3.6 % on the back of an increase in public consumption and a recovery in investment. A rising positive trade balance will also contribute to economic growth in 2017.

The macroeconomic scenario in the Stability Programme is broadly in line with the latest Draft Budgetary Plan and the Commission 2016 spring forecast in terms of economic growth, although the programme assumes slightly higher growth in 2017. However, the differences are more pronounced with regard to the composition of GDP growth. The Stability Programme scenario assumes a significantly stronger contribution of net exports in both years. Regarding the sub-components of domestic demand, the Stability Programme expects a decline in government consumption in 2016, whereas the Commission forecast assumes continued growth, albeit at a slower pace than in the previous year. In 2017, the Stability Programme scenario assumes significantly lower growth in overall investment and private consumption compared to the Commission forecast.

The Stability Programme expects labour market conditions to improve further, with the unemployment rate falling below 10 % in 2017. Driven by solid domestic demand and robust wage growth, inflation is anticipated to turn positive in 2016 and gradually increase thereafter.

The Commission scenario shows stronger growth in employment but a broadly similar unemployment outlook compared to the Stability Programme, while it shows a marginally lower inflation profile over the forecast horizon.

The output gap, as recalculated by the Commission based on the information in the Stability Programme following the commonly agreed methodology, is somewhat more negative compared to the estimates in the Commission forecast. From a moderately negative starting position in 2015, it is expected to remain broadly stable until 2017, before turning positive in subsequent years, partly due to accelerating growth.

Overall, the macroeconomic assumptions underpinning the Stability programme appear to be plausible.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	3.6	3.6	3.2	3.2	3.3	3.6	4.1	4.6
Private consumption (% change)	2.4	2.4	3.6	3.2	3.2	2.6	2.7	2.9
Gross fixed capital formation (% change)	14.0	14.0	1.5	0.9	5.7	1.4	0.9	2.0
Exports of goods and services (% change)	7.0	7.0	4.3	4.9	5.9	6.1	7.5	8.5
Imports of goods and services (% change)	8.2	8.2	3.5	3.6	6.5	4.6	5.8	6.6
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	4.9	4.9	2.6	1.8	3.6	2.1	1.8	2.1
- Change in inventories	-0.2	-0.2	-0.2	0.0	0.0	-0.1	0.0	0.0
- Net exports	-0.8	-0.6	0.8	1.5	-0.3	1.7	2.2	2.6
Output gap ¹	-0.9	-1.1	-0.6	-1.2	-0.3	-1.0	-0.2	1.1
Employment (% change)	2.0	2.0	1.8	1.3	1.5	0.9	1.1	0.9
Unemployment rate (%)	11.5	11.5	10.5	10.4	9.5	9.5	8.3	7.3
Labour productivity (% change)	1.6	1.6	1.3	1.9	1.8	2.7	3.0	3.9
HICP inflation (%)	-0.3	-0.3	-0.1	0.2	1.5	1.6	2.1	2.2
GDP deflator (% change)	-0.3	-0.3	0.0	0.1	1.3	1.6	2.1	2.2
Comp. of employees (per head, % change)	2.4	2.4	3.5	3.3	3.9	4.5	4.7	5.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.1	2.4	-0.9	3.1	-1.1	4.1	4.7	5.7
Note:								
¹ In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
Source:								
Commission 2016 spring forecast (COM); Stability Programme (SP).								

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

The Stability Programme presents two fully-fledged fiscal scenarios – a 'no-policy-change' and a central scenario. The 'no-policy-change' scenario takes the expected end-year outcome of the 2016 budget as a basis for projecting fiscal outcomes for years beyond 2016, correcting future years for temporary factors in 2016; it therefore does not assume any additional measures beyond those envisaged for 2016. The central scenario is presented as the single most likely outcome of fiscal policy. With the exception of 2016, the central scenario is consistent with the fiscal targets presented in the programme being met. For 2016 the Stability Programme states that the deficit target of 1.9% of GDP remains valid and that it is likely to be achieved in light of some upside risks to tax revenues. Nevertheless, the central scenario assumes a deficit of 2.1% of GDP in 2016. Not all the measures of the central scenario (especially on the expenditure side) are sufficiently specified. The current assessment and the tables in the Annexes are based on the central scenario.

3.1. Deficit developments in 2015

The general government deficit reached 3.0 % of GDP in 2015, exceeding the target¹ of 2.5 % of GDP presented in the 2015 Stability Programme and the expected outcome of 2.7 % of GDP in the 2016 Draft Budgetary Plan.

Differences in the 2015 budgetary outturn compared to the 2015 Stability Programme are mainly explained by additional spending, which more than outweighed positive developments on the revenue side. The surge in the absorption of the EU funds in 2015 - the final year of the drawdown window for the 2007-2013 programming period - drove up domestic co-financing and overall public investment. Other types of expenditure such as intermediate consumption, compensation of employees and social payments grew as well. While revenues turned out stronger across all revenue components, the largest impact came from non-tax revenues, mirroring the increased absorption of EU funds. A large difference between the final 2015 budgetary outcome and the expected deficit presented in the 2016 Draft Budgetary Plan is due to the fact that the Draft Budgetary Plan assumed revenues amounting to 0.4 % of GDP, which were not recorded as government revenue in the April 2016 EDP notification. This concerns the front-loaded repayment of a loan by the railway freight transport company Cargo and the accounting treatment of EU resources (from structural EU funds Jessica II and Jessica III programmes) that were used for extending loans.

The Stability Programme assumes a one-off measure on the expenditure side in 2015, amounting to some 0.3 % of GDP and related to financial corrections for programmes financed with EU funds.² This is also assumed in the Commission 2016 spring forecast, which

¹ Originally, the 2015 Draft Budgetary Plan had assumed a target of 2.0% of GDP. However, the adopted budget targeted a deficit of 2.5% of GDP, the difference being a reserve for a worse macroeconomic outlook and the introduction of a tax allowance for the health insurance contributions of low-paid workers

² Financial corrections in the case of programmes supported through EU structural and investment funds are not uncommon. They can be related to a number of issues, usually stemming from irregularities of some sort in the overall implementation of programmes or of individual projects. Occasionally, such corrections may be sizeable. Eurostat has followed a practice of recording financial corrections to EU funds in the year when the decision was taken by the European Commission and accepted by the national authorities; but that year does not necessarily correspond to the year in which the actual expenditure being corrected was realised. Since 2013, significant financial corrections to EU funds have been recorded in the fiscal data of Slovakia. The amounts were particularly large in 2014 and 2015 (around 0.3% of GDP in both years), also due to the acceleration in the drawing of EU funds with the conclusion of the 2007-2013 programming period. Since the corrections can be traced back to a single triggering event which led to the suspension of almost all

further incorporates one smaller additional one-off measure with a positive impact on revenues relating to the establishment of a national resolution fund.³ On the contrary, the 2016 Draft Budgetary Plan had not considered the financial corrections as a one-off, whilst it had considered a one-off measure on the revenue side related to the early loan repayment by Cargo amounting to 0.1 % of GDP⁴.

3.2. Medium-term strategy and targets

When taken at face value, the fiscal targets presented in the Stability Programme aim at reaching the medium-term objective (MTO) – a structural deficit of 0.5 % of GDP – by 2019, two years later than assumed in the 2015 Stability Programme. Based on the information in the Stability Programme, the recalculated structural balance⁵ declines from -1.7 % of GDP in 2016 to -0.9 % of GDP in 2017 and -0.4 % of GDP in 2018 (Table 2). If achieved, this would imply a reaching of the MTO already in 2018, one year earlier than reported in the Stability Programme. The envisaged fiscal adjustment appears to be slightly front-loaded, with the projected consolidation effort peaking at 0.8 pps in 2017. The MTO is in line with the previous Stability Programme and reflects the objectives of the SGP.

Compared to the 2015 Stability Programme, the nominal fiscal targets have been relaxed for 2016 and 2017, by 0.2 pps. and 0.4 pps. respectively, with the headline deficit expected to reach 2.1 % of GDP in 2016 and 1.3 % of GDP in 2017 (Figure 1). The nominal deficit target was slightly tightened for 2018. When compared to the 2016 Draft Budgetary Plan, the current fiscal targets have been lowered more substantially, i.e. by 0.9 % of GDP in 2017 and 0.4 % of GDP in 2018. The main reason for relaxing the fiscal targets is linked to the newly formed government's investment priorities following the March 2016 general elections. Both the revenue and expenditure ratios to GDP are set to decline in 2016 owing to a fading-out of a strong EU funds drawdown, while in 2017 the improvement in the nominal deficit appears to be driven by cuts in expenditure (especially social spending).

According to the programme, in 2016 robust tax revenues reflecting favourable economic conditions and past efforts to fight tax evasion are expected to continue supporting the government's consolidation plans. The overall level of investment is anticipated to decline in 2016 after the end of drawdowns from the 2007-2013 programming period. Nevertheless, the government will make important investments, including building a highway ring around Bratislava, to be financed through a public-private partnership with upfront fiscal costs, and the preparation of an industrial park. These developments and measures are also assumed in the Commission 2016 spring forecast. Nevertheless, the Commission projects a slightly higher deficit of 2.4 % of GDP in 2016. The difference with the Stability Programme is mainly due to assumptions about developments of the public wage bill (incorporating the growth of salaries of teachers), intermediate consumption and social payments (especially

programmes financed by EU funds in 2012, they are currently treated as one-off in those two years. No corrections of this size are expected in 2016.

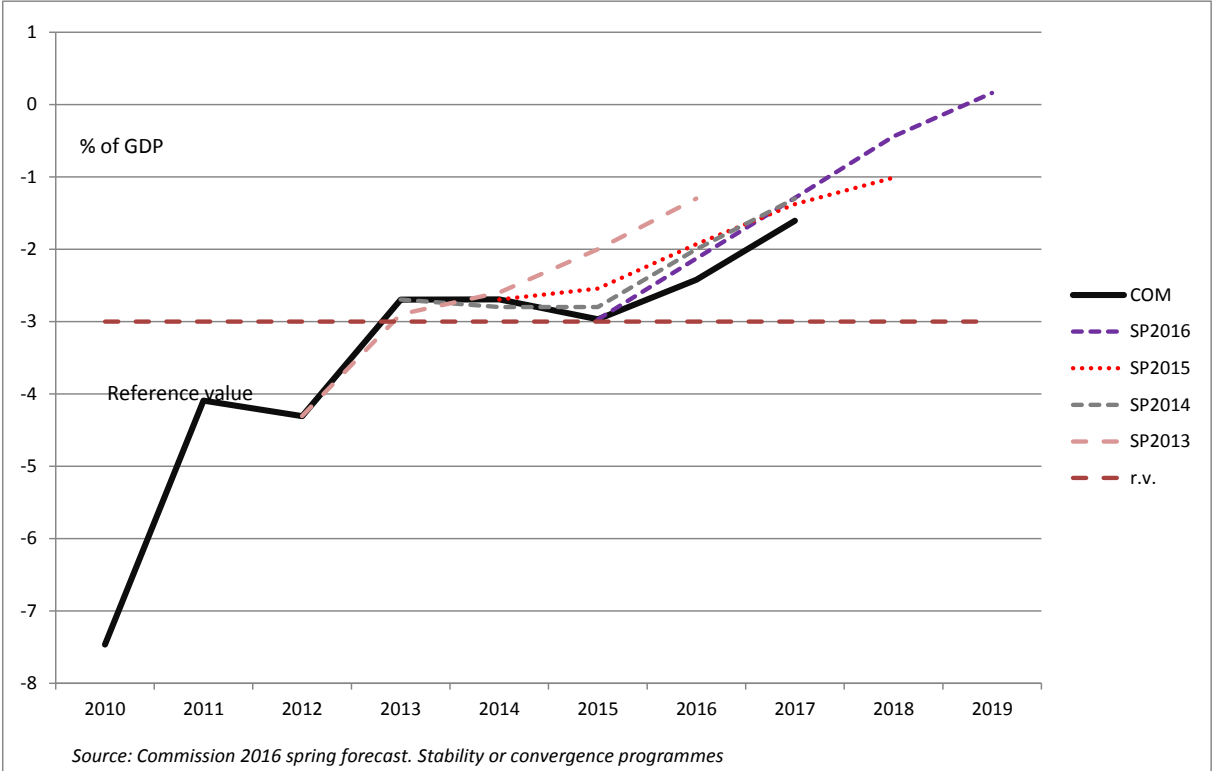
³ In 2015, Slovakia set up a national resolution fund. Contributions to this fund reached EUR 33.5 mil (0.05% of GDP) in 2015. In line with the Regulation (EU) 806/2014 by which a Single Resolution Fund was established, all resources from National Resolution Authorities were to be transferred to the SRF by end of January 2016.

⁴ This was not classified as government revenue in the April 2016 EDP notification and therefore ultimately did not contribute to reduce the deficit.

⁵ Recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology

healthcare spending, in light of past trends), due to incomplete information about the savings to be achieved in these areas.

Figure 1: Government balance projections in successive programmes (% of GDP)



In 2017, the Stability Programme assumes a further reduction in the headline deficit to 1.3 % of GDP. An important part of the adjustment relies on declining social payments and compensation of employees when expressed in percentage of GDP; however, the programme does not provide substantive details on this. The Commission 2016 spring forecast, assuming no other changes in government policies projects the deficit to decline to 1.6 % of GDP in 2017, driven mainly by tax-rich growth.

According to the Stability Programme, the general government deficit is expected to decrease to 0.4 % of GDP in 2018; a surplus of 0.2 % is targeted in 2019. This relies largely on expenditure-side consolidation measures.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		2018	2019	Change: 2015-2019
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	42.7	38.9	38.6	38.6	37.6	37.1	35.8	-6.9
<i>of which:</i>								
- Taxes on production and imports	10.9	10.6	10.6	10.6	10.4	10.1	9.9	-1.0
- Current taxes on income, wealth, etc.	7.2	7.3	7.3	7.3	7.0	7.0	7.1	-0.2
- Social contributions	14.0	13.8	13.7	13.5	13.5	13.4	13.3	-0.8
- Other (residual)	10.5	7.2	7.0	7.2	6.7	6.5	5.6	-4.9
Expenditure	45.6	41.3	40.7	40.2	38.9	37.5	35.6	-10.0
<i>of which:</i>								
- Primary expenditure	43.8	39.8	39.2	38.8	37.5	36.1	34.3	-9.6
<i>of which:</i>								
Compensation of employees	9.0	9.0	8.7	9.1	8.4	8.2	7.9	-1.1
Intermediate consumption	5.9	5.5	5.3	5.3	5.2	4.6	4.6	-1.3
Social payments	19.0	18.6	18.5	18.2	17.7	17.3	16.8	-2.1
Subsidies	0.6	0.5	0.5	0.5	0.5	0.5	0.4	-0.2
Gross fixed capital formation	6.2	3.2	3.2	3.0	3.2	2.9	1.9	-4.3
Other (residual)	3.2	3.0	2.8	2.7	2.5	2.7	2.6	-0.6
- Interest expenditure	1.8	1.5	1.5	1.5	1.4	1.4	1.3	-0.5
General government balance (GGB)	-3.0	-2.4	-2.1	-1.6	-1.3	-0.4	0.2	3.1
Primary balance	-1.2	-0.9	-0.6	-0.2	0.1	0.9	1.5	2.7
One-off and other temporary	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.3
GGB excl. one-offs	-2.7	-2.3	-2.1	-1.6	-1.3	-0.4	0.2	2.9
Output gap ¹	-0.9	-0.6	-1.2	-0.3	-1.0	-0.2	1.1	2.0
Cyclically-adjusted balance ¹	-2.6	-2.2	-1.7	-1.5	-0.9	-0.4	-0.3	2.3
Structural balance²	-2.3	-2.1	-1.7	-1.5	-0.9	-0.4	-0.3	2.1
Structural primary balance ²	-0.6	-0.6	-0.1	0.0	0.5	1.0	1.1	1.6
Notes:								
¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.								
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
Source:								
Stability Programme (SP); Commission 2016 spring forecasts (COM); Commission calculations.								

3.3. Measures underpinning the programme

In 2016, the tax measures in the Stability Programme (Table below) include a widening of the 10 % reduced VAT rate on basic foods. The programme also expects an additional discretionary impact in 2016 of the allowance for healthcare contributions for low-paid (low-skilled) workers introduced in 2015, as the uptake in 2015 was lower than expected. On the expenditure side, the Stability Programme includes up-front costs related to the highway ring around Bratislava and the industrial park (0.7 % of GDP).

Programme includes a reduction in the corporate income tax rate by 1 pp. to 21 % in 2017 and elimination of corporate tax licences (a requirement to pay a specified minimum level of corporate income tax) in 2018. Both measures were part of the so-called 'government manifesto' of the new government. To partly compensate for the revenue shortfall, the levy for regulated services, originally planned to expire after 2016, will be retained. The financing of

the up-front costs related to the Bratislava motorway ring and the creation of the industrial park are expected to continue to affect expenditure also in 2017 (0.4 % of GDP).

Other developments on the expenditure side are not sufficiently specified. Notably, the programme assumes savings on the compensation of employees vis-à-vis the no-policy-scenario throughout the programme horizon due to the assumption that the rate of growth of public sector wages is below that in the private sector, without providing further details on how this will be achieved. Intermediate consumption is expected to increase compared to the no-policy-scenario in 2017 and then decline significantly in 2018, without specified measures. Moreover, a substantial decline in social payments is assumed in 2017 without clarifying the underlying reasons.⁶ In the absence of sufficient details, these developments were not considered in the Commission 2016 spring forecast.

The Stability Programme does not assume any one-off measure from 2016 onwards. The Commission 2016 spring forecast assumes two small one-off measures on the expenditure side in 2016, amounting together to some 0.1% of GDP.⁷

Main budgetary measures

Revenue	Expenditure
2015	
<ul style="list-style-type: none"> • Keeping VAT rate at 20 % instead of lowering it to 19 % as originally legislated (0.3 % of GDP) • Changes to the depreciation rules for corporate income tax (0.2 % of GDP) • Introduction of low capitalisation rules (0.1 % of GDP) • Extension of compulsory use of cash registers (0.1 % of GDP) • Introduction of an allowance for healthcare contributions (-0.1 % of GDP) • Lowering of the bank levy rate (-0.1 % of GDP) 	<ul style="list-style-type: none"> • Spending on social services such as supporting free train transport for students and retired people, pre-school facilities (0.1 % of GDP) • Increase in teachers' salaries (0.1 % of GDP) • EU financial corrections (0.3 % of GDP)
2016	
<ul style="list-style-type: none"> • Introduction of an allowance for healthcare contributions (-0.2 % of GDP) • Extension of the reduced VAT rate to basic 	<ul style="list-style-type: none"> • Up-front costs related to Bratislava motorway ring and Jaguar Land Rover industrial investment (0.7 % of GDP)

⁶ This decline is assumed in both the central and the no-policy change scenario.

⁷ The first one-off relates to a correction in the contribution for the EU budget following the adoption of the 2014 Own Resources Decision by the European Council of 26 May 2014, which introduced some changes to the EU budgetary framework for the period 2014-2020. The second one-off is the transfer of resources collected by the National Resolution Authority to the Single Resolution Fund (see Footnote 3).

foodstuff (-0.1 % of GDP)	
2017	
<ul style="list-style-type: none"> • Lowering the corporate income tax rate from 22 % to 21 % (0.2 % of GDP) • Extension of the regulated sector levy (0.1 % of GDP) • Additional decrease of the bank levy rate (-0.1 % of GDP) 	<ul style="list-style-type: none"> • Up-front costs related to Bratislava motorway ring and Jaguar Land Rover industrial park investment (0.4 % of GDP) • Higher expenditure in intermediate consumption (0.2 %) • Savings on the public wage bill (-0.2 %)
2018	
<ul style="list-style-type: none"> • Suppression of corporate tax licences (-0.1 % of GDP) 	<ul style="list-style-type: none"> • Savings in intermediate consumption (-0.2 %)
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the Stability Programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

3.4. Debt developments

The general government debt declined to 52.9 % of GDP in 2015 (Table 3). An important factor contributing to the reduction of the debt-to-GDP ratio in 2015 is a negative stock-flow adjustment that is mainly due to proceeds from the sale of shares in Slovak Telecom, as well as the possibility introduced for pension savers in the fully funded private pillar to opt out of it and join exclusively the public pension scheme. The 2015 debt outcome was slightly above the projection in the 2016 Draft Budgetary Plan but below the expectations of the 2015 Stability Programme (Figure 2), mainly due to the lower-than-expected interest outlays and larger positive stock-flow adjustments. In 2016, the Stability Programme projects the debt-to-GDP ratio to remain unchanged at 52.9 %, representing an upward revision compared to the 2016 Draft Budgetary Plan. This is mainly due to an estimated higher primary deficit, and lower expected inflation. The Commission 2016 spring forecast projects the debt ratio in 2016 to be around half a percentage point higher compared to the Stability Programme, mainly due to the difference in general government deficit projections.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019
			COM	SP	COM	SP	SP	SP
Gross debt ratio¹	49.1	52.9	53.4	52.9	52.7	52.2	49.8	47.3
Change in the ratio	3.6	-1.0	0.5	-0.1	-0.7	-0.7	-2.4	-2.5
<i>Contributions²:</i>								
1. Primary balance	2.6	1.2	0.9	0.6	0.2	-0.1	-0.9	-1.5
2. “Snow-ball” effect	0.3	0.0	-0.1	-0.2	-0.9	-1.2	-1.7	-1.8
<i>Of which:</i>								
Interest expenditure	1.7	1.8	1.5	1.5	1.5	1.4	1.4	1.3
Growth effect	-1.1	-1.9	-1.6	-1.6	-1.7	-1.8	-2.0	-2.1
Inflation effect	-0.3	0.1	0.0	-0.1	-0.7	-0.8	-1.0	-1.0
3. Stock-flow adjustment	0.7	-2.2	-0.3	-0.5	0.0	0.7	0.3	0.8
<i>Of which:</i>								
Cash/accruals diff.				-0.4		1.1	0.2	0.2
Acc. financial assets				0.2		0.0	-0.1	0.5
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				-0.3		-0.4	0.2	0.2

Notes:

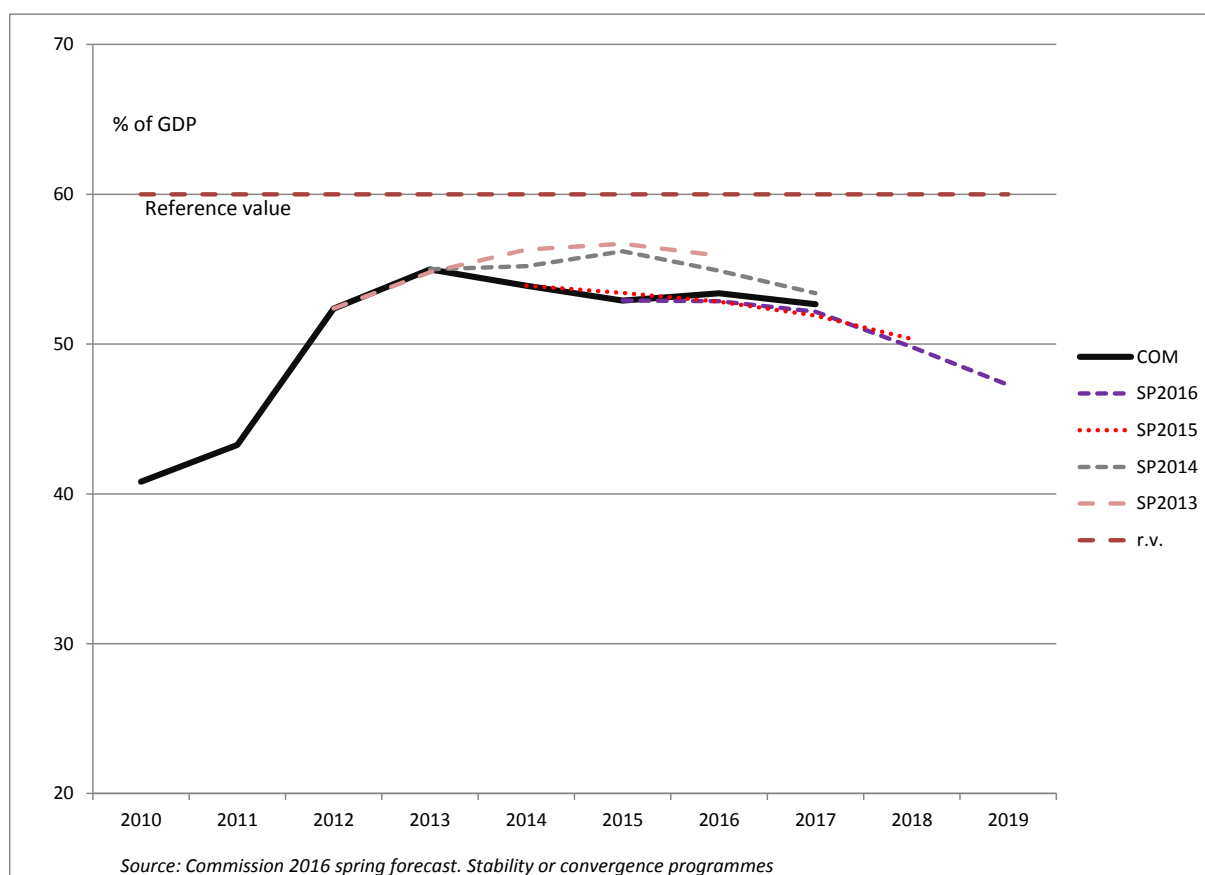
¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2016 spring forecast (COM); Stability Programme (SP), Commission calculations.

Figure 2: Government debt projections in successive programmes (% of GDP)



3.5. Risk assessment

The 2016 Commission forecast projects higher headline deficits over the forecast horizon, thereby indicating negative risks to the fiscal targets presented in the Stability Programme.

In 2016, the savings on compensation of employees and intermediate consumption relative to the previous year are not underpinned by specific measures. The programme does not include the pledge presented in the government manifesto to increase teachers' salaries by 6 % in September 2016. In addition, the programme appears to assume relatively high surpluses of local governments, comparable to those for the 2015 budget, even though the latter turned out well below originally budgeted figures; no measures have been presented to suggest or encourage different behaviour of local governments in 2016. Finally, while the government announced measures to reduce spending on pharmaceuticals, their impact so far is not clear. In the absence of major reform measures that would change this pattern, the programme appears to underestimate expenditure in the healthcare sector. On the revenue side, risks appear to be balanced. While on the one hand the programme seems to overestimate revenue from dividends, it appears to underestimate non-tax revenue from payments for services.⁸ The higher projection of the headline deficit in the Commission 2016 spring forecast reflects these risks.

In 2017, risks stem from the assumptions on expenditure savings underlying the programme's 'no-policy-change' scenario (in particular, social spending declines by some 0.8 pps and this is

⁸ A part of revenue for certain services (e.g. school canteens) is not budgeted. Nevertheless, these revenues (and corresponding expenditures) are reported in the final accounts for the general government.

retained also in the central scenario) and subsumed in the central scenario (in particular, the public wage bill)⁹. It is not clear from the programme what drives the assumed developments for these items. As concerns social outlays, in the absence of major reforms to the social security system or the healthcare sector it is not clear how such a decline is to be delivered. The assumed decline of public wages does not appear plausible in light of the regular practice of under-budgeting of compensation of employees. These savings are instrumental to make room for the higher expenditure on investment and in goods and services incorporated in the central scenario. The risks suggest that, ultimately, the government may not have much space for additional spending in 2017. In this context, the planned spending reviews within the 'value for money' project of the Ministry of Finance (see section 6) have potential to reduce the outstanding risks. These risks are incorporated in the Commission 2016 spring forecast which projects a higher general government deficit.

An additional risk to the fiscal targets for 2017 presented in the Stability Programme stems from the fact that it only partially includes the plans of the new government outlined in its government manifesto. The reduction in the corporate income tax rate and the prolongation of the levy on regulated sectors are reflected in the Stability Programme (and the Commission 2016 spring forecast). However, for other planned measures no information about impact or time profile is provided in the Stability Programme.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Slovakia is subject to the preventive arm of the SGP. Based on outturn data for 2015 validated by Eurostat, the estimated deterioration in the structural balance in 2015 by 0.3 % of GDP points to some deviation from the requirement of an unchanged structural balance. The growth rate of government expenditure, net of discretionary revenue measures, is estimated to have exceeded the reference rate – a negative gap of 0.9 % of GDP – which suggests a significant deviation under this pillar. For 2014 and 2015 on average, the structural balance points to a significant deviation, while the expenditure benchmark points to some deviation. As the two indicators provide conflicting signals, an overall assessment is warranted.

When looking at 2015 alone, the difference between the two indicators is explained by four main factors. The structural balance pillar was negatively impacted by a surge in public investment largely due to the high absorption of EU funds towards the end of the 2007-2013 programming period. However, this pillar was also positively impacted by revenue windfalls. The expenditure benchmark pillar was negatively impacted by a one-off expenditure amounting to 0.3% of GDP on account of the financial corrections related to the projects financed through EU funds. Finally, both pillars were negatively impacted by the surge in drawdown on EU-funds in 2015, in the final year of the past programming period, which contributed to faster expenditure growth. While the adjustment of the expenditure aggregate takes into account spending matched by EU revenue, it does not reflect fully the co-financing of these projects (which have an impact on the structural balance of some additional 0.5% of GDP compared to 2014 according to the Ministry of Finance).¹⁰ After correcting for these

⁹ Under the no-policy-change scenario presented in the Stability Programme, the deficit would decline to 0.9% of GDP in 2016. Under the no-policy-change scenario, the compensation of employees, intermediate consumption, capital expenditure and social spending in terms of GDP decline by 0.1%, 0.3%, 0.8% and 0.8%, respectively.

¹⁰ When calculating the expenditure benchmark, public investment is smoothed over four years. National co-financing is part of overall public investment, which is therefore smoothed in these calculations. However, given the exceptional surge in co-financing in 2015, the expenditure benchmark is still impacted by the peak in investment. Moreover, co-financing of the government's current expenditure and the projects of the private sector is also not reflected in the adjustment of the expenditure benchmark.

factors, the deviation indicated by both pillars would decrease below the threshold of significance. Therefore the overall assessment points to some deviation from the required adjustment path towards the MTO in 2015.

The conclusion of some deviation from the one-year assessment appears to be confirmed when looking at the averages over 2014 and 2015 and taking into account that in 2014 Slovakia was considered to be compliant.

Slovakia is required to achieve an annual fiscal adjustment of 0.3 % of GDP towards the MTO in 2016 and of 0.5 % of GDP in 2017. Based on the Stability Programme, the recalculated structural balance improves by 0.6 pps in 2016, therefore meeting the requirement. This is confirmed by the Commission 2016 spring forecast which, despite a smaller improvement in the structural balance of 0.2 pps.¹¹, suggests compliance¹² with the requirements. Considering the expenditure benchmark, the Stability Programme expects that the growth rate of government expenditure, net of discretionary revenue measures, would respect the applicable benchmark rate. This is confirmed by the Commission forecast. Looking at the two-year averages, based on the Stability Programme, Slovakia would respect the requirements under both pillars. Conversely, the Commission forecast shows that when averaging over 2015 and 2016, both pillars point to some deviation. This is mainly due to the outcome for 2015. The gap for the structural balance amounts to some 0.2 % of GDP while in the case of the expenditure benchmark it is somewhat smaller, at 0.1 % of GDP. Thus, following an overall assessment, Slovakia appears at risk of some deviation from the requirements of the preventive arm in 2016.

In 2017, according to the information provided in the Stability Programme, Slovakia would deliver a structural effort of 0.8 % of GDP and the expenditure benchmark would be met. The Commission forecast expects a more moderate improvement in the structural balance of 0.6 pps and expects expenditure growth in line with the expenditure benchmark requirement. Both pillars hence point to compliance with the requirements of the Pact in 2017.

In sum, based on the outturn data and the Commission 2016 spring forecast, the ex-post assessment suggests some deviation from the adjustment path towards the MTO in 2015. Following an overall assessment, there is a risk of some deviation from the adjustment path towards the MTO in 2016, while the adjustment path towards the MTO seems to be in line with the requirements of the preventive arm of the Pact in 2017.

¹¹ The difference between the two figures can be mostly explained by the difference in the output gap, which is larger when recalculated based on figures in the Stability Programme.

¹² A small discrepancy is due to rounding.

Table 4: Compliance with the requirements of the preventive arm

(% of GDP)	2015	2016		2017	
Initial position¹					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance ² (COM)	-2.3	-2.1		-1.5	
Structural balance based on freezing (COM)	-1.9	-2.1		-	
Position vis-a-vis the MTO³	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	2015	2016		2017	
	COM	SP	COM	SP	COM
Structural balance pillar					
Required adjustment ⁴	0.0	0.3		0.5	
Required adjustment corrected ⁵	0.0	0.3		0.5	
Change in structural balance ⁶	-0.3	0.6	0.2	0.8	0.6
<i>One-year deviation from the required adjustment⁷</i>	-0.3	0.4	0.0	0.3	0.1
<i>Two-year average deviation from the required adjustment⁷</i>	-0.3	0.1	-0.2	0.3	0.1
Expenditure benchmark pillar					
Applicable reference rate ⁸	2.9	2.2		1.3	
<i>One-year deviation⁹</i>	-0.9	1.6	0.8	0.4	0.0
<i>Two-year average deviation⁹</i>	-0.1	0.2	-0.1	1.0	0.4
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Compliance	Compliance	Compliance
Conclusion over two years	Overall assessment	Compliance	Overall assessment	Compliance	Compliance
Notes					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.					
² Structural balance = cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.					
⁷ The difference of the change in the structural balance and the corrected required adjustment.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<i>Source:</i>					
<i>Stability Programme (SP); Commission 2016 spring forecast (COM); Commission calculations.</i>					

5. FISCAL SUSTAINABILITY

Slovakia does not appear to face fiscal sustainability risks in the short run.¹³

Based on the Commission forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 52.9% of GDP in 2015, is expected to decline to 47.5% of GDP in 2026, thus remaining below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2016 at slightly above 53% of GDP. This highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would put debt on an even faster decreasing path by 2026, also remaining below the 60% of GDP reference value in 2026.

The medium-term fiscal sustainability risk indicator S1 is at -1.3 pps. of GDP, primarily thanks to the favourable initial budgetary position (-0.7 pps. of GDP) and the government debt ratio below the 60 % Treaty reference value translating into a negative distance to the debt target (-0.6 pps. of GDP), thus indicating low risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at -3.9 pps. of GDP, leading to a similar conclusion about medium-term risks. Overall, risks to fiscal sustainability over the medium term are, therefore, low. Fully implementing the fiscal plans in the Stability Programme would further decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 3.0 pps. of GDP. In the long-term, Slovakia therefore appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs (contributing with 2.1 pps. of GDP). Full implementation of the programme would put the S2 indicator at 2.0 pps. of GDP, leading to a lower long-term risk.

While the pension reform in 2012 contributed to increasing the sustainability of public finances, the projected healthcare expenditure is posing a challenge for the public finances in the long-run. To contain the costs, government efforts to improve budgeting of health care expenditure and procurement in the healthcare sector and spending processes in the state hospitals have continued and so has the planned introduction of an integrated care model of healthcare services. However, planned rationalisation and restructuring of hospital capacities, the introduction of a prospective reimbursement system for the inpatient care and progress on e-health will be essential to bring the healthcare expenditure on the sustainable path.

¹³ This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Fiscal Sustainability Report 2015 (page 67).

Table 5: Sustainability indicators

<i>Time horizon</i>	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	LOW risk			
S0 indicator ^[1]	0.2			
Fiscal subindex (2015)	0.3	LOW risk		
Financial & competitiveness subindex (2015)	0.2	LOW risk		
Medium Term	LOW risk			
DSA ^[2]	LOW risk			
S1 indicator ^[3]	-1.3	LOW risk	-3.9	LOW risk
<i>of which</i>				
IBP	-0.7		-2.8	
Debt Requirement	-0.6		-1.3	
CoA	0.0		0.2	
Long Term	MEDIUM risk		LOW risk	
S2 indicator ^[4]	3.0		2.0	
<i>of which</i>				
IBP	0.9		-0.4	
CoA	2.1		2.4	
<i>of which</i>				
Pensions	0.9		1.2	
HC	1.3		1.3	
LTC	0.2		0.2	
Other	-0.3		-0.4	
Source: Commission services; 2016 stability/convergence programme.				
Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.				
[1] The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.				
[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections. See Fiscal Sustainability Report 2015.				
[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating a cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.				
[4] The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.				

6. FISCAL FRAMEWORK

According to the national legislation related to the Fiscal Compact, Slovakia is required to run a balanced budget, defined as a structural deficit of 0.5% of GDP. The adjustment path towards the MTO is based on the deadline for reaching it. The Ministry of Finance is to present a report by the end of June on whether the deviation from the balanced budget rule in 2015 was significant and whether a correction mechanism should be triggered in line with national legislation.¹⁴ This report will be followed by an opinion of the national fiscal council in early July. In 2015, based on the national estimates, the structural deficit rose by 0.1 pp to 2.6 % of GDP. It is not clear how this deterioration will be judged by the Ministry of Finance and the national fiscal council given the fact that the 2016 Stability Programme postponed the deadline for meeting the MTO from 2017 to 2019. This would imply a change in the required adjustment path towards reaching the MTO.¹⁵ Based on the information in the Stability Programme, the recalculated structural balance is projected to decline over the forecast horizon. In 2018, it is expected to decrease to -0.4 % of GDP. This would imply that the national deadline for reaching the MTO in 2019 would be met one year earlier, suggesting that Slovakia would respect the national balanced budget rule.

Another important numerical fiscal rule is set by the constitutional debt brake, under which corrective measures are envisaged once specified thresholds are exceeded. In 2015, the gross government debt amounted to 52.9 % of GDP, which was 1.5 pp less than expected. This has resulted in relaxing the potential sanctions that, under the domestic debt rule, would provide for the correction mechanism if the debt level exceeded 53% of GDP. In August the national fiscal council publishes its regular report on compliance with the national fiscal rules. The gross government debt as projected in the programme is at 52.9 % of GDP in 2016 and falling to 47.3% of GDP in 2019. This would suggest that the first threshold of the domestic debt brake would be exceeded until 2018¹⁶ implying that the finance minister would be required to explain in a letter to the Parliament why the threshold was breached.¹⁷

Based on the information provided in the Stability Programme, the planned and forecast fiscal performance in Slovakia appears to broadly meet the requirements of the applicable national numerical fiscal rules applied to the general government.¹⁸ Slovakia considers the Stability Programme to be the national medium-term fiscal plan (NMTFPs) pursuant Art. 4(1) of the Two-Pack Regulation 473/2013. Member states were required to include in their national medium-term fiscal plans (or national reform programmes), indications on the expected economic returns on non-defence public investment projects that have a significant budgetary impact. Such assessment is neither part of the Stability Programme nor the National Reform Plan.

¹⁴ This report is in fact prepared twice a year – at the end of June and November.

¹⁵ The Stability Programme mentions that the adjustment path towards the MTO will be adjusted. However, it is not clear if this new adjustment path will be applied also ex-post to 2015 or only to the future years.

¹⁶ Corrective measures in the context of the national debt brake rule start applying when the debt threshold of 50% of GDP is exceeded. This threshold will be lowered as of 2018 by 1 pp per year until it reaches 40% of GDP in 2027.

¹⁷ A more stringent corrective measure is required once the debt exceeds the level of 53% of GDP. In that situation, the government is required to freeze a certain part of budgeted expenditure in the given budgeted year.

¹⁸ There are several other fiscal numerical rules that apply to the state budget and local governments.

The Stability Programme is based on the macroeconomic forecast published by the Institute for Financial Policy (IFP) of the Ministry of Finance in February 2016 and endorsed by the Macroeconomic Forecasting Committee (MFC) as realistic at a meeting held on 4 February 2016, according to the minutes published on the website of the IFP. The constitutional act on budgetary responsibility of December 2011 formally endowed the MFC with the responsibility for assessing macroeconomic forecasts produced by the government. According to the statutes, in its deliberations the MFC is independent and free from the government's influence.¹⁹

Medium-term budgeting remains a weak point as the the final years of the multi-annual budget are only indicative and the binding expenditure ceilings, which were envisaged by the constitutional law of 2011, have so far not been adopted. An extensive use of various expenditure reserves seems to undermine transparency of the budgetary process and weakens role of some corrective measures under the debt brake.²⁰

There is an on-going project aimed at increasing the efficiency of public spending in Slovakia. As reported in the Stability Programme, in 2016 the government plans to run pilot projects on spending reviews for primary and secondary schools, financial administration (i.e. the tax administration), labour offices and on the effectiveness of active labour market policies, which would become a regular part of the budgetary process from 2017. The reviews are expected to identify inefficient spending in specific areas of public policy. The ambition is to free up public resources without the need for across-the-board cuts and could improve value for money in public spending.

7. CONCLUSIONS

In 2015, the headline deficit in Slovakia increased to 3.0 % of GDP. This was mirrored in a worsening of the structural deficit by 0.3 % of GDP, which implied a deviation from the requirement to avoid a fiscal deterioration. The growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark rate by 0.9 % of GDP. Following an overall assessment, this points to some deviation from the recommended adjustment path towards the MTO.

Slovakia plans an improvement in the structural balance of 0.6 % of GDP in 2016 and 0.8 % of GDP in 2017. This path suggests compliance with the required adjustment path towards the MTO in both years. While according to the Commission 2016 spring forecast Slovakia would meet the requirements of the preventive arm of the SGP in 2017, an overall assessment suggests a risk of some deviation in 2016.

¹⁹ The MFC consists of a chairman (the Director of the IFP) and members from nine independent institutions entitled to vote (the Central Bank, the Academy of Science, the Institute of Informatics and Statistics and six commercial banks). There are three other members of the MFC with an observer's status without voting rights (the Council for Budgetary Responsibility, the National Statistical Office and one commercial bank). The MFC assesses whether the draft forecast submitted by the IFP is "conservative", "realistic" or "optimistic". The draft forecast is accepted by the MFC if the majority of voting members assesses the forecast as "conservative" or "realistic".

²⁰ For example, when the debt level exceeds 53 % of GDP, the government is required to freeze a part of its expenditure. Once expenditure reserves – i.e. budgeted but not allocated expenditure – are available, the government is not required to take any actual spending cutting measures.

8. ANNEX

Table I: Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	2.6	7.3	1.9	1.4	2.5	3.6	3.2	3.3
Output gap ¹	-1.6	1.3	0.4	-2.4	-1.8	-0.9	-0.6	-0.3
HICP (annual % change)	8.0	5.0	2.7	1.5	-0.1	-0.3	-0.1	1.5
Domestic demand (annual % change) ²	2.2	5.5	0.0	0.3	3.1	4.9	2.4	3.7
Unemployment rate (% of labour force) ³	17.3	15.4	12.8	14.2	13.2	11.5	10.5	9.5
Gross fixed capital formation (% of GDP)	30.9	26.5	23.0	20.7	20.9	23.0	22.7	23.3
Gross national saving (% of GDP)	24.7	21.0	20.0	21.7	20.2	23.4	21.5	21.6
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-7.8	-2.7	-5.2	-2.7	-2.7	-3.0	-2.4	-1.6
Gross debt	44.3	35.4	40.1	55.0	53.9	52.9	53.4	52.7
Net financial assets	-4.3	-8.5	-25.4	-32.3	-35.1	n.a	n.a	n.a
Total revenue	39.2	35.7	35.5	38.6	39.2	42.7	38.9	38.6
Total expenditure	47.0	38.4	40.7	41.3	41.9	45.6	41.3	40.2
<i>of which: Interest</i>	3.5	1.8	1.5	1.9	1.9	1.8	1.5	1.5
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	0.2	-3.0	2.3	4.2	1.5	0.9	-1.7	-2.7
Net financial assets; non-financial corporations	-69.7	-61.4	-61.6	-62.3	-65.3	n.a	n.a	n.a
Net financial assets; financial corporations	-9.8	-2.3	0.3	0.5	0.1	n.a	n.a	n.a
Gross capital formation	20.6	19.2	15.4	13.3	12.9	12.3	14.8	15.8
Gross operating surplus	24.8	26.7	26.5	26.7	25.7	25.2	25.0	24.6
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	1.0	-1.4	0.2	0.7	1.4	2.1	2.2	2.2
Net financial assets	52.8	32.6	34.9	36.8	38.7	n.a	n.a	n.a
Gross wages and salaries	31.8	30.4	30.3	30.3	30.6	31.2	31.9	32.2
Net property income	4.5	1.6	1.7	2.3	2.6	2.7	2.8	2.7
Current transfers received	16.9	16.2	18.0	18.3	18.5	18.8	18.4	18.0
Gross saving	6.6	3.9	4.8	5.1	5.8	6.4	6.6	6.4
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-6.6	-7.0	-2.7	2.2	0.2	1.1	-0.9	-1.1
Net financial assets	31.0	39.6	51.8	57.3	61.7	n.a	n.a	n.a
Net exports of goods and services	-6.6	-2.9	-0.6	4.3	3.6	2.4	3.0	2.4
Net primary income from the rest of the world	-0.3	-3.5	-2.1	-1.8	-3.2	-2.5	-2.4	-2.3
Net capital transactions	-0.5	0.1	1.3	1.6	1.0	0.3	-0.3	0.0
Tradable sector	53.7	53.8	50.8	49.3	51.0	50.4	n.a	n.a
Non tradable sector	36.4	36.1	40.2	42.0	39.8	40.0	n.a	n.a
<i>of which: Building and construction sector</i>	6.3	6.2	8.4	7.1	7.6	8.3	n.a	n.a
Real effective exchange rate (index, 2000=100)	62.1	77.4	99.5	98.9	99.1	97.5	98.9	99.4
Terms of trade goods and services (index, 2000=100)	106.6	105.4	99.7	97.0	97.0	96.8	96.6	96.5
Market performance of exports (index, 2000=100)	62.2	87.8	104.2	121.0	118.9	120.2	119.5	120.0
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source: AMECO data, Commission 2016 spring forecast								