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Assessment of the 2017 stability programme for Slovakia

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

On 26 April 2017 Slovakia submitted its April 2017 stability programme (hereafter called stability programme), covering the period 2017-2020. The government approved the programme on 26 April 2017 and is expecting to submit it the Parliament by the end of May.

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 22 February 2017 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 spring 2017 forecast. The following section presents the recent and planned budgetary developments, according to the stability programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the stability programme and a risk analysis of the budgetary plans based on 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 on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The Slovak economy expanded by 3.3% in 2016, with net exports being the main contributor to growth. Robust private consumption benefitted from sustained improvements in the labour market and declining consumer prices, which were dragged down by a drop in energy and food prices. In contrast, overall investment contracted sharply throughout 2016 after an exceptionally strong 2015, which in turn restrained imports due to the high import intensity of Slovak investment. The cyclical investment pattern was closely linked to a transition between EU funds programming periods and affected both public and private investment.

According to the stability programme, economic growth is expected to remain at 3.3% in 2017 and to strengthen to 4% in 2018, with net exports contributing most to economic expansion in both years. Growth in household consumption is projected to slow somewhat in 2017 and to re-accelerate thereafter. Overall investment is expected to recover swiftly in 2017, driven by a rise in private investment in the automotive industry and a recovery in public investment spending, including large infrastructure projects such as the Bratislava ring road. In 2018, investment growth is expected to slow somewhat, reflecting a decrease in public investment.

The macroeconomic scenario in the stability programme is broadly in line with the latest Draft Budgetary Plan with regard to both the headline growth path and its composition, although the stability programme assumes a marginally weaker expansion in 2017. At the same time, the macroeconomic scenario underlying the Stability Programme is broadly in line with the Commission spring 2017 forecast in terms of the headline growth figures, but there are some differences with regard to the composition of real GDP growth.

In particular, the stability programme scenario expects significantly stronger contributions of net exports in 2017 and 2018, mainly on the back of weaker import dynamics. At the same time, the stability programme projects a faster recovery in investment activity in 2017, while overall investment growth falls well below the Commission forecast in 2018, reflecting differing views on the timing of public investment projects. Forecast differences are limited

for private consumption, albeit more pronounced for changes in inventories, which contribute less to real GDP growth in 2017 in the macroeconomic scenario of the stability programme.

Table 1: Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019	2020
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	3.3	3.3	3.0	3.3	3.6	4.0	4.4	3.8
Private consumption (% change)	2.9	2.9	3.1	2.5	2.9	2.7	2.9	2.9
Gross fixed capital formation (% change)	-9.3	-9.3	0.9	3.0	5.8	1.9	2.0	3.6
Exports of goods and services (% change)	4.8	4.8	6.5	5.6	7.0	7.3	7.7	6.2
Imports of goods and services (% change)	2.9	2.9	6.6	4.2	6.8	6.0	6.3	5.5
Contributions to real GDP growth:								
- Final domestic demand	-0.2	-0.4	2.3	2.2	3.3	2.2	2.2	2.4
- Change in inventories	1.2	1.2	0.5	-0.5	0.0	0.0	0.0	0.0
- Net exports	1.8	2.0	0.2	1.7	0.4	1.9	2.1	1.4
Output gap[1]	-0.3	-0.6	0.2	-0.4	0.8	0.0	0.8	1.1
Employment (% change)	2.4	2.4	1.4	1.8	1.3	1.1	0.9	0.9
Unemployment rate (%)	9.7	9.7	8.6	8.4	7.6	7.6	6.9	6.2
Labour productivity (% change)	0.9	0.9	1.6	1.5	2.3	2.9	3.4	2.9
HICP inflation (%)	-0.5	-0.5	1.4	1.1	1.6	1.7	1.9	2.1
GDP deflator (% change)	-0.4	-0.4	0.8	1.0	1.5	1.6	2.0	2.1
Comp. of employees (per head, % change)	1.8	1.8	4.0	3.3	4.7	4.3	4.8	5.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.7	2.3	1.0	2.9	1.9	3.5	4.4	4.8

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 2017 spring forecast (COM); Stability Programme (SP).

Both the stability programme and the Commission 2017 spring forecast expect the labour market to improve further in the coming years, with the unemployment rate gradually receding to below 8% in 2018. Against the background of the continued labour market tightening, both sets of forecasts expect nominal wage growth to pick up to above 4% in 2018, with the Commission forecast expecting this rate to already be reached in 2017. At the same time, the Commission forecast shows a faster recovery in consumer prices throughout 2017.

The output gap as recalculated by Commission based on the information in the programme following the commonly agreed methodology is somewhat below the estimates in the Commission 2017 spring forecast. From a moderately negative starting position in 2016, the output gap is expected to close in 2018 and to turn positive thereafter, mainly on the back of acceleration in economic growth. In contrast, the Commission forecast shows a positive estimate of the output gap already in 2017.

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

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 2017 budget as a basis for projecting fiscal outcomes for 2018 and beyond; it therefore does not assume any additional measures beyond those envisaged for 2017. The central scenario is presented as the single most likely outcome of fiscal policy. From 2018 onwards the central scenario is consistent with the fiscal targets presented in the programme being met; for 2017 the stability programme states that the deficit target of 1.3% of GDP remains valid although the currently estimated deficit outcome by the authorities is 1.2% of GDP in light of upside risks to tax revenues and dividends income as well as savings on interest payments. The current assessment and the tables in the Annexes are based on the central scenario

3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017

The general government deficit declined to 1.7% of GDP in 2016, thus exceeding the target of 1.9% of GDP presented in the 2016 stability programme and the expected outcome of 2% of GDP in the 2017 Draft Budgetary Plan. The difference between the 2016 deficit outturn and the 2016 stability programme is explained mainly by an unexpectedly high surplus of local governments. Furthermore, tax revenue growth was stronger than expected on the basis of past estimated elasticities, particularly in the area of corporate income tax revenues. In turn, overall revenue growth was stronger than budgeted. Positive labour market developments were reflected in higher-than-expected revenues from social and healthcare contributions. In net terms, a large part of the additional revenue was matched by higher spending, particularly on public sector wage increases and healthcare spending. Several general government entities were not included in the budget for 2016 and hence the notified overall level of revenues and expenditures was higher compared to the 2016 stability programme.[1] Moreover, the Ministry of Finance has generally not budgeted revenues and expenditures of so-called extra-budgetary accounts before the 2017 budget, leading to a systematic underestimation of budgeted levels of revenues and expenditures in the past. This issue appears to have been addressed during the preparation of the 2017 budget and should be systematically tackled as of 2018 (see Section 6).

For 2017, the stability programme forecasts the deficit at 1.2% of GDP, slightly below the target of 1.3% of GDP presented in the 2016 stability programme and the 2017 Draft Budgetary Plan; nonetheless, as outlined above, the latter target remains unchanged. This slight expected improvement against the budget is explained by several factors. The outlook for social contributions receipts is more positive, reflecting expectations of a better labour market performance and a correction in the budgeting of pension system revenues of the armed forces. Additional revenue is expected also from non-tax revenues such as dividends. While the anticipated lower drawdown on EU funds is expected to lead to lower co-financing needs, it is also set to lead to lower investment. Extra spending on intermediate consumption and social outlays (both social benefits and healthcare spending) as well as inclusion of the JAVYS company, which is expected to have an overall negative impact on the expected deficit,[2] will prevent a swifter improvement in the headline balance.

[1] The general government budget did not include entities MH Invest I and MH Invest II, JAVYS (Nuclear and Decommissioning Company) and Železničná spoločnosť Slovensko (passenger railway transporter) which were reclassified in the general government sector only after the finalization of the budget preparation.

[2] JAVYS (Nuclear and Decommissioning Company) was reclassified in the general government sector during the 2016 autumn notification round and was hence not included in the 2017 budget.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The fiscal targets presented in the stability programme aim at reaching the medium term objective (MTO) – a structural deficit of 0.5% of GDP – already in 2018. Based on the information in the stability programme, the recalculated structural balance is projected to decline to -1.1% of GDP in 2017 and further to -0.5% of GDP in 2018, where the consolidation effort is concentrated. The MTO would thus be reached one year earlier than planned in the 2016 stability programme. As of 2019, the budget is projected to be in balance. The MTO reflects the objectives of the Pact.

Compared to the 2016 stability programme and the 2017 Draft Budgetary Plan, the nominal targets were relaxed. In 2018, the current deficit target of 0.5% of GDP is 0.1 pps higher compared to past plans and the orignally planned surplus of 0.2% of GDP in 2019 was abondoned in favour of a balanced budget. The targets were revised to use fiscal space available under the SGP rules.

According to the programme, in 2018 the expenditure-to-GDP ratio is projected to decline faster than the revenue ratio, making the expenditure side the main driver of the consolidation. Investment, social payments and intermediate consumption as a share of GDP are projected to decline by 0.6 pps, 0.5 pps and 0.4 pps, respectively, between 2017 and 2018. The programme does not explain the drivers of this decline. In the case of social payments, the decrease may be due to an assumption of subdued growth in healthcare outlays. Overall, the programme's expected decline in the spending ratio appears to be endogenously driven as spending levels projected under the no-policy-change scenario are lower than in the central scenario. On the revenue side, the largest decline is projected for non-tax revenue, which as a share of GDP is projected to decline by 0.7 pps. The programme does not indicate the cause for this decline. The Commission 2017 spring forecast projects a comparable deficit improvement, with the deficit declining to 0.6% of GDP in 2018. However, the adjustment stems both from the revenue and expenditure side. The Commission assumes a somewhat stronger take of income taxes and of other revenue, including from higher projected growth of government sales of market output. On the expenditure side, the Commission assumes investment growth in line with GDP and a decline in social spending, although not as markedly as in the stability programme, as healthcare spending is set to follow trends of previous years. The growth of other spending mirrors partly the assumed pick-up in EU funds drawdown.

In 2019, the stability programme assumes further consolidation that would ensure reaching a balanced budget. The adjustment would again come from the expenditure side, with the expenditure-to-GDP ratio declining by 0.8 pps to 38.6%. A balanced budget would be maintained also in 2020, when the decline in the revenue ratio would be fully compensated by the decline in the spending ratio.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018		2019	2020	Change: 2016-2020
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**40.0**	**40.3**	**39.7**	**40.8**	**38.7**	**38.6**	**38.0**	**-2.0**
of which:								
- Taxes on production and imports	10.6	10.8	10.9	10.7	10.7	10.5	10.3	-0.4
- Current taxes on income, wealth, etc.	7.7	7.7	7.5	8.0	7.6	7.5	7.6	-0.1
- Social contributions	14.3	14.5	14.4	14.3	14.3	14.1	14.1	-0.3
- Other (residual)	7.3	7.2	6.8	7.8	6.1	6.4	6.0	-1.3
Expenditure	**41.6**	**41.6**	**40.9**	**41.3**	**39.2**	**38.6**	**38.0**	**-3.7**
of which:								
- Primary expenditure	40.0	40.2	39.6	40.0	37.9	37.4	36.9	-3.1
of which:								
Compensation of employees	9.1	9.2	8.9	9.2	9.0	9.0	8.8	-0.3
Intermediate consumption	5.5	5.5	5.7	5.4	5.3	5.1	5.0	-0.5
Social payments	19.2	18.9	18.6	18.5	18.1	17.7	17.3	-1.9
Subsidies	0.5	0.6	0.6	0.6	0.5	0.5	0.4	0.0
Gross fixed capital formation	3.2	3.3	3.3	3.3	2.7	2.6	2.8	-0.4
Other (residual)	2.5	2.7	2.6	3.1	2.3	2.6	2.6	0.0
- Interest expenditure	1.7	1.4	1.3	1.3	1.3	1.2	1.1	-0.6
General government balance (GGB)	**-1.7**	**-1.3**	**-1.2**	**-0.6**	**-0.5**	**0.0**	**0.0**	**1.7**
Primary balance	**0.0**	**0.1**	**0.1**	**0.8**	**0.8**	**1.2**	**1.1**	**1.1**
One-off and other temporary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-1.6**	**-1.3**	**-1.2**	**-0.6**	**-0.5**	**0.0**	**0.0**	**1.6**
Output gap[1]	-0.3	0.2	-0.4	0.8	0.0	0.8	1.1	1.4
Cyclically-adjusted balance[1]	-1.5	-1.4	-1.1	-0.9	-0.5	-0.3	-0.4	1.1
Structural balance[2]	**-1.5**	**-1.4**	**-1.1**	**-0.9**	**-0.5**	**-0.3**	**-0.4**	**1.1**
Structural primary balance[2]	0.2	0.0	0.2	0.4	0.8	0.9	0.6	0.5

Notes:

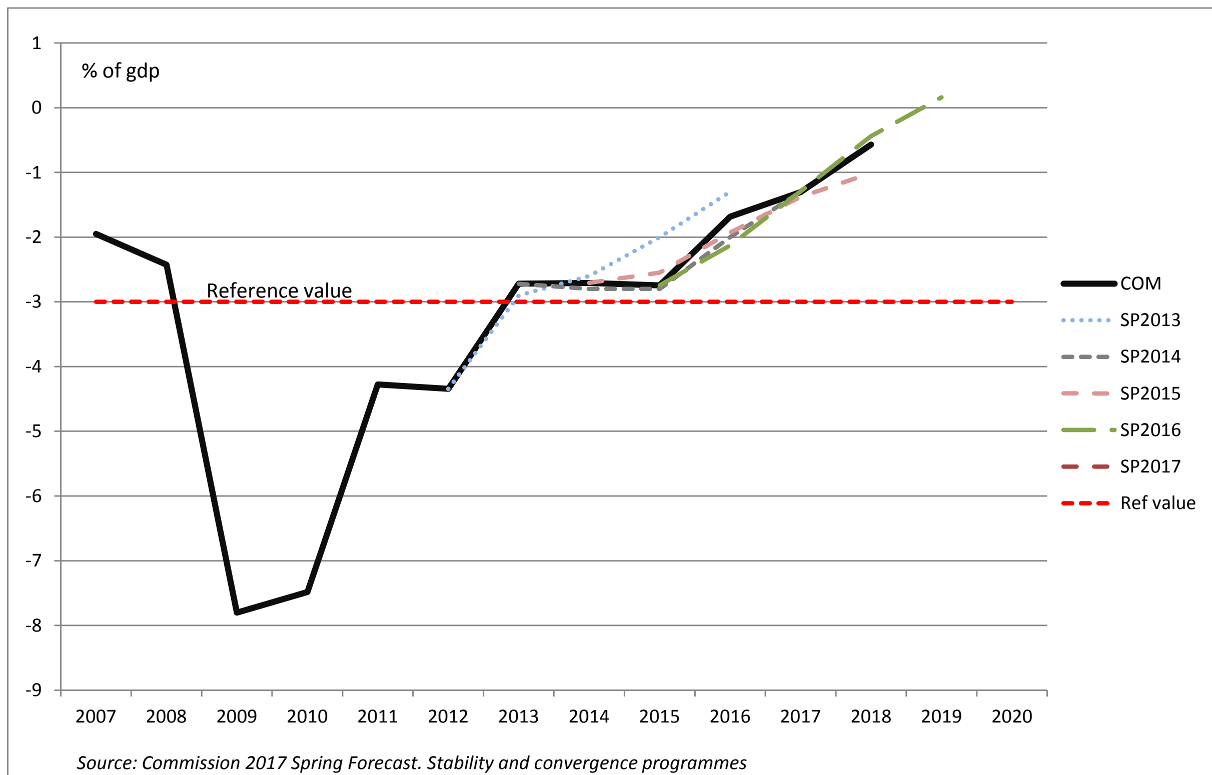
[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Stability Programme (SP); Commission 2017 spring forecasts (COM); Commission calculations.

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



3.3. MEASURES UNDERPINNING THE PROGRAMME

For 2017, the government adopted a set of revenue measures with an overall positive impact on revenues. A loss of revenue from the reduction of the corporate income tax rate by 1 pp to 21% is somewhat counterbalanced by an extension and increase of the levy on regulated industries. In addition, the ceiling for payments of social contributions was increased while that for paying healthcare contributions was completely removed. Other revenue-increasing measures included higher tobacco duties, higher taxes on gambling, and a tax on non-life insurance. On the other hand, revenues are expected to decline due to an increase of lump-sum deductions for self-employed and the gradual increase in the share of pension contributions towards the privately funded second pension pillar, thus lowering the part dedicated to the public pillar. Measures on the expenditure side are not listed in the programme. Nevertheless, based on the information in the programme an increase in public sector wages stands out as a deficit-increasing measure. These measures are included also in the Commission 2017 spring forecast.

In 2018, the stability programme incorporates the planned elimination of the minimum corporate income tax, which will depress revenues. The introduction of a dividend tax should, on the other hand, yield extra revenues. When comparing expenditure plans to the no-policy-change scenario presented in the programme, the government expects to carry out expenditure-increasing measures in the areas of wages, social benefits and investment. The increase in social benefits is mainly linked to the increase of pensions for retired persons whose pensions were calculated before the 2004 pension reform (and were low compared to pensions calculated after the reform). Compared to the no-policy-change scenario, intermediate consumption is projected to grow more slowly, especially at the level of local governments and universities. However, no measures underpinning such developments are

presented. Measures that the stability programme describes in sufficient detail (i.e. the revenue-side measures) are also included in the Commission 2017 spring forecast.

No one-offs are planned in 2017 or the coming years. The only one-off identified by the stability programme occurs in 2016 and relates to a correction in the contribution to 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 Commission 2017 spring forecast also only assumes this single one-off.

Main budgetary measures

Revenue	Expenditure
2016	
• Introduction of an allowance for healthcare contributions (-0.1 % of GDP) • Extension of the reduced VAT rate to basic foodstuffs (-0.1 % of GDP)	
2017	
• Lowering the corporate income tax rate from 22 % to 21 % (-0.2 % of GDP) • Extension and an increase of the regulated sector levy (0.1 % of GDP) • Increasing the ceiling for paying social contributions (0.1 % of GDP) • Removing the ceiling for paying healthcare contributions (0.1 % of GDP)	• Growth of public wage bill (0.1 % of GDP)
2018	
• Supression of corporate tax licences (-0.1 % of GDP) • Introduction of 7 % tax rate on dividends (0.1 % of GDP)	• Growth of the public wage bill (0.1 % of GDP) • Higher social benefits (0.1 % of GDP) • Higher investment and capital spending (0.3 % of GDP)
2019	
• Lower non-tax revenue (-0.1 % of GDP)	• Growth of the public wage bill (0.1 % of GDP) • Lower intermediate consumption (-0.1 % of GDP) • Lower investment (-0.1 % of GDP)
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.4. DEBT DEVELOPMENTS

The general government debt declined to 51.9 % of GDP in 2016 (Table 3), driven mainly by a negative stock-flow adjustment, as well as by an accelerating GDP deflator. The former factor was largely due to a series of government buy-backs by ARDAL (the debt management agency). The 2016 debt outcome was below the projections presented in the 2016 stability programme and the 2017 Draft Budgetary Plan (Figure 2), mainly due to a lower primary deficit and a different outcome in stock-flow adjustments. In 2017, the stability programme

projects the debt-to-GDP ratio to decline marginally to 51.8 %, which is, however, lower compared to the 2017 Draft Budgetary Plan. A more pronounced decline in the debt-to-GDP ratio that would mirror the accelerating growth of nominal GDP is set to be partly negated by a negative stock-flow adjustment (especially the expected impact of the cash-accrual adjustment). The Commission 2017 spring forecast projects the debt ratio in 2017 to be somewhat lower given a smaller expected stock-flow adjustment. The stability programme projects a further decline in the debt-to-GDP ratio after 2017 by some 2 pps of GDP on average. The debt should thus decline to 49.9 % of GDP in 2018, 48 % of GDP in 2019 and 46 % of GDP in 2020. In all years it is projected to be negatively impacted by the positive stock-flow adjustments.

Table 3: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020
			COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**51.3**	**51.9**	**51.5**	**51.8**	**49.8**	**49.9**	**48.0**	**46.0**
Change in the ratio	2.3	-0.5	-0.4	-0.2	-1.8	-1.8	-1.9	-2.0
Contributions[2]:								
1. Primary balance	**1.6**	**0.0**	**-0.1**	**-0.1**	**-0.8**	**-0.8**	**-1.2**	**-1.1**
2. “Snow-ball” effect	**0.3**	**0.2**	**-0.5**	**-0.9**	**-1.2**	**-1.5**	**-1.8**	**-1.6**
Of which:								
Interest expenditure	1.8	1.7	1.4	1.3	1.3	1.3	1.2	1.1
Growth effect	-1.2	-1.7	-1.5	-1.7	-1.8	-2.0	-2.0	-1.7
Inflation effect	-0.2	0.2	-0.4	-0.5	-0.7	-0.8	-0.9	-0.9
3. Stock-flow adjustment	**0.3**	**-0.7**	**0.2**	**0.8**	**0.2**	**0.4**	**1.1**	**0.7**
Of which:								
Cash/accruals diff.				0.5		0.6	0.5	0.5
Acc. financial assets				0.4		0.1	0.7	0.4
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				-0.1		-0.3	-0.1	-0.3

Notes:

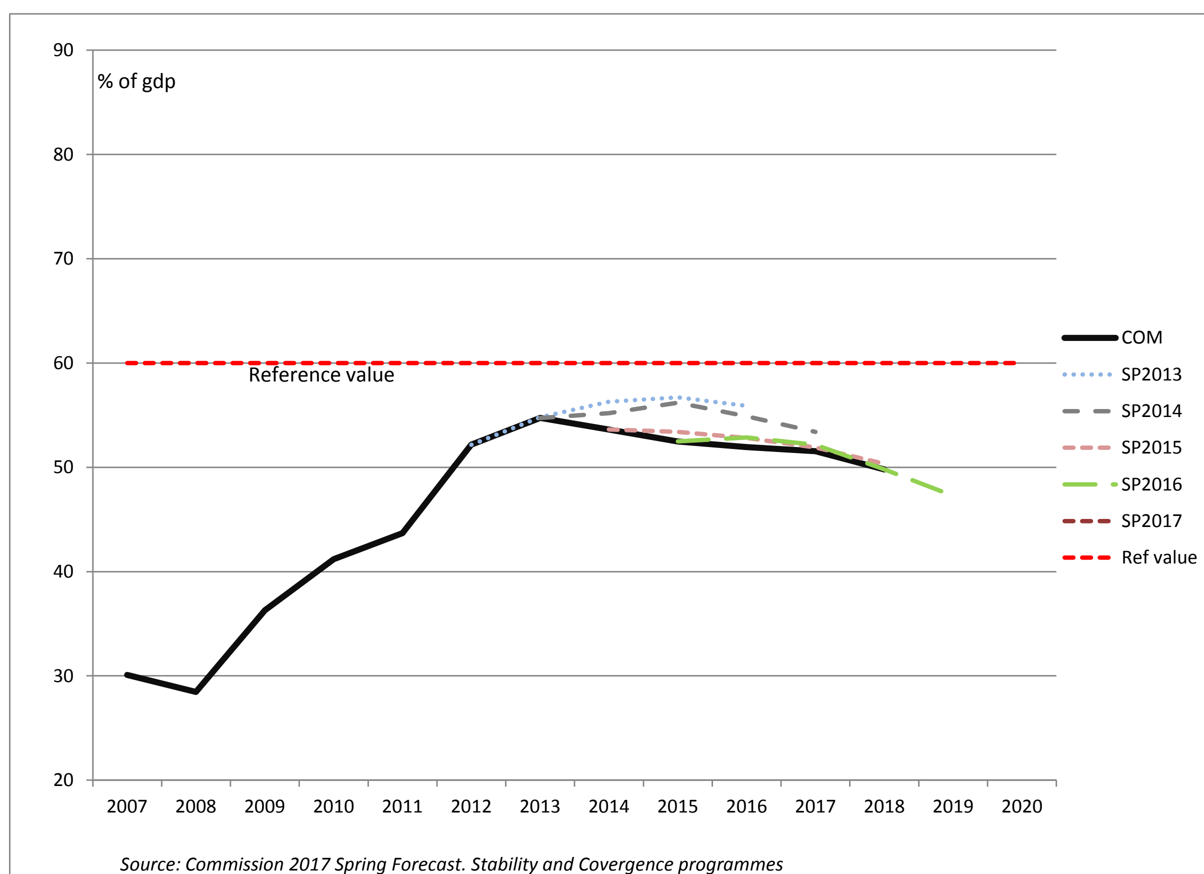
[1] End of period.

[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 2017 spring forecast (COM); Stability Programme (SP), Comission calculations.

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



Source: Commission 2017 Spring Forecast. Stability and Covergence programmes

3.5. RISK ASSESSMENT

In 2017 the stability programme takes into account the agreed wage increases for teachers, but growth in the public wage bill of 1.8% appears rather subdued vis-à-vis 2016. The average growth of compensation of employees over the past five years reached 4.8% of GDP, with growth being above this average in the past three years. Another area where the stability programme risks underestimating expenditure growth are healthcare outlays, which are expected to grow by less than 1%, while the average growth over the past five years was 4.6%. Although this may partly reflect the expected positive impact of spending reviews in the context of the 'Value for Money' project, it is not clear to what extent the envisaged measures are being implemented and if they can be expected to contribute to a major slowdown in healthcare spending. The Commission 2017 spring forecast takes account of these risks, while at the same time it does not expect an acceleration of the drawdown on EU funds in 2017; hence it does not assume the usage of the spending reserve for this purpose, which is budgeted under the item of intermediate consumption. In addition, the Commission 2017 spring forecast projects higher revenue from sales of market output of goods and services of the general government, although the impact on the budget balance is partly neutralised by a higher public wage bill linked to the production of these goods and services.

Furthermore, there are additional negative risks that are not reflected in the Commission forecast. First, spending of local governments may be higher given a large surplus achieved in 2016. Second, the government is expected to tackle an unfavourable financial position of the state-owned healthcare insurance company following a series of reported losses. Finally,

Eurostat is expected during the 2017 autumn notification to further inspect the application of the super-dividend test in 2016. This conclusion could impact also dividend revenues in 2017.

In 2018, risks stem from the assumptions on expenditure savings underlying the programme's 'no-policy-change' scenario (e.g. intermediate consumption falling by 0.4 pps, investment by 0.8 pps). These low expected levels of expenditure are largely retained under the central scenario, with only minor deviations. The programme includes only limited information on the reasons for relatively low expenditure in 2018. It could be inferred that, in the case of investment, the decline is potentially due to a projected lower drawdown of EU funds. This would in turn have a negative impact on EU-financed investments. Nevertheless, these explanations do not appear to fully account for the projected declines. In addition, given low assumed growth rates in the public sector wage bill and healthcare spending, outlays on these items risk being underestimated in 2018[3]. In the absence of concrete measures, the Commission 2017 spring forecast projects these variables under the customary no-policy-change assumption, which generally translates into higher growth rates compared to the stability programme. Nevertheless, the deficit projected in the Commission 2017 spring forecast is only 0.1 pps higher than in the stability programme. This is due to projected higher revenues - especially from sales of market output, in line with developments of the past years - and growth of nominal GDP.

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 2016, the structural balance improved by 0.8 pps. of GDP, thus exceeding the required adjustment of 0.25 % of GDP by a large margin. The growth rate of government expenditure, net of discretionary revenue measures and one-offs, is estimated to have also been within the limit set by the reference rate, suggesting compliance under this pillar too. For 2015 and 2016 on average, the structural balance points to compliance, while the expenditure benchmark points to some deviation (gap of -0.1% of GDP). This calls for an overall assessment. The expenditure benchmark pillar accounts better for the dynamics in nationally-financed government investment, which was impacted by a spike in the drawdown on EU funds in 2015, and also excludes savings on interest expenditure. Moreover, the structural balance was positively influenced by revenue windfalls in 2015. Hence the expenditure benchmark appears to be a more appropriate indicator of Slovakia's underlying budgetary position during the period in question. Taking 2015 and 2016 as a reference period, the assessment points to some deviation from the required adjustment path towards the MTO.

Box 1. Council recommendations addressed to Slovakia

On 12 July 2016, the Council addressed recommendations to Slovakia in the context of the European Semester. In particular, in the area of public finances the Council recommended to Slovakia to "achieve an annual fiscal adjustment of 0.25 % of GDP towards the medium-term budgetary objective in 2016 and of 0.5 % of GDP in 2017".

Slovakia is required to achieve an annual fiscal adjustment of 0.5 % of GDP towards the MTO in 2017 and 2018. Based on the stability programme, the recalculated structural balance points to a risk of some deviation in 2017, with a gap of -0.2 % of GDP. Considering the expenditure benchmark, based on the information provided in the stability programme, the

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[3] Nevertheless, current assumed growth rates appear to be more realistic than in the previous stability programmes.

growth rate of government expenditure, net of discretionary revenue measures and one-offs, would exceed the applicable benchmark rate (gap of -0.1% of GDP), thereby also suggesting a risk of some deviation. The structural balance indicator is positively influenced by a decline in interest expenditure; by contrast, the expenditure benchmark captures windfall savings on interest expenditure and better reflects investment dynamics, as peaks are partly netted out. Therefore, the expenditure benchmark appears to be a more appropriate indicator of Slovakia's underlying budgetary position in 2017. The overall assessment based on the stability programme thus suggests a risk of some deviation from the requirements of the preventive arm in 2017. The findings from the stability programme are confirmed by the Commission 2017 spring forecast, which points under both pillars to a risk of some deviation as the fiscal effort under both falls short of the requirement by some 0.4% of GDP. The overall assessment based on the Commission forecast then suggests a risk of some deviation from the requirements of the preventive arm in 2017.

In 2018, according to the information provided in the stability programme, Slovakia would deliver the required structural effort and the expenditure benchmark would be met both over one year and 2017-2018 taken together. Based on the stability programme, Slovakia would thus be compliant in 2018. The Commission 2017 spring forecast also implies adherence to the required fiscal effort under the structural balance pillar, but suggests a risk of significant deviation under the expenditure benchmark pillar in 2018. Several reasons for a less favourable reading of the expenditure benchmark are already presented in Section 3.5: In general, the Commission forecast assumes higher revenue (including from transfers due to an assumed accelerated drawdown of EU funds) compared to the stability programme, which is set to translate to higher projected expenditure. Over 2017 and 2018 taken together, the Commission forecast suggests a risk of some deviation under the structural balance pillar and a risk of significant deviation under the expenditure benchmark pillar. This calls for an overall assessment, with a focus on the two-year average as the more stringent of the two timeframes. As the expenditure benchmark captures the dynamics in the nationally-financed government investment better, the expenditure benchmark is considered the more appropriate indicator in this context, thus supporting the conclusion of a risk of significant deviation in 2018. Overall, based on the Commission forecast, there appears to be a risk of significant deviation in 2018.

These assessments are based on the matrix of preventive arm requirements agreed with the Council, which takes into account (i) the cyclical position of the economy, as assessed on the basis of output gap estimates using the commonly agreed methodology as well as the projected real GDP growth rate, and (ii) debt sustainability considerations. Given the current cyclical conditions and the uncertainty surrounding them, it is important that the fiscal stance strikes the right balance between both safeguarding the ongoing recovery and ensuring the sustainability of Slovakia's public finances. The Commission noted that, in carrying out its future assessments, it stands ready to use its margin of appreciation in cases where the impact of large fiscal adjustment on growth and employment is particularly significant. In that context, it will make use of any updated information regarding the projected position in the economic cycle of each Member State and work closely with the Council to that effect.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-1.5	-1.4		-0.9	
Structural balance based on freezing (COM)	-1.5	-1.4		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.3	0.5		0.5	
Required adjustment corrected[5]	0.3	0.5		0.5	
Change in structural balance[6]	0.8	0.3	0.1	0.6	0.5
One-year deviation from the required adjustment[7]	0.5	-0.2	-0.4	0.1	0.0
Two-year average deviation from the required adjustment[7]	0.1	0.2	0.1	0.0	-0.2
Expenditure benchmark pillar					
Applicable reference rate[8]	2.2	2.5		2.9	
One-year deviation adjusted for one-offs[9]	0.3	-0.1	-0.4	0.2	-0.5
Two-year deviation adjusted for one-offs[9]	-0.1	0.1	-0.1	0.1	-0.5
PER MEMORIAM: One-year deviation[10]	0.3	-0.1	-0.4	0.2	-0.5
PER MEMORIAM: Two-year average deviation[10]	-0.3	0.1	-0.1	0.1	-0.5
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Compliance	Overall assessment
Conclusion over two years	Overall assessment	Compliance	Overall assessment	Compliance	Overall assessment

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, revenue increases mandated by law and one-offs 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.

[10] 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.

Source :

Stability Programme (SP); Commission 2017 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

Slovakia does not appear to face fiscal sustainability risks in the short run according to the S0 indicator, which captures short-term risks of fiscal stress stemming from fiscal, macro-financial and competitiveness threats to the economy.

Based on the Commission 2017 spring forecast and a no-fiscal policy change scenario beyond current forecasts, government debt is expected to decrease from 51.9 % of GDP in 2016 to 39.6 % in 2027, thus remaining below the 60% of GDP Treaty threshold. Over this horizon,

government debt is projected to have peaked in 2016. This highlights low risks for the country from a debt sustainability analysis in the medium term. The full implementation of the stability programme would also put debt on a clearly decreasing path by 2027, remaining below the 60% of GDP reference value in 2027.

The medium-term fiscal sustainability risk indicator S1 stands at -2.1 pps. of GDP, primarily thanks to the initial budgetary position (contributing -1.4 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 -3.0 pps. of GDP, implying a broadly similar medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, low. Fully implementing the fiscal plans in the stability programme would 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 2.5 pps. of GDP. In the long-term, Slovakia therefore appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs, which contribute 2.2 pps. of GDP. Full implementation of the programme would keep the S2 indicator unchanged at 2.5 pps. of GDP, leading to a similar long-term risk.

The pension reform in 2012 improved the sustainability of public finances, in part by changing the indexation method – originally reflecting by equal parts growth of an average wage and inflation – into an inflation-based indexation.[4] During the phase-out period 2013-2017, the weight of wages was supposed to decline to zero. However, in 2017 pensions are set to increase by 2 %, which is more than suggested by the underlying formula, increasing the costs of the pension system by some 0.2% of GDP in 2017. In 2018, pensions of those retired before the 2004 pension reform and receiving lower pensions are to be increased. Planned measures in the healthcare sector (also in the context of the 'Value for Money' project) to contain spending can improve the projected negative impact of healthcare expenditure on public finances in the long run.

[4] For the purpose of pensions indexation a specific inflation taking into account a 'pension basket' is to be used.

Table 5: Sustainability indicators

Time horizon			No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.3			
Fiscal subindex			0.1	LOW risk		
Financial & competitiveness subindex			0.3	LOW risk		
Medium Term			**LOW risk**			
DSA [2]			LOW risk			
S1 indicator [3]			-2.1	LOW risk	-3.0	LOW risk
of which						
	Initial Budgetary Position		-1.4		-1.7	
	Debt Requirement		-0.8		-1.3	
	Cost of Ageing		0.1		0.1	
	of which					
		Pensions	-0.3		-0.2	
		Health-care	0.4		0.4	
		Long-term care	0.0		0.0	
		Other	0.0		-0.1	
Long Term			**MEDIUM risk**		**MEDIUM risk**	
S2 indicator [4]			2.5		2.5	
of which						
	Initial Budgetary Position		0.3		0.1	
	Cost of Ageing		2.2		2.3	
	of which					
		Pensions	1.0		1.2	
		Health-care	1.3		1.3	
		Long-term care	0.2		0.2	
		Other	-0.3		-0.4	

Source: Commission services; 2017 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 2017 forecast covering until 2018 included. 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 of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[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*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2016.

6. FISCAL FRAMEWORK

Based on the national legislation related to the Fiscal Compact, Slovakia is required to run a surplus or at least a balanced budget, defined as a structural deficit of 0.5% of GDP, which is at the same time its MTO as presented in the stability programme. The national deadline for reaching the MTO has been set for 2019 – this in turn determines the adjustment path towards the MTO. Based on the information in the stability programme, the MTO would be reached already in 2018 (hence one year ahead of schedule) and would be respected also in the following years. Slovakia would thus respect its national balanced budget rule from 2018 on.

In 2012 Slovakia introduced a constitutional debt brake, under which corrective measures are envisaged once specified thresholds are exceeded.[5] The current threshold interval is set at 50-60 % of GDP. As of 2018, the thresholds will be lowered by 1 pp per year until the lower bound reaches 40% of GDP in 2027. In 2016, gross government debt amounted to 51.9 % of GDP. Based on the information in the stability programme gross government debt is projected to gradually decline to 46% of GDP in 2020. This would suggest that until 2019 debt would exceed the lower threshold, requiring the finance minister to explain in a letter to Parliament why the threshold was breached. Discussions are ongoing on whether to change the national debt brake. They currently focus on a possible change of the underlying measure of debt from a 'gross' to a 'net' concept.

Based on the information provided in the stability programme, the past, planned and forecast fiscal performance in Slovakia appears to broadly comply with the requirements of the applicable national numerical fiscal rules applied to the general government.[6] The Council for Budgetary Responsibility (CBR; national fiscal council) also issued an ex-ante positive opinion on adhererence of the budget to the national fiscal rules. The CBR publishes annually in August a report on compliance with the national fiscal rules. Slovakia considers the Stability Progamme to be the national medium-term fiscal plan (NMTFP) pursuant to 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, however, neither part of the Stability Programme nor the National Reform Plan.

The macroeconomic forecast underlying the stability programme was published by the Institute for Financial Policy (IFP) of the Ministry of Finance in February 2017. The Macroeconomic Forecasting Committee (MFC) endorsed it as realistic at a meeting held on 1 February 2017, 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 from the government's influence.[7]

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5 Corrective measures in the context of the national debt brake rule start applying when the debt threshold of 50% of GDP is exceeded.

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

7 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

There have been no major changes in terms of medium-term budgeting, which remains weak in so far as the final years of the multi-annual budget are only indicative and the binding expenditure ceilings that were envisaged by the constitutional law of 2011 have so far not been adopted. However, there appear to be several positive developments that should increase transparency of the budgeting process. The government seems to resort to fewer expenditure reserves, which were part of past budgets and impacted transparency of the budgetary process and the use of resources, and which weakened the role of some corrective measures under the debt brake.[8] The new legislation should eliminate extra-budgetary accounting that was reducing the overall transparency of the budgetary process. Finally, any ad-hoc increases of tax revenues estimates during the Parliamentary discussion of the budget would need to be ex post approved by the Tax Revenue Committee.[9]

In 2016 a first batch of spending reviews in the context of the 'Value for Money' project focusing on healthcare, transport and IT spending, was delivered. Although the level of ambition appears to vary across reports, reflecting different degrees of ownership by the associated ministries, the project makes a valuable contribution by providing data-based analytical underpinnings for identifying spending inefficiencies in the areas reviewed. In 2017, spending reviews plan to cover environmental policies, labour market and social policies, and education.

7. SUMMARY

In 2016, Slovakia's headline deficit declined to 1.7 % of GDP. An improvement of 0.8 % of GDP in the structural balance met the required adjustment towards the MTO. The growth rate of government expenditure, net of discretionary revenue measures and one-offs, also respected the applicable expenditure benchmark rate. Nevertheless, over 2015-2016 taken together, the expenditure benchmark pillar points to some deviation. An overall assessment, taking the expenditure benchmark as a leading indicator, thus points to some deviation from the recommended adjustment path towards the MTO in 2016.

Slovakia plans an improvement of the structural balance of 0.3 % of GDP in 2017 and 0.6 % of GDP in 2018, when it plans to reach the MTO. This path suggests a deviation of 0.2 % of GDP from the required adjustment path towards the MTO in 2017, implying a risk of some deviation. In 2018, on the other hand, the planned progress towards the MTO appears appropriate according to the authorities' plans. However, the Commission 2017 spring forecast points to a risk of some deviation in 2017, and an overall assessment suggests a risk of significant deviation in 2018.

"optimistic". The draft forecast is accepted by the MFC if the majority of voting members assesses the forecast as "conservative" or "realistic".

[8] For example, when the debt level exceeds 55 % 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.

[9] The Tax Revenue Committee is an equivalent of the Macroeconomic Forecasting Committee, focussing on approval of the tax revenue projections of the Ministry of Finance.

8. ANNEX

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	2.9	7.4	1.1	2.6	3.8	3.3	3.0	3.6
Output gap [1]	-2.6	3.2	-1.7	-2.3	-1.2	-0.3	0.2	0.8
HICP (annual % change)	8.3	4.1	2.2	-0.1	-0.3	-0.5	1.4	1.6
Domestic demand (annual % change) [2]	1.4	6.8	-1.1	3.2	4.7	0.9	2.9	3.3
Unemployment rate (% of labour force) [3]	18.3	13.8	13.7	13.2	11.5	9.7	8.6	7.6
Gross fixed capital formation (% of GDP)	28.6	26.4	22.0	20.4	23.0	20.2	19.8	20.2
Gross national saving (% of GDP)	23.5	21.5	20.1	22.3	23.3	22.3	22.2	22.7
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-7.3**	**-2.6**	**-5.3**	**-2.7**	**-2.7**	**-1.7**	**-1.3**	**-0.6**
Gross debt	**45.9**	**32.9**	**45.6**	**53.6**	**52.5**	**51.9**	**51.5**	**49.8**
Net financial assets	**-5.4**	**-11.7**	**-29.4**	**-35.5**	**-35.1**	**n.a**	**n.a**	**n.a**
Total revenue	38.6	35.3	36.5	39.3	42.8	40.0	40.3	40.8
Total expenditure	45.9	37.9	41.8	42.0	45.6	41.6	41.6	41.3
of which: Interest	3.4	1.6	1.6	1.9	1.8	1.7	1.4	1.3
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**1.1**	**-2.7**	**4.8**	**4.3**	**4.0**	**1.4**	**1.2**	**1.1**
Net financial assets; non-financial corporations	**-66.0**	**-59.5**	**-63.2**	**-70.3**	**-67.8**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-8.1**	**-2.1**	**-1.1**	**-1.6**	**0.8**	**n.a**	**n.a**	**n.a**
Gross capital formation	19.1	19.6	13.9	13.3	12.5	14.4	14.6	15.0
Gross operating surplus	24.8	27.3	26.2	25.6	25.2	25.0	24.9	25.3
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**0.1**	**-1.5**	**-0.4**	**0.0**	**1.0**	**1.7**	**1.6**	**1.9**
Net financial assets	**48.4**	**31.7**	**37.0**	**39.6**	**40.7**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	31.4	30.1	30.4	30.4	31.0	31.9	32.5	32.8
Net property income	3.9	1.4	0.9	1.0	0.6	0.7	0.6	0.6
Current transfers received	16.8	16.3	18.5	18.5	18.9	19.0	19.2	19.0
Gross saving	5.9	3.8	4.2	4.3	5.3	5.5	5.3	5.4
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-6.0**	**-6.8**	**-0.9**	**1.6**	**2.2**	**0.7**	**1.0**	**1.9**
Net financial assets	**31.1**	**41.6**	**56.8**	**67.7**	**61.5**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-4.8	-3.1	0.8	3.6	2.4	3.7	3.2	3.4
Net primary income from the rest of the world	-1.3	-2.9	-1.9	-1.8	-1.6	-1.5	-1.5	-1.4
Net capital transactions	-0.5	0.3	1.4	1.0	2.1	0.5	0.9	1.5
Tradable sector	53.5	53.6	49.9	51.3	50.9	51.1	n.a	n.a
Non tradable sector	36.5	36.2	41.0	39.3	39.3	38.9	n.a	n.a
of which: Building and construction sector	6.1	6.8	8.1	7.0	7.1	6.8	n.a	n.a
Real effective exchange rate (index, 2000=100)	63.4	82.8	100.1	98.8	98.0	98.3	99.0	99.5
Terms of trade goods and services (index, 2000=100)	106.6	104.4	98.8	97.0	96.8	96.4	95.7	95.8
Market performance of exports (index, 2000=100)	65.2	93.2	108.0	119.0	120.1	120.7	122.7	125.2

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 2017 spring forecast