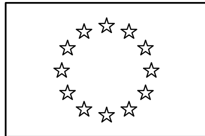

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.10.2009
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REPORT FROM THE COMMISSION

Slovakia

Report prepared in accordance with Article 104(3) of the Treaty

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn has brought about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Slovakia and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a

[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State". This article further specifies that the Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State.

Since the start of stage III of economic and monetary union, an EDP for Slovakia was initiated in May 2004 by the Commission with the adoption of a report under Article 104(3) in view of a deficit of 3.6%[2] of GDP in 2003, i.e. above the reference value. The Council decided in June 2004 in accordance with Article 104(6) that an excessive deficit existed and addressed a recommendation to Slovakia in line with Article 104(7) with a view to bringing the deficit below 3% of GDP by 2007 at latest. On 3 June 2008, following an overall assessment which showed that the correction of the excessive deficit situation in Slovakia was completed in 2007, the Council issued a decision under Article 104(12) abrogating Decision 2005/182/EC on the existence of an excessive deficit[3].

In April 2009, Slovak authorities notified a planned deficit of 3.0% of GDP for 2009[4] However, according to the Commission services' spring 2009 forecasts, the general government deficit in Slovakia is expected to reach 4.7% of GDP in 2009, thus exceeding the 3% of GDP reference value. In a letter to the Commission from 25 August 2009, the Slovak authorities confirmed the deterioration of the general government deficit to over 6% of GDP in 2009. According to the 2009 revised budget, the general government deficit will reach 6.3% of GDP in 2009. The general government gross debt would be 32.2% of GDP in 2009, according to the Commission services' spring 2009 forecasts, significantly below the 60% of GDP reference value.

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[2] The general government deficit was subsequently revised downwards in the April 2007 notification due to a data revision resulting from a change in the accrualization method for tax revenue.

[3] http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm

[4] According to Council Regulation (EC) No 479/2009 (previously Council Regulation (EC) No 3605/93), Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of the Slovak Republic can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

Table 1: General government deficit and debt [a]

	2003	2004	2005	2006	2007	2008	2009		2010
							COM	SK[b]	
General government balance	-2.8	-2.4	-2.8	-3.5	-1.9	-2.2	-4.7	-3.0	-5.4
General government gross debt	42.4	41.4	34.2	30.4	29.4	27.6	32.2	31.4	36.3

Note:
[a] In percent of GDP.
[b] April 2009 EDP notification
Source: Eurostat, Commission services' spring 2009 forecasts and April 2009 EDP notification.

The projected figure for the 2009 deficit provides *prima facie* evidence on the risk of an excessive deficit in Slovakia in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Slovakia with the adoption of this report. Section 3 of the report examines the deficit criterion and Section the debt criterion. Section 5 deals with public investment and other relevant factors. The document takes into account the Commission services' spring 2009 forecast, released on 3 May, and their evaluation of subsequent developments.

3. DEFICIT CRITERION

In 2009, according to the authorities' April 2009 EDP notification the general government deficit is planned to reach 3% of GDP. However, based on a significantly worse economic outlook than that assumed in the April EDP notification, the Commission services' spring 2009 forecast projects the general government deficit in Slovakia to reach 4.7% of GDP in 2009. The authorities confirmed the deterioration in the economic and budgetary outlook in a letter to the Commission and more recently in the revised 2009 budget[5] (published on 30 September 2009) according to which the deficit is to reach 6.3% of GDP in 2009.

Well in excess of 3% of GDP, the forecasted deficit is not close to the Treaty reference value.

The projected excess over the 3% of GDP reference value can be regarded as exceptional. In particular, it results, among other things, from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission services' 2009 spring forecast projected real GDP to contract by 2.6% in 2009 after increases of 10.4% and 6.4% in 2007 and 2008, respectively. Since the finalization of this forecast, the economic situation has worsened further and in June the Slovak authorities revised their real GDP growth forecast for 2009 from 2.4% (forecast of the April 2009 stability programme) to -6.2%. The most recent macroeconomic forecast of the Slovak authorities, which was used for the 2009 budget revision of end-September 2009, projects a contraction of 5.7% in 2009. While the headline general government deficit has declined since 2005, when the economy experienced very strong growth, the structural balance has deteriorated over the same period.

[5] http://www.rokovania.sk/appl/material.nsf/0/7F8F73C01D5CF914C125764000468F21?OpenDocument.

Table 2: Macroeconomic and budgetary developments [a]

	2003	2004	2005	2006	2007	2008	2009		2010	
							COM[c]	SK[d]	COM[c]	SK[e]
Real GDP (% change)	4.7	5.2	6.5	8.5	10.4	6.4	-2.6	-5.7	0.7	1.9
Potential GDP (% change)	4.1	4.8	5.6	5.8	5.6	4.9	4.4		3.9	
Output gap (% of potential GDP)	-1.9	-1.6	-0.7	1.8	6.5	8.0	0.9		-2.2	
General government balance	-2.8	-2.4	-2.8	-3.5	-1.9	-2.2	-4.7	-6.3	-5.4	-5.5
Primary balance	-0.3	-0.2	-1.1	-2.0	-0.5	-0.9	-3.3		-4.0	
One-off and other temporary measures	-0.4	0.0	-0.8	-0.3	0.0	0.2	0.1		0.0	
Gov't gross fixed capital formation	2.6	2.4	2.1	2.2	1.9	1.8	2.0		2.1	
Cyclically-adjusted balance	-2.2	-1.9	-2.6	-4.0	-3.8	-4.5	-4.9		-4.7	
Cyclically-adjusted primary balance	0.3	0.3	-0.9	-2.5	-2.4	-3.3	-3.6		-3.3	
Structural balance [b]	-1.9	-1.9	-1.8	-3.7	-3.8	-4.7	-5.0		-4.7	
Structural primary balance	0.7	0.3	-0.1	-2.3	-2.4	-3.5	-3.7		-3.3	

Notes:
[a] In percent of GDP unless specified otherwise.
[b] Cyclically-adjusted balance excluding one-off and other temporary measures.
[c] Commission services' spring 2009 forecasts.
[d] September 2009 update of macroeconomic forecasts – Ministry of finance of the SR and the revised budget for 2009.
[e] Draft budget for 2010-2012.
Source: *Eurostat, Commission services' spring 2009 forecasts and national sources.*

The projected excess over the 3% of GDP reference value is not temporary in the sense of the Treaty and the Stability and Growth Pact. The Commission services' 2009 spring forecast projects a widening of the general government deficit to 5.4% of GDP in 2010 based on the no-policy change assumption. This assumption takes into account that according to current government plans, only part of the measures of extraordinary nature linked to the crisis will be rolled back in 2010. Based on the draft budget for 2010-2012[6], the government expects the general government deficit to reach 5.5% of GDP in 2010.

In sum, the projected deficit is not close to the 3% of GDP reference value and the projected excess over the reference value is exceptional but not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that there is a high risk that the deficit criterion in the Treaty is not fulfilled.

4. DEBT CRITERION

The general government debt ratio has declined by over 14 percentage points of GDP since 2003. It reached 27.6% of GDP in 2008, clearly below the 60% of GDP reference value. However, according to the Commission's spring 2009 forecast, it is set to increase rapidly in 2009 and 2010, reaching 36.3% of GDP in 2010. This increase would reflect the higher headline deficit and the sharp decline in economic activity. Based on the draft budget for 2010-2012, the government expects the general government debt ratio to reach 40.8% of GDP in 2010.

[6] The draft budget for 2010-2012 was prepared on the basis of the most recent September 2009 macroeconomic forecast and it takes into account the revision of the 2009 budget.

5. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration. Finally, Article 2(5) of the Regulation provides that the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar should be considered in all assessments in the framework of the excessive deficit procedure. In 2005, Slovakia has adopted such a reform, which has already been fully implemented.

In view of the above provisions, the following five subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; and (4) other factors considered relevant by the Commission; and (5) pension reforms as mentioned above.

5.1. Medium-term economic position

Cyclical conditions and potential growth. Over the five years to 2008, real GDP growth averaged 7.4% in Slovakia, and the unemployment rate decreased from 18.2% to 9.5%. This impressive growth performance was supported by sound macroeconomic and structural policies. However, from the second half of 2008 Slovakia has been severely affected by the global financial crisis and the very sharp slowdown of external demand. Following a deep recession in 2009, the economy is expected to experience a gradual recovery in 2010 and the following years. Potential output growth is expected to slow, at least temporarily, to 4.4% in 2009 and 3.9% in 2010, reflecting the slower capital accumulation after the large drop of investment during the crisis. According to Commission services' calculations, the sharp recession would bring the economy at a level more in line with its potential in 2009, and the output gap would turn negative in 2010.

Recent structural reforms. After a period of ambitious structural reforms which put Slovakia on a fast growth track, the pace of reforms has slowed since 2006. In 2008, the government introduced an employee tax credit, which supplements the existing tax-free allowance, in order to stimulate labour demand at the low end of the wage scale. However, slower-than-envisaged progress has been made with respect to a much needed reform of the social contributions system, which remains characterised by high contribution rates and overall inefficiency. At some 0.5% of GDP, R&D investment in Slovakia is among the lowest in the EU. To address this problem, the government introduced, as part of its anti-crisis package, schemes to support R&D activities carried out by businesses.

5.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Over the good times period 2006-2008 (positive and increasing output gap), the fiscal policy stance has been clearly procyclical - the structural deficit increased by some 3 percentage points of GDP over the period - which has contributed to the overheating of the economy and to a worsening of the underlying position of government finances. In 2008, the structural deficit reached 4.7% of GDP, well

above the agreed medium-term objective of -1% of GDP[7]. Good economic times were thus not exploited to make progress with fiscal consolidation. Under unchanged policies, the Commission services' 2009 spring forecast projects a stabilization of the structural deficit in 2009 and 2010.

Public investment. The general government deficit ratio has exceeded the government investment-to-GDP ratio since 2005. Moreover, while government investment (as a share of GDP) has remained constant around 2% of GDP over 2005-09, the deficit increased by some 2 percentage points of GDP over the same period to reach an estimated 4.7% of GDP in 2009 according to the Commission services' spring forecast. The government investment-to-GDP ratio has also been significantly below the structural deficit since 2006. According to the Commission services' forecasts, the general government and structural deficits will continue to exceed public investment in 2010.

Quality of public finances. General government expenditure has decreased from close to 38% of GDP in 2004 to about 35% in 2008. This decline was driven by a significant reduction of current expenditure, notably compensation of employees and interest payments. At the same time, it appears that Slovakia's growth-enhancing spending such as education is markedly lower than in other countries. Health expenditure has been increased from just below 3% of GDP in 2003 to about 6.5% of GDP in 2007 and is envisaged to remain at levels above 6% of GDP for the foreseeable future. In its April 2007 stability programme, the government stated its intention to strengthen the quality of public finances. Greater emphasis is to be put on education, science, healthcare and infrastructure. The revenue ratio has also been on a downward path over 2004-2008, with a decline by roughly 2½ percentage points to 32.7%, reflecting lower revenue from indirect taxes and social contributions following the 2004 tax reform.

Fiscal institutions in Slovakia are rather strong, with the budget process being guided by a three-year rolling budgetary framework. However, there is room for improvement as under the current set-up, there are no binding expenditure ceilings. This has allowed the authorities to increase expenditure targets in response to cyclical revenue windfalls, which has resulted in a weakening of the underlying fiscal balance in Slovakia. While the Council has invited Slovakia in its recommendations on convergence programmes to introduce stronger budgetary rules, no action has been taken by Slovak authorities until now.

Long-term sustainability of public finances. In its opinion of 7 July 2009 on the April 2009 stability programme, the Council assessed the long-term sustainability of Slovakia's public finances. In particular, the Council was of the opinion that the long-term budgetary impact of ageing is slightly higher than the EU average, mainly due to a relatively high increase in pension expenditure during the coming decades. The budgetary position in 2008, as estimated in the programme, though improved from the estimated starting position of the previous programme, compounds the budgetary impact of population ageing on the sustainability gap. Achieving higher primary surpluses over the medium term, as foreseen in the programme, would contribute to reducing the medium risks to the sustainability of public finances.[8] The

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[7] The April 2009 stability programme of Slovakia does not explicitly specify the MTO. Nevertheless, it postpones achievement of the MTO which was defined in November 2007 convergence programme as a structural deficit (i.e. cyclically adjusted deficit net of one-off measures) of 1% of GDP by 2010 for the period after the programme horizon, i.e. after 2011.

[8] Since the submission of the stability programme, risks to the long-term sustainability may have changed in view of the worsened economic and budgetary situation. The new assessment will be

Council invited the authorities to continue reforming the PAYG pillar of the pension system and avoid undermining the stability of the fully-funded pension pillar.

5.3. Other factors put forward by the Member State

In a letter of 25 August 2009, the authorities of Slovakia listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above and below already covers most of the items put forward by the authorities. The remaining items on their list, and their relevance for the purpose of this report, are as follows.

In their letter, the Slovak authorities stress the very severe contraction of GDP in the first quarter of 2009 — -11.4% on a quarter on quarter basis, the largest in the EU. The authorities also state that the government deficit may be in excess of 6% of GDP in 2009, with 2.3 percentage points of the planned deficit to be attributed to cyclical developments. The authorities explain that the deficit also reflects the implementation of temporary fiscal measures and their decision to allow automatic stabilizers to operate freely in line with the European Economy Recovery Plan recommendations.

The Slovak government intends to spend some 0.5% of GDP on anti-crisis measures in 2009 and about the same amount in 2010 focusing mainly on boosting aggregate demand. The majority of these measures are of a temporary nature and in 2009 they should not influence the general government deficit as they constitute reallocations within the current budget. Given the limited fiscal space due to external imbalances, the fiscal stimulus package for 2009 and 2010 adopted by Slovakia appears to be an adequate response to the economic downturn. The adopted measures are in line with the EERP as they are targeted on disadvantaged groups and in most cases temporary.

5.4. Other factors considered relevant by the Commission

The Slovak government took several stimulus measures in order to counter the adverse impact of the crisis. The stimulus packages included measures targeted at specific sectors or disadvantaged groups as well as measures encouraging employment, providing temporary tax relief, stimulating R&D and energy efficiency investment. Measures included an increase in the basic tax allowance on personal income tax and employee tax credit, lower social contributions for mandatorily ensured self-employed, subsidies to create employment, a car scrapping scheme, and subsidies and tax reliefs to finance R&D activities in the private sector. Whereas the stimulus measures are not expected to have an impact on the government deficit as they will be covered by a reallocation of resources within the budget, the impact of automatic stabilisers on the deterioration of the budget balance is estimated at around 2.2% of GDP based on the Commission services' spring 2009 forecast.

In response to the financial crisis, the Slovak authorities introduced a full guarantee for deposits, thereby abandoning previous limits. This may have an impact on the government finances if the guarantees are called in. The Slovak authorities increased capital in the Slovak Guarantee and Development Bank and Eximbanka and opened a credit line with the European Investment Bank, which amounted to less than 0.2% of GDP.A Memorandum on cooperation and exchange of information for cofinancing of SMEs was signed between the Ministry of Finance, the Slovak Bank Association, Eximbanka and the Slovak Guarantee and

published in the upcoming report on the long-term sustainability of public finances in the European Union.

Development Bank with the aim of providing bank guarantees for loans issued by commercial banks to SMEs.

In its opinion on the most recent update of the stability programme, the Council considered that the macroeconomic scenario of the programme was overly optimistic and that the budgetary targets were subject to downside risks. The safety margin against breaching 3% of GDP reference value was not to be respected over the whole programme period. The Council invited Slovakia to (i) implement the anti-crisis measures in line with the EERP as planned and within the framework of the SGP; (ii) ensure consolidation starting in 2010 and support the strategy with specific measures and legally binding budgetary ceilings; and (iii) continue reforming the PAYG pension pillar and avoid undermining the stability of the fully-funded pension pillar in view of the long-term sustainability of public finance.

5.5. Systemic pension reforms

In 2005, Slovakia implemented a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar and increased the retirement age to 62 years with an envisaged further increase to 65. The new system consists of the PAYG (1st) pension pillar and of a fully-funded (2nd) pension pillar. The original 18% contribution of the gross salary which was channelled entirely to the PAYG pillar before the reform was divided into two equal parts, with one part being now directed to the private funds managed by pension fund companies. Whereas labour market participants entering the labour market before June 2006 could decide whether to participate in a private pension scheme or not, the scheme became mandatory for those entering afterwards. Nevertheless, since 2008 the fully-funded pillar has again become optional for the new labour market participants. However, on two occasions between January 2008 and June 2009 the government granted the pension savers an option to switch freely between the two pillars by 'opening' the fully-funded pension pillar. At the same time, the period after which a person would be entitled to pension benefits from the fully-funded pension pillar was extended from 10 to 15 years. While the opening of the fully-funded pension scheme may have a positive effect on government revenue in the short run, it might pose challenges for its long-term sustainability. In 2008, the Slovak authorities estimate the costs of the introduction of the fully-funded pension pillar at 1.3% of GDP with a small reduction in 2009 to 1.1% of GDP. However, according to the (EC) No 1467/97 Article 2(7), the implementation costs of a pension reform are to be considered only in cases where the deficit exceeds the reference value, while remaining close to it. Given the size of the forecasted excess over the reference value, this rule is not applicable to Slovakia.

Table 3: Illustration of the impact of the net cost of pension system reform in Slovakia

	2005	2006	2007	2008	2009	2010	2011	2012
Government balance*	-2.8	-3.5	-1.9	-2.2	-4.7	-5.4	--	--
Cost of pension reform (total)**	0.6	1.2	1.3	1.3	1.1	1.1	1.1	1.2
Cost (state 1)	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Cost (state 2)	--	0.6	0.6	0.6	0.5	0.5	0.5	0.6
Cost (state 3)	--	--	0.1	0.1	0	0	0	0
Degressive scale (stage 1)	100%	80%	60%	40%	20%	0%	0%	0%
Degressive scale (stage 2)	--	100%	80%	60%	40%	20%	0%	0%
Degressive scale (stage 3)	--	--	100%	80%	60%	40%	20%	0%
Cost to be considered (stage 1)	0.60	0.96	0.78	0.52	0.22	0.00	0.00	0.00
Cost to be considered (stage 2)	--	0.60	0.48	0.36	0.24	0.12	0.00	0.00
Cost to be considered (stage 3)	--	--	0.60	0.48	0.30	0.20	0.10	0.00
Cost to be considered (total)	0.60	1.56	1.86	1.36	0.76	0.32	0.10	0.00
Adjusted government balance ***	-2.21	-1.89	0.00	-0.83	-3.91	-5.04	--	--

* According to the Commission services' spring 2009 forecast
** Convergence programmes updates and April 2009 stability programme
*** Government balance adjusted for the costs of the pension reform to be considered
Source: Commission services

6. CONCLUSIONS

The general government deficit in Slovakia is projected by the Commission services to reach 4.7% of GDP in 2009, above and not close to the 3% of GDP reference value. The assessment is supported by a letter of the Slovak authorities from 25 August 2009 in which they expect the general government deficit to exceed 6% of GDP in 2009. The projected excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact but it can not be considered temporary. While it mainly reflects the severity of the economic downturn, it also results from the significant deterioration of the structural balance since 2005. These elements suggest that there is a high risk that the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains well below the 60% of GDP reference value.

In line with the Treaty, this report has also examined “relevant factors”, which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case on balance seem to present a mixed picture.

The existence of a severe economic downturn, with public finance implications, increases the need to undertake enhanced surveillance under the EDP.