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Analysis of the Draft Budgetary Plan of Slovakia

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Slovakia

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1. INTRODUCTION

Slovakia submitted its Draft Budgetary Plan for 2020 on 14 October in compliance with Regulation (EU) No 473/2013. Slovakia is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its medium term budgetary objective.

Some information is missing in the submitted tables compared to the formal requirements of the Code of Conduct (mainly data in tables 1a[1], 2c[2], 3[3], 5b, 5c[4] and 7[5]).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 autumn forecast. Section 3 presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2019 autumn forecast. In particular, it includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2019-2020 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in July 2019 in the context of the European Semester, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Slovakia's economy recorded robust growth of 4.0% in 2018 on the back of strong household spending and investment. Domestic demand was supported by strong employment growth and robust increases in real wages, as well as the construction of a new car factory.

According to the Draft Budgetary Plan, economic growth is set to slow markedly to 2.4% in 2019 and to 2.3% in 2020. Final domestic demand is forecast to be the main driver of growth contributing 1.8 percentage points in 2019 and 2.1 percentage points in 2020 (see Table 1). The net inventories contribution is 1.0 percentage point in 2019 and -1.3 percentage points in 2020. The net trade contribution is -0.2 percentage points in 2019 and 1.5 percentage points in 2020. Employment growth is forecast to slow to 1.2% in 2019 and to 0.2% in 2020, while unemployment is projected to fall to 5.8 per cent in 2019 and remain stable in 2020. Inflation is expected to reach 2.5% in 2019 and 2.1% in 2020.

The macroeconomic scenario in the Draft Budgetary Plan constitutes a downward revision of 1.6 percentage points of projected 2019 GDP growth and of 1.4 percentage points of projected 2020 GDP growth compared to the Stability Programme of Spring 2019. For 2019, this largely reflects surprisingly weak private consumption in the first quarter and weak trade in

[1] Final domestic demand; external balance of goods and services; change in inventories; contributions to potential GDP - all for 2018

[2] Estimates of contingent liabilities in 2019 and 2020

[3] Projections under the no-policy change scenario for year 2019 – due to a different national methodology

[4] Details on discretionary measures taken by general government subsectors

[5] The divergence from the latest Stability Programme

the second quarter of this year, partially offset by the building up of inventories. For 2020, the revision is mainly due to lower expected private consumption following lower growth of employment and compensation per employee, as well as changes in inventories lowering growth.

The macroeconomic scenario underlying the Draft Budgetary Plan is broadly in line with the Commission 2019 autumn forecast for 2019. For 2020, it is broadly in line as regards real GDP growth and final domestic demand. Nevertheless, the Draft Budgetary Plan assumes real GDP growth 0.3 percentage points below the Commission 2019 autumn forecast for both 2019 and 2020. For 2019, this mainly stems from small differences in net exports and inventories, while the contribution of final domestic demand is equal. For 2020, final demand provides a somewhat higher contribution to growth in the Commission 2019 autumn forecast (by 0.4 percentage points). The latter is largely explained by higher expected growth in private consumption, in line with higher expected growth in compensation of employees by the Commission.

Table 1. Comparison of macroeconomic developments and forecasts

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4.0	4.0	2.4	2.7	3.7	2.3	2.6
Private consumption (% change)	3.9	3.3	1.7	1.8	2.9	2.1	2.4
Gross fixed capital formation (% change)	3.7	1.9	1.9	1.0	2.9	3.6	2.6
Exports of goods and services (% change)	5.4	6.9	2.8	1.2	6.1	5.3	3.8
Imports of goods and services (% change)	5.0	5.9	3.2	1.6	5.3	4.1	3.8
Contributions to real GDP growth:							
- Final domestic demand	3.0	2.5	1.8	1.8	2.4	2.1	2.5
- Change in inventories	0.5	0.1	1.0	1.3	0.0	-1.3	0.0
- Net exports	0.5	1.5	-0.2	-0.4	1.3	1.5	0.1
Output gap[1]	1.7	1.8	1.9	1.8	1.9	1.7	1.6
Employment (% change)	2.0	1.1	1.2	0.8	0.8	0.2	0.2
Unemployment rate (%)	6.5	6.0	5.8	5.8	5.6	5.8	5.7
Labour productivity (% change)	2.0	2.9	1.2	1.8	2.9	2.0	2.4
HICP inflation (%)	2.5	2.6	2.5	2.7	2.4	2.1	2.5
GDP deflator (% change)	2.0	2.6	2.4	2.4	2.4	1.9	2.3
Comp. of employees (per head, % change)	5.6	6.7	6.5	7.1	6.3	4.6	5.4
Net lending/borrowing vis-à-vis the rest of	-1.3	-0.4	-1.4	-2.1	0.1	-0.6	-2.4

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

For 2020, the macroeconomic scenario underlying the Draft Budgetary Plan is based on more favourable net exports assumptions compared to the Commission 2019 autumn forecast, while it is based on a more cautious outlook for changes in inventories. These differences may be, in part, due to different technical assumptions in relation to changes in inventories. Given weak foreign demand, the Commission 2019 autumn forecast assumes a weaker recovery of net

exports. Nevertheless, the different assumptions largely offset each other as regards overall real GDP growth.

The output gap, as recalculated by the Commission based on the information in the Stability Programme, and following the commonly agreed methodology, is 0.1 percentage points above the estimates in the Commission 2019 autumn forecast in both 2019 and 2020. Both the Draft Budgetary Plan and the Commission estimate the output gap to be in positive territory but to narrow in 2020, reflecting the somewhat slower economic expansion.

Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan appear to be broadly plausible.

Box 1: The macro economic forecast underpinning the budget in Slovakia

Slovakia's Draft Budgetary Plan is based on the macroeconomic forecast published by the Institute for Financial Policy (IFP) of the Ministry of Finance in September and endorsed by the Macroeconomic Forecasting Committee (MFC). According to the statutes, in its deliberations the MFC is independent and free from the government's influence. The MFC consists of a chairman (the Director of the IFP) and members from eight independent institutions entitled to vote (the Central Bank, the Academy of Science, the Institute of Informatics and Statistics and five commercial banks). There are three other members of the MFC who are in the role of observers 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".

According to the minutes published on the website of the IFP, the macroeconomic forecast underpinning the Draft Budgetary Plan was deemed "realistic" by the four members of the MFC voting at the meeting held on 11 September 2019.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The Draft Budgetary Plan targets a general government deficit of 0.7% of GDP in 2019, some 0.7 percentage points higher than that presented in the spring 2019 Stability Programme, when the headline deficit was projected to be in balance (0.0% of GDP; see Table 2). The downward revision reflects stronger than initially expected expenditure, driven mainly by the strong growth of social payments, intermediate consumption, investment and the wage bill. The other expenditure categories are still expected to develop in line with the assumption presented in the Stability Programme. On the revenue side, all revenue categories are expected to perform better than projected in the Stability Programme. The tax collection is boosted by robust growth of value added tax and strong labour market developments affecting social contributions and personal income tax. Non-tax revenues are also broadly in line with the Stability Programme projection. Nevertheless, the projected solid revenue growth is not sufficient to compensate the strong acceleration in the expenditure growth.

The Commission 2019 autumn forecast projects a slightly higher 2019 deficit of 0.9% of GDP. Similar to the Draft Budgetary Plan, the Commission 2019 autumn forecast expects both higher revenue and expenditure. A substantial part of the difference in the ratios of total

revenue and expenditure to GDP between the two documents can be explained by a methodological adjustment based on the benchmark revision in national accounts affecting the level of taxes on production, on the revenue side, and the level of subsidies, on the expenditure side. In the Commission 2019 autumn forecast, higher expenditure on wages and investment is expected, attributed to a higher expected drawdown rate of EU funds impacting both current and capital transfers on the revenue side of the budget. Higher investment is partly compensated by lower levels of intermediate consumption in the Commission forecast.

The Draft Budgetary Plan also increases the headline deficit for 2020 by 0.5 percentage points when compared to the Stability Programme. The Draft Budgetary Plan presents improved projections for taxes on production and social contributions, despite the revised lower expected private consumption, which will be used to finance the increase in compensation of employees, intermediate consumption and social payments. The Draft Budgetary Plan projects a sharp drop in gross fixed capital formation in 2020, compared to the Stability Programme reflecting inter alia the authorities' assumption of a slow drawdown of EU funds and commensurately lower level of national financing. Therefore, the general government deficit in 2020 appears to be mainly driven by expenditure growth outstripping the rate of revenue increase.

The Commission 2019 autumn forecast projects a deficit of 1.2% for 2020, i.e. 0.7 percentage points of GDP higher than in the Draft Budgetary Plan. The Commission projects higher revenues from taxes on production (due to the methodological adjustment discussed above) and social contributions. Furthermore, it expects a higher drawdown of EU funds. On the expenditure side, the Commission forecast assumes faster growth in the wage bill, social benefits, as well as higher gross fixed capital formation, partly due to an assumed gradual acceleration of EU funds absorption, in contrast with the authorities' assumption.

Both the expected deficit in 2019 and the projected outcome in 2020 could be affected by implementation risks in view of upcoming elections to the Parliament, which will take place at the end of February 2020.

The fiscal strategy for 2020 presented in the Draft Budgetary Plan should allow for a change in the structural balance of 0.7 percentage points of GDP between 2018 and 2020. Targets set in the Stability Programme for both 2019 and 2020 were more ambitious than those submitted in the Draft Budgetary Plan. Differences can be mainly attributed to additionally agreed discretionary expenditure measures, because revenue-to-GDP ratios grew less (by 1.1 and 1.2 percentage points of GDP respectively in 2019 and 2020) than spending ratios (in both years by 1.7 percentage points of GDP). This could be interpreted as higher-than-expected revenues not being used for fiscal consolidation purposes, but instead for financing higher expenditure levels. The Commission forecast expects a higher structural deficit by 0.2 percentage points of GDP in 2019 and by 0.7 percentage points of GDP in 2020 compared to the Draft Budgetary Plan. These differences are due to both different assumptions on the development of revenues and expenditures, and due to slightly different estimates of the output gap. The assessment of compliance with the required structural adjustment follows in Section 4.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Slovakia currently standing at 0.06[6]. As a consequence, total interest payments by the general

[6] 10-year bond yields as of 28 October 2019. Source: Bloomberg.

government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Slovakia is expected to fall from 1.2% of GDP in 2019 to 1.1% in 2020 and is projected to decrease further in 2021, to 1.0% of GDP, well below the 1.8% recorded in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Slovakia´s Plan is confirmed by the Commission forecast.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2018		2019			2020			Change: 2018-2020
	COM	DBP	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**40.8**	**40.8**	**39.1**	***40.1***	**40.8**	**38.4**	***39.6***	**40.7**	**-1.2**
of which:									
- Taxes on production and imports	11.9	11.9	11.0	*11.4*	11.8	10.9	*11.7*	12.1	-0.2
- Current taxes on income, wealth,	7.3	7.3	7.3	*7.4*	7.3	7.3	*7.1*	7.1	-0.2
- Capital taxes	0.0	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	15.0	15.0	14.7	*15.1*	15.2	14.4	*15.1*	15.2	0.1
- Other (residual)	6.6	6.6	6.1	*6.2*	6.4	5.8	*5.7*	6.4	-0.9
Expenditure	**41.8**	**41.8**	**39.1**	**40.8**	**41.8**	**38.4**	**40.1**	**41.8**	**-1.7**
of which:									
- Primary expenditure	40.5	40.5	37.9	39.6	40.5	37.4	39.0	40.7	-1.5
of which:									
Compensation of employees	9.3	9.3	9.4	9.5	9.7	9.5	9.9	10.0	0.6
Intermediate consumption	5.5	5.5	5.5	5.9	5.4	5.0	5.5	5.3	0.0
Social payments	18.2	18.2	17.7	18.7	18.6	17.1	18.7	18.8	0.5
Subsidies	1.2	1.2	0.5	0.5	1.1	0.5	0.5	1.0	-0.7
Gross fixed capital formation	3.7	3.7	2.7	2.9	3.4	2.7	1.9	3.0	-1.8
Other (residual)	2.5	2.5	2.1	2.1	2.4	2.6	2.5	2.5	0.0
- Interest expenditure	1.3	1.3	1.2	1.2	1.2	1.1	1.1	1.1	-0.2
General government balance (GGB)	**-1.1**	**-1.1**	**0.0**	**-0.7**	**-0.9**	**0.0**	**-0.5**	**-1.2**	**0.6**
Primary balance	**0.3**	**0.3**	**1.2**	**0.5**	**0.3**	**1.1**	**0.6**	**0.0**	**0.3**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-1.1**	**-1.1**	**0.0**	**-0.7**	**-0.9**	**0.0**	**-0.5**	**-1.2**	**0.6**
Output gap[1]	1.7	2.0	1.8	1.9	1.8	1.9	1.7	1.6	-0.3
Cyclically-adjusted balance[1]	-1.7	-1.8	-0.7	-1.4	-1.6	-0.7	-1.1	-1.8	0.7
Structural balance (SB)[2]	**-1.7**	**-1.8**	**-0.7**	**-1.4**	**-1.6**	**-0.7**	**-1.1**	**-1.8**	**0.7**
Structural primary balance[2]	-0.4	-0.5	0.5	-0.2	-0.4	0.3	0.0	-0.6	0.4

Notes:

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

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

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

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 – this target is lower than Slovakia´s medium term budgetary objective in 2020 (-1% of GDP). Based on the information in the Draft Budgetary Plan, the structural balance[7], as recalculated by the Commission using the commonly agreed methodology on the basis of the macroeconomic

[7] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

scenario for Slovakia, is projected to decline from -1.4% of GDP in 2019 to -1.1% of GDP in 2020.

According to the Council for Budget Responsibility, reaching and maintaining a balanced budget until 2022 would not secure the long-term sustainability of public finances. Based on current assumptions, additional measures amounting to 2.3% GDP are necessary to offset the negative fiscal effects associated with the adoption of legislation in March 2019 capping the retirement age to a max of 64 years of age.[8]

3.2. Debt developments

The Draft Budgetary Plan projects the general government debt to decline to 47.9% of GDP in 2019, 0.4 percentage points higher than in the Stability Programme (Table 3). The difference can be explained by a slower-than-expected decline in the primary balance and a snow-ball effect (given mainly by weaker growth), only partly compensated by a lower positive stock-flow adjustment (by 1.1 percentage points of GDP compared to the Stability Report) resulting from a higher-than-projected use of state treasury liquidity. In 2020, the Draft Budgetary Plan projects the debt-to-GDP ratio to decline to 46.8%, (0.9 percentage points higher than in the Stability Programme). This is mainly due to a slower-than-expected decline in the primary balance (by 0.5 percentage points), weaker real growth and inflation effects which will be only partly compensated by a smaller positive stock-flow adjustment compared to the Stability Programme (by 0.9 percentage points). The Commission 2019 autumn forecast projects very similar developments in the debt ratio, declining to 48.1% and 47.3% of GDP in 2019 and 2020, respectively, though the ratio is expected to be slightly higher (by 0.2 and 0.5 percentage points in 2019 and 2020, respectively). The difference is due to smaller primary balances being expected in the Commission 2019 autumn forecast.

Based on the Draft Budgetary plan, the gross debt ratio net of the state liquid assets is expected to decline at a slower pace than gross debt in 2019 and 2020. This is due to a relatively high use of accumulated financial assets in 2019 and a neutral effect of this factor in 2020 stock-flow adjustment. Information in the Draft Budgetary Plan suggests that Slovakia would be below the national debt brake threshold for the debt-to-GDP ratio in both 2019 and 2020.[9]

According to the Council for Budget Responsibility, the gross debt-to-GDP ratio should decrease in a sustained manner in the medium-term horizon, even after consideration of risks identified by the Council for Budget Responsibility. However, following the decline in debt outside the sanction zones of the debt brake in 2018, taking into account the risks identified, the threshold of the first sanction zone may be exceeded again from 2019 onwards. Council for Budget Responsibility estimates that, in case of such a development, the debt would persist in the first sanction zone over the medium term horizon.[10]

[8] See Evaluation of Medium-term Budgetary Objectives for 2019-2022:
https://www.rozpoctovarada.sk/download2/strednodobe_ciele_2019_zhrnutie_eng.pdf

[9] The Slovak debt brake defines five thresholds. Once the public debt-to-GDP ratio exceeds these ceilings specific sanction and/or correction measures apply. As of 2018, the debt brake thresholds are set to decline by1 percentage point annually, until the lowest and highest ceiling reach 40% and 50% of GDP, respectively, in 2028. When the debt-to-GDP ratio exceeds 48% in 2019, the Ministry of Finance has to send a letter to the parliament explaining the reasons behind the high debt and proposing measures to ensure its reduction.

[10] See https://www.rozpoctovarada.sk/download2/strednodobe_ciele_2019_zhrnutie_eng.pdf

The Draft Budgetary Plan presents only guarantees as contingent liabilities identified in Slovakia in 2017 and 2018. The Slovak general government provided guarantees in the amount of 16.4% and 19.2% of GDP in the above-mentioned years. Around half of these guarantees are linked to the European Financial Stability Facility and the European Stability Mechanism. Data on the value of public-private partnership projects, liabilities of companies controlled by the state and the share of non-performing loans are missing.

Table 3. Debt developments

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**49.4**	**47.5**	**47.9**	**48.1**	**45.9**	**46.8**	**47.3**
Change in the ratio	-1.9	-1.9	-1.5	-1.3	-1.6	-1.1	-0.8
Contributions[2]:							
1. Primary balance	**-0.3**	**-1.2**	**-0.5**	**-0.3**	**-1.1**	**-0.6**	**0.0**
2. "Snow-ball" effect	**-1.6**	**-1.9**	**-1.1**	**-1.2**	**-1.7**	**-0.8**	**-1.1**
Of which:							
Interest expenditure	1.3	1.2	1.2	1.2	1.1	1.1	1.1
Real growth effect	-1.9	-1.9	-1.1	-1.3	-1.7	-1.1	-1.2
Inflation effect	-1.0	-1.2	-1.1	-1.1	-1.1	-0.9	-1.1
3. Stock-flow adjustment	**0.0**	**1.2**	**0.1**	**0.2**	**1.2**	**0.3**	**0.3**
Of which:							
Cash/accruals difference		1.2	0.9		1.0	0.7	
Net accumulation of financial		0.7	-0.6		0.3	-0.1	
of which privatisation proceeds		0.0	0.0		0.0	0.0	
Valuation effect & residual		-0.2	-0.1		-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:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan presents several measures for 2020 both on the revenue and on the expenditure side of the budget. For 2020, the impact of revenue measures is roughly neutral. The composition of revenues is expected to change due to the amendment of tax legislation resulting in a decrease of income taxes of 0.2% of GDP. This is due to the increase of the non-taxable part of income to twenty-one times the subsistance minimum (representing -0.14% of GDP) and to the reduction of the income tax rate for self-employed and companies with a turnover of up to EUR 100 thousand (representing -0.06% of GDP). By contrast, a positive impact is expected primarily from higher tax revenues on production and imports of approximately 0.2% of GDP, which is to come from an increase in the excise tax on tobacco products (0.1% of GDP) and the fuel identifiers ("nanomarkers") and the introduction of online sales records ("e-Kasa"), both 0.18% of GDP). This increase will be partially offset by

the reduction in the VAT rate on other foodstuffs (-0.08% of GDP). The Draft Budgetary Plan also includes additional revenue due to a temporary increase of health care facilities sales (0.1% of GDP). Moreover, it presents lower grants and transfers towards transport, health care and university education (-0.21% of GDP mainly due to lower current and capital transfers from abroad). The latter two measures are not reported among the discretionary revenue measures provided and illustrate developments against the no-policy change scenario of the Draft Budgetary Plan.

The Commission 2019 autumn forecast incorporates all revenue measures mentioned in the Draft Budgetary Plan, but factors in a lower level of additional revenues related to the increase of the excise tax on tobacco as parliamentary support for this measure is not guaranteed. Furthermore, the Commission is aware of implementation risks related to the introduction of nanomarkers and the e-Kasa project, therefore making their expected positive impact less certain. Their implementation was expected in part already in 2019 and has been postponed now to 2020. The Commission 2019 autumn forecast does not take into consideration the increase in sales of health care facilities due to its temporary character (as mentioned in the Draft Budgetary Plan) and lower grants and transfers from abroad. However, these transfers do not affect the balance, as their reduction should be offset by lower investment on the expenditure side.

Table 4. Main discretionary measures reported in the Draft Budgetary Plan

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2019	**2020**
Taxes on production and imports	0.1	0.2
Current taxes on income, wealth, etc.	-0.1	-0.2
Capital taxes		
Social contributions	-0.1	0.0
Property Income		
Other		
Total	**-0.1**	**0.0**

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source:

Draft Budgetary Plan (DRM) for 2020

On the expenditure side, the Draft Budgetary Plan includes mainly expansionary measures, worsening the budget deficit by 0.3% of GDP in 2020. The main measures relate to social payments including primarily an increase of parental allowances (0.17% of GDP), a doubling of the Christmas bonuses (0.09% of GDP) and additional financing of health services (0.06%). Other current transfers are projected to increase due to higher expenditure of the Ministry of Labour and the Ministry of Education (0.17% of GDP). In addition, outlays for civil servants' pay, teaching staff and university teachers are higher by 0.09% of GDP than in the no-policy-change scenario. This is mainly due to the indexation of their statutory pay for

three years agreed in 2018. These expansionary expenditure measures should be partially compensated by reducing investment in defence, transport and renewal of housing stock. A decrease in capital expenditure of municipalities and medical facilities is also expected. Limiting spending on these expenditure categories should bring savings of 0.45% of GDP.

The Commission forecast takes into account all expenditure measures presented in the Draft Budgetary Plan for 2019 and 2020. However, the Commission forecast includes only two-thirds of the investment reductions in 2020. This is based on an the Commission's assumption of a higher EU funds drawdown rate given the potential decommitments that non-spending would represent, and the central government´s limited ability to influence the amount of investment made by municipalities and other self-governing bodies. The introduction of minimum pensions (representing 0.15% of GDP) approved by the Parliament after the Draft Budgetary Plan submission has also been included in the Commission forecast.

Neither the Draft Budgetary Plan nor the Commission forecast assume any one-off measures in 2019 and 2020.

B. Discretionary measures taken by general Government - expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2019	**2020**
Compensation of employees	-0.1	0.1
Intermediate consumption	0.0	0.0
Social payments	0.1	0.4
Interest Expenditure		
Subsidies	0.0	0.0
Gross fixed capital formation	0.1	-0.5
Capital transfers		
Other	0.2	0.2
Total	**0.3**	**0.3**

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source:

Draft Budgetary Plan (DRM) for 2020

On 6 of November 2019, the Slovak authorities announced further measures including an increase in the existing bank levy and a correction in the impact assessment of the minimum pension formula.[11] The levy was originally supposed to be abolished by 2021. The new legislation is expected to prolong the measure beyond 2022 and to double the levy rate as of 2020. As the bank levy is a tax expenditure item for banks, the corporate income tax has to be lowered partly. A net impact of the measure is estimated to be around 0.12 % of GDP.

[11] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2020_en#slovakia

Morever, the expected cost impact of the change in the minimum pension formula, adopted by Parliament in October 2019, was adjusted downwards for 2020. Due to adopted modifications, the impact was revised downwards approximately by 0.07 percentage point of GDP. Such a revised cost is in line with the most recent estimate of the Council for Budget Responsibility and the one of the Ministry of Labor, Social Affairs and Family.

In addition, the Draft Budgetary Plan includes the effect of an increased tax for tobacco products as of 2020. Slovakia's authorities confirmed that the legislation will not be adopted. The Draft Budgetary Plan also contains a reserve for this purpose on the expenditure side. However, the Commission forecast does not contain this reserve.Therefore, the additional change announced by the Slovakia's authorities regarding these measures does not affect the original overall assessment by the Commission. Furthermore, Slovakia's authorities informed the Commission that the Ministry of Finance will submit an amendment of the government budget proposal which will include cuts in reserves on the expenditure side (e.g. the reserve for faster implementation of EU projects will be decreased by approximately 0.02% of GDP). Finally, the levy from profit of the state owned company Lesy will be waived by the government.

Overall, according to the Commission's assessment, those additional deficit-reducing measures amount to 0.21% of GDP compared to the measures included in the Commission 2019 autumn forecast.

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

Slovakia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium term budgetary objective. Box 2 reports the latest country specific recommendations in the area of public finances.

Box 2 Council recommendations [12] addressed to Slovakia

On 9 July 2019, the Council addressed recommendations to Slovakia in the context of the European Semester. In particular, in the area of public finances the Council recommended that Slovakia should achieve the medium-term budgetary objective in 2020.

In view of the autumn 2019 forecast projecting that Slovakia will be 0.6% of GDP away from its medium term budgetary objective in 2019, the nominal growth rate of net primary government expenditure should not exceed 4.6%, corresponding to an improvement in the structural balance by 0.3% of GDP.

4.1. Adjustment towards the medium term budgetary objective

According to the information provided in the Draft Budgetary Plan, the growth rate of government expenditure, net of discretionary revenue measures, will not exceed the applicable expenditure benchmark rate (4.6%) in 2019. When taking 2018 and 2019 together, the expenditure benchmark pillar points to a risk of significant deviation of -0.4% of GDP from the path towards the medium term budgetary objective. The annual change of the structural balance in 2019 projected in the Draft Budgetary Plan is the same as the required

[12] OJ C 301, 5.9.2019, p. 148–153

adjustment. Hence, the change in the recalculated structural balance does not deviate from the final requirement over one year. Nevertheless, it points to a risk of significant deviation when 2018 and 2019 are taken together. This means that fiscal slippages observed in 2018 were insufficiently compensated for in 2019. Therefore, an overall assessment based on the Draft Budgetary Plan points to a significant deviation from the adjustment path towards the medium term budgetary objective in 2019.

Based on the information in the Draft Budgetary Plan, both the expenditure benchmark and the structural balance pillars suggest compliance with the preventive arm of the Pact in 2020 when looking at the single-year deviation alone. The conclusion is confirmed when taken over 2019-2020 together. Following an overall assessment based on the Draft Budgetary Plan, the adjustment path towards the medium term budgetary objective appears to be in line with the requirement of the preventive arm of the Pact in 2020.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2018	2019		2020	
Initial position[1]					
Medium-term budgetary objective (MTO)	-0.5	-0.5		-1.0	
Structural balance[2] (COM)	-1.7	-1.6		-1.8	
Structural balance based on freezing (COM)	-0.8	-1.3		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
	2018	**2019**		**2020**	
(% of GDP)	**COM**	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.4	0.3		0.3	
Required adjustment corrected[5]	0.4	0.3		0.3	
Change in structural balance[6]	-0.3	0.4	0.1	0.3	-0.2
One-year deviation from the required adjustment [7]	-0.8	0.0	-0.3	0.0	-0.4
Two-year average deviation from the required	-0.2	-0.4	-0.5	0.0	-0.3
Expenditure benchmark pillar					
Applicable reference rate[8]	3.0	4.6		4.6	
One-year deviation adjusted for one-offs [9]	-1.2	0.3	-0.6	0.1	-0.6
Two-year average deviation adjusted for one-offs [9]	-0.6	-0.4	-0.9	0.2	-0.6

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 is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance corresponds to 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 ed. 2018, 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 2018) was carried out on the basis of Commission 2019 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.

Source :

Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.

Based on the Commission 2019 autumn forecast, the growth rate of government expenditure, net of discretionary revenue measures, will exceed the applicable expenditure benchmark (4.6%), with a deviation of 0.6% of GDP in 2019. The expenditure benchmark therefore points to a risk of significant deviation. The structural balance points to a risk of some deviation when looking at 2019 alone. When considering the two-year average for 2018 and 2019, both pillars point to a risk of significant deviation. An overall assessment shows that the structural balance is positively impacted by revenue windfalls and by a decrease in investment and interest expenditure. The difference between the two indicators also stems from differences between the potential GDP growth estimate underlying the structural balance and the medium-term potential GDP growth used to set the expenditure benchmark. Taking into account these factors, the overall assessment finds that there is a risk of a significant deviation from the path towards the medium term budgetary objective in 2019 as well as over 2018 and 2019 taken together on the basis of the Commission 2019 autumn forecast.

In 2020, the structural balance pillar points to a risk of some deviation (a gap of -0.4% of GDP). The expenditure benchmark suggests a risk of significant deviation (a gap of -0.6% of GDP). When considering the two-year average for 2019 and 2020, both pillars point to a risk of significant deviation from the path towards the medium term budgetary objective. An overall assessment shows that the structural balance is positively impacted by the combined effect of declining interest expenditure and relatively low investment, but it is also marginally negatively affected by revenue shortfalls. The expenditure benchmark is only negligibly and negatively impacted by the use of a lower GDP deflator underlying the expenditure benchmark compared to current estimates. Taking into account these factors, the overall assessment, favouring the expenditure benchmark pillar, confirms the conclusion of a risk of significant deviation from the path towards the medium term budgetary objective in 2020. The same conclusion of significant deviation is confirmed when considering 2019 and 2020 taken together.

Regarding the additional discretionary measures for 2020 announced by the Slovak authorities on 6 November 2019 (see section 3.3), the Commission assesses the deviation to have become smaller in 2020, with both the expenditure benchmark and the structural balance pointing to some deviation. For 2019 and 2020 taken together, the structural balance indicator would also point to a risk of some deviation, whereas the expenditure benchmark would still point to a risk of significant deviation, mainly in view of the slippage in 2019. On that basis, the overall assement points to a risk of significant deviation.

The Commission 2019 autumn forecast and the Draft Budgetary Plan lead to different conclusions as regards compliance with the progress towards the medium term budgetary objective in particular in 2020. The main differences stem from:

- Aggregate primary expenditure is lower in the Draft Budgetary Plan as it assumes a lower level of subsidies in both 2019 and 2020 (around 0.5% of GDP) compared to what would be the case if the data revisions for 2018, as verified by Eurostat after the autumn EDP notification, would have been used. The growth of primary government expenditure, net of discretionary measures is, therefore, significantly underestimated when compared to the Commission forecast, which incorporates the methodological change linked to the benchmark revision of national accounts[13]. The data adjustment has a limited impact on the structural balance (only due to a time lag in recording related revenue and expenditure), because the methodological change is also recorded on the revenue side of general government accounts (for more see section 5). The underestimation of expenditure growth in 2019 also contributes to a more optimistic and biased assessment of the two-year average in the expenditure benchmark pillar for 2020 in the Draft Budgetary Plan.
- Different assumptions on EU funds drawdown rates affect the structural balance mainly in terms of the amount of national co-financing, apart from the impact of implied tax revenues. The Commission forecast assumes a higher drawdown rate and therefore higher co-financing than that assumed by the Draft Budgetary Plan. The difference in the expenditure benchmark is mitigated by the fact that a significant part of such expenditure, i.e. expenditure directed at investments, enter the expenditure aggregate in a smoothed form (as a four-year average). Higher expected EU funds are also positively impacted by a higher amount of received EU funds subtracted from the

[13] For more see the box 4 of the Draft Budgetary Plan on page 12.

expenditure aggregate used for the expenditure benchmark pillar based on the Commission forecast.

- Consolidation measures presented in the Draft Budgetary Plan primarily consist of significant reductions of investment in 2020. The Commission forecast includes only about two thirds of the reduction as some of the items pertain to self-governing bodies and the central government has only a limited ability to constrain their expenditure. In addition, several investment projects have started or were planned and are/would be co-financed by EU funds and would risk decommitment (see section 3.3).
- Additional expenditure linked to the setting of a minimum pension, applicable from January 2020 and approved by Parliament after the submission of the Draft Budgetary Plan with a negative impact of 0.15% of GDP, is included in the Commission forecast but was not incorporated in the Draft Budgetary Plan.
- A discretionary revenue measure relating to the increase of excise taxes on tobacco products, which was included in the Draft Budgetary Plan, was only partially incorporated in the Commission Forecast due to uncertainty regarding its implementation (reduced by 0.05% of GDP). Indeed, full political agreement is not yet present to ensure the implementation of this policy.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The Draft Budgetary Plan assumes that a larger adjustment takes place on the expenditure side in both 2019 and 2020. The expenditure ratio is projected to decline at a faster pace than the revenue ratio, by 0.3 percentage points of GDP in 2019 and 0.2 percentage points in 2020.

The Draft Budgetary Plan expects a decline in the ratio of taxes from production and imports to GDP, as well as other revenues to GDP, in 2019. The latter category is primarily affected by the expected lower drawdown rate of EU funds with a fiscally neutral impact on the general government balance. The tax structure seems to be less growth-friendly in 2019 due to the declining share of indirect taxation focused on consumption. The compound tax quota is expected to decrease by 0.4 percentage points of GDP to 33.8%. However, this conclusion could be misleading, as the data on taxes from production and import in the Draft Budgetary Plan are not methodologically consistent with past time series validated by Eurostat after the autumn EDP notification. Because of a statistical benchmark revision, data on taxes from production and imports do not include revenues from levies on electricity paid by final consumers (amounting to approximately 0.5% of GDP). On the expenditure side, these revenues are largely neutralised[14] in subsidies paid to electricity producers.

On the expenditure side, the following two factors are apparent. First, rapid growth of most current expenditure categories is presented in the Draft Budgetary Plan in 2019. The expenditure categories with the fastest growing shares in GDP include social transfers (by 0.5 percentage points of GDP), intermediate consumption (by 0.4 percentage points of GDP) and compensations of employees (by 0.2 percentage points of GDP). Second, a contraction is expected in gross fixed capital formation (0.8 percentage points of GDP). Both the decline in investment and capital transfers can be largely attributed to a lower expected drawdown rate

[14] There is a two-year time lag between the subsidy paid to electricity producers and the collection of charges reflected in the price paid by final consumers. According to ESA methodology, this mismatch exacerbates the general government balance. In Slovakia, the expected impact is around 0.05% of GDP.

of EU funds and the assumption of weak investment activity by municipalities after the 2018 municipal elections. Part of the fiscal improvement (0.2 percentage points of GDP) is generated through declining interest outlays reflecting falling interest rates in 2019. The decline in subsidies is due to the methodological reason described above.[15]

In 2020, a tax burden is expected to increase slightly by 0.1 percentage points of GDP. The change can be assessed as a move towards a tax structure that is less detrimental to growth, because of the decline in direct taxes and the increase of indirect taxes (both by around 0.3 percentage points of GDP). Furthermore, the Draft Budgetary Plan projects a decrease in property incomes (by 0.1 percentage points of GDP) and a decline in current transfers from abroad affecting other revenues (by 0.5 percentage points of GDP). The latter factor should be neutral with regard to the development of the budget balance, as it is projected to be offset on the expenditure side.

On the expenditure side, the share of expenditure on compensation of employees to GDP will increase significantly (by 0.4 percentage points of GDP) for reasons that are explained in subsection 3.3. The decline in interest is expected mainly due to decreasing interest rates (0.1 percentage points of GDP). Slovakia plans a large decrease in public investment of about 1 percentage point of GDP. Other expenditure, mainly current transfers, will increase by 0.5 percentage points of GDP.

The government has proposed limiting investment expenditure in 2020 in areas that are not in line with a Council Recommendation to focus investment-related economic policy *inter alia* on transport, competitiveness and social housing. The limiting of expenditure co-financed by EU funds may also increase a risk of potential decommittments.

The implementation of the Recommendation to safeguard the long-term sustainability of public finances, notably that of the pension system, can be jeopardised by the introduction of the link of minimum pensions to average wages instead of a link to the subsistence minimum. The implementation of the cap on the statutory retirement age, enshrined in the constitution in spring 2019, also jeopardises the sustanability of the pension system. The capping of the statutory retirement age at 64 means that retirement age will continue to increase only up to around 2030, after which it is expected to stabilise at a maximum of 64 years. Note, too, that the adjustment in career length to bring retirement age up to 64 has also been made slower in 2019. Based on the Draft Budgetary Plan, pension expenditure will increase by some additional 1.7 percentage points of GDP by 2070 compared to the original scenario.

The Draft Budgetary Plan also assumes an increase in the expenditure of health insurance companies intended to finance increases in salaries, operating costs and other policy changes. This expenditure should be offset by savings identified by the healthcare spending review without an impact on the overall fiscal results of the healthcare sector. A change in the structure of expenditure in the area of health insurance is linked with risks arising from both the long-term implementation of some consolidation measures[16] and missing legislation for some measures. In 2019, the Ministry of Finance carried out a third healthcare spending review. The implementation of measures identified in previous spending reviews has improved the efficiency of the public health insurance system. However, the expenditure of university hospitals has also increased mainly due to the automatic rise in the wage bill. The

[15] For more information, see the Draft Budgetary Plan of the Slovak Republic for a year 2020 - pages 12 and 13.
[16] For some measures, the Draft Budgetary Plan assumes a phased implementation up to ten years.

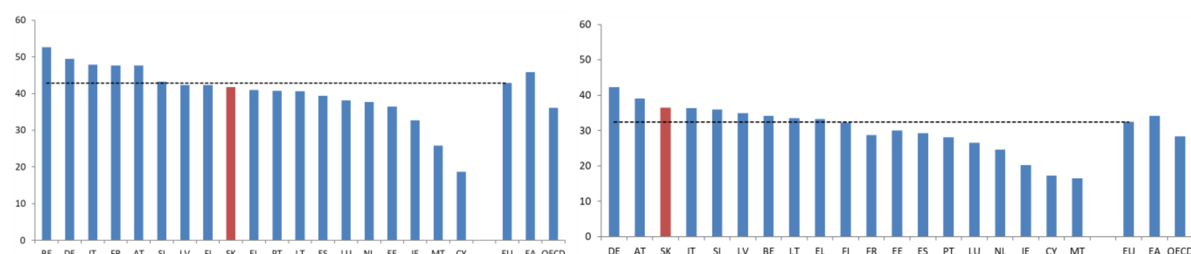
introduction of a performance budgeting system, which should improve allocation efficiency, is in preparation. The cabinet approved strategic documents focused on follow-up health care and on a stratification of hospitals. A system of DRG-based payments is being implemented. While these measures are crucial, it is expected that the savings they can bring about are quickly absorbed by the system which is, amongst others factors, facing increased demand and running sizable arrears.

Box 3 - Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Slovakia for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Slovakia at the average wage and at low wage (2018)



Notes: EU and EA averages are GDP-weighted. The OECD average is not weighted.
Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Slovakia´s Draft Budgetary Plan contains the following measures that affect the tax wedge on labour:
Increase in the non-taxable part of the tax base for taxpayers by a coefficient that was adjusted from 19.2 to 21-times of a subsistence minimum. Furthermore, the level at which the non-taxable part of the tax base begins to decline is reduced from 100 to 92.8-times the subsistence minimum. The expected impact of the measure on government revenues represents -0.14% of GDP in 2020 in the Draft Budgetary Plan.

Reduction in the Personal income tax rate for the self-employed to 15%, for those whose income does not exceed EUR 100 thousand per year. Self-employed persons with incomes higher than the above-mentioned threshold will continue to be subject to the 19% and 25% tax rates. The expected impact of the measure on general government revenues is -0.06% of GDP in 2020 according to the Draft Budgetary Plan.
Introduction of a new category of "microtaxpayers" for natural persons with turnover up to EUR 49,790 - they can determine any depreciation period from 2021, amortize losses for five years without limitation and apply allowances in the form of tax expenditure without restrictions in the current law. In addition, the threshold for quarterly advances has been increased from EUR 2500 to EUR 5000. The expected impact of the measure on government revenues is -0.02% of GDP in 2020 according to the Draft Budgetary Plan.
Cancellation of the condition for payment of the 13th salary – it must be at least EUR 500 but the condition related to the employee's average monthly wage was cancelled. 13th wages are tax and health insurance free from the assessment base up to EUR 500 in 2019 and 2020. 14th wages are tax, health insurance and social insurance free from the wage up to EUR 500 in 2019 and 2020. The expected impact of the measure on government revenues is -0.02% of GDP in 2019 and 2020 according to the Draft Budgetary Plan.
Introduction of sport vouchers - a new nonfinancial employee benefit will be introduced from the beginning of 2020. It is designed for children of employees who have worked with the same employer for at least two years and whose child is under eighteen years and is a member of a registered sports organisation for at least six months. It could be provided on a voluntary basis. Benefit is paid up to 55% of EUR 500 per a year and is exempted from payment of taxes and levies by employees and employers. It is a tax eligible expenditure for the employer. The expected impact of the measure on government revenues is -0.002% of GDP in 2020 according to the Draft Budgetary Plan.
Increase of the tax-free amount for a non-financial benefit for accommodation, from EUR 60 to 100 per month in 2020. Furthermore, the tax-exempted amount of **a non-financial benefit for transport** will be increased to EUR 100 per month in 2021.

The Draft Budgetary Plan also assumes an increase in the expenditure of health insurance companies intended to finance increases in salaries, operating costs and other policy changes. This expenditure should be offset by savings identified by the healthcare spending review without an impact on the overall fiscal results of the healthcare sector. A change in the structure of expenditure in the area of health insurance is linked with risks arising from both the long-term implementation of some consolidation measures[17] and missing legislation for some measures. In 2019, the Ministry of Finance carried out a third healthcare spending review. The implementation of measures identified in previous spending reviews has improved the efficiency of the public health insurance system. However, the expenditure of university hospitals has also increased mainly due to the automatic rise in the wage bill. The introduction of a performance budgeting system, which should improve allocation efficiency, is in preparation. The cabinet approved strategic documents focused on follow-up health care and on a stratification of hospitals. A system of DRG-based payments is being implemented. While these measures are crucial, it is expected that the savings they can bring about are quickly absorbed by the system which is, amongst others factors, facing increased demand and running sizable arrears.

[17] For some measures, the Draft Budgetary Plan assumes a phased implementation up to ten years.

6. OVERALL CONCLUSION

Based on the Commission 2019 autumn forecast, the debt-to-GDP ratio is well below 60% of GDP and further declining.

Following an overall assessment, the Draft Budgetary Plan points to a risk of significant deviation in 2019, while it points to compliance in 2020. The conclusion for 2019, confirmed by the Commission forecast, is mainly due to fiscal slippages in 2018, which were not adequately compensated for in 2019.

The overall assessment based on the Commission's 2019 autumn forecast points to a risk of significant deviation from the path towards the medium-term budgetary objective for both 2020 and 2019 and 2020 taken together. The additional measures announced by the Slovakia's authorities on 6 November 2019 reduced the deviation, which is therefore no longer significant in 2020. However, mainly in view of the slippage in 2019, there is still a risk of significant deviation for 2019 and 2020 together from the adjustment path towards the medium-term budgetary objective recommended by the Council.