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COMMISSION STAFF WORKING DOCUMENT

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 2018 on 12 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Slovakia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2017 autumn forecast. The following section 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 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis on the composition of public finances and on fiscal-structural issues in response to the latest country-specific recommendations adopted by the Council in the spring of 2017, including those to reducing the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Following a moderation in economic growth in 2016 on the back of a significant downturn in investment activity, Slovakia's real GDP growth is expected to maintain a robust pace of 3.3% in 2017, according to the Draft Budgetary Plan (Table 1). Private consumption is set to become the key contributor to growth in 2017, benefitting from further improvements in labour market conditions, low credit costs and upbeat economic sentiment. Overall investment is projected to recover in 2017, driven mainly by private investment in the automotive industry. Public investment is expected to remain subdued, partly due to low co-financed investment from EU funds, for which project calls are somewhat lagging behind based on the information in the Draft Budgetary Plan. The Draft Budgetary Plan scenario expects economic growth to pick up to 4.2% in 2018, buttressed mainly by a substantial strengthening in (net) exports, reflecting buoyant foreign demand and expanded production capacities in the automotive sector. The completion of a new car factory along with large investment projects such as the Bratislava ring road is anticipated to cause investment growth to peak in 2018. The unemployment rate is expected to gradually fall to just above 7% in 2018, with employment gains likely to remain strong and broad-based across sectors, further supporting increases in the participation rate.

The expected pace and composition of economic growth in the Draft Budgetary Plan is broadly in line with the latest Stability Programme in 2017, with the Draft Budgetary Plan projecting stronger private consumption and inventories along with weaker foreign trade performance. In 2018, GDP growth was revised marginally upwards in the Draft Budgetary Plan, mainly due to stronger investment and household consumption, which outweigh the weaker contribution from net trade. Delays in major infrastructure projects due to litigation, coupled with a relatively slow use of EU investment funds, shifts the peak in investment activity to 2018.

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.3	3.3	3.3	3.3	4.0	4.2	3.8
Private consumption (% change)	2.7	2.5	3.3	3.3	2.7	2.9	3.3
Gross fixed capital formation (% change)	-8.3	3.0	3.0	1.0	1.9	4.2	5.9
Exports of goods and services (% change)	6.2	5.6	5.0	4.6	7.3	7.8	6.7
Imports of goods and services (% change)	3.7	4.2	4.8	4.6	6.0	6.8	6.5
Contributions to real GDP growth:							
- Final domestic demand	-0.2	2.2	2.4	2.2	2.2	2.6	3.4
- Change in inventories	1.1	-0.5	0.5	0.9	0.0	0.0	0.0
- Net exports	2.4	1.7	0.6	0.2	1.9	1.6	0.5
Output gap[1]	-0.4	-0.4	-0.4	0.0	0.0	0.3	0.5
Employment (% change)	2.4	1.8	2.0	1.3	1.1	1.4	1.2
Unemployment rate (%)	9.7	8.4	8.2	8.3	7.6	7.3	7.4
Labour productivity (% change)	0.9	1.5	1.3	2.0	2.9	2.7	2.6
HICP inflation (%)	-0.5	1.1	1.3	1.3	1.7	1.7	1.7
GDP deflator (% change)	-0.4	1.0	1.1	2.0	1.6	1.6	1.5
Comp. of employees (per head, % change)	2.3	3.3	3.9	4.1	4.3	4.5	4.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.2	2.9	0.3	0.8	3.5	1.1	0.5

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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

The macroeconomic scenario underlying the Draft Budgetary Plan is broadly in line with the Commission 2017 autumn forecast, with the latter projecting a slightly slower pace of economic expansion in 2018. The differences are somewhat more pronounced with regard to the composition of growth. In contrast to the Draft Budgetary Plan scenario, the Commission forecast expects a weaker contribution of net trade to overall growth in both years, reflecting less buoyant exports accompanied by solid import growth, which are partially driven by equipment needs for new and expanding automotive factories. A comparatively weaker export

performance in the Commission forecast is broadly offset by a higher contribution of inventories to GDP growth in 2017 and by stronger investment and private consumption in 2018. Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan appear to be plausible in both years, notwithstanding differing judgements on the sources of growth.

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 at the end of September 2017 and endorsed by the Macroeconomic Forecasting Committee (MFC).

The constitutional act on budgetary responsibility, adopted in December 2011, formally endowed the MFC with the responsibility for assessing macroeconomic forecasts produced by the government. According to the statutes, in its deliberations the MFC is independent and free from the government's influence. 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 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". The draft macroeconomic forecast for the Draft Budgetary Plan was deemed "realistic" by all of the voting members of the MFC at a meeting held on 13 September 2017, according to the minutes published on the website of the IFP.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The Draft Budgetary Plan targets a general government deficit of 1.6 % of GDP in 2017, some 0.4 percentage point higher compared to the Stability Programme, when the headline deficit was projected at 1.2% of GDP. The higher deficit is mainly due to expected spending slippages on the public wage bill, for goods and services (for which local governments are important drivers) as well as social spending and healthcare. On the revenue side, the expected drop in corporate income tax revenue is projected to be fully compensated by higher-than-expected growth of revenue from social contributions, leaving the projected decline in overall revenue as being mainly due to the slower drawdown of EU funds. The Commission 2017 autumn forecast also projects a 2017 deficit of 1.6 % of GDP.

The Draft Budgetary Plan revises the headline deficit target also for 2018. While the Stability Programme targeted a general government deficit of 0.5% of GDP, the Draft Budgetary Plan increases it to 0.8% of GDP. The Draft Budgetary Plan notes that the higher deficit target in 2018 reflects worsened projections for corporate income tax and dividend revenues[1,2].

[1] The Draft Budgetary Plan accounts for a lower expected dividend revenue by creating a reserve on the expenditure side rather than lowering actual dividend receipts. This causes an overestimation of revenues and expenditures.

However, compared to the Stability Programme, the Draft Budgetary Plan in fact shows that more buoyant revenues from taxes on production and social contributions more than compensate the worsened outlook for corporate income tax receipts. The adjustment in 2018 appears to be mainly driven by expenditure growing at a relatively restrained rate and more slowly than nominal GDP growth. The revenue-to-GDP ratio declines by 0.9 percentage point to 38.5 % driven mainly by an assumed marked slowdown in EU funds drawdown. The ratio of expenditure to GDP is expected to decline by 1.7 percentage points to 39.3 % in 2018, largely on account of curbing growth of intermediate consumption, social spending and by weaker investment due to expected lower EU funds utilisation, which will have a n additional fiscal impact via lower co-financing. The benign development of the expenditure-to-GDP ratio appears somewhat counter-intuitive when considering the array of expenditure-increasing measures specified in the Draft Budgetary Plan, and achieving an overall expenditure decline is heavily contingent on expenditure restraint in all other categories such as intermediate consumption and investment (reflecting mainly the expected drop in the drawdown of EU funds) as well as strong growth of the nominal GDP.

The Commission 2017 autumn forecast projects the deficit at 1.0% of GDP in 2018, slightly higher than in the Draft Budgetary Plan. The Commission projects lower revenue from dividends, from the sale of emission allowances and from fees for emergency oil stocks storage as well as lower social contributions (see below), but expects a higher drawdown of EU funds. On the expenditure side, the Commission forecast assumes a slower deceleration in growth of healthcare spending compared to the Draft Budgetary Plan, while the contributions to the EU budget are expected to be lower.[3] Unlike the Draft Budgetary Plan, the Commission forecast does not take into account the provision of reserves on the expenditure side that capture the negative impact of the introduction of a voluntary 13th and 14th salary, the exemption of pensioners' earnings (up to a specified ceiling) from paying social security contributions, and lower dividend revenue. Instead, the Commission forecasts directly account for the expected lower revenue from these items on the revenue side. Finally, the assumed higher drawdown of EU funds assumed in the Commission forecast associated with higher co-financing translates into higher projected investment. Euro area sovereign bond yields remain at historically low levels, with 10-year rates for Slovakia currently standing at 0.82 %[4]. As a consequence, total interest payments by the general 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 1.6 % of GDP in 2016 to 1.3 % in 2017 and to remain stable in the following year, well below the 1.8 % recorded back in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Member States' plans is broadly confirmed by the Commission forecast.

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 also constitutes Slovakia's MTO. Based on the information in the Draft Budgetary Plan, the (recalculated)

[2] The expected shortfall from dividend revenue is triggered by the decision of Eurostat to classify a part of 2016 dividend revenue as so called 'super-dividend', which is considered a financial transaction and hence does not enter government revenues. Since the 2018 budget assumed dividend revenue from the same sources, it is expected that a part of it will need to be classified as 'super-dividend' and will hence not enter public revenues.

[3] See Draft General budget of the European Union for financial year 2018: http://ec.europa.eu/budget/biblio/documents/2018/2018_en.cfm#draft_budget01.

[4] 10-year bond yields as of 6 November 2017. Source: Bloomberg

structural balance[5] is projected to decline to -0.9 % of GDP in 2018, implying that Slovakia would not reach a balanced budget in that year. Other fiscal numerical rules apply to the state budget and local governments. It cannot be inferred ex ante from the information available in the Draft Budgetary Plan if these will be met.[6]

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**39.3**	**39.7**	**39.4**	**38.9**	**38.7**	**38.5**	**38.2**	**-0.8**
of which:								
- Taxes on production and imports	10.6	10.9	11.0	10.8	10.7	11.0	10.8	0.4
- Current taxes on income, wealth, etc.	7.3	7.5	7.1	7.1	7.6	7.1	7.1	-0.2
- Capital taxes	0.0	0.0		0.0	0.0		0.0	n.a.
- Social contributions	14.3	14.4	14.8	14.6	14.3	14.6	14.5	0.3
- Other (residual)	7.0	6.9	6.5	6.4	6.1	5.8	5.8	-1.3
Expenditure	**41.5**	**40.9**	**41.0**	**40.6**	**39.2**	**39.3**	**39.2**	**-2.2**
of which:								
- Primary expenditure	39.9	39.6	39.7	39.2	37.9	38.0	37.9	-1.8
of which:								
Compensation of employees	9.1	8.9	9.0	8.9	9.0	9.1	9.0	-0.1
Intermediate consumption	5.5	5.7	6.0	5.7	5.3	5.5	5.3	0.0
Social payments	19.1	18.6	18.8	18.6	18.1	18.3	18.3	-0.8
Subsidies	0.5	0.6	0.4	0.4	0.5	0.4	0.4	0.0
Gross fixed capital formation	3.2	3.3	3.3	3.4	2.7	2.4	2.7	-0.8
Other (residual)	2.5	2.5	2.2	2.2	2.3	2.3	2.3	-0.1
- Interest expenditure	1.6	1.3	1.3	1.3	1.3	1.3	1.3	-0.4
General government balance (GGB)	**-2.2**	**-1.2**	**-1.6**	**-1.6**	**-0.5**	**-0.8**	**-1.0**	**1.4**
Primary balance	**-0.5**	**0.1**	**-0.3**	**-0.3**	**0.8**	**0.4**	**0.2**	**1.0**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.1**	**-1.2**	**-1.6**	**-1.6**	**-0.5**	**-0.8**	**-1.0**	**1.3**
Output gap[1]	-0.4	-0.4	-0.4	0.0	0.0	0.3	0.5	0.8
Cyclically-adjusted balance[1]	-2.0	-1.1	-1.5	-1.6	-0.5	-0.9	-1.2	1.0
Structural balance (SB)[2]	**-2.0**	**-1.1**	**-1.5**	**-1.6**	**-0.5**	**-0.9**	**-1.2**	**1.0**
Structural primary balance[2]	-0.3	0.2	-0.2	-0.3	0.8	0.3	0.0	0.6

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

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

The recalculated structural balances in 2017 and 2018 based on the information in the Draft Budgetary Plan are worse compared to the Stability Programme, mainly due to higher expected headline deficits in both years. The Commission forecast projects a slightly higher

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

[6] For the fiscal rules under the constitutional debt brake please see Section 3.2.

structural deficit for 2017 than the Draft Budgetary Plan despite an identical headline deficit. This is due to a somewhat better cyclical position projected in the Commission forecast, which suggests that the output gap would close in 2017, while based on the Draft Budgetary Plan the output gap would still be negative in 2017. A higher positive output gap in the Commission forecast also partly accounts for the difference in structural balances in 2018, although the main source of the discrepancy in that year stems from diverging projections in headline deficits. The projected improvement in the structural balance in 2017 and 2018 (to -1.6 % and -1.2 %, respectively) indicated by the Commission forecast is accompanied by a less pronounced improvement in the structural primary balance (to -0.3 % and 0 %, respectively).

3.2. Debt developments

The Draft Budgetary Plan projects the general government debt to decline to 51.1 % of GDP in 2017, 0.7 percentage point lower compared to the Stability Programme (Table 3). The difference is driven by the projected impact of a stock-flow adjustment. The Stability Programme assumed that it would increase the general government debt, while the Draft Budgetary Plan now assumes a small debt-reducing impact. In 2018, the Draft Budgetary Plan projects the debt-to-GDP ratio to decline to below 50 % mainly due to the impact of nominal GDP growth on the denominator. The Commission 2017 autumn forecast projects the same debt ratio in 2018. Based on the Draft Budgetary Plan the gross debt ratio, net of the state liquid assets (in particular cash surpluses), is expected to follow the same declining path as gross debt as the ratio of liquid assets to GDP is projected to remain broadly stable. Information in the Draft Budgetary Plan suggests that Slovakia would breach the first ceiling[7] of the national debt brake thresholds for the debt-to-GDP ratio in 2017 and 2018.[8]

[7] 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 by 1 percentage point annually, until the lowest and highest ceiling reach 40% and 50% of GDP, respectively, in 2028.

[8] When the debt-to-GDP ratio exceeds 50% (or 49% in 2018) 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.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**51.8**	**51.8**	**51.1**	**50.6**	**49.9**	**49.9**	**49.9**
Change in the ratio	-0.5	-0.1	-0.7	-1.2	-1.8	-1.2	-0.7
Contributions [2] :							
1. Primary balance	**0.5**	**-0.1**	**0.3**	**0.3**	**-0.8**	**-0.4**	**-0.2**
2. "Snow-ball" effect	**0.2**	**-0.9**	**-0.9**	**-1.3**	**-1.5**	**-1.5**	**-1.3**
Of which:							
Interest expenditure	1.6	1.3	1.3	1.3	1.3	1.3	1.3
Growth effect	-1.7	-1.6	-1.7	-1.6	-2.0	-2.0	-1.8
Inflation effect	0.2	-0.5	-0.6	-1.0	-0.8	-0.8	-0.7
3. Stock-flow adjustment	**-1.3**	**0.9**	**-0.1**	**-0.2**	**0.4**	**0.8**	**0.8**
Of which:							
Cash/accruals difference		0.5	0.2		0.6	0.5	
Net accumulation of financial		0.4	-0.3		0.1	0.4	
of which privatisation proceeds		0.0	0.0		0.0	0.0	
Valuation effect & residual		-0.1	-0.1		-0.3	-0.1	

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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan presents several measures for 2018 on both the revenue and expenditure side of the budget. For 2018, the overall impact of revenue measures is likely to be broadly budget-neutral.[9] Revenues are expected to increase thanks to a new 7% dividend tax which was introduced along with the abolition of healthcare contributions on dividends, the new taxation of gambling[10], an extension of the withholding tax on non-life insurance premia to also include life insurances premia, and a better targeting of the healthcare contribution towards the low-paid. The abolition of the minimum corporate income tax and the further reduction of the pension contributions towards the public pension pillar in favour of the private one are expected to reduce revenues. Additional measures that address government priorities, including an increase of R&D tax credits, the provision of tax allowances for spa-related services and specific accelerated depreciation rules for spas also dent public revenues, but their impact is be rather negligible. Two additional measures – the exemption from social security payments of pensioners' income from so-called 'agreement contracts' and of the new, voluntary 13th and 14th monthly salaries – are projected to reduce

[9] The obligatory Table 5a provided in the Annex to the Draft Budgetary Plan does not seem to reflect all the discretionary measures adopted for 2018, but only those that were approved in 2017.

[10] The government plans to de-monopolise the online gambling market. The additional revenue would stem from the sale of multi-year gambling licences.

revenues from social security contributions. Although the authorities did not include the negative impact of these measures on the revenue side, the Draft Budgetary Plan does provide an estimate of their budgetary cost and accounts for its impact on the deficit by creating a commensurate reserve on the expenditure side (see also Section 3.2). The Commission forecast accounts for this negative impact directly on the revenue side as the measure was credibly announced and sufficiently specified.

In 2019, the Draft Budgetary Plan assumes higher revenue from a planned hike in excise duties on tobacco and an additional impact of the extended withholding tax on insurance. The positive impact is, however, projected to be broadly counterbalanced by a decline of social security contributions by an ongoing reduction of the share of pension contribution dedicated to the public pension pillar and a shortfall of the revenue from the de-monopolisation of gambling.

On the expenditure side, the Draft Budgetary Plan includes for 2018 mainly expansionary measures when compared to the no-policy change scenario. The main measures include higher outlays for the compensations of teachers and civil servants, an introduction of a minimum pension valorisation and a pension increase for those who retired before the 2004 pension reform, extra support for disabled care, higher payments of the state for social services and an increase in the allocation for mobility support. An increase of investment beyond the no-policy-change scenario presented in the Draft Budgetary Plan is due to spending on the national football stadium, the modernisation of army and transport facilities, the reconstruction of the Slovak National Gallery, and a reserve for the support of significant investments (i.e. the Jaguar Land Rover investment). Despite these deficit-increasing measures, which are estimated in the Draft Budgetary Plan at 1 % of GDP, the expenditure-to-GDP ratio is projected to decline based on the Draft Budgetary Plan. The Commission forecast takes into account all expenditure measures presented in the Draft Budgetary Plan. However, as explained in Section 3.2, the Commission forecast neither includes a reserve for lower tax and non-tax revenues (but rather assumes lower dividend receipts) nor a reserve for the negative impact of exempting pensioners working on 'agreement contracts' and the voluntary 13th and 14th salary from social contributions. On the other hand, the Commission projects somewhat stronger growth of healthcare spending (while also assuming a deceleration) and stronger investment under the assumption of a smaller plunge in the drawdown of EU funds. The expenditure-to-GDP ratio thus decreases less in the Commission forecast.

Neither the Draft Budgetary Plan nor the Commission forecast assume any one-off measures in 2017 and 2018.

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)		
	2017	**2018**	**2019**
Taxes on production and	0.0	0.1	0.0
Current taxes on income,	0.0	0.0	0.0
Capital taxes			
Social contributions	0.0	0.1	0.0
Property Income			
Other	0.0	0.0	0.0
Total	0.0	0.2	0.0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	0.0	0.2	0.0
Intermediate consumption	0.0	0.2	0.0
Social payments	0.0	0.2	0.0
Interest Expenditure			
Subsidies	0.0	0.0	0.0
Gross fixed capital formation	0.0	0.3	0.0
Capital transfers			
Other	0.0	0.1	0.0
Total	0.0	1.1	0.0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

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 MTO. Box 2 reports the latest country-specific recommendations in the area of public finances.

Box 2: Council Recommendations[11] addressed to Slovakia

On 11 July 2017, 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 pursue a substantial fiscal effort in 2018 in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Slovakia's public finances.

The Council recalled that in 2018, in the light of its fiscal situation, Slovakia is expected to further adjust towards its medium-term budgetary objective of a structural deficit of 0.5 % of GDP. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure which does not exceed 2.9 %. It would correspond to a structural adjustment of 0.5 % of GDP.

4.1. Adjustment towards the MTO

Slovakia is required to achieve an annual fiscal adjustment of 0.5 % of GDP towards the medium-term budgetary objective in 2017. According to the information provided in the Draft Budgetary Plan, the real growth rate of net primary government expenditure[12] in 2017 will exceed the applicable expenditure benchmark rate of 1.3 %, leading to a deviation of 0.3 % of GDP. The structural balance pillar also points to a risk of some deviation although with a smaller gap. The expenditure benchmark is not impacted by slow revenue growth, which lags behind nominal GDP growth (mainly due to low corporate income tax receipts) and it deducts savings from the projected decline in interest expenditure. The expenditure benchmark hence appears to capture more accurately the fiscal effort of Slovakia at the current juncture. Information provided in the Draft Budgetary Plan hence points to a risk of some deviation in 2017. The Commission 2017 autumn forecast confirms this conclusion for 2017, as the expenditure benchmark pillar also points to a risk of some deviation when looking at 2017 alone; moreover, the structural balance suggests the same conclusion. Taking 2016 and 2017 together, both pillars point to compliance. In summary, the overall assessment thus points to a risk of some deviation in 2017.

[11] OJ C 261, 9.8.2017.

[12] Net government expenditure is comprised of total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a four-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

Table 5. Compliance with the requirements of 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)	-2.0	-1.6		-1.2	
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	**DBP**	**COM**	**DBP**	**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	0.4	0.3	0.6	0.4
One-year deviation from the required adjustment [7]	0.5	-0.1	-0.2	0.1	-0.1
Two-year average deviation from the required adjustment [7]	0.1	0.2	0.2	0.0	-0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	2.2	1.3		2.9	
One-year deviation adjusted for one-offs [9]	0.3	-0.3	-0.2	-0.3	-0.3
Two-year average deviation adjusted for one-offs [9]	-0.1	0.0	0.1	-0.3	-0.2
PER MEMORIAM: One-year deviation [10]	0.3	-0.2	-0.1	-0.3	-0.3
PER MEMORIAM: Two-year average deviation [10]	0.3	0.0	0.1	-0.2	-0.2
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Compliance	Compliance	Overall assessment	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 2016) was carried out on the basis of Commission 2017 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 :

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

According to the Council Recommendation addressed to Slovakia on 11 July 2017, Slovakia's adjustment requirement for 2018 is of a nominal growth rate of net primary government expenditure which does not exceed 2.9%.[13] This corresponds to a structural adjustment of 0.5 % of GDP. Based on the information in the Draft Budgetary Plan, the planned deviation from the expenditure benchmark amounts to 0.3 % of GDP. The structural balance pillar, on the other hand, suggests compliance with the preventive arm of the SGP. When taken over 2017-2018 together, the expenditure benchmark pillar suggests a risk of a significant deviation (an average gap of 0.3 % of GDP) while the structural balance indicator still points to compliance. Taking the more stringent two-year period as the reference point, an overall assessment is needed. As the expenditure benchmark is not being impacted by revenue shortfalls (again mainly due to corporate income tax revenues) and smooths investment volatility related to the expected drop in the drawdown of EU funds, it appears to be the preferred indicator at the current juncture. However, in 2018, the expenditure projected in the Draft Budgetary Plan plans two non-spending-related reserves (worth 0.2 % of GDP) that cater for expected revenue shortfalls (these are largely excluded in the Commission forecast, see Section 3.1 for more detail). Partly netting these from the expenditure aggregate, the expenditure benchmark over 2017 and 2018 taken together would point to a risk of some deviation. The overall assessment over 2017 and 2018 based on the Draft Budgetary Plan hence points to a risk of some deviation.

The Commission 2017 autumn forecast broadly confirms the readings based on the Draft Budgetary Plan relating to 2018.. The expenditure benchmark indicator suggests a risk of some deviation in 2018 with the structural balance pillar confirming this deviation, although with a smaller margin. Analogous to the Draft Budgetary Plan, the Commission forecast assumes slow growth in corporate income tax revenues and a drop in drawdown of EU funds that affects investment.[14] As these developments do not impact the expenditure benchmark it appears a more telling measure of the underlying fiscal effort. Taking 2017 and 2018 together, the picture is similar. The overall assessment hence points to a risk of some deviation in 2018.

The Commission Communication on the 2017 European Semester of May 2017[15] stated that the Commission stands ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment is particularly significant. The country-specific recommendations adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. However, in light of the fact that Slovakia is not found at risk of a significant deviation in 2018, such a qualitative assessment does not need to be carried out at this stage.

Following an overall assessment based on the Draft Budgetary Plan and the Commission's 2017 autumn forecast, the adjustment path towards the MTO seems to point to some deviation from the adjustment path towards the MTO in both 2017 and 2018.

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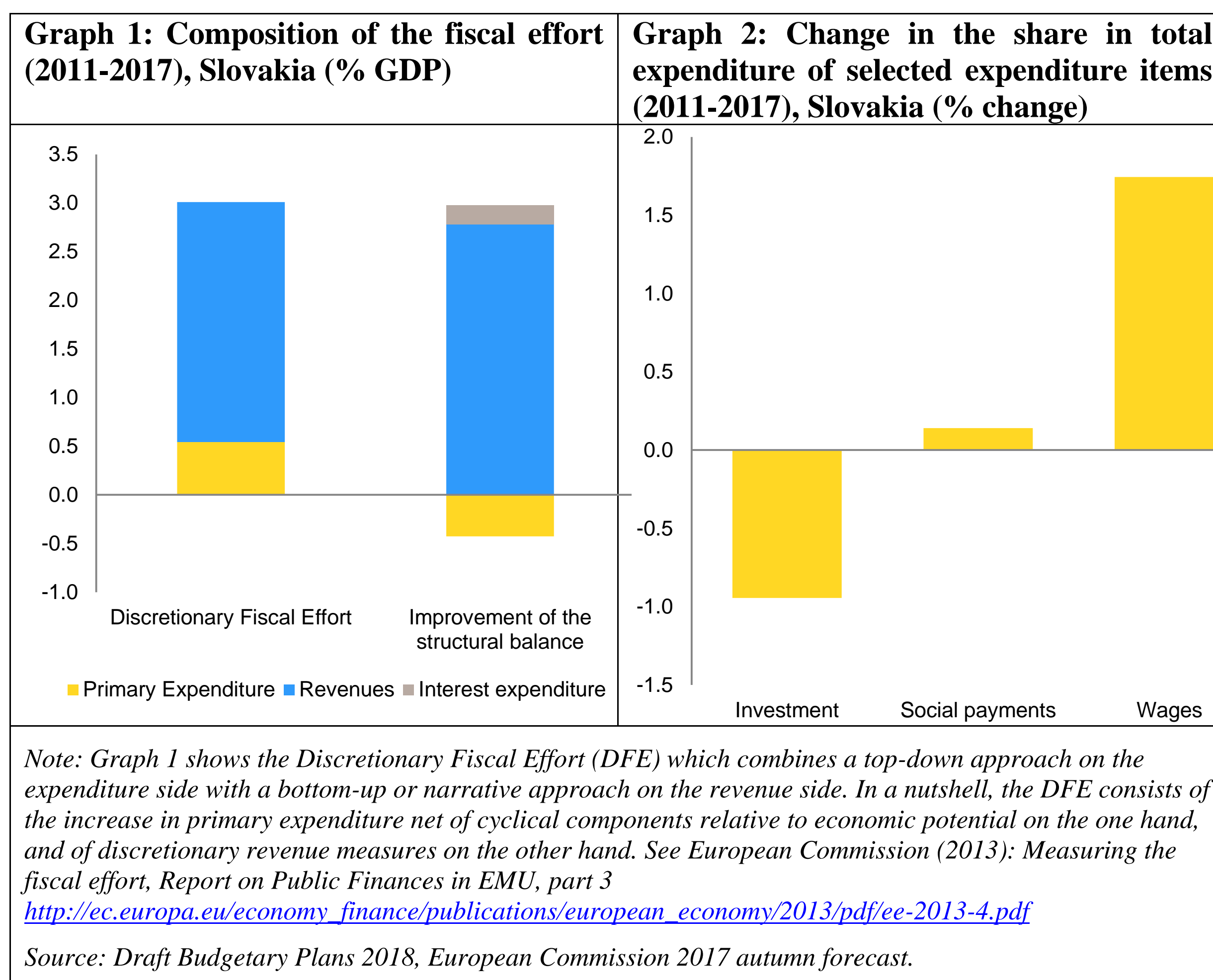
[13] As part of the agreement on the EFC Opinion on "*Improving the predictability and transparency the SGP: a stronger focus on the* expenditure *benchmark in the preventive arm",* which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

[14] As explained in Section 3.1, the Commission 2017 autumn forecast corrects for the non-spending reserves created for expected revenue shortfalls.

[15] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

5. Composition of public finances and Implementation of fiscal structural reforms

The fiscal adjustment between 2011 and 2017 has been primarily driven by the revenue side (Graph 1). While the Discretionary Fiscal Effort indicator suggests that part of the adjustment was also supported by primary expenditure, the decomposition of the structural balance improvement suggests that during this period expenditure was slightly expansionary and that the improvement on the expenditure side was achieved mainly through declining interest outlays reflecting falling interest rates. Based on the information provided in the Draft Budgetary Plan, the fiscal adjustment in 2018 is likely to come mainly from the expenditure side as expenditure growth is kept below that of nominal GDP.



Graph 1: Composition of the fiscal effort (2011-2017), Slovakia (% GDP)

Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Slovakia (% change)

Note: Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3
http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

Source: Draft Budgetary Plans 2018, European Commission 2017 autumn forecast.

The share of investment in total public spending has decline by almost 1 percentage point in 2011-2017 while outlays on social policies and especially the public wage bill have become more prominent (Graph 2). This development reflects the fact that investment is an expenditure item that can be – in case of a need – cut most easily. This deterioration, nevertheless, hides temporary hikes in investment, especially in 2015, which were related to massive increase in the drawdown of EU funds in view of the finishing 2007-2013 programming period. This also suggests great dependency of Slovak public investment on EU funds which is confirmed in 2018 when the share of investment in total spending is projected to decline mainly due to an expected drop in EU funds utilisation. Increases in salaries of teachers, healthcare staff and civil servants, the perceived low levels of which have led to

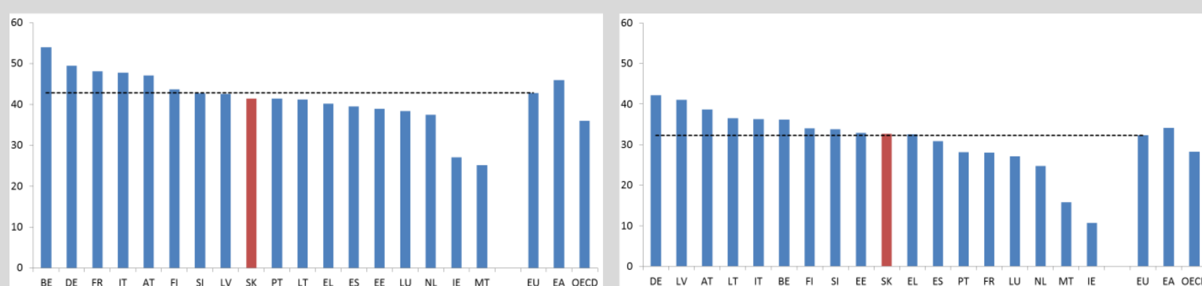
several strikes in the past, have driven up spending on the public wage bill. This is expected to endure in 2018, when the share of public wages in total spending is set to increase by 1 percentage point.

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 a low wage (2014)



Notes: No recent data is available for Cyprus. 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. The government plans to introduce a voluntary 13th and 14th salary which would be exempted from social security contributions. In addition, the income of pensioners (up to a certain ceiling) working on 'contract agreements' would also be exempted from social security contributions. These measures address government priorities and do not constitute a part of a more general tax shift. Introduction of these measures is possible thanks to positive cyclical position of the economy which generally supports tax revenues. The 13th and 14th salaries are not expected to have an impact on the labour market as it is expected that these salaries will replace existing bonus schemes.

In 2018, the Ministry of Finance plans to carry out a spending review of public wages (excluding employees of healthcare and education institutions as well as armed forces) in the context of the Value for Money project. The review is expected to address both the adequacy of staffing of public institutions and pay structures of employees. The additional two areas to be examined under the expenditure reviews will include agricultural policies and inclusion policies for marginalised groups. These reviews will complement the ones carried out in 2017 for expenditures on education, environmental policies and labour market and social policies.

On 11 July 2017, the Council addressed Slovakia in the context of the European Semester recommendations to improve the cost-effectiveness of the healthcare system, including by implementing the value-for-money project. The Draft Budgetary Plan reports the measures being implemented as a result of the 2016 spending review in the healthcare sector. These include measures to curb spending on medicines (mainly by reducing their overuse and centralised purchases), diagnostics (e.g. radio-diagnostic and laboratory examinations) and special healthcare materials. A new directorate was established in the Ministry of Health to govern all hospitals falling under the responsibility of the Ministry and oversight bodies in hospitals were created with the aim to strengthen hospital management. At the beginning of 2017, the diagnosis-related groups (DRG) payment mechanism was introduced with specific reimbursement rates for each hospital. From 2018, these rates are expected to converge over five years into a single reference rate.

A comprehensive assessment of progress made in the implementation of the country-specific recommendations will be made in the 2018 Country Reports and in the context of the country-specific recommendations to be proposed by the Commission in May 2018.

6. Overall conclusion

Following an overall assessment of the Draft Budgetary Plan, the planned structural adjustment would point to a risk of some deviation in 2017 from the required adjustment path towards the MTO in a one-year time frame. This conclusion is confirmed by the Commission 2017 autumn forecast. For 2018, the Draft Budgetary Plan points to a risk of a significant deviation under the expenditure benchmark pillar over 2017 and 2018 taken together; however, once correcting for inflated reserve levels on the expenditure side, a risk of some deviation from the adjustment towards the MTO is identified. Following an overall assessment, the risk of some deviation in 2018 is also confirmed by the Commission 2017 autumn forecast.