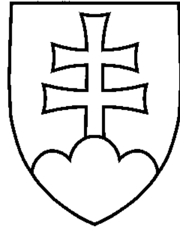

Stability Programme of the Slovak Republic for 2012 - 2015

April 2012

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Statement of the Government of the SR

Government of the SR recognises and reaffirms its commitment arising from Slovakia's membership in the European Union and the euro area. The Stability Programme submitted hereafter was drafted by a government whose mandate ended on 4 April 2012. On the same day a new Government was appointed and obliged to present to the National Council of the SR, within 30 days, its policy manifesto and ask the Parliament for a vote of confidence. The policy manifesto of the Government identifies with the objectives of the Stability Programme 2012 but offers fundamentally different tools. Nevertheless, the continuity in the area of the challenges that Slovakia faces today and that need to be addressed, is important. However, the new Slovak Government does not completely identify with the measures taken in the past and their assessment. In accordance with the decision of the European Council – Ecofin, the Government of the SR submits the Stability Programme of the SR 2012 by the set deadline of 30 April 2012. The Government commits to supplement the Stability Programme of the SR in the shortest possible time with measures that will be in line with the policy manifesto of the new Government.

INTRODUCTION

Members of the euro area are required to prepare stability programmes each year, while other European Union members prepare convergence programmes. Preparation of the stability and convergence programmes forms an integral part of the Stability and Growth Pact and, after approval by national governments; these programmes are submitted to the European Commission and the Council. Their purpose is to present the development of fiscal position in the medium term, expected economic development, and a description of the fiscal and economic policy measures taken to achieve the goals of the programme. Slovakia is submitting its fourth stability programme which is an updated version of the April 2011 stability programme.

The stability programme is submitted to the European Commission within the framework of the "European Semester", the objective of which is to improve the coordination of fiscal and structural policies, taking into account the rules of the Stability and Growth Pact and the Europe 2020 strategy. The whole process began with the publication of the Annual Growth Survey for 2012 in which the Commission outlined five main priorities, including differentiated growth-friendly fiscal consolidation. Member States have been invited to follow the recommendations outlined for individual priority areas in developing their stability programmes and national reform programmes.

Following Slovakia's accession to the euro area, the main goals of the Government in the area of macroeconomic policies focused primarily on the area of fiscal policy and structural policies which represent the main tools for influencing the development of the real economy should internal or external shocks occur.

Along with 22 other EU Member States, Slovakia is currently subject to the excessive deficit procedure (EDP), with deadline for excessive deficit elimination set for 2013. The first major step towards improving fiscal position was the 2011 fiscal consolidation when the general government deficit decreased from 7.7% of GDP in 2010 to 4.8% of GDP in 2011. Taking into account other factors and the economic cycle effect, the year-on-year improvement in the fiscal balance, the so-called consolidation effort, represented 3.4% of GDP.

The stability programme presents a strategy which, in the medium-term, should lead to the abrogation of the excessive deficit procedure. However, the ultimate goal remains unchanged: achieving a solid fiscal position which ensures sustainability of public finances in the long run. This will require further consolidation effort also beyond 2013 in order to bring Slovakia closer to meeting its medium-term budgetary objective, i.e., structural deficit of 0.5% of GDP.

The main objectives of the Stability Programme of Slovakia up to 2015:

- The basic objective is to reduce the general government deficit to 2.9% of GDP in 2013 on a permanent and sustainable basis in order to comply with the EDP requirements.
- One of the essential prerequisites to achieving this objective is to fulfil the budget approved for 2012 with the deficit target of 4.6% of GDP and adopt consolidation measures representing 2.3% of GDP (compared to an unchanged economic policies scenario) in 2013, while observing the Government's priorities.
- In the following years, the deficit will be further reduced so as to ensure annual consolidation effort at 0.5% of GDP in compliance with the Stability and Growth Pact rules. Hence, the target deficit values have been set at 2.3% of GDP for 2014 and 1.7% of GDP for 2015. The meeting of these targets will enable gradual reduction of the government debt to GDP ratio after 2014. The measures that need to be taken represent 0.4% of GDP for 2014 and additional 0.6% of GDP for 2015; some of these measures have already been incorporated in the draft of the General Government Budgetary Framework for 2013-2015.

For 2012, the 2012-2015 Stability Programme is based on the General Government Budget for 2012-2014 as approved by the Slovak Parliament in December 2011. For 2013-2015, the Stability Programme is based on the draft General Government Budgetary Framework for 2013-2015 submitted to the Government for approval. The Stability Programme, once approved by the Government, is submitted to the Slovak Parliament.

The content and the format of the document are in full compliance with the guiding principles of the European Commission. These guiding principles are based on the *"Specifications on the Implementation of the Stability and Growth Pact"* and the *"Guidelines on the Format and Content of Stability and Convergence Programmes"*. These documents were approved in 2005 with a view to improving the implementation of the Stability and Growth Pact, which is an essential part of the macroeconomic framework of the Economic and Monetary Union. The Stability Programme reflects the most recent revision of these documents from January 2012 linked to the revision of the Stability and Growth Pact within the framework of the comprehensive reform of the EU economic surveillance rules through the adoption of five regulations and one directive ("six pack"). The Stability Programme of the Slovak Republic also takes account of the deliberations, documents and recommendations of the Economic and Financial Committee.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The objectives of the Government's economic policy have been set so as to react flexibly to the current economic crisis, yet the underlying priority remains the same – ensuring sustainable economic growth on a long-term basis in order to improve the standard of living and speed up the process of catching up with the advanced EU Member States. Accession of Slovakia to the euro area and the loss of independent monetary policy underscore the importance of pursuing a responsible fiscal policy focusing on consolidation and effective operation of automatic stabilisers, as well as structural policies aimed at boosting economic growth potential.

I.1. Fiscal policy

The main objective of the Slovak fiscal policy is to achieve such an improvement in the fiscal position that creates conditions for long-term sustainability of public finances. The 2011 consolidation was the first step towards meeting this objective.

The fiscal policy objectives for the following years have been set so as to ensure that Slovakia reduces its general government deficit below 3% of GDP by 2013 in a permanent and sustainable manner, which would lead to the abrogation of the excessive deficit procedure. Public finance consolidation will also continue beyond 2013 in order to bring Slovakia closer to achieving its medium-term budgetary objective, i.e., structural deficit of 0.5% of GDP.

Given the restrictive nature of the fiscal policy throughout the period covered by the stability programme, it is essential that the measures adopted have the least possible adverse impact on economic growth. The drawing of EU funds may provide an important impetus for the economy.

I.2. Monetary policy

Price stability remains the main monetary policy objective following Slovakia's accession to the euro area. The European Central Bank defines price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) in the euro area below 2%. However, with Slovakia's real and nominal convergence still underway, a slightly higher rate of inflation should be expected given the absence of the exchange-rate channel. From a long-term perspective, responsible fiscal policy and structural policies aimed at enhancing the flexibility of the labour market and the market in goods and services will be particularly essential to ensuring price stability in Slovakia.

I.3. Structural policies

The goal of structural reforms is to improve the quality of life in Slovakia, primarily by fostering economic growth and employment in line with the Stability and Growth Pact and the Europe 2020 strategy. In order to improve the quality of life, changes are necessary in the following priority areas: (1) education, science and innovation, (2) employment and social inclusion, (3) business environment, (4) transparency and rule of law, and (5) health. The achievements in individual priority areas are monitored through performance indicators which are part of the National Reform Programme of the Slovak Republic.

The **education system reform**, particularly in the **tertiary education and science,** with emphasis on enhancing the quality of educational and scientific institutions, is essential to Slovakia's prosperity in the long run. The Government will support better **employment** particularly through a comprehensive reform of the active labour market policies. The Government will take steps towards making these active polices, including social benefits, better targeted. **In the business sector,** particular attention is being paid to reducing administrative burden, enhancing transparency, and supporting the development and modernisation of the transport infrastructure. The continuation of changes in the **healthcare and public administration sectors** should make public spending more efficient and, at the same time, improve the quality of public services.

I.4. Slovakia under the Excessive Deficit Procedure

Under Article 126(6) of the Treaty on the functioning of the European Union (TFEU), on 2 December 2009 the ECOFIN Council adopted Council Decision on the existence of an excessive deficit in Slovakia, placing Slovakia under the excessive deficit procedure. At the same time, the EU Council approved, under Article 126(7) of the TFEU, recommendations for Slovakia; the recommendations and Government's responses are included in the following table:

TAB 1 – Reactions of the Slovak Government to EU Council recommendations

Recommendation	Reaction
Excessive deficit should be corrected by 2013.	The goal of the Slovak Government is to reduce the general government deficit to 2.9% of GDP in 2013 in a permanent and sustainable manner and continue with the consolidation of public finances in the years to come.
The deficit-reducing measures should be implemented in 2010 as planned in the general government budget for 2010–2012.	The first package of consolidation measures was adopted with effect from 2011; its implementation led to a consolidation effort of 3.4% of GDP. Further consolidation measures will be taken in the course of 2012.
Annual average consolidation effort should reach 1% of GDP over the period of 2010–2013.	The annual average consolidation effort in 2010 and 2011 represented 1.4% of GDP. If budgetary objectives are met in 2012 and 2013, the average consolidation effort is expected to reach 1.4% of GDP. It means that the annual average consolidation effort will represent 1.4% of GDP for the 2010-2013 period.
The Slovak government should specify the measures necessary to achieve the correction of the excessive deficit by 2013 and accelerate the reduction of the deficit if macroeconomic developments turn out better than currently expected.	The Government will shortly draw up a list of specific measures designed to bring the general government deficit below 3% of GDP in 2013 on a sustainable basis.
To limit risks to the adjustment, the enforceability of medium-term budgetary framework should be strengthened and the monitoring of the budget execution throughout the year should be improved, in particular to avoid expenditure overruns.	The Fiscal Responsibility Act (a constitutional act in force as of 1 March 2012) created conditions for the imposition of expenditure ceilings, which will strengthen the binding nature of the medium-term budgetary framework. Their concrete shape has been defined in an amendment to the Budgetary Rules Act, which currently in the legislative pipeline.

The medium-term objective of the Slovak fiscal policy remains unchanged compared to the previous Stability Programme – reduction of the general government deficit to 2.9% of GDP in 2013. In order to meet this objective, additional measures in the total amount of EUR 1,166 million (1.6% of GDP) will have to be adopted in the course of 2012, as envisaged in the draft General Government Budgetary Framework for 2013-2015.

II. ECONOMIC OUTLOOK AND PROJECTIONS

The economy of Slovakia continued to grow in 2011. However, as a consequence of fiscal consolidation, the pace of growth slightly slackened compared to the year before. Slovakia's GDP growth was driven by foreign demand and investments, whereas domestic consumption stagnated and the shrinking public consumption pulled GDP growth downwards in line with the austerity measures. The economic forecast anticipates decelerating economic growth in 2012 due to feeble foreign demand and the additional consolidation measures in the years to come. This, together with higher unemployment, will weaken the growth in household consumption.

II.1. External environment

The global economic recovery slackened in 2011. However, recovery is not evenly distributed and its momentum differs in different parts of the world. In 2011, the EU economy grew by 1.5% year-on-year, with Germany alone by as much as 3.0%, while the U.S. grew by 1.7%. The emerging economies, particularly those in Asia, grew rapidly in 2011. In its interim forecast published in February 2012, the Commission revised its 2012 growth expectations downwards, both for the euro area and the EU as a whole.

Global industrial output and global trade slowed down in 2011 and their growth will be gaining momentum at a slower pace. The medium-term output expectations, as measured by the leading "soft" indicators (IFO, ZEW, PMI, ESI), have been improving since the end of 2011. The economic growth of Slovakia largely depends on the economic performance of Germany, its key trading partner, whereas the slow growth in the EMU peripheral economies does not pose that much of a risk to Slovakia's growth. Soft indicators suggest that the growth may pick up in the second half of 2012. In its interim forecast, the Commission adjusted downwards its growth estimates for the euro area, which will get into a shallow recession (-0.3%) in 2012, although a moderate growth (0.6%) is still expected for Germany.

The U.S. economy grew by 1.7% in 2011 (compared to 3.0% in 2010); following the negative repercussions of earthquakes in Japan in the beginning of the year, economic growth gained speed towards the year-end. Despite slower economic growth compared to 2010, unemployment fell quite considerably at the end of 2011, which supported final household consumption in the last quarter when GDP growth (0.7%) even exceeded the forecasts published by the Commission in the autumn of 2011. The U.S. economy is expected to grow at a slightly faster pace, about 2% in 2012, provided that global demand will develop in line with expectations and that the debt crisis in the euro area will not deepen further.

In the euro area, the economic growth of Germany (a country of key importance for the Slovak economy) slowed down, while the countries on the euro area periphery (with less of an impact on the Slovak economy) are slipping into recession. According to the revised GDP growth projection, GDP in the euro area fell 0.3% in the fourth quarter compared to the previous quarter after an extremely sluggish growth of 0.1% in the third quarter. This still represents a growth of 0.7% year-on-year. The economic growth of Slovakia's major trading partner, Germany, also slipped into negative figures in the fourth quarter, falling 0.2% on the previous quarter, but still increasing 2% year-on-year.

As in 2011, the euro area financial markets remain in serious condition also in 2012, despite fairly positive developments in early 2012 and a moderate calm down of the overall situation. Stock markets, which respond mainly to future expectations, continued to grow. Uncertainty (traded through the stock market volatility index, VIX), reached its lowest values since June 2007. Several euro area countries (notably Italy and Spain) successfully sold their bonds, both in terms of volume and yield (compared to end-2011), Greece met the conditions for the second bailout package and restructured its debt to private creditors, and the EUR/USD exchange rate swung back above 1.30 despite the Standard and Poor's downgrade of sovereign debt ratings of a number of countries. Notwithstanding these positive signs, the situation remains serious as troubled economies continue to struggle with structural difficulties; hence, the market sentiment from the beginning of 2012 may as well be short-lived. This is indicated by a non-standard functioning of the interbank market or the necessity for the ECB to implement extraordinary measures to supply liquidity.

The slowdown of recovery on the emerging markets, which are less affected by the financial and debt crisis, has only been moderate. These countries intensified their trade relations which, in combination with only a slight output contraction during the crisis, gives them a wider margin to implement the necessary economic policies. The growth in foreign demand and domestic consumption in the emerging economies of Asia slowed down a bit, but continued to have positive effects on the global economic growth. The growth in real GDP is projected to reach 5.4% on the emerging markets in 2012, which is only slightly below the 6.2% level in 2011. The still robust growth in this region is primarily driven by China and India. The Chinese economic growth reached 9.2% in 2011 (down from 10.4% in 2010). According to IMF estimates, China should grow by 8.2% in 2012. The International Monetary Fund expects that the developed global economies will only grow by 1.2% of GDP in 2012, while the emerging markets by as much as 5.4%. The projections on external developments are in line with the most recent Commission's expectations for its spring forecast (currently under preparation), save for minor differences which are negligible.

TAB 2 – External assumptions for the February forecast

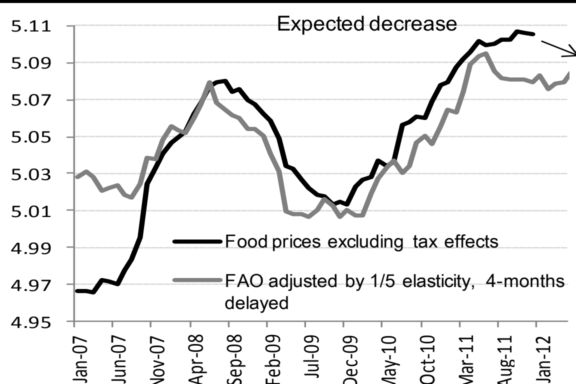
	MF SR			EC		
	2011	2012	2013	2011*	2012*	2013**
Economic growth						
EU	1.5	0.0	1.2	1.5	0.0	1.5
Euro area	1.4	**-0.5**	1.0	1.4	-0.3	1.3
Germany	3.0	**0.5**	1.7	3.0	0.6	1.5
USA	1.7	**2.1**	2.5	1.7	1.5	1.3
China	9.2	**8.2**	8.2	9.2	8.6	8.2
Imports of Slovakia's trading partners	5.0	**1.2**	4.0	5.0	**1.3**	4.4
Long-term interest rates (10Y)						
Euro area	2.7	2.2	2.9	2.7	2.0	2.5
USA	2.8	2.1	2.6	2.8	2.1	-
ECB key interest rate	1.3	0.8	1.0	-	-	-
Exchange rate (USD/EUR)	1.39	1.26	1.24	1.39	1.32	1.37
Oil price (Brent, USD/bl)	112.1	114.5	117.8	112.1	113.1	99.7
Oil price (Brent. EUR/bl)	80.5	91.2	95.3	80.5	85.7	72.8

*Source: MF SR February *EC Interim Forecast February,**Autumn Forecast, November 2011*

Under the pressure of a number of factors, the prices of oil and other global commodities continued to rise in 2011. Oil price (Brent) rose by more than 20% in 2011 and, following its upsurge in the beginning of the year, ranged from 110-115 USD/bl for the rest of the year on a relatively high volatility, but without any clear trend. At the beginning of 2012, oil prices began to surge again, attacking 130 USD/bl. In addition to the growing oil prices in dollar terms, the euro area has also been negatively affected by the EUR/USD exchange rate fluctuations, particularly when the euro slumped below 1.30 EUR/USD in the course of 2011. Oil prices in euro terms have now reached their all-time-high, attacking 100 EUR/bl. Apart from the global economic recovery, the hike in oil prices is probably also attributable to the quantitative easing in the U.S., political turmoil in North Africa, and the uncertainties around oil supplies from Iran.

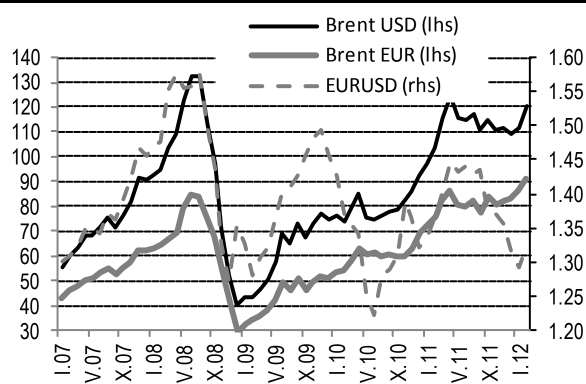
Global inflation was on the rise throughout 2011, mainly due to high food and oil prices and also thanks to the ongoing recovery of economic activity on the emerging markets, such as China and India. Inflationary pressures in the euro area where stronger than the ECB would wish to see when the prices in 2011 increased by 2.7% year-on-year, shooting inflation well above the ECB's target of 2% in many years (the last time when inflation exceeded 2% was in 2008). Global food prices stabilised at the end of 2011, but inflationary pressures persevere in 2012 due to growing oil prices. The euro area inflation rate is expected to decrease to 2.1% in 2012, according to the Commission forecast, which is only slightly above the ECB's inflation target.

GRAPH 1 – FAO food commodities index and food prices index in Slovakia



Source: MF SR, SO SR, FAO UN

GRAPH 2 – BRENT Oil (USD/bl) and EUR exchange rate



Source: Reuters

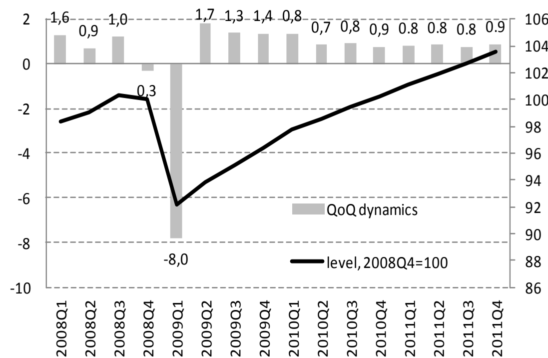
The monetary policy of most major central banks remained strongly expansionary throughout 2011, with a brief exception on the part of the ECB. Following a series of cuts, the key central bank, the FED, kept its interest rates at record lows throughout 2011. The FED's key interest rate has remained unchanged at 0.25% since December 2008. After two rounds of quantitative easing carried out primarily through bond purchases on the secondary market, the FED launched "Operation Twist" in 2011 (often described as the third round of quantitative easing) with the aim to curb the rise in long-term interest rates despite the growing deficit, weaker dollar and slightly higher inflation. Unlike the FED, the ECB cut its main refinancing operations rate by a total of 0.5 p.p. in 2011 amid concerns of inflation. Its key interest rate thus increased to 1.5%. Following the appointment of the new governor, the ECB embarked on interest rate cuts in the second half of the year, bringing its key rate back to 1% where it stood at the beginning of the year.

II.2. Economic development in Slovakia in 2011

In 2011, the Slovak economy grew by 3.3%, ranking second (after Estonia) on the list of the fastest growing economies in the euro area. The economy surpassed its pre-crisis level from the end of 2008 already in the second quarter of 2011. However, the economic growth slightly decelerated compared to 2010 (when it rose by 4.2%). This slowdown is largely attributable to the consolidation of public finances with adverse effects on the price level, labour market, and all components of the domestic demand.

The 2011 growth was mainly driven by the manufacturing sector, which was reflected in a robust export increase by nearly 11%. Total net exports contributed 5.5 p.p. to GDP growth. Investments (up 5.7%) also contributed positively to GDP growth, in particular investments in preparations for the launch of new production capacities in the automotive industry and, to a lesser degree, also investments in motorway construction. The most negative contribution (-2 p.p.) to GDP growth in 2011 was attributable to the change in inventories. Companies began to reduce inventories in the second quarter of 2011 amid growing uncertainty about future sales and, consequently, unwillingness to stockpile their output. However, the biggest drop in inventories, which occurred at the end of 2011, could, on the contrary, have been caused by higher-than-expected demand which the production capacities were not able to accommodate. A decrease in the household disposable income, caused by the higher tax and contribution burden and higher inflation, contracted household consumption by 0.4%. The decline in consumption was mainly due to the reduced household spending on food and non-alcoholic beverages. The lower income has also led to a drop in the savings rate, which, nevertheless, remains at a high level. From among all components, the general government consumption declined most steeply (3.5% in real terms) due to the negative effects of consolidation measures, especially in the case of purchases of goods and services.

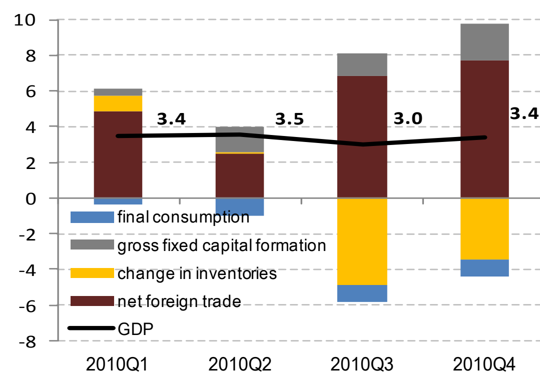
GRAPH 3 – GDP, adjusted for seasonal and one-off effects *



**GDP adjusted for cigarettes stockpiling*

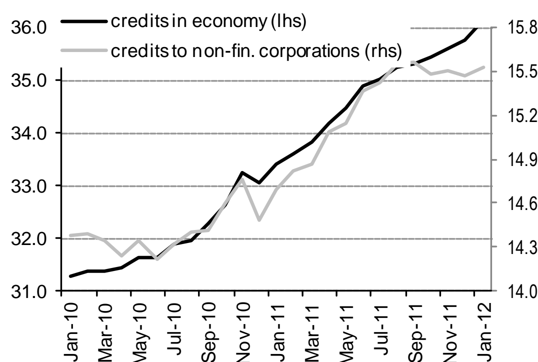
Source: SO SR, MF SR calculation

GRAPH 4 – Contributions to annual GDP growth in 2011



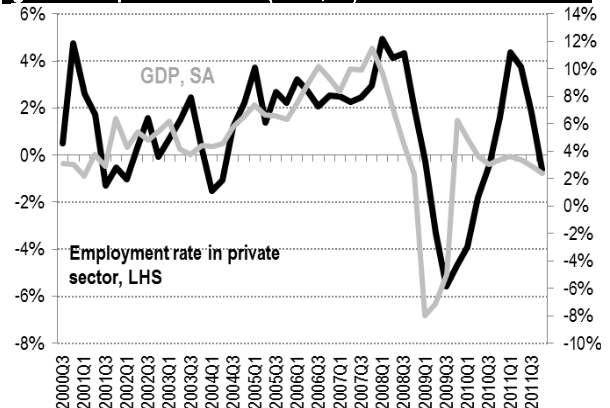
Source: SO SR

GRAPH 5 – Credits in economy and credits to non-financial corporations (bn. EUR)



Source: NBS

GRAPH 6 – Annualised GDP growth and employment growth in private sector (QoQ, %)

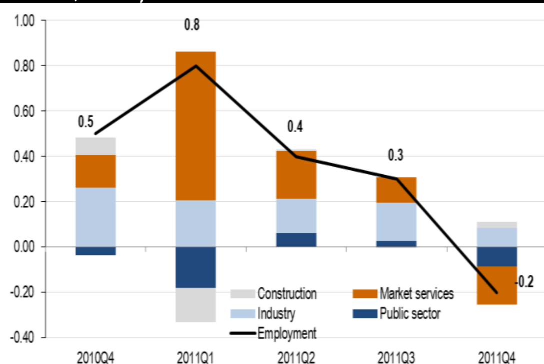


Source: MF SR

Although the labour market showed signs of recovery in 2011, its momentum was curbed by the consequences of fiscal consolidation. The economy created 38,000 new jobs in 2011, which represents a 1.8-percent increase in employment under the ESA95 methodology. The highest number of new jobs was created in the manufacturing and market services sectors which the crisis affected the most. On the other hand, the effort to reduce the general government deficit resulted in redundancies in public administration and state-owned enterprises. More than 6,000 persons lost their jobs in public administration in 2011.[1] Notwithstanding the overall increase in employment, its level is still far below the pre-crisis levels. While the output side of the economy returned to its pre-crisis level in 2010, the employment gap is still almost 40,000 jobs. Consequently, the labour productivity and the number of hours worked per employee continued to rise also in 2011.

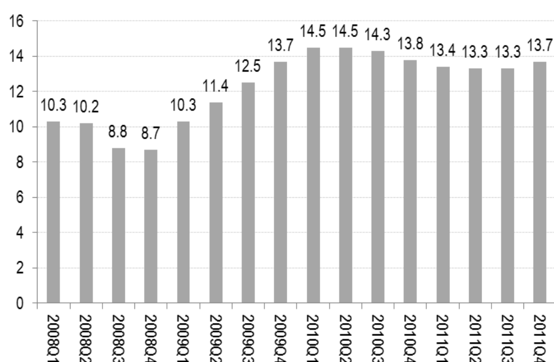
[1] Business reporting methodology

GRAPH 7 – Employment growth in selected sectors (ESA 95, QoQ)



Source: SO SR

GRAPH 8 – Unemployment rate, seasonally adj. (%)



Source: SO SR

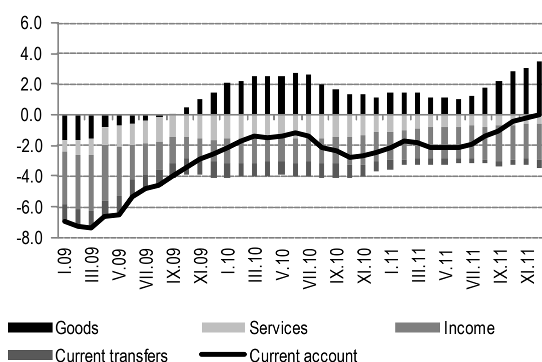
According to the LFS methodology based on the national concept, the number of unemployed in 2011 decreased on average by more than 20,000 year-on-year. The rate of unemployment (LFS) thus reached 13.5% in 2011. Despite this development, the problem of long-term unemployment is further exacerbated, with the share of the long-term unemployed continuing to rise, reaching 63.9% of all unemployed in 2011.

The average nominal wage grew by 2.2% in 2011, which was below the previous year's growth rate. The main reasons behind the slow growth in wages include the wage cuts in public administration and the growing uncertainty about future developments at the end of the year, which stifled the payout of year-end bonuses. The average nominal monthly wage in 2011 reached EUR 786. Given the low increase in nominal wages and the higher inflation, the real wage dropped by 1.6%. As was the case with employment, the wage development was also affected by fiscal consolidation. Nominal wages in public administration fell by 1%.

The 2011 trade balance was higher than in 2010 and reached a considerable surplus of 3.5% of GDP. This indicates that the manufacturing sector continues to be highly competitive and that the domestic demand remains sluggish. In 2011, the imports of industrial supplies and consumer goods increased, while the imports of capital goods slowed down considerably. The highest exports were reported in the categories of vehicles and metals. Except for metals, all other export components exceeded in 2011 their pre-crisis levels from 2008. Total nominal exports of goods increased by 16.9% and imports by 13.6% year-on-year.

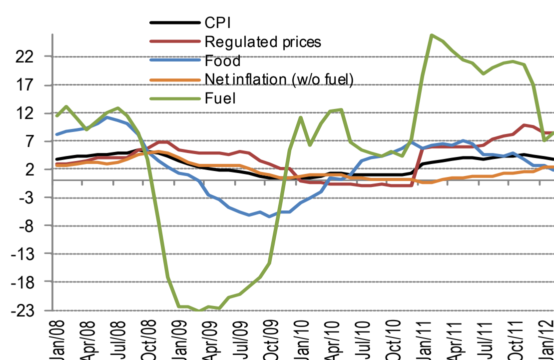
The current account of the balance of payments showed a surplus of 0.1% of GDP in 2011, compared to the 2010 deficit of 2.5% of GDP. The balance of payments improved thanks to the more favourable development of the balance of goods and services. The balance of services improved, among other things, thanks to lower imports of financial services and faster growth in transport services. Improvements also occurred in the balance of current transfers; however, the balance of income deteriorated.

GRAPH 9 – External imbalances – components of the CA BP (% HDP last twelve months)



Source: NBS, MF SR

GRAPH 10 – Structure of consumer inflation (annual growth in %)



Source: SO SR

Following the extremely low inflation rate in 2010 (1%), which was influenced by feeble global demand, Slovak consumer prices in 2011 rose considerably (3.9%). In addition to the domestic factors, the 2011 inflation in Slovakia remained under the influence of external factors, such as growing global food prices and higher price of oil, as a result of which the price of natural gas surged (by 6.9%) in July 2011. Since the middle of the year, the upward inflationary pressure has primarily been driven by the rising prices of gas and heat. The overall contribution of the Government's consolidation measures to the growth in average prices represented 0.9 p.p.; the most significant component – increase in the basic VAT rate from 19% to 20% - contributed 0.5 p.p. The poor harvest, both locally and globally, hiked food prices in early 2011 to their record heights since the summer of 2008. Inflation in the EU peaked in the autumn of 2011, reaching 3.0% year-on-year in the euro area. In December, inflation in Slovakia reached 4.6% year-on-year (measured by HICP), which was the highest inflation rate in the euro area at the year-end.

II.3. Medium-term economic forecast

The latest official forecasts published by the Ministry of Finance on 7 February 2012 reflect, in particular, the worse-than-expected economic performance of Slovakia's major trading partners in 2012, as well as the additional consolidation effort in 2013-2015. The insufficient foreign demand will couple with feeble growth in domestic demand, which will mainly be driven by investments. Compared to the previous year, the growth in 2012 is expected to slow down to 1.1%, mainly as a consequence of the slackened growth in the external environment. In the following forecast years, the economic growth is expected to accelerate to 3.7% and its structure should be more balanced as household consumption picks up when the labour market reaches a turning point.

TAB 3 – Forecast of selected indicators of Slovak economy for the budgetary framework for 2013

No.	Indicator		Actual		Forecast			
		Unit	2010	2011	2012*	2013	2014	2015
1	GDP, current prices	EUR bn.	65.7	69.1	71.3	74.8	79.2	84.0
2	GDP, constant prices	%	4.2	3.3	1.1	2.7	3.6	3.7
3	Final consumption of households and NPISH[2]	%	-0.7	-0.4	0.0	0.7	2.9	3.9
4	Final consumption of government	%	1.1	-3.5	-2.1	-4.2	1.2	-1.9
5	Gross fixed capital formation	%	12.4	5.7	1.6	2.1	1.9	2.9
6	Export of goods and services	%	16.5	10.8	2.2	8.2	5.9	5.3
7	Import of goods and services	%	16.3	4.5	0.7	7.8	5.2	4.7
8	Output gap (share of potential output)	%	-1.0	-0.1	-1.6	-1.5	-0.8	0.0
9	Average monthly wage in the economy (real growth)	%	3.2	2.2	3.4	4.3	4.7	5.6
10	Average employment growth, LFS	%	-2.0	1.5	-0.3	0.4	0.6	0.8
11	Average employment growth, ESA95	%	-1.5	1.9	-0.2	0.3	0.5	0.8
12	Average unemployment rate, LFS	%	14.4	13.5	13.8	13.7	13.5	13.2
13	Harmonized index of consumer prices (HICP)	%	12.5	13.2	13.6	13.6	13.5	13.2
14	Current account balance (share of GDP)	%	0.7	4.1	2.8	2.3	2.3	2.5
15	GDP, current prices	%	-2.5	0.1	-0.2	-0.3	0.3	0.6

**Newer „flash" forecast, described below, is available for 2012* *Source: MF SR*

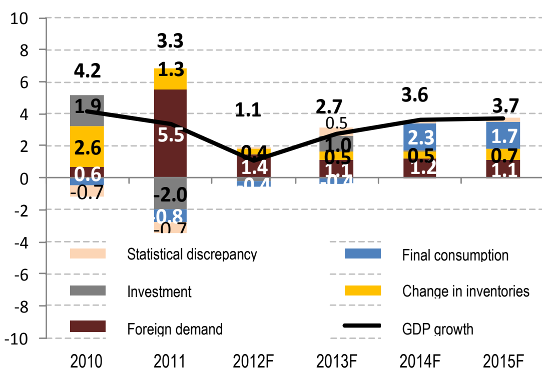
The budgetary framework is based on the February forecast which assumes a growth of **1.1%** in 2012, driven mainly by fixed investments, inventory re-stocking and foreign demand. Its deceleration is largely due to the consolidation effort and the worse-than-expected performance of Slovakia's trading partners. On the other hand, the consolidation-related expectations increase consumer uncertainty which, coupled with the very slow recovery of the labour market, will bring household consumption to stagnation in 2012. In line with the public finance consolidation plan, final government consumption will have the most negative dynamics of all GDP components

[2] In the following text households' consumption denotes consumption of households and non-profit institutions serving households (NPISH).

and is expected to shrink by 2.1%. Albeit positively influenced by the expected new investment of Volkswagen Slovakia, the growth in investments will be toned down by fiscal consolidation and weak foreign demand. Nevertheless, the existing production capacities should be sufficient to meet the foreign demand which is expected to revive from 2013 onwards. However, the export of Slovak of goods and services is primarily contingent on foreign demand for goods and services, which is expected to rise only by 2.2% in 2012. Since the import forecast reflects the underperformance of both domestic demand and exports, the 2012 contribution of foreign trade to GDP will still be positive despite slowdown. In the following years, GDP growth should accelerate and reach 3.7% in the medium term.

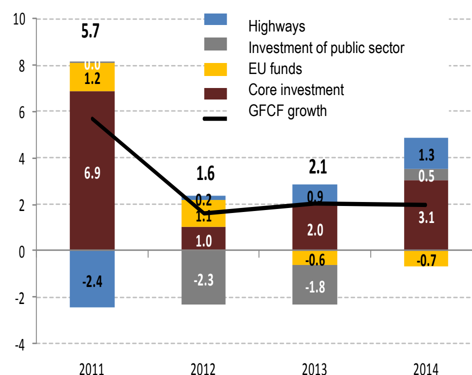
The new "flash" estimate of GDP growth for 2012 also takes into consideration, in addition to the improved expectations for the external environment, **the data published for the fourth quarter of 2011,** according to which the Slovak economy grew by a surprising 0.9% on a quarterly basis (3.4% year-on-year). If we apply the same quarter-on-quarter growth figures as those reported in February, the 2012 growth would reach 1.6%. Based on the most recent revised estimates (from March 2012), the Slovak economy should grow at **2.3%,** which is faster than the original expectation. **The higher growth is attributable to a more positive development in the last quarter of 2011 and to the upward revision of growth estimates for exports and investments in 2012 due to more positive external-environment expectations.** On the expenditure side, the higher than expected growth in exports and investments came as a surprise. Moreover, exports will also be driven by the improved expectations of the euro area development in the first two quarters of 2012. The euro area could thus rise by 0.2% in 2012 compared to the decline of 0.5% projected in the February forecast. The more positive than originally expected development is also indicated by the January figures on the growth of the Slovak manufacturing output, export of goods, and industrial orders.

GRAPH 11 – Contributions to GDP growth in 2009-2015



Source: MF SR

GRAPH 12 – Contributions to gross capital formation (GCF)



Source: MF SR

BOX 1 – Impact of fiscal consolidation

In connection with the excessive deficit procedure, the Slovak Government committed itself to reducing the general government deficit below 3% of GDP in 2013. In line with the provisions of the preventive arm of the Stability and Growth Pact, Slovakia should annually improve its structural balance by 0.5% of GDP, starting in 2014. At the time of preparation of the macroeconomic forecast, this translated into the general government deficit of **2.9%** of GDP in 2013, **2.3%** of GDP in 2014, and **1.5%** of GDP in 2015. Such deficit reductions would require the adoption of consolidation measures worth EUR 1.4 billion (1.9% of GDP) in 2013, EUR 556 million (0.7% of GDP) in 2014, and EUR 687 million (0.8% of GDP) in 2015 [3]. Both the expenditure measures (approximately 40%) and revenue measures (approximately 60%) have been planned for implementation in 2013. This assumption is only illustrative, serving forecast purposes only, because their actual mix will be decided by the new Government. For the 2014-2015 period, the forecast anticipated the adoption of expenditure measures only. The savings on the expenditure side were divided between current and capital expenditures in a 70/30 ratio. In the structure of current expenditures, the consolidation effort is divided evenly between the government intermediate consumption and employee compensations (50/50).

In 2013, 40% of fiscal consolidation measures concentrate on the expenditure side which, through lower wage expenditure and lower government intermediate consumption and investments, will have a negative impact on the government's final consumption and gross capital formation overall. The forecast anticipates cuts in wage expenditure across the general government, by reducing both employment and employee compensations. Reduced employee compensations will deflate general government consumption. Unemployment rate will increase due to reduced employment in the general government sector. The slower growth in wages will reduce disposable income and deflate household consumption (though only partially) since the level of savings is also expected to decline. Reduced domestic demand will also affect import intensity through lower imports of goods and services. The revenue measures, which account for 60% of the fiscal package, will have a negative impact on inflation. Their overall impact on average inflation will represent 0.14 p.p. in 2013. Increased consumer prices will accelerate the dynamics of the deflators of final household consumption and GDP. The revenue component of the measures will also negatively influence household disposable income and, thereby, household consumption. However, the full impact of the change will be softened by a reduction in the level of savings. **The 2013 impact of fiscal consolidation on GDP growth is estimated at -0.7 p.p., which will bring fiscal multiplier to 0.4. The fiscal measures implemented in the following years will have a negative effect on economic growth, -0.5 p.p. in 2014 and -0.8 p.p. in 2015.**

The overall influence on individual macro-indicators is presented in the following table:

Impact of fiscal consolidation on GDP (Change from dynamics in the baseline scenario in p.p.)

	2013	2014	2015
consolidation measures (% of GDP)	**1.9**	**2.6**	**3.4**
contribution to y/y change in CPI	0.14	0.0	0.0
contribution to y/y change in employment	-0.3	-0.3	-0.3
contribution to y/y change in wages	-0.6	-0.4	-0.4
contribution to y/y change in private consumption	-0.1	-0.1	-0.2
contribution to y/y change in public consumption	-1.7	-2.9	-5.0
contribution to y/y change in investments	-0.3	-0.7	-0.2
contribution to y/y change in import	-0.3	-0.2	-0.1
contribution to y/y change in GDP	**-0.7**	**-0.5**	**-0.8**

Labour market

The slower pace of economic growth will cause the labour market to stagnate in 2012. The economic growth of 1.1% will be insufficient to generate new jobs. The 2012 forecast is based on the assumption of continued layoffs from public administration and railway companies as part of the deficit reduction effort. Although employers tend to cut working hours first in response to a bearish demand, employment is nonetheless expected to drop by 5,400 jobs in 2012. According to the ESA95 methodology, employment is expected to contract by 0.2%. The forecast anticipates that the layoffs in public administration and state-owned enterprises will continue throughout 2012 and that about 3,000 people will be made redundant. Given the unfavourable external economic development, the

[3] The calculation of the 2015 target and the size of necessary measures covering the years from 2013 to 2015 was updated following the preparation of the tax revenues forecast and the draft General Government Budget Framework for 2013-2015.

number of Slovaks working abroad is expected to decrease. With Slovaks working abroad included, the overall employment is expected to decline by 0.3% (almost 7,000 jobs). In the years to come, employment growth will be curbed by the expected fiscal consolidation. The number of the employed is unlikely to return to the pre-crisis levels even at the end of the forecast period in 2015. The adverse situation in employment will automatically be reflected in the unemployment forecast. The unemployment rate (LFS) is expected to rise by 0.3 p.p. to 13.8% in 2012 and, from 2013 onward, it should gradually decrease to 13.2%. Along the same lines, the registered unemployment rate will increase to 13.6% percent in 2012 and then gradually decrease to 13.2%.

Wages in 2012 are expected to grow at a faster pace than in 2011. Wages in the private sector will dip slightly compared to the previous year given the uncertainties around the debt crisis which could have had a negative impact on wage indexation. The wage growth in public administration and the healthcare sector will push the average wage upwards. The average wage growth in these sectors is expected to reach 4.1%. This will mainly be due to the expected hike in the wages of doctors and nurses in 2012 (approximately 23%). The average nominal wage will amount to EUR 813, up by EUR 26.7 compared to 2011. The average nominal wage growth rate will reach 3.4% which, together with lower inflation, should reverse the development in real wages from -1.4% last year to +0.6% this year. Wages in both the private and public sector will be influenced by fiscal consolidation in 2013. Nominal wage should begin to grow at a faster pace from 2013. This will accelerate the growth in real wages to an average annual rate of 2.4% in the following years, despite the planned consolidation effort.

Inflation

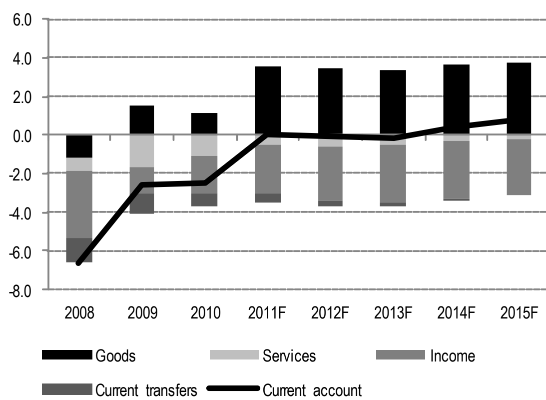
CPI inflation for 2012 is estimated at 2.8%. Faltering domestic consumption will not contribute considerably towards accelerating inflation through demand pressures; the cost components of inflation should also develop more favourably than in 2011. Only a moderate increase in the demand pressures and the negative output gap will help keep net inflation relatively stable. The forecast anticipates that the unfavourable development in the global prices of commodities, oil and food, which started to soar at the beginning of the year, will continue. Against the backdrop of surging oil and gas prices, the regulated prices in Slovakia (energy, in particular) increased in January 2012. According to the information published by the Regulatory Office for Network Industries, gas prices should be considerably reduced in April, by 5.2%, based on the new and more advantageous contract signed between SPP and Gazprom. The 2012 rise in food prices should significantly decrease and reach 2.3% year-on-year.

The rate of inflation is expected to decrease in the coming years, mainly as the upward pressures of higher oil prices – which have been accelerating the growth in energy and fuel prices – will gradually ebb. The 2013 inflation is expected to further decrease to 2.3%, followed by moderate increases until 2015 to the average level of 2.5%. Following the adoption of the euro and the transition to the common monetary policy, the whole nominal convergence has been reduced to price-level convergence through the inflationary channel. As a consequence, the Ministry of Finance anticipates that the average increase in the prices of market services will be near the level of 3.6% by 2015.

External balance

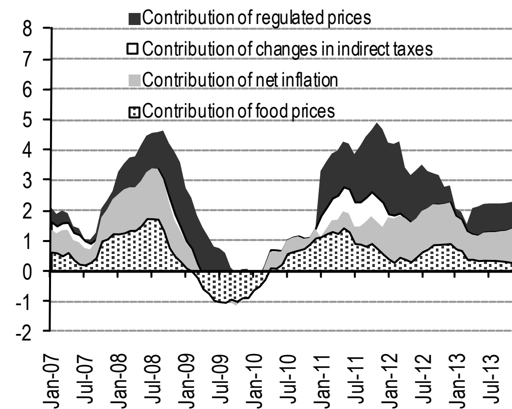
Slovakia's external balance will remain close to its 2011 levels despite the slowdown in the external demand. In 2012 the growth of export of goods at current prices will slow down and reach 4.4%. Exports are expected to regain momentum in 2013 as the GDP growth of Slovakia's most important trading partners picks up. The export forecast also takes into account new planned investments in the automotive industry related to the launch of new models. The slow growth in exports, coupled with feeble domestic demand, will mean that the import growth will follow a similar trajectory and thus the trade surplus will remain about the same. In 2012, imports should grow by 4.6% and then accelerate, similarly to exports. The trade balance will thus reach a surplus of 3.5% of GDP in 2012. However, the trade surplus will be more than offset by the deficit in the balances of services and income, bringing the overall balance of payments in 2011 to a deficit of 0.2% of GDP. Nevertheless, the gradual narrowing of the balance of services deficit will reduce the deficit in the balance of payments by the end of the forecast period.

GRAPH 13 – External imbalances – components of CA BP (% GDP)



Source: NBS, MF SR

GRAPH 14 – Structure of the consumer inflation (HICP)



Source: SO SR

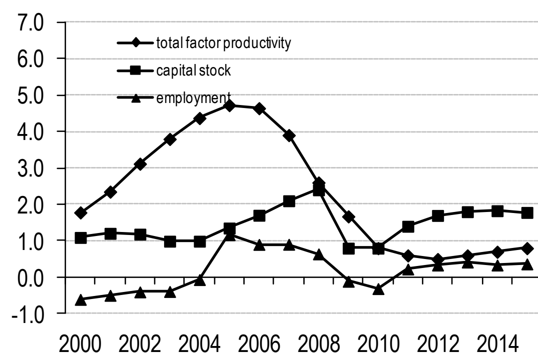
Main risks associated with the forecast

The risks of the February forecast used in the preparation of the budgetary framework are on the positive side. The positive risks include the likely continuation of employment growth in the U.S. and increase in German exports to Asia. This would mean a faster recovery of demand in Germany and other major economies, which would in turn accelerate growth in exports and investments that are essential to stable economic growth. The negative risks mostly relate to the development on the financial markets and in the external environment. The uncertainty on the financial markets stems from the fact that the financial system faces a threat of being frozen up should the debt crisis strike with full force. Another negative risk includes a possibly robust downturn of the emerging economies, such as China, which could impede economic recovery in Germany and, consequently, also in Slovakia.

II.4. Cyclical development of the economy

Compared to the previous year, when the growth in potential output reached its historical low, all production factors gained speed as a consequence of economic recovery. The equilibrium employment, which even declined in 2010 reflecting an increase in NAIRU and the presence of hysteretic effects, began to grow again in 2011. The inflow of new investments accelerated growth of capital stock, but productivity grew slowly. The growth in potential output should regain speed in the years to come, mainly as the total factor productivity accelerates.

GRAPH 15 – Contributions of production factors to potential growth (p. p.)



* total factor productivity

TAB 4 – Contributions of production factors to potential growth

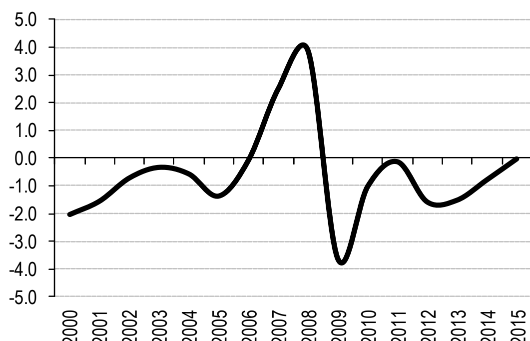
	Pot. GDP (growth, %)	TFP*	Capital stock	Equilibrium employment
2007	7.0	**3.9**	**2.1**	**0.9**
2008	5.5	**2.4**	**2.4**	**0.6**
2009	2.3	**1.7**	**0.8**	**-0.1**
2010	1.3	**0.8**	**0.8**	**-0.3**
2011	2.2	**0.6**	**1.4**	**0.2**
2012F	2.5	**0.5**	**1.7**	**0.3**
2013F	2.8	**0.6**	**1.8**	**0.4**
2014F	2.8	**0.7**	**1.8**	**0.3**
2015F	2.9	**0.8**	**1.8**	**0.4**

Source: MF SR

In 2011, real GDP continued to grow as in the previous year and outpaced the growth of the projected potential output. This nearly closed the negative output gap at the level of -0.1% of potential GDP. However, the 2012 slowdown caused by a weak external demand will re-open the output gap at the level of 1.6% of potential GDP.

From 2014 onwards, real GDP will be growing at a considerably faster pace than the potential output, closing the output gap again in 2015.

GRAPH 16 – Output gap (% potential GDP)



TAB 5 – Output gap

	GDP*) (real growth, %)	Potential GDP (growth, %)	Output gap (% pot. GDP)
2007	9.7	7.0	**2.5**
2008	6.7	5.5	**3.9**
2009	-5.1	2.3	**-3.7**
2010	4.1	1.3	**-1.0**
2011	3.4	2.2	**-0.1**
2012F	1.1	2.5	**-1.6**
2013F	2.1	2.8	**-1.5**
2014F	3.6	2.8	**-0.8**
2015F	3.7	2.9	**0.0**

*) *Output gap is calcuated based on GDP adjusted for cigarette stockpiling and other one-off effects.* *Source: MF SR*

II.5. Comparison of forecasts by the Ministry of Finance and other institutions

The following table compares selected macroeconomic indicators of the Slovak economy as forecast by selected national and foreign institutions. As far as GDP forecasts are concerned, the estimate of the Ministry of Finance for the years 2012-2013 is more on a conservative side. This is mainly due to the more negative outlook for external developments (compared to assumptions from autumn 2011) which will have a negative impact on investments and export performance of the Slovak economy in the beginning of the year. When updating its forecasts, the Ministry of Finance worked with the latest data from the *business tendency surveys* in the euro area and the downward revision of the economic growth projections for the euro area and the EU; the forecast is in line with the Commission's interim forecast published in February 2012.

TAB 6 – Comparison of MoF and other institutions' forecasts

	Year 2012	Year 2013	Year 2014
Real GDP growth (%)			
MF SR (Feb 2012)	**1.1**	**2.7**	**3.6**
NBS	2.1	3.1	4.2
EC	1.2*	2.9	-
OECD	1.8	3.6	-
IMF	3.3	-	-
HICP (%)			
MF SR	**2.8**	**2.3**	**2.3**
NBS	2.9	1.9	2.0
EC	1.9*	2.1	-
OECD	2.9	2.8	-
MMF	1.8	-	-
Current account (% HDP)			
MF SR	**-0.2**	**-0.3**	**0.3**
NBS	0.4	0.7	1.5
EC	-1.2	-1.9	-
OECD	-1.5	-0.5	-
IMF	-1.1	-	-

*Source: MF SR (February 2012), NBS (March 2012), EC (November 2011), OECD (November 2011), IMF (September 2011), * EC Interim Forecast February 2012*

III. PUBLIC FINANCE POSITION

After Slovakia's entry into the euro area, the fiscal policy and structural policies became the key instruments for influencing the development of real economy when exposed to internal or external shocks. When the impacts of the global economic crisis on the Slovak economy subsided, it was necessary to embark on consolidation in order to improve fiscal position. The continuation of consolidation is the main prerequisite for stabilisation and subsequent reduction of the general government debt, which is indispensible to ensuring long-term sustainability of public finances.

III.1. Policy strategy and objectives

The strategy behind the fiscal policy is built around the primary objective, which is to safeguard the long-term sustainability of public finances, especially in the context of population ageing and taking into account contingent liabilities. This objective is also enshrined in the constitutional Fiscal Responsibility Act.

The medium-term objectives of the Slovak Government remain unchanged. **Assuming that the economy will develop in line with the baseline scenario presented in this programme**, the primary objective **is to reduce general government deficit to 2.9% of GDP by 2013 in a permanent and sustainable manner** and thus comply with the requirements of the excessive deficit procedure. However, in order to ensure long-term sustainability of public finances, fiscal consolidation must continue also beyond 2013 so that Slovakia attains its medium-term budgetary objective (MTO), that is, structural deficit of 0.5% of GDP.

The first step towards reducing the general government deficit to 2.9% of GDP in 2013 was the 2011 fiscal consolidation. The consolidation effort reached 3.4% of GDP. The general government budget for 2012, approved in the pre-election period, contained a deficit of 4.6% of GDP instead of the previously proclaimed deficit target of 3.8% of GDP. **In order to meet the target set for 2013, consolidation effort amounting to 2.7% of GDP on a cumulative basis will be required in the next two years.** Beyond 2013, the annual consolidation effort is envisaged at 0.5% of GDP, in compliance with the provisions of the preventive arm of the Stability and Growth Pact. At the same time, the envisaged increase in expenditures in the period from 2012 to 2015 will comply with the benchmark set under the preventive arm of the Stability and Growth Pact.

Due to the ongoing fiscal consolidation and the negative output gap, which will progressively narrow, the Government's fiscal policy will have a restrictive and pro-cyclical impact for most of the time during the forecast period. The year 2012 will be an exception because the increased drawdown of EU funds may offset the restrictive impact of fiscal consolidation. **The restrictive impact of fiscal policy on the aggregate demand will reach an average level of 1.1% of GDP annually during 2012-2015.**

TAB 7 – Consolidation effort and prognosis of gross GG debt in 2010 - 2015 (ESA95, % of GDP)

	2010	2011	2012	2013	2014	2015
1. Net lending / net borrowing	**-7.7**	**-4.8**	**-4.6**	**-2.9**	**-2.3**	**-1.7**
2. Cyclical component	-0.3	0.0	-0.5	-0.4	-0.2	0.0
3. One-off effects	-0.2	-0.4	0.1	0.0	0.0	0.0
4. Cyclical adjusted GG balance net of one-offs (MTO) (1-2-3)	**-7.2**	**-4.4**	**-4.2**	**-2.5**	**-2.1**	**-1.7**
5. Impact of the implementation of the 2nd pillar of pension scheme	-1.2	-1.2	-1.3	-1.2	-1.2	-1.2
6. Interest expenditures	-1.3	-1.6	-1.8	-2.0	-2.1	-2.1
7. Highways construction outside the GG balance sheet	0.7	0.3	-0.1	-0.2	-0.2	-0.2
8. Adjusted primary balance (4-5-6-7)	**-5.3**	**-1.9**	**-1.1**	**0.9**	**1.4**	**1.9**
Consolidation effort (y-o-y change in adj. primary balance)*	**-0.7**	**3.4**	**0.8**	**2.0**	**0.5**	**0.5**
Gross general government debt	**41.0**	**43.3**	**50.2**	**52.0**	**53.0**	**52.3**

*Note.: * (+) restriction, (-) expansion* *Source: MF SR*

2011 – estimate, 2012 – approved budget, 2013 - 2015 - Budgetary Framework

The first step towards improving fiscal position was the 2011 fiscal consolidation as a consequence of which the general government deficit decreased from 7.7% of GDP in 2010 to 4.8% of GDP in 2011. Adjusted for major one-off effects unrelated to the actual Government policy (assumption of debts of healthcare facilities and railway companies incurred in the 2004-2010 period and a one-off VAT revenue from a PPP project, described in more detail in Chapter III.4), the general government deficit reached 4.2% of GDP in 2011. This was achieved despite the adverse effect of macroeconomic developments on public finances, reflected notably in the shortfall of tax revenues. Another negative factor lied in the continued low efficiency of state-owned enterprises due to which the debts of railway companies and hospitals increased. On the other hand, higher non-tax revenues and savings in interest payments, as well as lower expenditures of local governments and social security funds and the expenditures on co-financing of joint Slovakia-EU projects, considerably offset the aforementioned negative impacts. The general government gross debt increased by 2.3 p.p. in 2011 and reached 43.3% of GDP at the year-end.

The approved general government budget set the deficit target for 2012 at 4.6% of GDP. Compared to the target presented in the Stability Programme of April 2011 (deficit of 3.8% of GDP), the new deficit target is less ambitious, mainly due to the less favourable macroeconomic outlook for 2012 and the fall of the Government. No additional measures have been adopted following the vote of no-confidence in the Government and the ensuing preparations for early parliamentary elections.

As far as the development in the following years is concerned, assuming that the Government fails to adopt any additional measures and the general government balance will only be influenced by the macroeconomic development – so-called “unchanged policies scenario” or “no-policy change scenario” – the general government deficit will rise by 0.6 p.p. year-on-year to 5.2% of GDP in 2013 mainly as a consequence of declining tax revenues. In the subsequent years, the deficit would slightly improve and reach 5.1% of GDP. Such a scenario would send the general government’s gross debt above the Maastricht threshold of 60% of GDP by the end of 2015. Under the unchanged policies scenario, the primary deficit would slightly improve, from 2.9% of GDP in 2012 to 2.8% of GDP in 2015.

The table below illustrates the need for consolidation measures. In order to achieve the defined target of 2.9% of GDP for the general government deficit, measures of an overall magnitude of 2.3% of GDP have to be implemented in 2013. Additional measures will need to be adopted in subsequent years, representing 0.4% of GDP in 2014 and additional 0.6% of GDP in 2015.

TAB 8 –Necessary fiscal measures compared to unchanged policies scenario (ESA95, % of GDP)

	2013	2014	2015
1. Primary GG balance – unchanged policies scenario (i.e. „no policy change“)	-3.2	-3.0	-2.8
2. Primary GG balance – GG Budgetary Framework 2013–2015	-2.5	-2.1	-1.5
3. Primary GG balance – target	-0.9	-0.2	0.5
Difference (3-2)	1.6	1.9	1.9
Difference (in EUR mill.)	1,166	1,480	1,612
Difference (3-1)	2.3	2.7	3.3
- y-o-y change (additional necessary measures)	-	0.4	0.6
Difference (in EUR mill.)	**1,713**	**2,155**	**2,773**
- y-o-y change (additional necessary measures)	**-**	**442**	**619**

Source: MF SR

Some of the necessary measures have already been incorporated in the draft General Government Budgetary Framework for 2013-2015. They primarily concentrate on the expenditure side and include a freeze on wages and operating expenditures in public administration, as well as cuts in the expenditures of municipalities. **In addition to the aforementioned measures, additional measures amounting to 1.6% of GDP will be necessary in order to meet the target for 2013. These measures will be specified as soon as possible after the adoption of the new Government’s Manifesto. Given the relatively low share of the general**

government revenues and expenditures in GDP, the 2013 fiscal consolidation will concentrate more on the revenue side. The potential measures include: higher collection of property taxes, pension reform, increase in certain excise taxes, higher gambling tax, revision of the current setup of the bank levy, and reductions in the general government's wage bill and in current expenditures.

Successful attainment of the fiscal objectives is a prerequisite for stabilising the general government debt to GDP ratio. The general government gross debt will increase from 43.3% of GDP in 2011 to 53.0% of GDP at the end of 2014 (of that, Slovakia's share in financial assistance to Greece, Portugal and Ireland under the European Financial Stability Facility account for 2.7 p.p.), and is expected to decrease below 53% of GDP by the end of the forecast period. It means that throughout the entire period **the general government debt will remain below the reference value set both under the Pact and the debt brake. Such a development would, however, trigger sanction mechanisms under the constitutional Fiscal Responsibility Act** (described in more detail in Box 2).

BOX 2 – Application of the Fiscal Responsibility Act provisions under the current debt forecast

Based on the general government gross debt forecast for 2012-2015 (more details in Chapter III.5), the gross debt would exceed 50% of GDP for the entire forecast period. This value is the lower threshold defined in the Fiscal Responsibility Act which triggers sanctions (described in more detail in Chapter VII.).

Assuming that the actual debt reaches the aforementioned values, the procedure under the Fiscal Responsibility Act would be activated. The overrun above the 50% threshold would be published in a Eurostat notification, probably in April 2013 (actual debt at the end of 2012). Subsequently, the Ministry of Finance of the Slovak Republic would send a written explanation of the debt amount, including the measures proposed for its reduction, to the Slovak Parliament. If these measures are not implemented, the situation would recur also in the subsequent forecast years.

The Stability Programme is based on the macroeconomic and tax revenue forecasts of February 2012. The macroeconomic scenario, as well as projected tax revenues, is subject to the scrutiny by committees comprised of national public and private sector experts. The constitutional Fiscal Responsibility Act has strengthened the position of these committees because their existence and the frequency of their meetings are directly enshrined in the Act. In March, the Ministry of Finance also published a revised "flash" estimate of macroeconomic development for 2012. **The flash estimate increased GDP projection for 2012 from 1.1% to 2.3%.** The upward revision is based on the better-than-expected performance of exports and private investments with limited positive implications for public finances.

III.2. General government balance in 2011 and its impact on the 2012 budget

A thorough assessment of the current state of public finances is a key prerequisite for setting adequate and realistic objectives in the general government budget. This chapter therefore contains basic information on the development of general government balance in 2011 and its impact on the general government budget in 2012. Furthermore, it describes measures adopted in the course of 2011 with the aim of meeting the 2012 consolidation objective and laying the groundwork for further consolidation effort. Its final part provides up-to-date information on developments in 2012.

III.2.1. General government balance in 2011

Under the General Government Budget for 2011-2013, the Government's key fiscal objective for 2011 was defined as reaching the general government deficit level of 4.9% of GDP. Based on the deficit and debt notification published by Eurostat on 23 April 2012, the general government deficit reached 4.8% of GDP.

TAB 9 - General government balance in 2011 (ESA95)

	EUR mill.	% of GDP
GENERAL GOVERNMENT BALANCE – BUDGET	**-3,449**	**-4.91**
Impact of macroeconomic development	**-108**	**-0.16**
- core tax revenues and social contributions	-208	-0.30
- interest expenditures	100	0.14
One-off revenues	**289**	**0.42**
- VAT from PPP projects	24	0.03
- unrealized sales of emission quotas	-100	-0.14
- telecommunication licence fees	89	0.13
- non-tax revenues of the state budget and other GG entities	177	0.26
- revenues of Social Insurance Agency from healthcare debt bailout	59	0.09
- contribution from Solidarity fund	20	0.03
- other	20	0.03
Transactions related to the EU budget	**307**	**0.44**
- co-financing for EU funds	227	0.33
- transfer to the EU budget	80	0.12
Efficiency of state-owned enterprises	**-242**	**-0.35**
- dividends	85	0.12
- assumption of debt (railways, hospitals) related to 2011	-327	-0.47
Core expenditures and other factors	**511**	**0.74**
- expenditures of local governments	123	0.18
- healthcare expenditures	116	0.17
- reserve on state debt interest expenditures	50	0.07
- expenditures of Social Insurance Agency	130	0.19
- VAT from PPP projects	150	0.22
- other factors	-58	-0.08
Effect of assumption of debt (railways, hospitals) related to previous years	**-633**	**-0.92**
GENERAL GOVERNMENT BALANCE - ESTIMATE	**-3,326**	**-4.82**
of which: impact of updated nominal GDP forecast (p.p.)		-0.08

(+) indicates improvement and (-) deterioration of the general government balance *Source: MF SR*

The **macroeconomic development** affected mostly tax revenues, resulting into a shortfall in the amount of EUR 207.8 million (0.3% of GDP). Compared to the budget target, the largest decline occurred in excise taxes, amounting to EUR 108.8 million (0.2% of GDP) and personal income tax, amounting to EUR 97.1 million (0.1% of GDP). In the case of excise taxes, the substantial portion of the shortfall relates to the increase in cross-border shopping due to exchange-rate fluctuations of Hungarian forint and Polish złoty with a negative impact on excise tax revenues (cigarettes, fuel). In the case of debt interest payments, savings came as a result of lower interest rates and shorter maturities for debt refinancing, which was reflected in lower yields.

With respect to **one-off revenues**, revenues from the extension of licences to telecom operators (EUR 88.5 million) and a formally higher VAT revenue from PPP projects (EUR 23.6 million) had a positive impact on the balance. The state budget's contribution to higher non-tax revenues represented EUR 80 million, while the aggregate contribution of other general government entities, municipalities and self-governing regions in particular, reached EUR 97.5 million. Higher than budgeted revenues came from the repayment of the healthcare providers' debts to the Social Insurance Agency as part of their bailout. Revenues increased also thanks to the contribution received from the EU Solidarity Fund to cover the costs of the flood recovery effort. Failure to sell emission allowances reduced the revenues of the Environmental Fund by EUR 100 million.

Transactions with the EU budget had a positive impact on the balance in the amount of EUR 307 million (0.4% of GDP). With respect to the lower drawdown of EU funds, only at 63% of the budget estimate, the volume of expenditures on co-financing decreased by EUR 227 million. The redistribution of the 2010 EU budget surplus among Member States reduced Slovakia's contribution to the EU budget by EUR 80 million.

The efficiency of state-owned enterprises is expressed through revenues from dividends and the expenditures incurred in their operation. State-owned enterprises had a positive impact on the balance through higher dividends in the amount of EUR 85.4 million. On the other hand, the balance remains to be adversely affected by the losses generated by railway companies, although partly offset by the allocation of additional funds towards the cost of public services contracted by the state, and the expected rise in the debt of healthcare facilities by a total of EUR 327 million.

On the expenditure side, the **expenditures of other general government entities** developed positively and decreased by EUR 369 million (0.5% of GDP). In the case of municipalities, more than 70% of savings are attributed to the cuts in capital expenditures. The Social Insurance Agency reduced its expenditures in the pension insurance scheme, while health insurance companies reduced mainly their healthcare expenditures. Additional savings were achieved due to the exclusion of the budgeted VAT payment under PPP projects (EUR 150 million) from the 2011 expenditures since the PPP-related expenditures (including paid VAT) are spread over individual years in accordance with the contract.

The most negative impact on the general government balance in 2011 is attributable to the **government liabilities towards railway companies and the debts of hospitals amassed in the 2004-2010 period,** in the amount of EUR 633.5 million (0.9% of GDP). In the case of hospitals, the debt comprises unpaid liabilities accumulated during the previous period which the Government decided to assume in connection with the transformation of hospitals in 2011. With respect to the railway companies (ŽSR and ŽSSK), the debt includes previously unreported liabilities of the Ministry of Transport, Construction and Regional Development of the Slovak Republic towards the railway companies based on annual contracts for the operation of railway infrastructure and the provision of transport services in public interest, resulting from the difference between the agreed and actual price of the contracted services.

III.2.2. General government budget for 2012 and the measures taken

The 2012 general government budget sets the target value of the general government deficit at 4.6% of GDP. The original target, set at 3.8% of GDP as mentioned in the Stability Programme of April 2011, will not be met. No additional measures have been adopted following the vote of no-confidence in the Government and the ensuing preparations for early parliamentary elections.

The budget and the proposed consolidation measures were prepared based on the development of public finances envisaged by the unchanged policies scenario (the approach applied in developing the unchanged policies scenario is described in Box 3). Under that scenario, the general government deficit would reach 5.6% of GDP in 2012. The difference between the 5.6-percent deficit and the target value of 4.6% represents approximately 1% of GDP, which defined the scope of measures necessary to meet the budgetary objective.

TAB 10 – Summary of measures adopted for 2012 (ESA95)

	EUR mil.	% of GDP
GG balance - unchanged policies scenario	**-3,978**	**-5.6**
1. Primary GG balance - unchanged policies scenario	**-2,696**	**-3.8**
2. General government revenues	**215**	**0.3**
Changes in taxes and social contributions	**144**	**0.2**
- corporate income tax - changes in deprecation of assets	55	0.1
- corporate income tax - tax exemption on revenues from the lease of assets by municipalities and self-governing regions	-9	0.0
- special levy on financial institutions (net effect)	83	0.1
- excise tax on tobacco products - increased rate	30	0.0
- social security contributions - compulsory entry to the fully-funded pillar	-15	0.0
Efficiency of state-owned enterprises	**71**	**0.1**
- loan repayments previously recorded as a capital transfer	51	0.1
- profit levy from Lesy SR, š. p.	20	0.0
3. General government expenditures	**435**	**0.6**

- wages in public administration	79	0.1
- expenditures on goods and services	187	0.3
- capital expenditures	74	0.1
- lower expenditures of local governments due to changed income tax redistribution	112	0.2
- national top-up payment to direct payments in agriculture	-18	0.0
4. Other changes	**-9**	**0.0**
5. Primary GG balance - budget (1+2+3+4)	**-2,056**	**-2.9**
GG balance - budget	**-3,324**	**-4.6**

Note: (+) indicates improvement and (-) indicates deterioration of the GG balance under ESA95 *Source: MFSR*

Measures on the revenue side of the general government

The impact of the measures adopted on the revenue side represents 0.3% of GDP in 2012, with changes made in respect of the tax and social contribution revenues and the efficiency of state-owned enterprises. They include, in particular:

- **Changes in the depreciation of assets affecting the revenues from the corporate income tax** – with effect from 1 January 2012, the rules for depreciation have been harmonised for all forms of assets acquisition by changing the tax depreciation of tangible assets from yearly to monthly. The changes only apply to the depreciation of newly acquired assets.
- **Tax exemption on income from the lease of assets by municipalities and self-governing regions** – the income of municipalities and self-governing regions from the lease of their assets is again exempt from taxation, which will have a negative effect on the corporate income tax revenue.
- **Introduction of a special levy on financial institutions** – from 1 January 2012, a special levy on financial institutions has been introduced at a rate of 0.4% of the value of their liabilities net of equity and deposits protected under the Deposit Protection Fund. The net effect of this measure is estimated at EUR 83 million since the additional revenue in the amount of EUR 102 million will be partially offset by a lower corporate income tax revenue stemming from the expected decline in the profitability of these institutions.
- **Earlier-than-planned increase in the excise tax on tobacco products** – in order to secure additional revenue in 2012, the original plan to increase the excise tax on tobacco products as of 1 March 2013 changed. The excise tax increased by 3.7% with effect from 1 February 2012.
- **Social security contributions** – the default parameters for participation in the pension system scheme for new labour market participants changed as of 1 April 2012. All new labour market participants will, by default, participate in both pillars of the pension system (pay-as-you-go and fully-funded) and will have a two-year grace period to opt out from the fully-funded pillar. This legislative change will cause a moderate shortfall in the 2012 revenues from social security contributions.
- **Efficiency of state-owned enterprises** – the improved efficiency of state-owned enterprises will be reflected in a profit levy from the Slovak Forest Company (*Lesy SR*) and the repayment of financial assistance (*Nemocnica sv. Michala, Vodohospodárska výstavba*) previously classified as capital transfer (due to anticipated non-repayment of these funds).

Measures on the expenditure side of the general government expenditure

Most consolidation measures concentrate on the expenditure side of public administration and their total effect is estimated at 0.6% of GDP. They include, in particular:

- **Wages in public administration –** the payroll expenditures allocated under individual chapters of the 2012 state budget have been frozen at the 2011 level. In the other general government entities, wages are expected to grow below the benchmark rate (projected wage growth in the private sector). The only exemption is the wages of teachers at regional schools, which are among the Government's priorities.
- **Expenditures on goods and services** - state budget chapters account for the largest share of savings in expenditures on goods and services, with their operating expenditures having decreased by 5% in nominal terms compared to the 2011 budget.

- **Capital expenditures –** also in the case of capital expenditures, the largest share of savings is expected to come from individual state budget chapters.
- **Lower expenditures of local governments due to changed income tax redistribution -** in addition to the aforementioned expenditure cuts, a recent legislative change will generate additional savings at the local government level. With effect from 1 January 2012, the redistribution of the personal income tax revenue between the state budget and local governments changed (the local government share decreased from 70.3% to 64.5% for municipalities and from 23.5% to 21.9% for self-governing regions). The lower share in the tax revenue for local governments is expected to reduce their expenditures. The assumption is based on the fact that, despite the reduced share, local governments will receive 3.7% more from the redistribution of this tax in 2012 than in the year before. At the same time, expenditure savings in 2011 are expected to be reflected also in subsequent years. This ambition may be put at risk if the collection of income taxes lags behind projections.

BOX 3 – Drawing up the unchanged policies scenario

*The **unchanged policies scenario** is defined as a scenario of development in public finances based on the assumption that the Government and/or Parliament adopt no measures and the public finance situation would be influenced solely by macroeconomic development and existing policies, including the applicable legislation.*

The balance of the general government revenues and expenditures in the current year serves as a basis for the preparation of the scenario for the period covered by the general government budget. In the first step, the balance is adjusted for one-off effects and items that will not recur after the base year. In the next step, those items of the base year's balance whose development in the forecast period is already known are identified. The remaining items of the base year balance are then adjusted using pre-defined assumptions (defined by legislation or macroeconomic expectations concerning their growth).

The assumptions for development of the most important items of the general government balance under the unchanged policies scenario:

- *tax revenue projection is only affected by macroeconomic development and existing legislation;*
- *wage expenditures develop in line with the projected average wage growth rate in the private sector;*
- *expenditures on goods and services develop in line with the projected growth of prices measured by CPI;*
- *expenditures on current transfers have been divided into three groups: the first group comprises those expenditures that are subject to indexation under the law (e.g. old-age and disability pensions, state social benefits); the second group includes those that are expected to grow in line with the projected price growth (inflation measured by CPI); and the third group includes transfers to state-owned enterprises (for example, railway companies or healthcare facilities) the amount of which is based on the assumption that they will not incur new debts or that the existing debt will be covered;*
- *interest expenditure on the general government debt – the estimate is based on the budgeted values adjusted for the effect of a difference between the primary deficit in the budget against the unchanged policies scenario;*
- *capital expenditures develop in line with the projected GDP growth rate adjusted for the elasticity of the tax and social contribution revenues in GDP.*

The macroeconomic assumptions necessary for the preparation of the unchanged policies scenario have been taken from the official forecast prepared by the Macroeconomic Forecasts Committee.

III.2.3. Developments in 2012

The assessment of developments in 2012 takes into consideration the effects of the 2011 economic performance, updated macroeconomic and tax forecasts, and potential risks connected with the budget execution.

While economic performance in 2011 was better than expected, the official macroeconomic and tax forecast of February 2012 and the flash estimate (incorporating the most recent information on the better-than-expected development of the Slovak economy in the last quarter of 2011, along with slightly more positive expectations for GDP growth in the euro area in the first half of 2012) indicate a negative impact on the tax revenues and debt

interest payments. The budgetary risks lie in the potentially negative effect of rolling over the unspent expenditures from the previous year, the need to address the situation in the healthcare sector and railway companies, and possible sanctions that may be imposed based on the ongoing audits of the use EU funds. Another risk lies in the lower collection of taxes caused by the temporary unavailability of IT systems in the financial administration.

It would be premature at this stage to assess how these factors will affect the general government balance in 2012. **Nonetheless, should need arise, the Government is committed to adopting further measures in the course of the year to meet the 2012 budgetary objective, i.e., the general government deficit not exceeding 4.6% of GDP.**

III.3. Medium-term budgetary outlook

The Government has drawn up the draft General Government Budgetary Framework for 2013-2015, including the definition of fiscal targets for this period. For 2013, the general government deficit is expected to reach 2.9% of GDP. For 2014 and 2015, the fiscal targets for the general government deficit were set at 2.3% and 1.7% of GDP, respectively.

This section aims to quantify the impact of the measures incorporated in the budgetary framework and set the magnitude of the additional measures necessary to meet the fiscal targets. The basic assumption is that the 2012 fiscal objective is met, i.e., the general government deficit does not exceed 4.6% of GDP. Following that and based on the unchanged economic policies scenario, medium-term estimates of the general government balance can be made. Through comparing this scenario with the general government balance targets, the magnitude of the necessary additional measures can be quantified.

III.3.1. Unchanged policies scenario

Assuming that there are no changes in economic policies (the procedure and assumptions used in the preparation of the scenario are described in Box 3), the general government deficit would reach 5.2% of GDP in 2013 with a slight decline to 5.1% of GDP in 2014 and 2015. If we disregard changes in interest payments, primary deficit would initially rise from 2.9% of GDP in 2012 to 3.2% of GDP in 2013, provided that there are no changes in policies. In the subsequent years, it would gradually improve to 2.9% of GDP in 2014 and 2.8% of GDP in 2015.

TAB 11 – General government balance – unchanged policies scenario 2013 – 2015 (ESA95, % of GDP)

	2012B	2013	2014	2015
TOTAL REVENUES	**33.6**	**33.1**	**32.1**	**31.5**
Tax revenues	**16.1**	**15.6**	**15.6**	**15.6**
Personal income tax	2.7	2.7	2.7	2.7
Corporate profit tax	2.6	2.7	2.7	2.7
Withholding tax on capital income	0.2	0.2	0.3	0.3
Value added tax	6.6	6.4	6.4	6.4
Excise taxes	2.9	2.7	2.6	2.6
Tax from international trade and transfers	0.1	0.1	0.1	0.1
Property tax and others	1.0	0.9	0.9	0.9
Social contributions	**11.9**	**11.7**	**11.5**	**11.4**
Non-tax revenues	**3.4**	**3.2**	**3.0**	**2.8**
Grants and transfers (mainly EU funds)	**2.2**	**2.6**	**2.0**	**1.6**
TOTAL EXPENDITURES	**38.2**	**38.3**	**37.2**	**36.6**
Current expenditures	**34.9**	**34.8**	**34.1**	**33.6**
Gross wages	6.2	6.2	6.2	6.2
Goods and services	10.5	10.4	9.9	9.3

- Health insurance companies	5.1	4.9	4.8	4.8
Subsidies and transfers	16.4	16.3	15.9	15.9
Interest	1.8	2.0	2.1	2.2
Capital expenditures	**3.3**	**3.5**	**3.1**	**3.1**
Capital assets	2.3	1.9	1.6	1.7
Capital transfers	1.0	1.6	1.5	1.4
GENERAL GOVERNMENT BALANCE	**-4.6**	**-5.2**	**-5.1**	**-5.1**
GENERAL GOVERNMENT PRIMARY BALANCE	**-2.9**	**-3.2**	**-3.0**	**-2.8**
p. m. GG balance – target	*-4.6*	*-2.9*	*-2.3*	*-1.7*
Primary GG balance – target	*-2.9*	*-0.9*	*-0.2*	*0.5*

Note: B –General government budget for 2012-2014 *Source: MF SR*

A comparison of this scenario with the general government balance targets makes it possible to ascertain the extent of necessary measures. As the meeting of the general government balance targets will simultaneously decrease interest payments compared to the unchanged policies scenario, it would be more appropriate to compare primary balances. In view of the above, measures will have to be adopted to improve the primary general government balance by a total of EUR 1,713 million in 2013, EUR 2,155 million in 2014 and EUR 2,773 million in 2015.

TAB 12 – Comparison of the unchanged policies scenario with fiscal targets (ESA95, % of GDP)

	2013	2014	2015
1. Primary GG balance – target	-0.9	-0.2	0.5
2. Primary GG balance – unchanged policies scenario	-3.2	-3.0	-2.8
Difference (1-2)	2.3	2.7	3.3
Difference (in EUR mill.)	**1,713**	**2,155**	**2,773**

Source: MF SR

III.3.2. Description and quantification of measures to achieve fiscal targets

The total amount of the measures necessary to achieve fiscal targets is quantified in the preceding section. With this in mind, the draft General Government Budgetary Framework for 2013-2015, which was submitted to the Slovak Government, incorporated the following key measures focusing on the expenditure side of the general government budget:

1. **Reducing expenditures of the state budget**
   In the general government budgetary framework, most areas (except for those regulated by specific legislation) are budgeted at the 2012 budget level. This applies to wages, as well as to the current and capital expenditures. The only exception represent the expenditures in the defence sector, which have been fixed at 1.01% of GDP during the entire period (in 2012, the budgeted level was 1.13% of GDP) and the creation of a reserve for the co-financing of EU projects between 2014 and 2015 due to the envisaged implementation of programmes within the 3rd programming period.

   The framework also includes two across-the-board measures aimed at motivating the state budget chapters to take steps towards more efficient spending of public funds in the medium term. In the case of wage expenditures, 5% of their 2012 level has been set aside. It applies to all state budget chapters with the exemption of wage expenditures on employees in the healthcare sector, education and science, police and financial administration. In the case of expenditures on goods and services, 10% of the 2012 level has been set aside. The funds obtained from these two measures are allocated in the budget of the General Treasury Administration until the austerity measures proposed by individual budget chapters are evaluated, which means that this operation is neutral in terms of its impact on the balance.

2. **Reducing the expenditures of municipalities**
   For municipalities, the growth in all expenditure items is expected to stay below the benchmark (see methodology for the preparation of an unchanged policies scenario in Box 3).

In addition to the above measures, the Government will also focus on making the tax collection more effective (mainly in the case of VAT and excise taxes) and exert particular effort to combat tax evasion (stricter checks, risk management, etc.).

Another priority is to modernise the system of public administration by making it more transparent and efficient. The modernisation will be ensured through higher transparency, better law enforcement, computerisation and institutional reform of state administration. Regardless of the size of the country, the focus on efficient systems is crucial to its success. Any redistribution of public funds should be guided by the principle of efficiency.

TAB 13 – Measures incorporated in Budgetary Framework 2013 – 2015 (ESA95, % of GDP)*

	2013	2014	2015
State budget – expenditures	**0.5**	**0.5**	**0.6**
- gross wage expenditures	0.1	0.2	0.4
- expenditures on goods and services	0.2	0.1	0.1
- capital expenditures	0.2	0.2	0.2
Municipalities – expenditures	**0.4**	**0.2**	**0.3**
Others	**-0.2**	**0.1**	**0.4**
PRIMARY GG BALANCE	**0.7**	**0.9**	**1.4**

Note: (+) indicates improvement and (-) indicates deterioration of the GG balance in ESA95 *Source: MF SR*
** compared with unchanged policies scenario*

Compared to the unchanged policies scenario, the positive implications of these measures for the general government balance represent 0.7% of GDP in 2013, 0.9% of GDP in 2014 and 1.4% of GDP in 2015.

TAB 14 – General government balance – Budgetary Framework 2013 – 2015 (ESA95, % of GDP)

	2012B	Budgetary Framework			Difference against NPC		
		2013	2014	2015	2013	2014	2015
TOTAL INCOME	**33.6**	**33.1**	**32.1**	**31.6**	**0.0**	**0.0**	**0.0**
Tax revenues	**16.1**	**15.6**	**15.6**	**15.6**	**0.0**	**0.0**	**0.0**
Personal tax income	2.7	2.7	2.7	2.7	0.0	0.0	0.0
Corporate profit tax	2.6	2.7	2.7	2.7	0.0	0.0	0.0
Withholding tax on capital income	0.2	0.2	0.3	0.3	0.0	0.0	0.0
Value added tax	6.6	6.4	6.4	6.4	0.0	0.0	0.0
Excise taxes	2.9	2.7	2.6	2.6	0.0	0.0	0.0
Tax from international trade and transactions	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Property tax and others	1.0	0.9	0.9	0.9	0.0	0.0	0.0
Social contributions	**11.9**	**11.7**	**11.5**	**11.4**	**0.0**	**0.0**	**0.0**
Non-tax revenues	**3.4**	**3.1**	**3.0**	**2.8**	**-0.1**	**0.0**	**0.0**
Grants and transfers (mainly EU funds)	**2.2**	**2.6**	**2.0**	**1.6**	**0.0**	**0.0**	**0.0**
TOTAL EXPENDITURES	**38.2**	**37.5**	**36.3**	**35.2**	**-0.8**	**-0.9**	**-1.5**
Current expenditures	**34.9**	**34.6**	**33.7**	**32.8**	**-0.2**	**-0.4**	**-0.7**
Gross wages	6.2	6.0	5.8	5.5	-0.2	-0.4	-0.7
Goods and services	10.5	10.1	9.8	9.4	-0.3	-0.1	0.2
- Health insurance companies	5.1	4.9	4.8	4.8	0.0	0.0	0.0
Subsidies and transfers	16.4	16.5	16.0	15.8	0.2	0.1	-0.1
Interest	1.8	2.0	2.1	2.1	0.0	0.0	-0.1
Capital expenditures	**3.3**	**2.9**	**2.6**	**2.3**	**-0.6**	**-0.5**	**-0.8**
Capital assets	2.3	2.0	1.8	1.5	0.0	0.2	-0.2
Capital transfers	1.0	1.0	0.8	0.8	-0.6	-0.7	-0.6

GENERAL GOVERNMENT BALANCE	**-4.6**	**-4.5**	**-4.2**	**-3.6**	**0.7**	**0.9**	**1.5**
GENERAL GOVERNMENT PRIMARY BALANCE	**-2.9**	**-2.5**	**-2.1**	**-1.5**	**0.7**	**0.9**	**1.4**

Note: B –General government budget for 2012–2014 *Source: MF SR*

After incorporating these measures into the 2013-2015 draft General Government Budgetary Framework, the total amount of the necessary measures has decreased.

TAB 15 – Comparison of the GG Budgetary Framework 2013 – 2015 with fiscal targets (ESA95, % of GDP)

	2013	2014	2015
1. Primary GG balance – target	-0.9	-0.2	0.5
2. Primary GG balance – draft GG Budgetary Framework 2013–2015	-2.5	-2.1	-1.5
Difference (1-2)	1.6	1.9	1.9
Difference (in EUR mill.)	**1,166**	**1,480**	**1,612**

Source: MF SR

This means that, in order to **meet the fiscal objective for 2013, it will be necessary to adopt (in addition to the measures already incorporated in the 2013-2015 draft General Government Budgetary Framework) additional measures totalling EUR 1,166 million (1.6% of GDP)**. If the flash estimate for 2012 proves correct, the risks would be concentrated on the positive side.

III.4. Structural balance, fiscal position, fiscal impulse

The consolidation of public finances should create room for sustainable economic growth with low inflation, low interest rates and positive expectations of stakeholders concerning future economic policy, exerting a positive influence on the supply side of the economy, and thus more than compensate for the lower contribution to aggregate demand.

The consolidation effort describes the path the government plans to take in order to meet its medium-term objective. The consolidation effort presented in this document takes into account, in addition to the cyclical component of the budget and one-off effects, also the costs associated with the launch the 2nd pillar of pension system (also referred to as the fully-funded pension pillar) as an important structural reform contributing to the long-term sustainability of public finance, as well as the effect of interest payments and of the construction of highways and expressways outside the general government balance sheet.

TAB 16 – Consolidation effort between 2010 and 2015 (ESA95, % GDP)

	2010	2011	2012B	2013	2014	2015
1. Net lending / net borrowing	**-7.7**	**-4.8**	**-4.6**	**-2.9**	**-2.3**	**-1.7**
2. Cyclical component	-0.3	0.0	-0.5	-0.4	-0.2	0.0
3. One-off effects	-0.2	-0.4	0.1	0.0	0.0	0.0
- temporary increase of basic tax allowance in personal income tax	-0.3	-	-	-	-	-
- remission of receivables towards non-financial corporations	-0.1	-	-	-	-	-
- expenditures related to floods	-0.2	-	-	-	-	-
- accrual recording of hospitals and railway companies liabilities	0.4	-0.9	-	-	-	-
- revenues of Social Insurance Agency from assumed health sector debt	-	0.1	-	-	-	-
- tax on excess emission allowances	-	0.1	-	-	-	-
- VAT revenues from PPP projects	-	0.3	0.1	-	-	-
- revenues from telecommunication licences	-	0.1	-	-	-	-
4. Implementation of the 2nd pillar of pension scheme	-1.2	-1.2	-1.3	-1.2	-1.2	-1.2
5. Interest payments	-1.3	-1.6	-1.8	-2.0	-2.1	-2.1
6. Highways and expressways construction outside the GG balance sheet	0.7	0.3	-0.1	-0.2	-0.2	-0.2
- construction costs of PPP projects (expressway R1)	0.7	0.4	0.1	-	-	-
- availability payments for PPP projects augmented by paid VAT	-	0.0	-0.1	-0.2	-0.2	-0.2

- new loans taken by NDS	0.0	0.1	0.1	0.0	0.0	0.0
- repayments of principal NDS	-0.1	-0.1	-0.1	0.0	0.0	0.0
7. Adjusted primary balance (1-2-3-4-5-6)	**-5.3**	**-1.9**	**-1.1**	**0.9**	**1.4**	**1.9**
Consolidation effort	**-0.7**	**3.4**	**0.8**	**2.0**	**0.5**	**0.5**

(+ tightening, - loosening of fiscal policy)
B – approved budget, 2013 – 2015 Budgetary Framework

Source: MF SR

In order to quantify the government's consolidation effort, it is first of all necessary to separate the actual (officially reported) general government balance into its cyclical and structural components. The structural component reflects the state of public finance, assuming that the economy functions at its potential level of output. The structural general government balance thus corresponds to the actual general government balance net of changes in the cyclical component which expresses the response of general government revenues and expenditures to changes in the output gap. The magnitude of the cyclical component depends on the size of the output gap and elasticities of selected revenue and expenditure categories that respond to fluctuations in economic activity. The Ministry of Finance has adopted sensitivity estimates of the general government balance to changes in the output gap from European Commission estimates made using OECD methodology[4].

The second item comprises one-off and temporary measures taken by the Government. In the period between 2010 and 2015, eight one-off effects can presently be identified:

- The first factor includes the increase in the basic tax allowance applicable to personal income tax. This measure was introduced as part of the Government's anti-crisis measures and its scope of application was limited to 2009 and 2010. The shortfall in tax revenues in each of these years accounted for 0.3% of GDP.
- The second factor is the remission of receivables from non-financial entities amounting to 0.1% of GDP in 2010. They concern receivables of the state from called guarantees and loans provided to companies that went bankrupt in the past years (the majority of them were wound up in the 1990s).
- The third effect reflects the floods that affected Slovakia in 2010. State budget spending to deal with the aftermath of the floods amounted to 0.2% of GDP.
- The fourth factor includes the accrual recording of liabilities assumed from hospitals and liabilities of the state towards railway companies. In the period between 2004 and 2010, these companies incurred liabilities resulting from insufficient reforms in this area; however, these liabilities were not recorded in general government accounts. After their actual amount was identified in 2011, Eurostat recommended that they be recognised in that year. Given the fact that the above liabilities relate to the policies pursued by governments in the previous period, for the purpose of calculating the consolidation effort, they have been allocated to the years when they occurred.
- The fifth factor covers the revenues of the Social Insurance Agency from the healthcare sector bailout during 2011. The healthcare facilities paid the Social Insurance Agency outstanding premiums for the previous period totalling 0.1% of GDP.
- The sixth factor represents the temporary application of a tax on excess emission allowances levied on the transfer and holding of excessive CO_2 emission allowances in 2011-2012. In 2011, this tax increased the general government revenue by 0.1% of GDP. Its anticipated effect in 2012 is less than 0.05% of GDP; for this reason it is not listed in the table.
- The seventh factor includes VAT revenues from the commissioning of the completed R1 expressway sections built as part of a PPP project. Upon commissioning the individual sections (in 2011 and 2012), the investor will pay VAT, which will be reflected in the tax revenues of the general government. As the above project is recorded outside the general government balance sheet, the VAT payment by the state (paid in 2011 and 2012) will be recorded evenly, throughout the entire concession period (30 years), together with the availability payments paid by the state.
- The last factor represents one-off revenues from the sale of telecom licences representing 0.1% of GDP in 2011. This involves the renewal of licences for the next ten years for two leading mobile network operators in Slovakia.

[4] Girouard, N., André, Ch.: Measuring cyclically-adjusted budget balances for OECD countries. OECD Economics Department working papers, no. 434, 2005

The third item taken into account in the quantification of the government's consolidation effort refers to the costs related to the implementation of the 2nd pillar of the pension system. The pension reform costs reached 1.2% of GDP in 2010 and 2011. In 2012, these costs are estimated at 1.3% of GDP and, in each following year, at 1.2% of GDP.

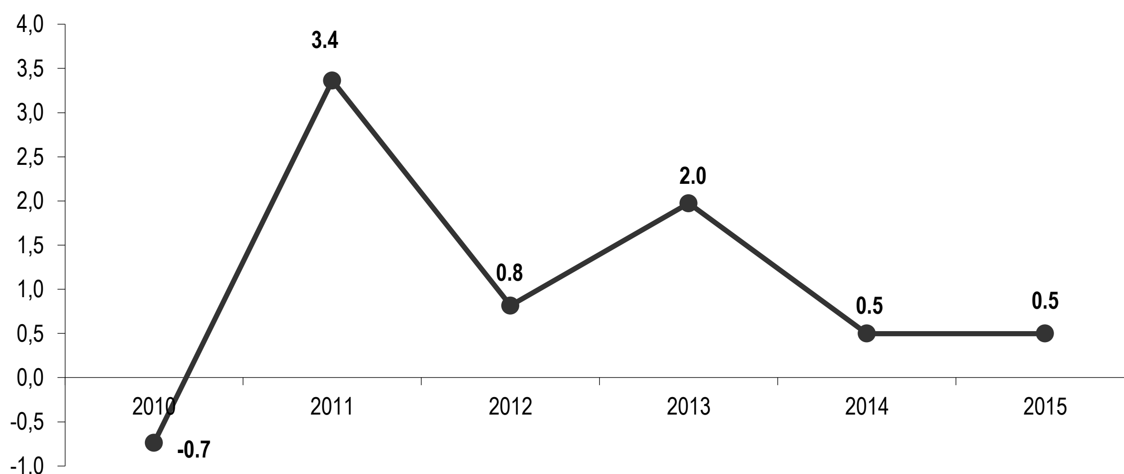
The fourth item covers interest payments. Since the amount of interest payments primarily depends on the general government debt accumulated over the past years and the need to finance it, this item should not influence the government's consolidation effort. For this reason, the general government balance is also adjusted for interest payments.

The last item involves the construction of highways and expressways outside the general government balance, i.e., through PPP projects and loans to the Národná diaľničná spoločnosť, a.s. (NDS, a state owned highway construction company), which is classified outside the general government sector:

- With regard to PPP projects, the main reason is that there may be a delay between when the decision on their use is taken and their actual impact on the general government balance. In terms of how the government influences this item, however, it is the decision-making period that is crucial rather than the time when payments are made. For this reason the general government balance is adjusted in a manner that the impact on the balance occurs during the construction (capital expenditures) rather than during the repayment of the PPP project.
- In the case of the NDS, the financing of highway construction through debt accumulation and repayment needs to be taken into account. The construction financed in this way should be reflected in the consolidation effort despite the fact that the corresponding entity is classified outside the general government, because the other option would be to finance the construction directly from the state budget.

The fiscal policy was expansionary in 2010 and restrictive in 2011. In the years to come, consolidation should continue in line with the recommendations of the excessive deficit procedure and the Stability and Growth Pact.

GRAPH 17 – Consolidation effort between 2010 and 2015 (% of GDP)



Source: MF SR

In addition to calculating the consolidation effort, this section also offers an alternative perspective on the fiscal position development by comparing the growth in general government expenditures against the reference growth rate (the so-called "expenditure benchmark") set on the basis of the revised rules of the Stability and Growth Pact.

For Slovakia, as a country which is currently not meeting its medium-term fiscal objective, the adjusted primary general government expenditures, net of discretionary revenue measures, should be growing in real terms at a slower pace than the average potential growth of the economy in order to ensure that the cyclically adjusted

general government balance net of one-off and temporary measures declines by 0.5% of GDP year-on-year (the calculation of the expenditure aggregate net of changes in discretionary revenues and the calculation of the expenditure benchmark is described in detail in Box 4).

TAB 17 – Comparison of adjusted expenditures with the expenditure benchmark (real growth, in %)

	2012B	2013	2014	2015
1. Expenditure Benchmark – reference rate of expenditure growth	1.8	1.4	1.1	1.1
2. Y-o-y growth of aggr. expenditures net of discretionary revenue measures	0.5	0.1	0.7	0.8
3. Compliance with expenditure benchmark	**Yes**	**Yes**	**Yes**	**Yes**

B – approved budget, 2013 – 2015 – Budgetary Framework *Source: MF SR*

Taking account of the general government expenditures and the revenue-side discretionary measures, as incorporated in the 2012 general government budget and in the draft General Government Budgetary Framework for 2013-2015, the adjusted expenditures should not be growing faster than 1% in each of the years. **For every year, the growth in expenditures is below the reference rate, which means that general government expenditures for 2012-2015, as currently proposed, are in line with the expenditure benchmark.**

BOX 4 - Calculation of expenditure benchmark and expenditure aggregate

Expenditure benchmark

The expenditure benchmark is calculated on the basis of the medium-term GDP growth rate estimated as a geometric mean of the potential GDP growth for the past five years, the current year and the forecast for the next four years. Subsequently, for countries not meeting the medium-term objective (MTO), it is necessary to estimate a lower rate at which expenditures should grow to ensure that the cyclically adjusted balance, net of one-off and temporary measures declines by 0.5% of GDP year-on-year. The slower expenditure growth rate depends on the amount of primary general government expenditures and may be expressed as follows:

$$Lower\ expenditure\ growth\ rate\ (p.p.) = \frac{100 * 0.5}{Primary\ expenditures\ (\%\ of\ GDP)}$$

Compared to the approach adopted by the European Commission, the individual components needed for the calculation of the reference expenditure growth rate are based on the MFSR estimates.

Calculation of the expenditure benchmark for Slovakia as a country not meeting MTO (real growth, in %)

	2011	2012B	2013F	2014F	2015F
1. Medium-term reference rate of potential GDP growth	3.6	3.2	2.8	2.6	2.6
2. Shortfall in the growth of expenditure (p.p.)	1.4	1.4	1.4	1.5	1.5
3. Expenditure benchmark (3=1-2)	**2.2**	**1.8**	**1.4**	**1.1**	**1.1**

B - Approved budget, F - GG Budgetary Framework *Source: MF SR*

Expenditure aggregate net of discretionary revenue measures

Rather than being compared against the overall expenditure, the expenditure benchmark is compared against the expenditure expressed, for analytical purposes, net of factors beyond the Government's reach and those not affecting the general government balance. These include interest expenditures, changes in expenditures for unemployment benefits unrelated to government policies, expenditures financed from the EU funds and expenditures covered by measures on the revenue side. At the same time, considering a high year-on-year volatility of the government's investments (which is, in particular, the case of small EU Member States), the average amount of investments for the past three years and the current year is taken into account.

The nominal growth of expenditures adjusted in this manner is converted to real growth using the GDP deflator so that it could be compared against the expenditure benchmark.

Expenditure aggregate net of discretionary revenue measures (ESA95, in EUR mill.)

	2011	2012B	2013F	2014F	2015F
1. Total expenditure	**25,798**	**27,148**	**27,793**	**28,456**	**29,252**
2. Interest expenditure	1,095	1,250	1,476	1,652	1,802
3. Gross fixed capital formation	1,587	1,382	1,175	1,190	1,042
4. Gross fixed capital formation (average for *t-3* through *t*)	1,520	1,537	1,465	1,334	1,197
5. Expenditures on EU programmes fully matched by EU funds revenue	792	1,369	1,402	1,021	864
6. Non-discretionary changes in unemployment benefit expenditure	12	12	11	7	6
7. Expenditures fully matched by mandated revenues increases	0	0	0	0	0
8. Primary expenditure aggregate (1-2-3+4-5-6-7)	**23,833**	**24,672**	**25,194**	**25,918**	**26,735**
9. Year-on-year change in the primary expenditure aggregate	-	839	522	725	817
10. Change in discretionary revenue measures	703	215	-26	-9	9
11. Nominal year-on-year growth of the expenditure aggregate net of discretionary revenue measures($(9_t-10_t)/8_{t-1}$)	-	2.6	2.2	2.9	3.1
12. Real year-on-year growth of the expenditure aggregate net of discretionary revenue measures	**-**	**0.5**	**0.1**	**0.7**	**0.8**
p. m. GDP deflator	*1.6*	*2.2*	*2.1*	*2.2*	*2.3*

B - approved budget, F - GG Budgetary Framework *Source: MF SR*

The third part discusses the fiscal impulse that measures the contribution of public budgets to the year-on-year change in aggregate demand. It indicates whether the government pursues an expansionary or a restrictive fiscal policy. In conjunction with the output gap, it characterises the fiscal policy as to whether it has a stabilising effect or, on the contrary, a procyclical impact on the economy.

For the purpose of calculating the fiscal impulse, the primary balance used for quantifying the consolidation effort was adjusted by taking account of the financial links to the EU budget that further specify the effects of fiscal policy on aggregate demand.

The financial links to the EU budget have been included because Slovakia's contributions to the EU budget reduce aggregate demand while, on the other hand, revenues from the EU have an expansionary effect on the economy, however, without deteriorating the deficit (appearing on both the revenue and expenditure sides).

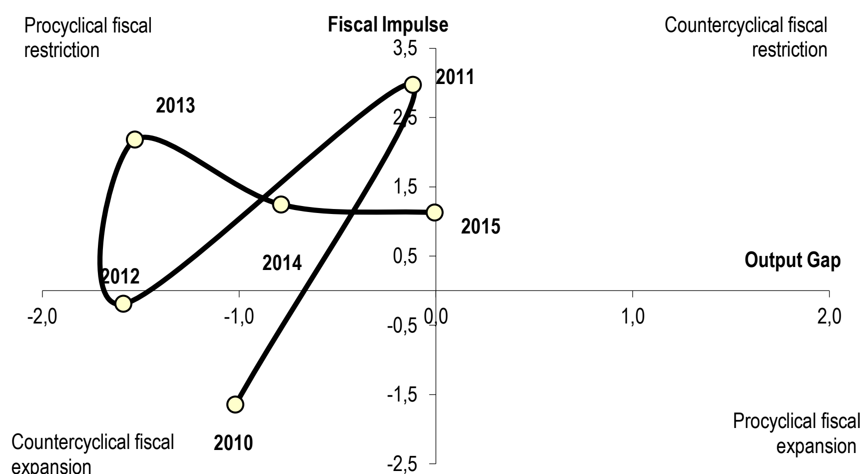
TAB 18 – Fiscal impulse (ESA 95, % of GDP)

	2010	2011	2012	2013	2014	2015
1. Net lending / net borrowing	**-7.7**	**-4.8**	**-4.6**	**-2.9**	**-2.3**	**-1.7**
2. Cyclical component	-0.3	0.0	-0.5	-0.4	-0.2	0.0
3. One-off measures	-0.2	-0.4	0.1	0.0	0.0	0.0
4. Implementation of the 2nd pillar of pension scheme	-1.2	-1.2	-1.3	-1.2	-1.2	-1.2
5. Interest payments	-1.3	-1.6	-1.8	-2.0	-2.1	-2.1
6. Highways construction outside the GG balance sheet	0.7	0.3	-0.1	-0.2	-0.2	-0.2
7. Adjusted primary balance (1-2-3-4-5-6)	**-5.3**	**-1.9**	**-1.1**	**0.9**	**1.4**	**1.9**
8. Financial links the EU budget	2.1	2.5	3.5	3.3	2.5	1.9
- Revenues from EU budget	2.9	3.3	4.3	4.2	3.4	2.8
- Contributions to the EU budget	-0.8	-0.8	-0.8	-0.9	-0.9	-0.9
9. Aggregated balance incl. EU effects (7-8)	**-7.4**	**-4.4**	**-4.6**	**-2.4**	**-1.2**	**0.0**
10. Fiscal impulse (+ restriction, - expansion)	**-1.6**	**3.0**	**-0.2**	**2.2**	**1.2**	**1.1**
p. m. Output gap	*-1.0*	*-0.1*	*-1.6*	*-1.5*	*-0.8*	*0.0*

Note: 2011 – estimate, 2012 - approved budget, 2013 - 2015 - Budgetary Framework *Source: MF SR*

In 2011 the government pursued a restrictive and procyclical fiscal policy which was due, in particular, to the fiscal consolidation. In 2012 the consolidation of public finances will be counter-balanced by an expansionary impulse resulting from the drawing of EU funds. In the subsequent years, fiscal consolidation is expected to continue, the drawing of EU funds will decelerate as the available financing allocated under the 2007-2013 programming period becomes depleted, and the output gap will gradually narrow.

GRAPH 18 – Fiscal Impulse (ESA 95, % of GDP)



Source: MF SR

III.5. General government debt and its development

Assuming that the budgetary objectives are met, the general government gross debt will grow from 43.3% of GDP at the end of 2011 to 50.2% of GDP at the end of 2012 and 53.0% of GDP[5] at the end of 2014, and then decline moderately to 52.3% of GDP at the end of the forecast period. During the entire period the general government debt will remain below the corresponding reference value of the Treaty. **At the end of the forecast period, the net debt of the general government will be 48.3% of GDP.**

TAB 19 – General government debt development between 2010 and 2015

		2010	2011	2012	2013	2014	2015
Gross debt (EUR mill.)		**26,998**	**29,911**	**35,788**	**38,931**	**42,001**	**43,934**
Gross debt (% of GDP)	(1)	**41.0**	**43.3**	**50.2**	**52.0**	**53.0**	**52.3**
Change in gross debt (p. p.)		5.5	2.3	6.9	1.9	1.0	-0.7
Growth in nominal GDP		-1.6	-1.9	-1.4	-2.3	-2.9	-3.0
Primary balance		6.6	3.1	2.9	0.9	0.2	-0.5
Interest payment		1.3	1.7	1.8	2.0	2.1	2.1
Stock-flow adjustment		-0.8	-0.6	3.6	1.3	1.6	0.6
Liquid financial assets (% of GDP)	(2)	1.9	1.1	2.3	2.7	3.9	4.0
Net debt (% of GDP)	(1-2)	**39.1**	**42.2**	**47.9**	**49.3**	**49.2**	**48.3**
p.m. Implicit interest rate (%)		*4.0*	*4.1*	*4.2*	*4.1*	*4.2*	*4.3*
Impact of ESM and EFSF on gross debt		*0.0*	*0.2*	*2.5*	*3.0*	*3.1*	*3.0*

Source: MF SR

In nominal terms, the gross debt of the general government rose by EUR 2,912 million in 2011, the state debt being the principal contributor and increasing by EUR 2,946 million year-on-year. Concerning other general government entities, the debt of self-governing regions increased by EUR 18 million whereas the debt of municipalities declined by EUR 52 million.

In the next few years the evolution of debt will be primarily influenced by the **state budget cash deficit**. In case of other general government entities, the debt rise will be fuelled primarily by the credit facilities taken by municipalities and self-governing regions in 2012 and 2014 to implement their investment plans.

The general government gross debt projections also take into account the **State Treasury system**. The development of the State Treasury funds used for the financing of government operations in 2012 has been influenced by the expected increase in the momentarily available resources within the system (which are deposited with commercial banks and are not used for debt servicing) approximately to the end-2010 level in order to create an **additional liquidity cushion in response to the situation on the bond market in the euro area**. This means that, unlike in 2011 when the decline in the momentarily available resources helped reduce the general government debt, their impact on the debt will be the opposite in 2012. Further increase in the amount of the momentarily available resources at the end of 2014 will be necessitated by the redemption of bonds with high nominal value due in January 2015. This will temporarily increase the debt at the end of 2014.

Slovakia's contributions to the European Stability Mechanism (ESM) will have a negative impact on the gross debt as well. These contributions are reducing the financial resources of the State Treasury available for the financing of the state's operations, thus contributing to an increase in the gross debt.

The debt projections also reflect Slovakia's commitments under the European Financial Stability Facility (EFSF). In particular, this **involves Slovakia's contribution to guarantee for the countries receiving financial assistance from the EFSF (Ireland, Portugal and Greece).**

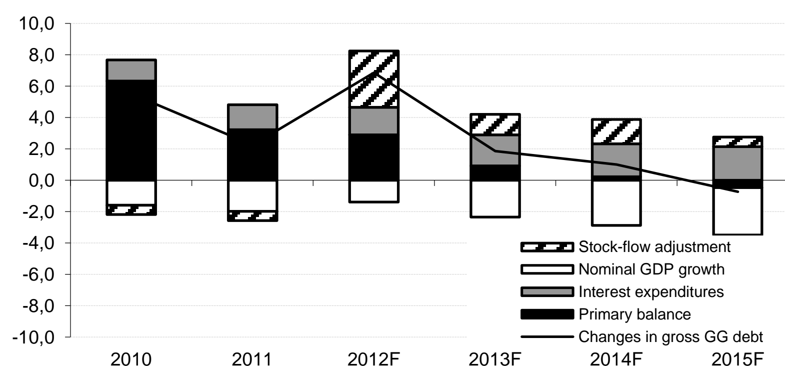
[5] The above debt values reflect Slovakia's contribution to guarantees under the European Financial Stability Facility for Ireland, Portugal and Greece in line with Eurostat Decision No. 13/2011 of 27 January 2011.

TAB 20 – Effects of SR guarantees in EFSF on Maastricht debt (EUR mill.)					
	2011	**2012**	**2013**	**2014**	**2015**
Share of SR on EFSF debt till 31.12. in given year	**173**	**1,809**	**2,097**	**2,161**	**2,161**
- % of GDP	**0.2**	**2.5**	**2.8**	**2.7**	**2.6**
Year-on-year change	**173**	**1,637**	**287**	**64**	**0**

Source: Eurostat, MFSR

As regards relative contributions of individual factors to debt changes, the most important factor increasing the debt in the forecast period will be the planned general government deficits. In addition to higher interest payments, this period will also be marked by quite a large primary deficit, although it will progressively decline as the planned fiscal consolidation gets underway. The stock-flow adjustment will also contribute positively to the growth of gross debt and its amount will be affected, to a large extent, by an increase in Slovakia's guarantees under the EFSF. The only factor contributing since 2012 to a lower debt-to-GDP ratio is the nominal GDP growth, which will exceed the other previously mentioned adverse factors in 2015.

GRAPH 19 – Contribution of factors to the change in gross GG debt (p. p.)



Source: MF SR

The value of stock-flow adjustment will be influenced, particularly in 2012, by the increase of Slovakia's guarantees under the EFSF. Another factor is the net increase in financial assets, predominantly resulting from positive cash balances held by other general government entities and from the expected developments in the available resources of the State Treasury system. Slovakia's deposits in the ESM will also contribute to the growth of gross debt. Because a large portion of the general government gross debt is denominated in EUR, the forecast disregards the impact of exchange rate fluctuations.

TAB 21 - Stock-flow adjustment (% of GDP)					
	2011	**2012**	**2013**	**2014**	**2015**
Stock-flow adjustment	**-0.6**	**3.6**	**1.3**	**1.6**	**0.6**
Differences between cash and accruals	0.0	0.2	0.3	0.1	0.4
Net accumulation of financial assets	-1.0	1.1	0.6	1.3	0.3
- of which deposit into ESM	0.0	0.0	0.2	0.2	0.2
Guarantees of SR on EFSF	0.2	2.3	0.4	0.1	0.0
Appreciation (+) /depreciation (-) of foreign currency debt	0.0	0.0	0.0	0.0	0.0
Other	0.1	0.0	0.0	0.0	0.0

Source: MF SR

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

Slovakia's Stability Programme is underpinned by the baseline scenario of economic developments, including exogenous assumptions concerning developments in the external environment as described in Table 3. This section presents four risk scenarios, namely a simulation adopting the external assumptions of the Commission used in its spring forecast, and three alternative scenarios with faster recovery of foreign demand, lower nominal government consumption, and higher interest rates.

IV.1. Alternative scenarios and risks

Scenario 1. External assumptions of the Commission

Scenario 1 simulates the economic development using external assumptions prepared for the Commission's spring forecasts for 2012 and 2013. It reflects the trends in interest rates, exchange rates, foreign demand and crude oil prices. As a result, there is a difference between the simulated forecast and the MFSR forecast in the years 2012 and 2013.

Because the Commission's assumptions depart only slightly from those of the MFSR, the difference between both forecasts is very small. The expectations of a stronger nominal effective exchange rate coupled with impaired competitiveness will slightly curtail export performance. This will reduce investments and demand for labour which, hand in hand with slightly lower wages, will decelerate GDP growth by 0.1 percentage point. In 2013, the stronger exchange rate backed by lower interest rates will increase the real growth of the economy by 0.1 percentage point.

TAB 22 – Scenario 1 – External assumptions according to EC
Cumulative change of parameters compared to baseline scenario in p. p.

	Households' consumption	Gross fixed investments	GDP	Unemployment rate	CPI	CA balance (% of GDP)	GG balance (% of GDP)
2012	-0.1	-0.1	-0.1	0.02	-0.05	-0.01	0.0
2013	0.0	0.0	0.0	0.02	-0.08	0.03	0.0

Source: MF SR

Scenario 2. Faster recovery of foreign demand

Scenario 2 envisages a more vigorous economic growth of Slovakia's trading partners, which should translate into higher demand for Slovakia's exports. This scenario reflects the positive news on expected developments in the euro area economies, Germany in particular. The simulation envisages a one-off increase, by 1 percentage point in 2012, in the growth of the summary indicator for real foreign demand against the baseline scenario.

Slovakia's exports will be driven by a higher foreign demand, resulting in the need to build new production capacities. The growth of investments will therefore accelerate. The recovery of economic activity will speed up household consumption. Rising domestic demand and lower unemployment will gradually increase CPI inflation. The positive development in the overall demand will also boost imports. With higher real domestic demand and domestic inflation, nominal imports should grow faster than exports, gradually dragging the current account balance into negative figures. Higher economic activity will result in a more positive general government balance.

TAB 23 – Scenario 2 – Acceleration of foreign demand growth by 1 p. p. in 2012
Cumulative change of parameters compared to baseline scenario in p. p.

	Households' consumption	Gross fixed investments	GDP	Unemployment rate	CPI	CA balance (% of GDP)	GG balance (% of GDP)
2012	0.5	0.6	0.6	-0.1	0.1	0.1	0.2
2013	0.9	0.6	0.6	-0.3	0.6	-0.1	0.4
2014	0.7	0.3	0.3	-0.4	1.1	-0.2	0.3
2015	0.4	0.1	0.1	-0.4	1.3	-0.3	0.2

Source: MF SR

Scenario 3. Lower government consumption

The third scenario is inspired by the ongoing global debt crisis when governments are striving to consolidate their general government debts and budgets. The simulation assumes a reduced growth rate in nominal government consumption by 1 p.p. in 2012 in terms of government demand for finished products. At the same time, wages paid in the public sector are assumed to remain unchanged.

A lower government demand for finished products has an adverse impact on GDP, which will subsequently reduce household consumption and investments. Weaker domestic demand will slow down the creation of new jobs and increase the unemployment rate in the following year. As a result of low economic activity, the CPI inflation will lose momentum. Due to low consumption and investments, there will be less demand for imports, and the current account balance will slightly improve. During 2014-2015, current account will be propped up by slightly higher exports due to higher price competitiveness on international markets. The primary effect of reduced government consumption in 2012 will shift the general government balance towards positive figures; however, in the years to follow, the secondary implications in the form of reduced economic activity will have a slightly adverse impact on the balance.

TAB 24 – Scenario 3 – Decrease in nominal government consumption by 1 p.p. in 2012
Cumulative change of parameters compared to baseline scenario in p. p.

	Households' consumption	Gross fixed investments	GDP	Unemployment rate	CPI	CA balance (% of GDP)	GG balance (% of GDP)
2012	-0.1	-0.2	-0.2	0.0	0.0	0.1	0.2
2013	-0.2	-0.2	-0.2	0.1	-0.2	0.1	-0.1
2014	-0.2	-0.1	-0.1	0.1	-0.3	0.2	-0.1
2015	-0.1	0.0	0.0	0.1	-0.3	0.2	0.0

Source: MF SR

Scenario 4. Increased interest rates

The fourth scenario analyses the sensitivity of the forecast to short-term and long-term interest rates moving up by one percentage point in 2012. The shift in the yield curve is understood as an increase in the risk premium to interest rates on private and public debt. These unfavourable developments could occur due to the current uncertainties surrounding the solution of the debt crisis in the euro area.

Higher interest rates will impair the access of businesses and households to loans, thus slowing down household consumption and investments. This would lead to a slight contraction of economic growth translated into a slower employment growth and, consequently, slower rate of increase in household consumption. While the contraction of aggregate demand will reduce the pressure on price growth, slower employment growth will relax wage growth pressures. Lower consumption and investment rates will slow down the growth of imports, thus improving the current account balance. An overall adverse impact on the general government balance, including direct interest costs of the general government debt, is quantified at 0.1-0.2% of GDP.

TAB 25 – Scenario 4 – Increase of short-term and long-term interest rates by 1 p. p.
Cumulative change of parameters compared to baseline scenario in p. p.

	Households' consumption	Gross fixed investments	GDP	CPI	Short- and long-term interest rates	CA balance (% of GDP)	GG interest payment (% of GDP)	GG balance (% of GDP)
2012	-0.2	-0.3	-0.1	0.0	1.0	0.1	0.1	-0.2
2013	-0.1	-0.2	0.0	-0.1	0.0	0.1	0.1	-0.1
2014	0.0	-0.2	0.0	-0.1	0.0	0.0	0.0	0.0
2015	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0

Source: MF SR

IV.2. Comparison with the previous update

The Stability Programme of the Slovak Republic for 2012-2015 comprises updated macroeconomic and fiscal objectives. Compared to the last year's update of February 2011, the general government debt forecast deteriorated, as did the forecast for general government balance in 2012; these changes are clarified in Chapter III.

TAB 26 - Comparison between the previous forecast and the updated forecast

	ESA code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
Real GDP growth (%)						
Previous update*		3.4	4.8	4.8	4.8	-
Current update		3.3	1.1	2.7	3.6	3.7
Difference		-0.1	-3.7	-2.1	-1.2	-
General government balance (% of GDP)	EDP B.9					
Previous update*		-4.9	-3.8	-2.9	-2.8	-
Current update		-4.8	-4.6	-2.9	-2.3	-1.7
Difference		0.1	-0.8	0.0	0.5	-
General government gross debt (% of GDP)						
Previous update*		44.1	45.3	45.3	45.2	-
Current update		43.3	50.2	52.0	53.0	52.3
Difference		-0.8	4.9	6.7	7.8	-

*Note: * Stability Programme of the Slovak Republic for 2011 - 2014*

Source: MF SR

V. SUSTAINABILITY OF PUBLIC FINANCES

The long-term sustainability of public finances has an economic and a moral dimension. From the economic point of view, sound public finance is an essential precondition for high and sustainable economic growth. The moral dimension lies in ensuring intergenerational equity. This is because general government budgets do not just reallocate resources between different groups of the population (solidarity), but also between generations. The pursuit of a policy of high deficits and amassing debts in the long run automatically means requiring the future generations to pay the cost – usually through higher taxes.

V.1. Policy strategy

From this perspective Slovakia belongs among responsible countries that demonstrated their ability to significantly reduce the general government deficit while addressing important issues for the long-term sustainability of public finances. The positive initial fiscal position constitutes an essential prerequisite for the ability of public finances to absorb future negative influences of demographic developments. Reducing the general government deficit from 4.8% of GDP in 2011 therefore remains the core medium-term fiscal policy objective. The approved General Government Budget for 2012-2014 and the draft General Government Budgetary Framework for 2013-2015 envisage a gradual decline in the general government deficit aiming at 1.7% of GDP in 2015. Moreover, by adopting the constitutional Fiscal Responsibility Act, Slovakia undertook to manage its public finances in a responsible and sustainable manner since the Government has committed itself to also taking into account reductions in the sustainability indicator (GAP) in defining its medium-term fiscal objectives in the future.

Notwithstanding additional consolidation, the adverse effects of population ageing must be toned down through structural reforms. Higher employment, productivity gains and economic growth are not just the only sustainable sources of improvement in the population's living standards; they can also contribute significantly to a sustainable pension system and the overall consolidation of public finances. The prerequisites for employment and productivity growth include an adequate and effective tax burden, smart regulation of the labour market and flexible markets for goods and services.

V.2. Long-term budgetary outlook in the context of population ageing

Population ageing as a global phenomenon currently affects mainly advanced economies, Slovakia being no exception. In recent years, this issue has been given particular attention in the EU framework. It is addressed by the Ageing Working Group (AWG) established to analyse, in cooperation with the European Commission, the expenditures that are sensitive to demographic trends, and to identify their implications for the overall development of public finances. Its objective is to obtain comparable and the most complete information possible concerning the risks associated with expected demographic changes. In 2009, the AWG and the European Commission presented updated projections extending to 2060[6].

In line with the requirements for the contents of the stability programmes[7], Member States are obliged to present in their Stability Programmes the projections produced by the AWG. Slovakia endorsed the updated projections of 2009 at expert level within the AWG, and the Ministry of Finance therefore fully accepts them and uses them in its own analyses. The Commission subsequently uses these projections to assess the long-term sustainability of the fiscal position and fiscal objectives.

As regards the up-to-datedness of these projections, given the fact that they were prepared in the course of 2008 based on the legislation effective as of July 2008, they do not capture the impacts of the opt-out from the fully-

[6] European Commission (DG ECFIN) and the Economic Policy Committee (AWG) (2009) 'The 2009 Ageing report: economic and budgetary projections for the EU-27 Member States (2008-2060)', European Economy, No 2, April 2009

[7] Guidelines on the format and content of the Stability and Convergence Programmes

funded pension pillar between 15 November 2008 and 30 June 2009; however, its impact on the long-term sustainability was negligible. The projections do not reflect the implications of the economic crisis either.

This section has three parts. The first part describes the magnitude of the problem that will have to be tackled in the field of public finance in Slovakia in the future. The second part deals with long-term sustainability measured through the sustainability indicators based on the Commission's methodology. The third part describes long-term sustainability based on the GAP indicator, which is part of the national fiscal rules and which the Slovak Government will take into account in setting its medium-term fiscal targets.

Long-term projections of revenues and expenditures sensitive to population ageing

The AWG identified those general government expenditures that may be favourably or adversely influenced by demographic changes. These include expenditures on pensions, health care, long-term care, education and unemployment benefits. In the future, the first three types of expenditures will grow while expenditures on education and the jobless will go down (fewer children, lower unemployment, fewer labour market participants).

Moreover, the revenue side reflects changes in property income and for some countries, including Slovakia, changes resulting from pension system adjustments. In the case of Slovakia, this is related to the shortfall in general government revenues resulting from the introduction of the 2nd pillar of the pension system.

TAB 27 - Changes in GG revenues and expenditures induced by demographic changes (% of GDP)

	2007	2010	2020	2030	2040	2050	2060	Change 2007-2060
A. Revenue shortfall (loss due to 2nd pillar)	**-1.0**	**-1.2**	**-1.4**	**-1.6**	**-1.7**	**-1.7**	**-1.8**	**-0.7**
B. Expenditures sensitive to population ageing	**15.2**	**14.9**	**14.5**	**16.1**	**17.5**	**19.2**	**20.4**	**5.2**
- pension benefits	6.8	6.6	6.3	7.3	8.3	9.4	10.2	**3.4**
- health care	5.0	5.2	5.7	6.2	6.7	7.1	7.2	**2.3**
- long-term care	0.2	0.2	0.2	0.3	0.4	0.5	0.6	**0.4**
- education	3.1	2.8	2.2	2.2	2.1	2.1	2.3	**-0.8**
- unemployment benefits	0.1	0.1	0.1	0.1	0.1	0.1	0.1	**-0.1**
C. Property income	**1.5**	**1.4**	**1.2**	**1.1**	**1.1**	**1.1**	**1.0**	**-0.5**
Impact on general government balance								**-6.4**

* Current legislation status: retirement age 62 years; indexation 50: 50 (wages, inflation), 2nd pillar implemented

Source: Ageing report 2009

The Commission's and AWG projections suggest that, unless remedial action is taken in the affected areas, adverse demographic developments coupled with declining general government revenues will increase the general government deficit by 6.4 percentage points of GDP by 2060. The above-mentioned results take into account all major measures, including the introduction of a 2nd pillar, increase in the retirement age to 62 years, pension indexation in line with wages and inflation, and the like.

Assessment of long-term sustainability by the European Commission

The purpose of assessing the long-term sustainability is to appraise the current situation in public finances in the light of the future growth of age-related public finance expenditures presented in the preceding section, i.e., to judge whether the current policy mix (fiscal discipline, pension system, healthcare system) is sustainable in the long run (capable of preventing an uncontrolled growth of debt and maintaining its stable level) with the current level of government debt. To this end, the Commission uses the so-called sustainability indicators[8]: *S1 indicator, S2 indicator, RPB – Required Primary Balance, Costs of Delay.* These indicators quantify the volume of immediate fiscal measures needed to ensure sustainability. A brief description of individual indicators was provided in the previous Convergence Programmes. The Stability Programme only contains two basic indicators used, i.e., S1 and S2.

[8] European Commission-DG ECFIN (2009) Sustainability Report 2009, European Economy, No. 9 2009

In carrying out its sustainability assessment the Commission, besides quantifying the size of fiscal measures needed to ensure sustainability, classifies Member States into three categories depending on the degree of risk (low, medium and high). In the 2009 Sustainability Report, Slovakia was, along with a number of other countries, for the first time classified as one with a high risk of long-term sustainability of public finance. In classifying the countries into the above-mentioned categories, the Commission used the S2 indicator and the year 2009 as the baseline for quantification (the 2009 Scenario) while, for some countries, it also took account of other, "qualitative", factors such as the existence of the time frame for carrying out the necessary reforms (if the sustainability problem is mainly related to ageing and the country has sufficient time to implement the necessary reforms), current debt level, forecast of the development of primary structural balance, level of implicit liabilities, evolution of the replacement rate in the pension system, and the tax-to-GDP ratio. However, in Slovakia's case, no consideration was given to such "qualitative" factors.

The S2 calculation in the "2009 Sustainability Report" was based on the 2009 data published in the EC 2009 Spring Forecasts. Important parameters of the calculation include the structural primary deficit level, current debt, and the level of future public expenditure sensitive to demographic changes, which are assumed to develop in accordance with the previously-mentioned AWG projection. Demography-unrelated revenues and expenditures (except for income from property) remain constant as a percentage of GDP over the entire period. In other words, only those revenues and expenditures that are influenced by the ageing of the population have an impact on the deficit level. An important factor in Slovakia's case is the shortfall in revenues attributable to the fully-funded pillar of the pension system introduced in 2005, which will rise overtime (as a percentage of GDP) because the group of the population participating in this pillar will be growing in the future.

The EC 2009 Sustainability Report also estimated the S2 indicator for Slovakia at 7.4% of GDP. The programme scenario was calculated using the basic demographic and macroeconomic assumptions presented in the report. However, the Ministry of Finance introduced two important changes compared to the 2009 calculations. Firstly, some numeric errors were eliminated, e.g. the failure to include the shortfall in general government revenues resulting from the introduction of the fully-funded pillar of the pension system. This resulted in the S2 indicator rising by 0.5 percentage point to 7.9% of GDP. Secondly, the estimate of the initial primary structural balance for 2009 (-3.7% of GDP) was replaced by the actual data derived from the most recent notification (-5.1% of GDP). **As a result, the reference S2 value for 2009 changed to 9.3% of GDP.**

The present Stability Programme envisages a gradual decline in the general government deficit to 1.7% of GDP in 2015, which would translate into a structural primary surplus of 0.5% of GDP. By attaining this fiscal objective, the S2 indicator will drop from the current level of 8.1% of HDP to 4.7% of GDP (disregarding the impact of the expected updated version of the projections concerning the implications of population ageing in 2012 – the Ageing Report 2012). **Even with its consolidation targets met, Slovakia will have to make parametric adjustments to the pension system in order to be classified as a country with a low risk of long-term sustainability.**

TAB 28 – Sustainability indicators

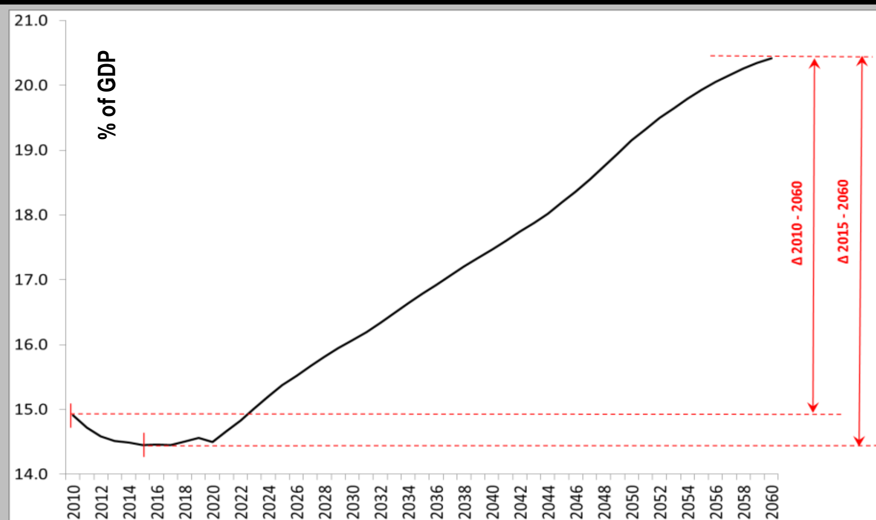
	S2	LE	LR	IBP	S1	Assumptions		
						End year	SPB	Debt
EC sustainability report (scenario 2009)	**7.4**	2.9	0.3	4.3	**5.7**	2010	-3.7	36.5
corrected EC scenario (scenario 2009)	**7.9**	2.9	0.8	4.3	**6.1**	2010	-3.7	36.7
Accounting for actual deficit (scenario 2009)	**9.3**	2.9	0.8	5.7	**7.6**	2010	-5.1	40.4
Scenario - 2011	**8.1**	3.6	0.6	3.9	**6.6**	2015	-2.8	60.6
Scenario – Stability Programme	**4.7**	3.6	0.6	0.5	**3.1**	2015	0.5	52.3

LE – Long-term expenditures (ageing costs)
LR – Long-term revenues (revenues from property, II. pillar)
IBP – Initial budgetary position
SPB – Structurally-adjusted primary balance

BOX 5 – Why are long-term ageing costs increasing?

Despite the fact that under the above calculations of sustainability, the impact of population ageing on public finances will be the same until 2060 (the 2009 Ageing Report), the impact of the long-term ageing costs (LE) in the 2011 scenarios and SGP is higher (up to 3.6 from 2.9). The reason is that the long-term sustainability calculation always starts from last year of the Stability Programme. Because the women's retirement age will increase to 62 years by 2024 (with the men's retirement age already at the 62 year mark), the pension expenditures should be slightly shrinking in the years to come (approximately until 2016). The postponement of the starting year as of which the increase in age-related expenditures is taken into consideration reduces savings on this account – these savings should be reflected in the initial budgetary position (IBP) because the decline of these expenditures has a positive impact on consolidation.

Long-term projections of expenditure on pensions (2009 Ageing report, % of GDP)



Source: MF SR

Assessment of long-term sustainability as part of the national fiscal rules

The Fiscal Responsibility Act entered into force in Slovakia on 1 March 2012. The approval of this Act by all political parties represented in the Parliament provides a solid ground for its long-lived existence. This objective of the Act is to support the pursuit of a long-term and counter-cyclical fiscal policy (see Chapter VII for more details).

The constitutional Fiscal Responsibility Act also defines the role of the **Fiscal Responsibility Council** in this area, i.e., the **drawing up and publishing of the reports on long-term sustainability, including the baseline scenario and the definition of long-term sustainability indicator (GAP)** by 30 April of each year, and always within 30 days of the parliamentary debate on the Government's Manifesto and the vote of confidence in the Government.

In calculating GAP, the **Government will – for the whole term of its office – set the pace at which it intends to improve the indicator down to zero, while respecting the rules laid down in the EU law**. The Government can reduce the level of the indicator using various economic policy measures, such as reforms reducing implicit debt (e.g., pension reform), measures designed to improve the economic performance of state-owned enterprises[9] and measures focusing on the consolidation of the general government budget. It is up to the Government to decide which path, or combination of the options referred to above, it takes to meet the objectives.

[9] Currently, the projections of the economic performance of state-owned enterprises and the central bank (NBS) are not included as parameters in the calculation of the long-term sustainability indicator. For this reason, the permanent improvement in the economic performance of these entities does not, in itself, directly affect the value of the indicator. The impact on the indicator may be indirect, if the general government assumes liabilities on behalf of these enterprises when their economic performance becomes unsustainable. Forecasts of the economic performance of these enterprises entities will be reflected in the calculation as soon as the Fiscal Responsibility Council begins to function.

BOX 6 – Long-term sustainability indicator (GAP)

Long-term sustainability *means such an economic performance of the Slovak Republic which ensures that the general government balance and general government debt are capable of ensuring that an expected change in the general government's revenues and expenditures according to the baseline scenario does not bring the* ***general government debt above the upper debt ceiling (50% of GDP)*** *in the next 50 years.*

The calculation of the long term sustainability indicator is based on ***the baseline scenario*** *of public finance development* ***in the next 50 years****. The aim of the baseline scenario is to indicate the trends in revenues, expenditures and the general government debt, as well as the economic performance of the central government's corporations, local government's corporations and the National Bank of Slovakia (NBS), assuming that no new measures are taken during the forecast period and that the existing legislation remains in place. It includes a long-term forecast of the future costs related to population ageing, property income, projections of other implicit liabilities of the general government (such as liabilities related to the decommissioning of nuclear facilities) and the liabilities under PPP projects. The other items that are not affected by the above liabilities develop in line with pre-defined assumptions.*

Scope of the data used in GAP calculations

a) *value of the structural primary balance;*
b) *demographic forecasts published by Eurostat;*
c) *macroeconomic forecasts by the Macroeconomic Forecasts Committee and long-term macroeconomic forecasts by the European Commission;*
d) *long-term projections of expenditures sensitive to population ageing as calculated by the European Commission;*
e) *long-term projections of property income as calculation by the European Commission;*
f) *implicit liabilities and contingent liabilities (PPP projects, costs of decommissioning of nuclear facilities)*
g) *other indicators affecting long term sustainability.*

Compliance with the defined objective of improving the long-term sustainability indicator will be assessed by the Fiscal Responsibility Council. The indicator will be calculated on the basis of the actual data and compared with the Government's target. When comparing the values, consideration will have to be given as to whether, and if so to what extent, the long-term sustainability indicator has been affected by the factors beyond the reach of the Government. This may be a situation where the Government meets its consolidation targets (in line with the objective of improving the long-term sustainability indicator at the time when the targets are set), yet the long-term sustainability indicator does not change in line with expectations. Such a development may be caused by one-off or permanent factors that are beyond the Government's control and have a negative impact on the future development of the fiscal position (through increasing the general government debt) and by the revisions of long-term macroeconomic and demographic forecasts (changes in baseline scenario for public-finance development).

When compared against sustainability indicators of the Commission, the GAP indicator is most akin to the S1 indicator, as both of them target the general government gross debt in the defined year. While the S1 indicator aims at reaching the debt level of 60% at the end of the target period (2060), GAP is stricter in that it targets the debt level of 50% of GDP 50 years on. In addition to the debt target alone, including the trends in some revenue and expenditure items that are not stable as a percentage of GDP (PPP projects, costs of decommissioning nuclear power plants, contributions to the National Nuclear Fund), the horizon targeted by the indicator is another aspect that departs from the Commission's methodology. In general, however, the GAP indicator is more stringent than S1, even in a situation where the S1 indicator is set to bring the general government debt to 50% of GDP in 2060.

TAB 29 – Comparison of sustainability indicators

	S1: debt 60%	S1: debt 50%	GAP
Scenario – Stability Programme	3.1%	3.2%	4.3%

Source: MF SR

VI. QUALITY OF PUBLIC FINANCE

In order to ensure economic recovery of the EU, the Commission recommends, in its Annual Growth Survey for 2012, that efforts at the national and EU level should concentrate on the following five priorities:

- Pursuing differentiated growth-friendly fiscal consolidation
- Restoring normal lending to the economy
- Promoting growth and competitiveness for today and tomorrow through structural reforms
- Tackling unemployment and the social consequences of the crisis
- Modernising public administration.

The main focus is on fiscal consolidation, which is essential to restoring macroeconomic and financial stability and confidence in the financial markets. On the expenditure side, the Commission deems it most important that the growth in public expenditure be kept below the rate of GDP growth in the medium term. Particular attention should be given to prioritising growth-friendly expenditures (such as education, research, innovation and energy) and continuing the reform and modernisation of the pension and healthcare systems. On the revenue side, more attention is needed, for the most part, in the design and structure of the tax systems to make them more effective, efficient and fairer, while also taking into account the need to increase taxes.

VI.1. Developments on the revenue side

The optimal situation in terms of fiscal policy would be that the level of overall tax burden, measured as a ratio of taxes and social contributions to GDP without the impact of legislative amendments, does not markedly change in the long run. A stable ratio of taxes and social contributions to GDP increases the predictability of developments in public finances and facilitates consolidation. A decline in the overall tax burden makes fiscal consolidation more difficult, as it requires adoption of more stringent consolidation measures on the expenditure side.

At the same time, the tax system structure is one of those factors that significantly contribute to the economic growth of a country. For this reason, individual taxes should be seen as both a potential source of budgetary revenues and the drivers of economic growth. Therefore, if change in the structure of the tax system or additional revenues for the consolidation of public budgets are needed, it is appropriate to modify the tax system in a way that has the least adverse impact on growth[10].

BOX 7 - Commission's recommendations in the area of taxation

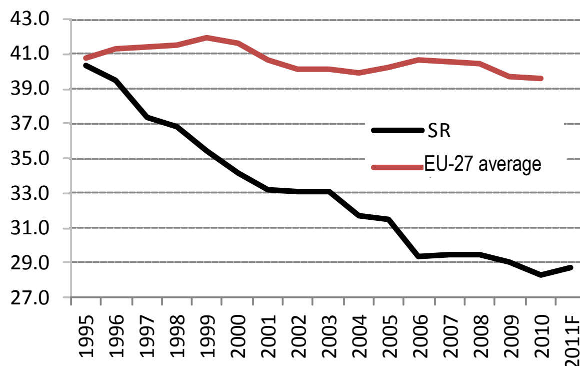
- *Broadening the tax base by phasing out certain exemptions that are in place, in particular as regards VAT and corporate and personal income tax*
- *Shifting taxation away from labour towards taxation which is less detrimental to growth – i.e. increasing consumption, environmental and wealth taxation, with particular attention paid to the needs of the most vulnerable groups*
- *Improving the efficiency of tax collection by tackling tax evasion*
- *New sources of national revenues such as the auctioning of CO_2 emission allowances*
- *Joint coordination of efforts in the area of taxation through enhanced dialogue at EU level (see proposals for common consolidated corporate tax base or for a financial transaction tax)*

In terms of the share of the less and more harmful taxes in the overall tax revenue, Slovakia's tax system is among the better ones in the EU. Of all tax revenues, the "good" taxes, i.e., those with the least adverse impact on economic growth, account for almost 38%. On the other hand, shortly after the introduction of the tax reform in

[10] As shown by professional literature and experience of individual countries, direct taxes (personal income tax, corporate tax, social contributions) belong among those with the most negative impact on economic growth as they are directly affecting the activities of the entities concerned (willingness to find a job or hire employees, scale of production, etc.), i.e., they are among more harmful taxes. At the same time, these taxes open wide opportunities for tax evasion (non-declaration of income, increasing expenditures). As opposed to the above, indirect taxes and property taxes are better in all of the above categories (less harmful taxes), and the only risk associated with indirect taxes is their regressive character which poses more of a burden for low-income consumers.

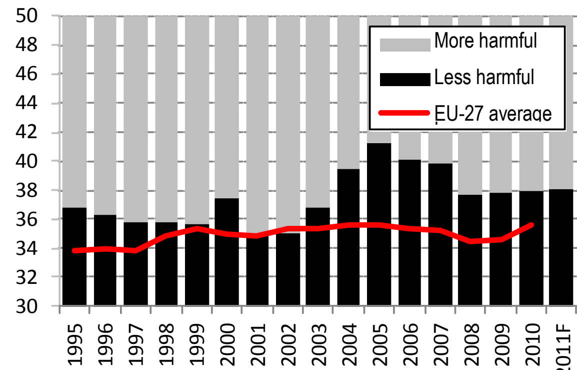
2004 that shifted the tax burden from direct taxes towards indirect taxes, they accounted for as much as 41%. Despite the fact that fundamental changes in the structure of general government revenues took place back in 2004 and the subsequent changes did not considerably influence the structure of revenues (except for the launch of the fully-funded pillar of the pension system scheme), the share of the less harmful taxes and the overall tax revenues in GDP have declined compared to 2004.

GRAPH 20 – Development of tax-to-GDP share (% of GDP)



Source: MF SR

GRAPH 21 – Tax share depending on their effect upon economic growth (% of GDP)



Source: MF SR

BOX 8 - Main reasons behind the declining share of taxes and social contributions in GDP and changes in the structure of the less/more harmful taxes since 2004

Inelasticity of the tax system – for several types of taxes, the rates are fixed and thus incapable of responding to economic developments and/or market trends (for example, real estate tax and excise taxes).

Present **neutrality of taxation,** which encourages tax optimisation. The differing taxation of labour and capital, including the differing taxation of various types of labour, lends itself to the wrong and undesirable motivation to prefer the less-taxed types of income (reclassifying employees into self-employed, preferring work contracts to employment contracts, setting up one-person limited liability companies, etc.).

Efficiency of tax administration and related **tax evasions** – analysis of the estimated loss of VAT revenue shows that, provided that tax evasions are rigorously suppressed, the additional VAT revenue could realistically reach 1.6% of GDP (EUR 1.1 billion)[11].

Since the decline in tax revenues as a share of GDP and the changed revenue structure are not in line with the objectives pursued by the tax policy, measures aimed at halting this negative trend need to be adopted as soon as possible. Furthermore, with fiscal consolidation underway, these measures represent a considerable source of additional revenue without the need to adopt other measures that are more detrimental to economic growth. For the above reasons, particular attention should be given to the measures outlined below, which can be structured based on their implementation and impact on the general government balance, into short-term (implementable in 2013-2014) and medium-term (with gradual effects spread over several years) measures.

In the short term, the focus will be on those taxes that reduce disposable income of the low-income population groups and economic activity to the least possible extent, or which are relatively low compared to other countries. The progressivity of the tax system will increase. Consideration will also be given to increasing the collection of property taxes, taking into account such factors as luxury or environmental harm. Some excise taxes still offer a margin for increase, such as the alcohol excise tax. The Slovak Government will take steps to eliminate distortions in the system of taxation and social contributions. With a view to increasing public revenues, the current level of the bank levy will be reassessed. Gambling tax rates will be increased, and the more efficient

[11] Economic analysis by the MFSR Institute for Financial Policy: Odhad straty príjmov z DPH (http://www.finance.gov.sk/Default.aspx?CatID=8181)

economic performance of state-owned enterprises will bring higher dividends to the state budget. Taxes will only be raised to the extent necessary to ensure that the fiscal consolidation remains growth-friendly as much as possible.

The medium-term measures include:

- **Simplified payment of taxes and social contributions (UNITAS project)** – the UNITAS project is designed to make the system of taxation and social contributions streamlined, efficient and transparent, lay the groundwork for the integrated collection of taxes, custom duties and social contributions, and considerably reduce red-tape burden for citizens and employers;
- **More efficient tax collection (in particular VAT and excise taxes)** – the effort should primarily focus on detecting tax evasions (stricter checks, risk management, etc.).

VI.2. Developments on the expenditure side

The General Government Budget for 2012-2014 includes consolidation measures, especially in the form of frozen wage expenditures and overhead costs, as well as reductions in capital expenditures, which, however, should be offset by the more effective use of EU funds. The savings on the expenditure side represent 0.6% of GDP.

In 2012, the wage expenditures in most of budget chapters have been frozen at the 2011 level and the expenditures on goods and services are cut by 5%. State-owned enterprises are beginning to contribute to the recovery of public finances as they make their operations more efficient so as to require less government subsidies; some of these companies have even become net contributors to the state budget.

In order to protect the expenditures promoting economic growth, two basic and political priorities are apparent in the 2012 budget: transport infrastructure and education.

The first priority is the construction and modernisation of the transport infrastructure in order to facilitate its interconnection with the European transport network and make all Slovak regions more accessible; the Government will thus create conditions for improving the standard of living across different regions and reducing regional disparities. The expenditures on the road and railway transport (both capital and operating) will rise approximately to EUR 2 billion in 2012, which is the highest level ever. Such an increase is capable of ensuring major construction and modernization in the sector. At the same time, the growing indebtedness of railway companies, as witnessed in previous years, is expected to come to an end.

The second priority is education, where the volume of funds per student in the regional education system and per university student will increase by 5.03% and 4.66%, respectively, compared to the 2012 budget. Teachers in the regional school system remain exempt from the wage freeze also in 2012. In order to increase the wages of these teachers, the 2012 allocation increased by 4.1% compared to the budget approved for 2011. Assuming that the number of teachers declines so that the number of students per teacher remains at the 2009 level, the average wage expenditure on teachers in 2012 would increase by 13.6% compared to 2011.

In the period of 2013-2015, the need for capital expenditures will be thoroughly assessed in light of the possibilities afforded by the use of EU funds. The Government will be making investments and purchasing goods and services from public funds using the most cost-efficient and transparent methods of procurement. The implementation of expenditure-reducing measures across all budget chapters will continue, and the social and economic benefits of public expenditures will increase. The Government may decide to limit the payment of certain social benefits and allowances to families with above-average income. Specific steps will be taken to ensure the financial and social sustainability of the pension system as a whole, i.e., in all of its three pillars. The Government expects additional savings after the reform and audit of the state administration and public administration with the objective of reducing expenditures and increasing the quality and availability of public services, for instance, by putting in place a centralised system of public procurement or by setting up a government real estate agency.

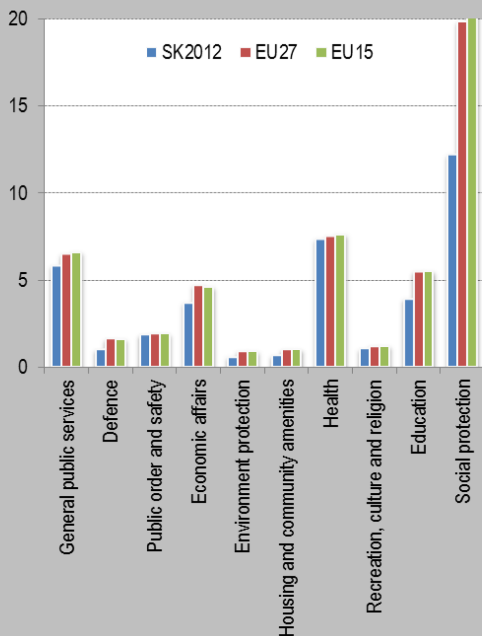
The Government will reform the pension system, which is unsustainable in the long run, and parameters will therefore have to be changed. In order to stabilise financial flows in the long run, the Government will introduce a link between demographic trends and the pension system parameters, while gradually enhancing the solidarity dimension to the pension system. The Government will also focus on the measures that ensure smart, sustainable and inclusive growth. These measures will also be defined during the preparation of the cohesion policy for the next period.

BOX 9 - International comparison of public expenditures

In the charts below, the public expenditures of Slovakia, shown in the amounts budgeted for 2012, are compared with the EU average. The left side of the chart indicates their share in GDP, and the share in total public expenditures is shown on the right side. Simply put, the share-in-GDP indicates the funding of individual areas given the size of the economy, whereas the relative terms indicate priorities in the context of the size of the country.

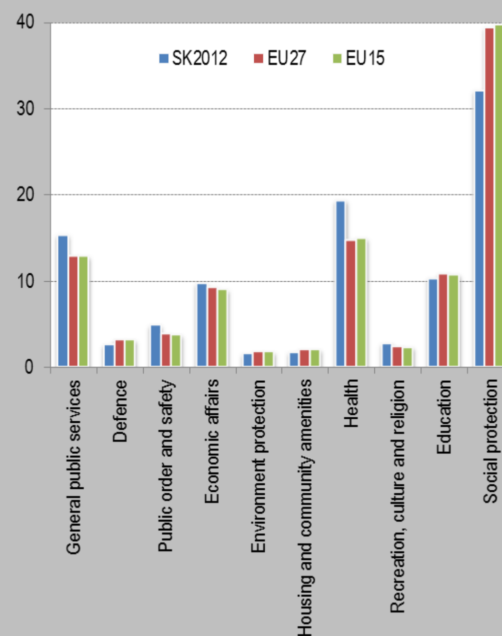
Slovakia's social security expenditures are well below the EU average. Considering the size of the economy and the relative size of the public sector, the expenditures on defence and education are lower. On the other hand, relatively more funds in the 2012 budget are earmarked for healthcare, public order and security (such as police, judiciary and prison service), general services (administration, government agencies and debt service), as well as recreation, culture and religion.

Public expenditures - % of GDP (SK-2012, EU-2010)



Source: Eurostat, MF SR

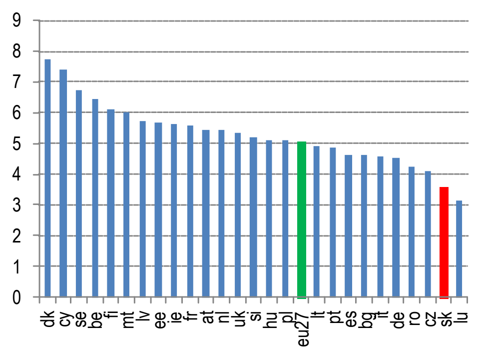
Relative public expenditures – share of total costs (%, SK-2012, EU-2010)



Source: Eurostat, MF SR

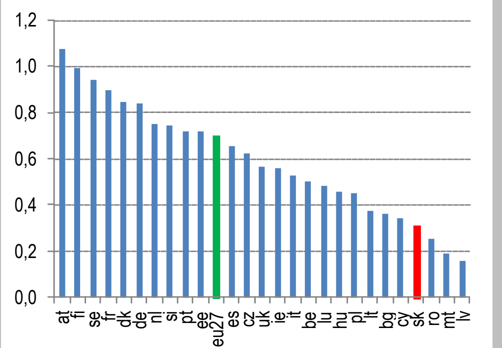
Compared internationally, Slovakia's expenditures on the productive sectors remain low. Public expenditures on education, as well as research and development, were among the lowest in the EU in 2008 or 2010. Therefore, even during the consolidation process, expenditures should be primarily targeted to those areas that are key to economic growth (education, transport, science and research). Even though the effects of these investments are expected to materialise in the long term, their present value should not be underestimated.

Public expenditures on education (% of GDP, 2008)



Source: Eurostat

Public expenditures on research and development (% of GDP, 2010)



Note: without universities *Source: Eurostat*

VII. INSTITUTIONAL ASPECTS OF PUBLIC FINANCE

The ongoing budgetary framework reform, through the adoption of the constitutional Fiscal Responsibility Act and the subsequent amendment to the General Government Budgetary Rules Act, constitute a significant institutional change in the public finance area.

VII.1. Fiscal framework reform

The Fiscal Responsibility Act entered into force in Slovakia on 1 March 2012. The Act was approved by the Parliament in December 2011 through the consensus of all parliamentary parties. The purpose of the Act is to promote the pursuit of a long-term and counter-cyclical fiscal policy. This substantial strengthening of fiscal framework has a potential to underpin Slovakia's credibility on international financial markets and contribute towards smooth fiscal consolidation.

The Act covers the following four main areas:

- the constitutional ceiling on the maximum amount of general government debt (debt brake);
- establishment of the Fiscal Responsibility Council;
- rules of transparency in public finance;
- rules and constraints in the management of local governments.

One of the most important rules is the **uppermost ceiling for the general government gross debt, which may not exceed 60% of GDP until 2017**. Subsequently, the general government debt ceiling will be gradually reduced by one percentage point each year to reach 50% of GDP in 2027. The Act also establishes automatic sanction mechanisms which will be triggered whenever the defined gross debt level is surpassed. The brackets of the sanction mechanism start at 10 p.p. below the debt ceiling (Box 10).

BOX 10 - General government gross debt-to-GDP limits and sanction mechanisms in 2012-2017

- ***Debt amounting to 50–53% of GDP*** *– the Ministry of Finance sends to the Parliament a written explanation of the amount of debt, including the proposed measures for its reduction*
- ***Debt amounting to 53–55% of GDP*** *– the Government will submit to the Parliament a proposal of measures aimed at reducing the debt; the salaries of Cabinet members will be reduced to the level applicable in the previous fiscal year*
- ***Debt amounting to 55–57% of GDP*** *– The Ministry of Finance will set aside 3% of the total state budget expenditures (other than those on the government debt service, EU funds, contributions paid to the EU, transfers to the Social Insurance Company); at the same time, the Government may not propose to the Parliament a draft state budget featuring any nominal year-on-year increase in general government expenditures and the local governments are required to approve budgets with expenditures not exceeding those in the previous year's budgets.*
- ***Debt amounting to 57–60% of GDP*** *– the Government may not submit to the Parliament a proposal for a deficit-based budget of the general government, while the local governments are required to approve a balanced or surplus budget for the next fiscal year.*
- ***Debt exceeding 60% of GDP*** *– in addition to the steps described above, the Government will ask the Parliament for a vote of confidence.*

As from 2018, the brackets for the application of the sanction mechanism, as well as the general government debt ceiling, will be reduced annually by 1 p.p. until the upper ceiling drops to 50% of GDP (in 2027).

The Act also establishes the **Fiscal Responsibility Council** the main role of which is to foster transparency in the budgetary process. On annual basis, the Council will:

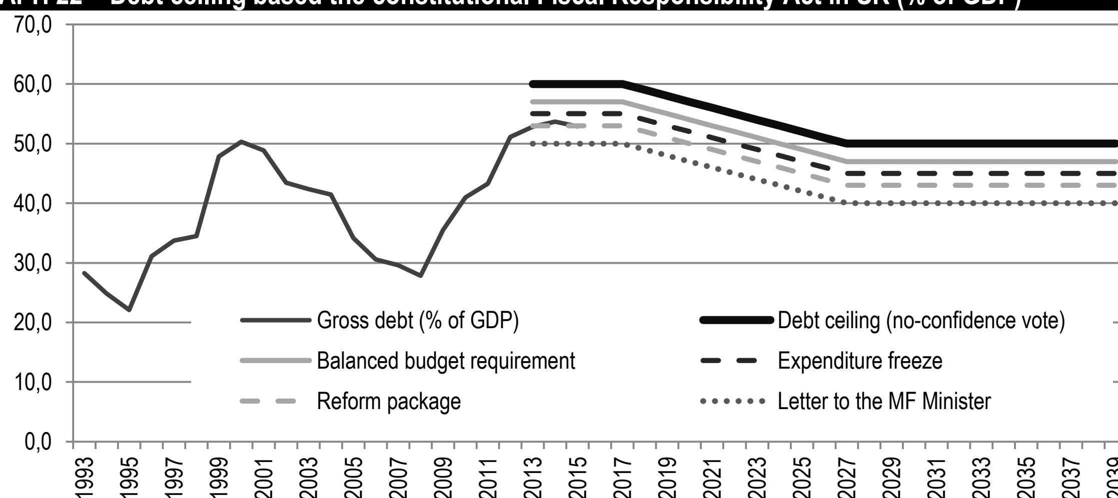
- Prepare and publish a report on long-term sustainability;

- Prepare and submit to the Parliament a report on compliance with the fiscal responsibility rules and fiscal transparency rules;
- Prepare and publish its opinions on the legislative proposals submitted to the Parliament, in particular as regards their impact on the budget and long-term sustainability;
- Perform other activities related to the monitoring and evaluation of Slovakia's economic performance and compliance with the fiscal responsibility rules.

The new Act reinforces the **fiscal transparency rules** based on the net worth concept. The professionalism and transparency of macroeconomic and tax forecasts in the budget will be supervised by two committees. At the same time, the new budget legislation requires that the budget and the comprehensive annual report of the Slovak Republic contain the consolidated balance, net worth, implicit and contingent liabilities, report on economic performance of state-owned enterprises, and an overview of tax expenditures.

Local governments will be subject to similar fiscal rules under the constitutional act**.** One of the new elements is that municipalities and self-governing regions will be sanctioned if their debt exceeds 60% of their actual current revenues in the previous fiscal year.

GRAPH 22 – Debt ceiling based the constitutional Fiscal Responsibility Act in SR (% of GDP)



Source: MF SR, SO SR

In terms of ensuring permanent and sustainable public finance consolidation, the Fiscal Responsibility Act is important in that it lays foundation for new mechanisms for the management of public finances. The Act directly defines several important analytical terms, such as long-term sustainability, baseline scenario and long-term sustainability indicator, and paves the way for introducing expenditure ceilings specified in detail in the amendment to the General Government Budgetary Rules Act. The definition of the basic indicators represents an essential part of the new fiscal framework in order for the fiscal policy, whether underway or planned, to be assessed in a trustworthy manner.

Long-term sustainability means such an economic performance of the Slovak Republic which ensures that the general government balance and general government debt are capable of ensuring that an expected change in the general government's revenues and expenditures according to the baseline scenario does not bring the general government debt above the upper debt ceiling in the next 50 years**.**

The baseline scenario is a long-term forecast of general government revenues and expenditures reflecting the future economic and demographic development of the Slovak Republic and the existing legislative framework; the general government liabilities also cover implicit liabilities and contingent liabilities of the general government.

The **long-term sustainability indicator** is the difference between the current value and the sustainable value of the structural primary balance expressed as a percentage of the gross domestic product**.**

The **upper ceiling on public expenditures** has been incorporated in the amendment to the General Government Budgetary Rules Act, which is currently in the legislative pipeline (the inter-ministerial commenting procedure has been completed), and represents an instrument to actively manage the general government balance with a view to ensuring its long-term sustainability. Unlike the debt rule, the mechanisms of which are triggered only if a significant deviation from fiscal position occurs, the expenditure ceilings constitute operational instruments linked to the consolidation targets and the plan for improving the indicator of long-term sustainability of public finances.

The public expenditure ceiling means the maximum amount of the total accrued consolidated expenditures of the general government adjusted for the economic cycle and tax expenditures, except for the expenditures of local governments. The ceiling does not include the funds from the EU and the state budget earmarked for the financing of joint programmes of the Slovak Republic and the European Union, contributions to the EU budget, and expenditures associated with the management of the general government debt less the expenditures associated with the management of local government debt. The expenditure ceiling will be set for a period covering the next four fiscal years and expressed in absolute rather than relative terms.

ANNEXES

Annex No. 1 – Required tables

Table 1a: Macroeconomic prospects (ESA95, EUR bn.)								
		2011	2011	2012	2013	2014	2015
	ESA code	Level	Rate of change	Rate of change	Rate of change	Rate of change	Rate of change
1. Real GDP	B1*g	63.9	3.3	1.1	2.7	3.6	3.7
2. Nominal GDP	B1*g	69.1	5.0	3.3	4.9	5.9	6.1
Components of real GDP							
3. Private consumption expenditure	P.3	33.1	-0.4	0.0	0.7	2.9	3.9
4. Government consumption expenditure	P.3	10.8	-3.5	-2.1	-4.2	1.2	-1.9
5. Gross fixed capital formation	P.51	15.0	5.7	1.6	2.1	1.9	2.9
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53		-0.8	-1.0	0.0	0.1	0.1
7. Export of goods and services	P.6	58.2	10.8	2.2	8.2	5.9	5.3
8. Imports of goods and services	P.7	52.7	4.5	0.7	7.8	5.2	4.7
Contribution to real GDP growth							
9. Final domestic demand (total)		-	0.5	0.0	0.1	2.1	2.4
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-2.0	-0.2	1.0	0.1	0.0
11. External balance of goods and services	B.11	-	5.5	1.4	1.1	1.2	1.1

Source: SO SR, MF SR

Table 1b: Price developments (ESA95)							
		2011	2011	2012	2013	2014	2015
	ESA code	Level	Rate of change	Rate of change	Rate of change	Rate of change	Rate of change
1. GDP deflator		1.06	1.7	2.1	2.1	2.2	2.3
2. Private consumption deflator		1.18	3.8	3.3	2.3	2.3	2.5
3. HICP		-					
4. Public consumption deflator		1.16	1.4	2.1	2.2	2.2	2.5
5. Investment deflator		1.03	0.3	1.6	2.2	2.3	2.3
6. Export price deflator (goods and services)		1.06	4.0	2.4	1.9	2.1	2.2
7. Import price deflator (goods and services)		1.13	5.4	3.8	2.3	2.4	2.4

Source: MF SR

Table 1c: Labour market development (ESA95)

	ESA code	2011 Level	2011 Rate of change	2012 Rate of change	2013 Rate of change	2014 Rate of change	2015 Rate of change
1. Employment, persons (thousands) [1]		2 208	1.8	-0.2	0.3	0.5	0.8
2. Employment, hours worked (thousands) [2]		3 959,5	1,0	-1.5	0.9	0.4	0.6
3. Unemployment rate (%) [3]		13,5	13.5	13.8	13.7	13.5	13.2
4. Labour productivity per persons (EUR) [4]		30 768	2,1	1.3	2.5	3.1	2.9
5. Labour productivity per hours worked (EUR) [5]		17 016	2,1	6.7	4.0	5.5	5.4
6. Compensation of employees (EUR mill.)	D.1	25 891	3.4	3.0	4.6	5.1	6.4
7. Compensation per employee (EUR)		13 964	0.9	3.4	4.3	4.7	5.6

[1] Total occupied population, domestic concept – national accounts definition
[2] National accounts definition
[3] Harmonised definition according to Eurostat; levels
[4] Real GDP per person employed
[5] Real GDP per hour worked

Source: SO SR, MF SR

Table 1d: Sectoral balance (ESA95, % of GDP)

	ESA kód	2011	2012	2013	2014	2015
1. Net lending / borrowing vis-à-vis the rest of the world	B.9	1.3	1.3	1.3	1.9	2.3
of which:						
- Balance on goods and services		3.0	2.8	3	3.4	3.6
- Balance of primary incomes and transfers		-2.9	-3.1	-3.3	-3.2	-3
- Capital account		1.3	1.5	1.6	1.6	1.6
2. Net lending / borrowing of the private sector	B.9	6.1	5.9	4.2	4.2	3.9
3. Net lending / borrowing of general government	EDP B.9	-4.8	-4.6	-2.9	-2.3	-1.7
4. Statistical discrepancy						

Source MF SR

Table 2a: General government budgetary prospects *

	ESA code	2011	2011	2012	2013	2014	2015
		EUR mill.	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-3,327	-4.8	-4.6	-4.5	-4.2	-3.6
2. Central government	S.1311	-3,609	-5.2	-4.6	-4.6	-4.2	-3.8
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	2	0.0	-0.1	0.0	0.0	0.2
5. Social security funds	S.1314	281	0.4	0.1	0.1	0.1	0.1
General government (S13)							
6. Total revenue	TR	22,472	32.5	33.3	32.7	31.7	31.2
7. Total expenditure	TE [1]	25,798	37.4	37.9	37.1	35.9	34.8
8. Net lending/borrowing	EDP B.9	-3,327	-4.8	-4.6	-4.5	-4.2	-3.6
9. Interest expenditure	EDP D.41	1,095	1.6	1.7	1.9	2.1	2.1
10. Primary balance	[2]	-2,232	-3.2	-2.9	-2.5	-2.1	-1.5
11. One-off and other temporary measures	[3]	-263	-0.4	0.1	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		11,090	16.1	16.2	15.6	15.6	15.6
12a. Taxes on production and imports	D.2	7,213	10.4	10.3	9.8	9.7	9.6
12b. Current taxes on income, wealth, etc.	D.5	3,876	5.6	5.9	5.8	5.9	6.0
12c. Capital taxes	D.91	0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	8,635	12.5	11.9	11.8	11.6	11.5
14. Property income	D.4	622	0.9	1.1	0.8	0.8	0.7
15. Other	[4]	2,125	3.1	4.1	4.5	3.8	3.4
16=6. Total revenue	TR	22,472	32.5	33.3	32.7	31.7	31.2
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)	[5]	19,724	28.6	28.1	27.4	27.1	27.1
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	7,867	11.4	11.1	10.6	10.3	9.7
17a. Compensation of employees	D.1	4,914	7.1	6.6	6.4	6.1	5.8
17b. Intermediate consumption	P.2	2,953	4.3	4.6	4.2	4.2	3.9
18. Total social payments		12,757	18.5	18.3	18.1	18.0	17.7
of which: unemployment benefits	[6]	162	0.2	0.2	0.2	0.2	0.2
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	3,393	4.9	5.1	4.9	4.8	4.8
18b. Social transfers other than in kind	D.62	9,364	13.6	13.3	13.2	13.1	12.9
19.=9. Interest expenditure	EDP D.41	1,095	1.6	1.7	1.9	2.1	2.1
20. Subsidies	D.3	863	1.2	1.3	1.1	1.0	1.0
21. Gross fixed capital formation	P.51	1,587	2.3	1.9	1.6	1.5	1.2
22. Capital transfers	D.9	364	0.5	0.9	1.0	0.8	0.8
23. Other	[7]	1,267	1.8	2.6	2.7	2.3	2.2
24=7. Total expenditure	TE [1]	25,798	37.4	37.9	37.1	35.9	34.8
p.m.: Government consumption (nominal)	P.3	12,262	17.8	17.6	17.0	16.6	15.9

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9. *Source: MF SR*

[2] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9)

[3] A plus sign means deficit-reducing one-off measures

[4] P.11+P.12+P.131+D.39+D.7+D.9 other than D.91)

[5] Including those collected by the EU

[6] Comprises cash benefits (D.621 a D.624) and benefits supplied via market producers (D.631) in relation to unemployment benefits

[7] D.29+D4 (other than D.41) +D.5+D.7+D.9+P.52+P.53+K.2+D.8.

* Table reflects the 2013-2015 GG Budgetary Framework which means that the headline deficits are different from the targets of the Government. In order to achieve the fiscal targets, it will be necessary to adopt some of the proposed measures listed in section III.3.2. Due to the fact that at the moment it is not known which measures will be adopted, it was not possible to prepare a table with GG revenues and expenditures reflecting fiscal targets for 2013-2015.

Table 2b: Breakdown of revenue

	2011 EUR mill.	2011 % of GDP	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP
1. Total revenue assuming unchanged policies scenario	21,769	31.5	33.0	32.7	31.7	31.2
2. Discretionary revenue measures *	703	1.1	0.3	0.0	0.0	0.0

*Note: * 2011 - Ex-ante estimate*

Source: MF SR

Table 2c: Expenditure to be excluded from the expenditure benchmark

	2011 EUR mill.	2011 % of GDP	2012 % of GDP	2013 % of GDP	2014 % of GDP	2015 % of GDP
1. Expenditures on EU programmes fully matched by EU funds revenue	792	1.1	1.9	1.9	1.3	1.0
2. Expenditures fully matched by mandated revenues increases	0	0.0	0.0	0.0	0.0	0.0
3. Non-discretionary changes in unemployment benefit expenditure	12	0.0	0.0	0.0	0.0	0.0

Source: MF SR

Table 3: General government expenditures by function (% of GDP)

	COFOG code	2010	2015*
1. General public services	1	6.3	
2. Defence	2	1.3	
3. Public order and safety	3	2.7	
4. Economic affairs	4	3.6	
5. Environmental protection	5	0.9	
6. Housing and community amenities	6	1.0	
7. Health	7	6.4	
8. Recreation, culture and religion	8	1.2	
9. Education	9	4.5	
10. Social protection	10	12.3	
11. Total expenditure	**TE**	**40.1**	

* Due to an early stage of budget preparation, data for 2015 in COFOG classification are not available

Source: SO SR

Table 4: General government debt development (% of GDP)

	ESA code	2011	2012	2013	2014	2015
1. Gross debt		43.3	50.2	52.0	53.0	52.3
2. Change in gross debt ratio		2.2	6.9	1.9	1.0	-0.7
Contributions to change in gross debt						
3. Primary balance		3.2	2.9	0.9	0.2	-0.5
4. Interest expenditure	EDP D.41	1.6	1.8	2.0	2.1	2.1
5. Stock-flow adjustment		-0.6	3.6	1.3	1.6	0.6
of which:						
- differences between cash and accruals		0.0	0.2	0.3	0.1	0.4
- net accumulation of financial assets		-1.0	1.1	0.6	1.3	0.3
of which: revenues from privatisation		0.0	0.0	0.0	0.0	0.0
- valuation effects and others		0.1	0.0	0.0	0.0	0.0
p.m. implicit interest rate on debt		4.1	4.2	4.1	4.2	4.3
Other relevant variables						
6. Liquid financial assets		1.1	2.3	2.7	3.9	4.0
7. Net financial debt (7=1-6)		42.2	47.9	49.3	49.2	48.3
8. Debt repayment (existing debts) since the end of the previous year		3.5	3.7	5.0	4.8	4.5
9. Percentage of debt denominated in foreign currency		0.3	4.0	3.7	3.4	3.2
10. Average maturity (years)*		5.3	5.4	-	-	-

*Note: * maturity of state debt*

Source: MF SR

Table 5: Cyclical developments (% of GDP)

	ESA code	2011	2012	2013	2014	2015
1. Real GDP growth (%)		3.3	1.1	2.7	3.6	3.7
2. Net lending of general government	EDP B.9	-4.8	-4.6	-2.9	-2.3	-1.7
3. Interest expenditure	EDP D.41	1.6	1.8	2.0	2.1	2.1
4. One-off and other temporary measures	[1]	-0.4	0.1	0.0	0.0	0.0
5. Potential GDP growth (%)		2.2	2.5	2.8	2.8	2.9
contributions:						
- labour		0.2	0.3	0.4	0.3	0.4
- capital		1.4	1.7	1.8	1.8	1.8
- total factor productivity		0.6	0.5	0.5	0.7	0.8
6. Output gap		-0.1	-1.6	-1.5	-0.8	0.0
7. Cyclical budgetary component		0.0	-0.5	-0.4	-0.2	0.0
8. Cyclically-adjusted balance (2 - 7)		-4.8	-4.2	-2.5	-2.1	-1.7
9. Cyclically-adjusted primary balance (8 + 3)		-3.2	-2.4	-0.5	0.0	0.5
10. Structural balance (8 - 4)		-4.4	-4.2	-2.5	-2.1	-1.7

[1] A plus sign means deficit-reducing one-off measure *Source: MF SR*

Table 6: Comparison between the previous forecast and the updated forecast

	ESA code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
Real GDP growth (%)						
Previous update*		3.4	4.8	4.8	4.8	-
Current update		3.3	1.1	2.7	3.6	3.7
Difference		-0.1	-3.7	-2.1	-1.2	-
General government balance (% of GDP)	EDP B.9					
Previous update*		-4.9	-3.8	-2.9	-2.8	-
Current update		-4.8	-4.6	-2.9	-2.3	-1.7
Difference		0.1	-0.8	0.0	0.5	-
General government gross debt (% of GDP)						
Previous update*		44.1	45.3	45.3	45.2	-
Current update		43.3	50.2	52.0	53.0	52.3
Difference		-0.8	4.9	6.7	7.8	-

*Note: * Stability Programme for 2011 - 2014* *Source: MF SR*

Table 7: Long-term general government sustainability – scenario from Stability Programme (% of GDP) **

	2010	2020	2030	2040	2050	2060
Total expenditures	**40.0**	**40.8**	**43.0**	**46.4**	**52.0**	**59.2**
of which: age-related costs	**14.9**	**14.5**	**16.1**	**17.5**	**19.2**	**20.4**
A. Public expenditures in pensions	6.6	6.3	7.3	8.3	9.4	10.2
1. Pensions from social security	6.6	6.3	7.3	8.3	9.4	10.2
a) Old-age and early retirement pensions	4.0	3.6	4.1	4.8	5.6	6.2
b) other pensions (disability, survivors' pensions)	2.6	2.7	3.2	3.5	3.8	4.1
2. Occupational pension scheme (if in GG sector)	-	-	-	-	-	-
B. Health care	5.2	5.7	6.2	6.7	7.1	7.2
C. Long-term care	0.2	0.2	0.3	0.4	0.5	0.6
D. Education	2.8	2.2	2.2	2.1	2.1	2.3
E. Other age-related expenditure	0.1	0.1	0.1	0.1	0.1	0.1
F. Interest expenditure *	1.3	2.5	3.1	5.2	9.1	15.0
Total income	**32.4**	**31.9**	**31.6**	**31.5**	**31.4**	**31.3**

of which: pension from property (D.4)	1.4	1.2	1.1	1.1	1.1	1.0
of which: from social contributions	12.6	12.2	12.1	12.0	11.9	11.9
Reserves of pensions funds	5.5	16.5	28.4	41.7	53.4	61.2
of which: consolidated reserves from GG pension funds	0.0	0.0	0.0	0.0	0.0	0,0
Systemic pension reforms						
Social contributions diverted to mandatory private scheme	1.1	1.4	1.6	1.7	1.7	1.8
Pension expenditure paid by mandatory private scheme	0.0	0.1	0.5	1.0	1.7	2,2
Underlying assumptions						
Labour productivity growth	4.7	3.1	2.7	1.7	1.7	1.7
Real GDP growth	6.2	3.4	2.0	0.5	0.2	0.5
Participation rate – male (age 15-64)	77.7	79.1	78.2	75.7	75.5	76.2
Participation rate – female (age 15-64)	62.9	66.7	67.5	65.3	65.2	66.1
Total participation rate (age 15-64)	70.3	72.9	72.8	70.5	70.4	71.2
Unemployment rate	11.0	6.2	6.2	6.2	6.2	6.2
Population share of 65+ on total population (in %)	12.3	16.4	21.3	25.3	31.6	36.1

** Scenario from Stability Programme* *Source: MF SR*

*** Age-related expenditure and macroeconomic assumptions from Ageing report 2009*

Table 7a: Contingent liabilities

	2011	2012 *
	% of GDP	% of GDP
Public guarantees	0.1	
of which: linked to the financial sector	0.0	

** estimates for 2012 are not available* *Source: MF SR*

Table 8: Basic assumptions

	2011	2012	2013	2014	2015
Short-term interest rate (annual average)	1.4	1.0	1.2	1.9	2.7
Long-term interest rate (annual average)	2.6	2.2	2.9	3.4	3.8
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.39	1.26	1.24	1.21	1.20
Real effective exchange rate	0.79	0.79	0.80	0.80	0.80
World excluding EU, GDP growth	4.2	4.1	4.3	4.5	4.6
EU GDP growth	1.5	0.0	1.2	1.6	1.8
Growth of relevant foreign markets	1.8	0.2	1.4	1.8	1.9
World import volumes, excluding EU	7.4	6.2	6.8	7.0	7.2
Oil prices (Brent, USD/barrel)	112.1	114.3	117.8	119.8	121.7

Source: Common external assumptions, MF SR

Annex No. 2 – Forecast of the Ministry of Finance - key macroeconomic and fiscal indicators till 2015

Estimate up to 2015						
	unit	2011	2012F	2013F	2014F	2015F
GDP; constant prices	%	3.3	1.1	2.7	3.6	3.7
Final consumption of households	%	-0.4	0.0	0.7	2.9	3.9
Final consumption of government	%	-3.5	-2.1	-4.2	1.2	-1.9
Gross fixed capital formation	%	5.7	1.6	2.1	1.9	2.9
Export of goods and services	%	10.8	2.2	8.2	5.9	5.3
Import of goods and services	%	4.5	0.7	7.8	5.2	4.7
Harmonised index of consumer prices (HICP) growth	%	4.1	2.8	2.3	2.3	2.5
Current account balance	% GDP	0.1	-0.2	-0.3	0.3	0.6
Average employment growth; LFS	%	1.5	-0.3	0.4	0.6	0.8
Average unemployment rate; LFS	%	13.5	13.8	13.7	13.5	13.2
Average registered unemployment rate	%	13.2	13.6	13.6	13.5	13.2
Average real growth of monthly wages	%	-1.4	0.6	1.9	2.3	3.0
GG balance (ESA 95)	% GDP	-4.8	-4.6	-2.9	-2.3	-1.7

Source: MF SR

Annex No. 3 – Committee for Macroeconomic Forecasts

In an effort to ensure greater transparency and objectiveness of macroeconomic forecasts, the Ministry of Finance addresses members of the Macroeconomic Forecasts Committee on a regular basis. Following the Committee meeting held in February 2012, the majority of its members assessed the medium-term macroeconomic forecast by the Ministry of Finance as **realistic or even conservative**:

Assessment of Ministry of Finance´s forecast by members of committee

Member	Forecast assessment
NBS	conservative
Infostat	realistic
VÚB	realistic
ING Bank	optimistic
Tatrabanka	optimistic
SLSP	realistic
UNICREDIT Bank	conservative
ČSOB	realistic
SAV	conservative

Source: Committee for Macroeconomic Forecasts

Average forecasts of the selected indicators of the Slovakia's economic development by the members of the Macroeconomic Forecasts Committee (excluding MoF) and MoF forecasts

	2011	2012		2013		2014		2015	
in % if not indicated otherwise		MFC	MFSR	MFC	MFSR	MFC	MFSR	MFC	MFSR
GDP; real growth	3.3	0.9	1.1	2.7	2.7	3.6	3.6	4.1	3.7
GDP; current prices; bn. EUR	69.1	71.0	71.3	74.4	74.9	79.0	79.3	84.1	84.1
Final consumption of households; real growth	-0.4	-0.1	0.0	1.3	0.7	2.3	2.9	3.1	3.9
Final consumption of households; nominal growth	3.4	2.4	3.3	4.1	3.0	5.5	5.3	6.1	6.5
Average monthly wages (real growth)	2.5	0.1	0.6	1.1	1.9	1.7	2.3	2.1	3.0
Average monthly wages (nominal growth)	-1.4	2.8	3.4	3.8	4.3	4.7	4.7	5.2	5.6
Average employment growth, LFS	1.9	-0.5	-0.3	0.3	0.4	0.6	0.6	0.8	0.8
Consumer price index, (average growth)	3.9	2.6	2.8	2.7	2.3	3.0	2.3	3.1	2.5
Current account balance (% of GDP)	-0.1	-1.3	-0.2	-1.1	-0.3	-1.2	0.3	-1.3	0.6

Source: Committee for Macroeconomic Forecasts

Annex No. 4 – Committee for Tax Revenue Forecasts

Following the Macroeconomic Forecasts Committee meeting, the Tax Revenue Forecasts Committee held its session on February 13, 2012. At the session the Ministry of Finance presented its updated medium-term forecast of tax revenues for 2012 - 2015. The medium-term forecast of tax revenues and social insurance contributions by the Ministry of Finance was described as realistic by all Committee members.

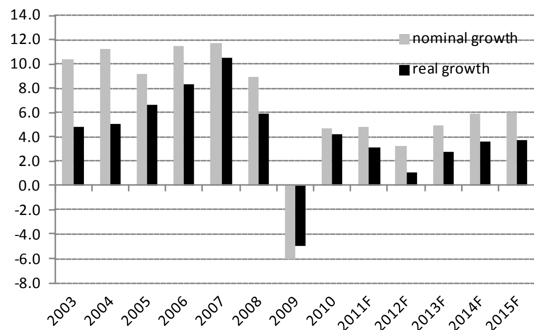
Assessment of MoF´s forecast by members of Tax Revenue Forecasts Committees

Member	Forecast assessment
NBS	realistic
Infostat	realistic
ING Bank	realistic
Tatra banka	realistic
ČSOB	realistic
SLSP	realistic
UniCredit Bank	realistic

Source: Tax Revenue Forecast Committee

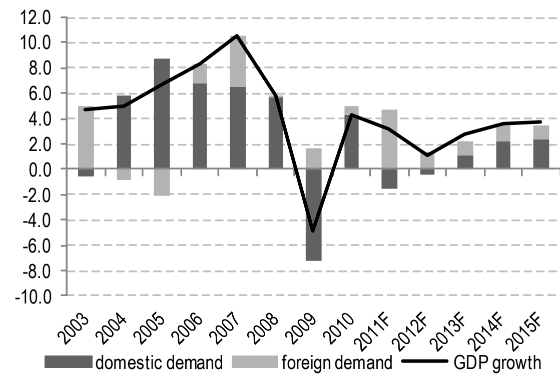
Annex No. 5 – Graphs

GDP growth (%)



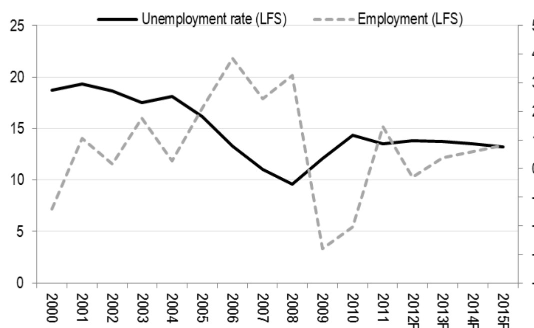
Source: SO SR, MF SR

Contributions to GDP growth (p. p.)



Source: SO SR, MF SR

Economic activity, LFS (%)

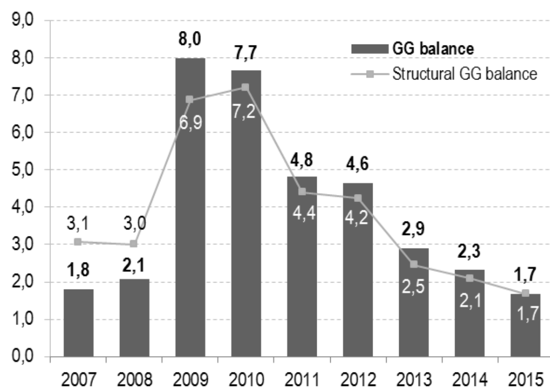


Source: SO SR, MF SR

Real wages and labour productivity growth (%)

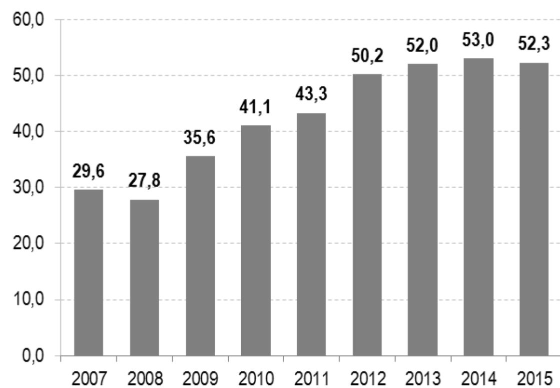
Source: SO SR, MF SR

General government deficit (% of GDP)



Source: SO SR, MF SR

Gross general government debt (% of GDP)



Source: SO SR, MF SR