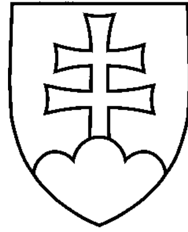

Stability Programme of the Slovak Republic for 2011 - 2014

April 2011

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POLITICAL COMMITMENTS OF THE SLOVAK GOVERNMENT

The Government of the Slovak Republic (the "Government") is committed to adopting the following measures during the next twelve months:

Pension system reform
The Government's goal is to steer Slovakia out of the group of high-risk countries – where it is currently placed according to the latest assessment of the long-term sustainability of public finances by the European Commission – into the group of countries with a low risk of long-term sustainability. Under the pay-as-you-go pillar, the Government will enhance the solidarity element and put in place an automatic stabilisation mechanism to reflect demographic changes as they occur. In other words, the policies themselves, without being altered, will include automatic stabilisers. Under the fully-funded pillar, the currently optional participation by those entering the labour market will become compulsory with an option to exit the scheme within a limited period of time. At the same time, investment rules will also be changed so that clients may benefit from higher yields.

Fiscal Responsibility Act
In the process of tightening the national fiscal framework, the Government will ensure, through adoption of the Fiscal Responsibility Act, that its fiscal policy remains responsible towards future generations and has a counter-cyclical effect. The new Act will contain six cornerstones: (1) greater emphasis on stock variables, particularly on the government's net worth in order to make public finances more transparent, (2) a cap setting gross general government debt at below 60% of GDP, (3) aggregate expenditure ceilings, (4) tighter rules for local government, (5) data disclosure rules and (6) an independent Fiscal Responsibility Council.

Reform of the system of taxes and social contributions
The reform of the system will enhance its efficiency and reduce the administrative burden on the taxpayer. A unified assessment base for the calculation of social contributions, identical with the tax assessment base, will be put in place as a prerequisite for concentrating the collection of taxes, customs duties and social contributions into one single institution. Taxpayers will file their personal income tax returns and social contributions using a single form.

Labour Code reform
The Labour Code reform will put Slovakia among the top ten countries with the most flexible legislature in the OECD. It will stimulate the creation of new jobs which the country needs, in particular for certain disadvantaged groups. The reform will also provide for increased flexibility of the rules regulating employment under full-time contracts, including the associated costs. Subject to mutual consent, the employer and employee will be able to choose the most suitable combination of notice period and severance pay. Relaxation of the rules regulating working time will increase employers' flexibility and adaptability to the changing economic conditions whilst reflecting the specific needs of individual workers.

Reduced administrative burden
The Government's objective is to improve the overall business environment to an extent that puts Slovakia in the Top-15 of the World Bank's *Doing Business* charts by 2020. In the next twelve months, the Government will implement measures aimed at reducing barriers to doing business, stabilising the legislative framework and expanding the scope of e-Government services. The amount of registered capital required for the incorporation of individual types of companies will be reduced and the registration periods shortened. The completion and full operation of the network of single contact points will improve the communication of taxpayers (both natural and legal persons) with the Government. In addition, a reduced administrative burden will facilitate the creation of new jobs.

Fight against corruption, increased transparency
New measures will be taken to increase transparency and combat corruption. Any contract involving public funds will become valid upon its publication on the Internet. Simplification and e-solutions in the area of justice will foster transparency. All court decisions, including their reasoning, will be published on the Internet. The selection procedure for new judges will be adjusted to ensure a transparent and fair process for all candidates.

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 and integral part of the Stability and Growth Pact and after approval by national governments, these programmes are submitted to the European Commission and the European Council. Their purpose is to present the development of fiscal position in the medium term, expected economic development, and a description of measures taken to achieve the goals of the programme. Slovakia is submitting its third stability programme which is an updated version of the January 2010 stability programme.

The stability programme is submitted to the European Commission for the first time within the framework of the "European Semester", endorsed by EU member states on September 7, 2010 in response to the need to coordinate policies at EU level more closely. The objective is to achieve better coordination of their fiscal and structural policies, taking into account the rules of the Stability and Growth Pact and the Europe 2020 Strategy. The whole process began in January 2011 with the publication of the *Annual Growth Survey* in which the Commission presented a consistent strategy aimed at restoring economic growth, and invited Member States to follow its recommendations, in particular with regard to strict fiscal consolidation and labour-market structural measures, in developing their stability programmes and national reform programmes.

Following Slovakia's accession to the euro area, the Government's main goals in the field of macroeconomic policies became focused 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.

The Government's fiscal targets for the years to come are influenced by the initial fiscal position of 2010. Despite the improved macroeconomic performance, the planned target of 5.5% of GDP has not been met and the deficit increased to 7.9% of GDP, i.e. to approximately the level of 2009. The permanent loss of potential output in the economy as a consequence of the crisis was an objective reason behind deterioration. The second reason lies in the structure of economic growth, which was fuelled by less tax-intensive components (exports). The third factor involved underestimated risks and optimistic budgeting unaccompanied by adequate measures (local government, railway companies, hospitals). This development led to general government gross debt increasing by 13.2 p.p. from 27.8% of GDP at the end of 2008 to 41.0% of GDP at the end of 2010.

Exceeding the reference value in 2009 (3% of GDP) as laid down in the Treaty on the Functioning of the European Union, and the negative outlook for 2010 led the Commission to launch the excessive deficit procedure ("EDP") against Slovakia; the EU Council formally opened proceedings in respect of Slovakia on December 2, 2009. As many as 24 EU member states are currently subject to EDP.

At the same time the European Commission has included Slovakia, along with several southern countries that are currently undergoing a debt crisis, in the group with the highest risk with respect to long-term sustainability of public finance. However, provided that the fiscal goals as stipulated in this document are met, and the pension system is reformed as proposed, Slovakia should be among the countries with the most favourable outlook with respect to long-term sustainability of public finance in the EU.

The stability programme presents a strategy which, in the medium-term, should lead to abrogation of the excessive deficit procedure. However, the ultimate goal remains unchanged: achieving a solid fiscal position which ensures the sustainability of public finances in the long run. This will require additional consolidation efforts in the post-2013 period so as to bring Slovakia closer to its medium-term budgetary objective, i.e. a close-to-balanced budget.

The main objectives of the Stability Programme of Slovakia up to 2014:

- The main objective is to bring the general government deficit below 3% of GDP in 2013 in compliance with EDP requirements, as well as to stabilise and reduce the general government debt.

- One of the essential prerequisites to achieving this objective is to fulfill the 2011 budget deficit target set at 4.9% of GDP. This will require a consolidation effort representing 2.5% of GDP in both the revenues and expenditures of general government, while observing the Government's priorities.
- In the coming years, the deficit is expected to contract to 3.8% of GDP in 2012 and to 2.9% of GDP in 2013. This will ensure compliance with the EDP requirements and a gradual reduction of general government debt from 2013 onwards. These ambitious objectives can be achieved by adopting the second package of consolidation measures for 2012 so that also the 2013 target can be met. The overall need for consolidation measures represents 1% of GDP in 2012 and an additional 0.9% of GDP in 2013. The majority of necessary measures have already been incorporated into the General Government Budget Framework for 2012-2014, while this document contains also proposals of other measures. The measures awaiting approval represent 0.3% of GDP in 2012 and an additional 0.6% of GDP in 2013.

For 2011, the 2011-2014 Stability Programme is based on the General Government Budget for 2011-2013 as approved by the Slovak Parliament in December 2010 and, for the years 2012-2014, on the General Government Budget Framework for 2012-2014. The stability programme, once approved by the Cabinet, is submitted to the Slovak Parliament.

The content and 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 December 2009 (requiring Member States to take account of implicit liabilities relating to population ageing in setting their medium-term budgetary objectives) and from September 2010 (laying down the timetable of the European Semester). The Stability Programme of the Slovak Republic also takes into account the deliberations, documents and recommendations of the Economic and Financial Committee.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

Slovakia considers the consolidation of its public finances to be a necessary prerequisite to re-launch robust and sustainable economic growth in the long run. As in 2002-2006, the Government views its consolidation strategy comprehensively, with the objective of minimising the negative impacts of austerity measures on the standard of living. The cornerstones of the strategy ("3S" Strategy) are:

- **Stabilisation** – involves rapid, vigorous and frequently, across-the-board measures designed to reduce the general government deficit in order to underpin Slovakia's credibility with the financial markets. At the present stage, the stabilisation measures need to address the specific revenue and expenditure items of the budget. As in the past, Slovakia attaches greater importance to those measures on the expenditure side which, as experience suggests, have a less negative impact on economic growth.
- **Structural reforms** – in order to foster economic performance in times of consolidation, structural reforms are required to fuel the growth potential of the economy. This is of particular importance at present since the external environment is unlikely to grow and monetary conditions to ease significantly in the years to come.
- **Sustainability** – no fiscal consolidation can be successful in the long run without the adoption of systemic changes designed to render public spending more efficient and to achieve better functioning of fiscal institutions.

By applying this comprehensive consolidation strategy, Slovakia succeeded in reducing its general government deficit in 2003-2005 without curbing economic growth. The current external environment is significantly different from that of the past consolidation. This underscores the importance of significant changes in all three areas of the strategy.

I.1. Stabilisation

The main focus of the stabilisation measures, adopted in two stages (2011 and 2012), is to cut the core expenditures of the state.[1] Expenditures on goods and services should decline in the majority of budgetary chapters by almost 20% in real terms over the two years (in nominal terms, by 10% in 2011 and by an additional 5% in 2012). Permanent savings will be achieved through the introduction of transparent electronic auctions which restrict the wastage of public funds. Public sector wages represent the second key area for expenditure cuts. With the exception of teachers and certain services within the armed forces, the wage bill in the public sector will contract overall by almost 16% in 2011-2012 in real terms (a nominal decline of 10% in 2011 and a freeze in 2012) compared to 2010 level. Individual general government entities may choose whether to comply with this requirement by laying off staff or by cutting the flexible component of their salaries. Besides these two basic measures, a number of subsidies will be either terminated or reduced and the importance of certain investment projects will be reviewed. In terms of its impact on economic growth, it is important that more than 50% of the consolidation effort by 2013 is concentrated on the expenditure side of the budget.

On the revenue side, particular emphasis will be laid on improving the efficiency and effectiveness of direct taxes and increasing the rates of indirect taxes in order to keep negative impacts on economic activity to a minimum. The consolidation package contains the broadening of tax bases and the termination of a large number of exemptions, in particular within the system of social contributions and excise taxes. Value added tax (VAT) has been temporarily raised to 20%; in addition, the increase in certain excise taxes and property taxes, where Slovakia lags significantly behind the OECD average revenue, is expected to generate additional income. Tax revenues should also be bolstered by introduction of a bank levy, unification of depreciations, and introduction of a tax on excess emission allowances. In the area of non-tax revenues, the State Material Reserves Administration and the National Nuclear Fund will benefit from new fees. Also the revitalisation of state-owned

[1] The core expenditures of the state are defined as cash expenditures from the state budget, excluding expenditures on the debt service, EU funds, co-financing to EU-financed projects and transfer to the Social Insurance Agency.

companies, which will have a positive impact on dividends paid to the state budget, constitutes an important part of the consolidation package.

The stabilisation measures adopted as part of the 2011 budget, plus the measures planned for 2012, should ensure that the main goal – reduction of the 2013 general government deficit to below 3% of GDP – is met.

I.2. Structural policies

The goal of the structural reforms is to foster the growth potential of the economy and alleviate the negative consequences of the necessary fiscal consolidation. In addition to fiscal consolidation and the reform of public finances, the Government has defined five priority areas: (1) education, science and innovation, (2) employment and social inclusion, (3) business environment, (4) transparency and rule of law and (5) health.

In the **business sector,** the Government places particular emphasis on rendering the Labour Code more flexible and attaining better law enforcement. The Government's ambition is to bring Slovakia into the Top-15 in *Doing Business* by 2020. In the area of employment legislature, the Government intends to remove the current practice which entitles employees to both severance pay and full wage over the course of the notice period. In addition, the Government is planning to create a so-called intermediate labour market to facilitate reintegration of the long-term unemployed into the labour market. Increased transparency and promptness of court rulings are two key priorities within the area of justice. As far as the basic conditions for doing business are concerned, starting of a business is to be substantially simplified, bureaucracy reduced, public procurement made more transparent, and the availability of electronic services in public administration extended.

The reform of the tax and social contributions system should also reduce the administrative burden on the business environment. The main objectives of the reform are: (1) a substantial simplification of the system by unifying the tax base used for calculation of personal income tax and the assessment bases used to determine the amount of social and health insurance contributions payable by natural persons and, subsequently, by unifying their collection, (2) elimination of potential abuses of the system, and (3) labour market support through gradual reduction of the percentages of employees' health and social insurance contributions. The contributions payable by employers will be abolished, making the total labour cost identical with the gross wage. A single social and a single health insurance contribution subject to the same ceiling will be introduced. The advantages which the self-employed and those on casual work contracts enjoy in comparison to regular employees will be restricted. If consolidation proceeds as planned, the Government has undertaken to reduce employees' social contributions by 1 percentage point annually (under the system as currently set up).

Although it will have no tangible positive effect on economic growth in the medium-term, **support for the knowledge-based economy** will be key to Slovakia's success in the long run. However, this will not be possible without reforming the present education system, in particular, higher education, science and research. Slovakia is planning to overhaul its accreditation process for universities in order to place quality above quantity. The international achievements of universities will play an ever more important role in the funding of research projects. A transparent system of differentiation will be put in place so as to give preference to faculties and universities which excel. In the field of innovation, the Government will improve access to venture capital funds and intensify the development of technological parks.

I.3. Sustainability

The long-term sustainability of the consolidation strategy largely depends on whether the processes in the public sector are made more efficient, the areas susceptible to population ageing are reformed, and the fiscal policy is set within an appropriate institutional framework. The Government is contemplating far-reaching changes in all of these areas.

An efficient public sector is not solely about the size of the deficit in 2013. Quality is equally important. For this reason, the Government is taking steps to implement vigorous fiscal measures across the entire public sector. The revitalisation and privatisation of state-owned enterprises and the dissolution of certain budgetary and semi-budgetary organisations should preclude those situations wherein the state budget would have to cover the additional costs associated with the rescue of these institutions. Transparent electronic auctions and the publication of all contracts on the Internet should discourage corruption and cronyism. Combating tax evasion, which occurs primarily in the area of VAT and excise taxes, represents an important part of the effort to make the system more efficient.

The pension system and healthcare are areas which cannot be ignored from a long-term perspective, as by 2060 Slovakia will have the steepest increase in the old-age dependency ratio out of all the EU member states and will rank second, (68.5) after Poland (69.0), in absolute terms. The Government will therefore put in place automatic stabilisation mechanisms and a new indexation mechanism in the pay-as-you-go pillar, measures designed to increase yields in the fully-funded pillar, and changes in special pension systems. In the area of healthcare, important measures will focus on the medicaments policy (especially generic prescription, reimbursement based on the average of the three lowest prices in the EU, definition of the cost-effectiveness ratio) and on expenditures for healthcare procedures. The Government will introduce payments for Diagnoses Related Groups based on the same payments for standard procedures. After bail-out, hospitals should be transformed into joint-stock companies and as such be subject to harder budgetary constraints. The sale of over-the-counter medicaments (without prescription) will generate further downward pressure on the prices of medicaments. The Government will also strengthen the transparency and independence of the medicaments categorisation process and limit the potential for a conflict of interest through compulsory Internet publication of the details of any training organised for physicians by pharmaceutical companies.

As part of the effort to improve **the institutional framework for fiscal policy** in Slovakia, the Government will adopt the Fiscal Responsibility Act aimed at fostering the transparency of processes in public finances and limit the scope for creative accounting. Long-term sustainability of public finances will become the primary objective of the fiscal policy. The aggregate expenditure ceilings and the overall debt cap should, together with establishment of an independent Fiscal Responsibility Council, ensure more efficient meeting of the fiscal objectives. The new fiscal framework will be based on a concept of net worth as a benchmark for transparency.[2] This will largely eliminate any information asymmetry between the Government and the populace, thereby decreasing the propensity to deficit creation.

I.4. Slovakia under the Excessive Deficit Procedure

On December 2, 2009, Slovakia was included in the excessive deficit procedure on the basis that, at the time, the estimate for the 2009 general government deficit was considerably in excess of 3% of GDP and its reduction below the limit was unlikely to occur in the following year. Within the procedure, the EU Council approved the following recommendations addressed to Slovakia:

1) Recognising that stimulus measures financed through reallocation within the budget amounting to 0.4% of GDP in 2009 were an adequate response to the European Economic Recovery Plan, and that consequently the worsening of the fiscal position in 2009 resulted from the free play of automatic stabilisers, the Slovak government should put an end to the excessive deficit by 2013;
2) The Slovak authorities should bring the general government deficit below 3 % of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Slovak authorities should:
    a. implement the deficit reducing measures in 2010 as planned in the budget for 2010-2012,
    b. ensure an average annual fiscal effort of 1 % of GDP over the period of 2010-2013,

[2] It is a way of assessing fiscal management through the public sector balance, i.e. difference between assets and liabilities of the public sector.

c. specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 and accelerate the reduction of the deficit if economic or budgetary developments turn out better than currently expected;

3) To limit risks to the adjustment, Slovakia should strengthen the enforceability of its medium-term budgetary framework as well as improve the monitoring of the budget execution throughout the year, in particular to avoid expenditure overruns compared to budget plans.

The Slovak authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the stability programmes which will be prepared between 2010 and 2013.

Slovakia considers the deadline for remedying its excessive deficit by 2013 to be adequate. In accordance with the General Government Budget for 2011-2013, as approved, and the General Government Budget Framework for 2012-2014, the general government deficit will be progressively reduced to attain 2.9% of GDP in 2013, with the greater part of the consolidation effort concentrated in 2011.

The consolidation strategy of the Slovak government is based on:

- termination of the validity of those anti-crisis measures that were introduced as temporary (up to 2010);
- implementation of the first package of fiscal measures in a total of 1.7 billion EUR (approximately 2.5% of GDP[3]) as planned for 2011 and adoption of the second package of fiscal measures totalling 775 million EUR in 2012 (approximately 1.0% of GDP),
- stable rate of economic growth at 4.8%, as anticipated for 2012 to 2014 and the favourable development of other key macroeconomic indicators.

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

Recommendation	Reaction
Excessive deficit should be corrected by 2013.	The targets of the approved General Government Budget for 2011-2013 and the General Government Budget Framework for 2012–2014 are such that the excessive deficit should be corrected in 2013.
The deficit-reducing measures should be implemented in 2010, as planned in the general government budget for 2010-2012.	Largely as a consequence of the parliamentary elections and local government elections, and in the light of the unfavourable macroeconomic developments, the 2010 budget target was not met. For this reason, the Government adopted the first package of measures effective from 2011 and proposed additional measures for 2012.
Annual average fiscal consolidation effort should reach1% of GDP over the period 2010–2013.	The consolidation effort in 2010 attained a negative value of 0.6% of GDP. The fiscal targets for 2011-2013 assume ambitious consolidation at 5.0% of GDP, cumulatively. This means that the average consolidation effort in 2010 to 2013 will achieve 1.1% of GDP annually.
The Slovak government should specify the measures needed to achieve correction of the excessive deficit by 2013 and accelerate the reduction of the deficit if the macroeconomic developments turn out better than currently expected;	The Stability Programme contains a list of the specific adopted and planned measures, in particular for years 2011 and 2012, needed to correct the excessive deficit. Should the macroeconomic developments exceed expectations, the government undertakes to consolidate public finances at a faster pace.
To limit risks to the adjustment, enforceability of the medium-term budgetary framework should be strengthened and monitoring of the budget execution throughout the year should be improved, in particular to avoid expenditure overruns.	The Fiscal Responsibility Act currently in preparation also addresses this aspect, in particular by introducing expenditure ceilings and rules designed to enhance the transparency of public finances.

[3] The need to take measures amounting to 2.5% of GDP in 2011 resulted from the comparison of an unchanged policies scenario, under which the general government deficit would have reached 7.4% of GDP in 2011 and the deficit target of 4.9% of GDP.

II. ECONOMIC OUTLOOK AND PROJECTIONS

The Slovak economic recovery in 2010 was relatively strong. Economic growth experienced by its main trading partners supported Slovakia's GDP, primarily through exports and inventory restocking. However, domestic demand remained effectively flat. Economic recovery is stimulating the creation of new jobs but only very slowly. This, together with the high level of unemployment, is the cause of very weak growth in household consumption. Our economic forecast anticipates a gradual acceleration of economic growth in the medium-term, but also reflects the negative impact of public finance consolidation on GDP growth in 2011.

II.1. External environment

The global economic recovery in 2010 was more rapid than expected. The EU economy as a whole grew by 1.7% year-on-year, Germany alone by 3.5%, and the U.S. by 2.9%. However, the recovery is not evenly distributed and is occurring at different rates in different parts of the world. Growth in 2010 was particularly rapid in the emerging markets, especially those in Asia. In its autumn forecast for 2011, the Commission adjusted growth expectations for developed economies upwards.

Global industrial output and global trade are on the increase and are expected to show further growth. The medium-term output expectations, as measured by the leading "soft" indicators (IFO, ZEW, PMI, ESI), are improving. Slovakia's economy is largely influenced by developments in Germany, its key trading partner, while the sluggish growth in the EMU peripheral economies poses little risk to the country's economic growth. The soft indicators suggest that robust growth may also continue in the first half of 2011. In its autumn forecast the Commission increased the projection for German economic growth for 2011 to 2.2%, compared to 1.6% in the spring forecast. The projection for the U.S. was adjusted downwards, from 2.5% to 2.1%. However, because of the timing of the Commission's forecast, this projection does not reflect the influence of the fiscal package approved at the end of the year.

Under the first estimate, the U.S. economy grew by 2.9% in 2010 (compared to -2.6% in 2009), thanks largely to increased economic activity at the beginning and towards the end of the year. Despite improving economic growth, unemployment in 2010 reached its highest level since early 1980. The gradual recovery in 2010 was mainly due to the growth in domestic demand and investments and, to a lesser degree than in 2009, also to fiscal measures. At the end of 2010, the U.S. adopted a new fiscal package designed to support economic growth in 2011 by 0.5%. In 2011, the U.S. economy is expected to grow by 3.0%.

The strong economic growth in the euro area is largely driven by Germany, which is a key economy from the perspective of Slovakia, and was slowed down by the peripheral economies (with less of an impact on the Slovak economy). According to the GDP flash estimate, the euro area also sustained its pace of growth in the fourth quarter and grew by 0.3% compared to the third quarter of the year. This represents an increase of 2% year-on-year. Although economic growth in Germany, which is Slovakia's most important trading partner, eased to 0.4% quarter-on-quarter, it showed a 4% increase year-on-year.

Financial markets in the euro area are operating in a business-as-usual mode, despite the adverse fiscal situation in some EMU member states. Also there is a positive trend in the access of companies and households to loans. At the end of the year, the credit standards did not tighten for the first time since 2007; the slacking of their tightening has continued for quite some time. As a result, loans to companies in the euro area also began to grow in the third quarter. The stock and commodity markets are recording significant gains, despite the risks associated with the escalation of the debt crisis, especially in Europe. Against the backdrop of rising stock indices, market volatility has subsided to its pre-crisis lows.

The emerging economies, less affected by the financial crisis, are recovering at a faster pace. Since trade between these countries intensified and their output declined only slightly over the course of the crisis, they were better placed to implement the necessary economic policies. The growth in foreign demand and increasing domestic consumption in the emerging markets of Asia has had a positive impact on their economic growth. The

emerging economies' real GDP is projected to rise by 6.5% in 2011, which is only slightly less than the 7.1% achieved in 2010. The robust growth in the region is driven mainly by China and India. Thanks also to its extensive stimulus package designed to support domestic consumption, China is expected to post growth of 10.3% in 2010 (as against 9.2% in 2009). In 2011, Chinese economic growth is projected to achieve 9.6%. The International Monetary Fund expects the GDP of developed economies to grow by 2.5% and of emerging economies by 6.5% in 2011.

TAB 2 – External assumptions

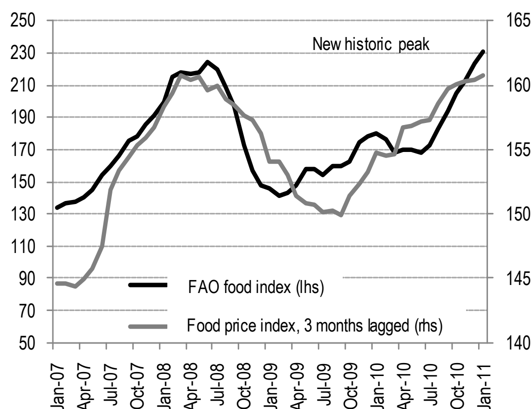
	MF SR			EC		
	2010	**2011**	**2012**	**2010**	**2011**	**2012**
Economic growth						
EU	1.8	1.8	2.0	1.8	1.7	2.0
Germany	3.7	**2.7**	2.0	3.7	2.2	2.0
USA	2.7	**3.0**	2.5	2.7	2.1	2.5
China	10.3	9.6	9.5	10.5	9.2	8.9
Imports of Slovakia's trading partners	10.4	**6.9**	7.0	10.4	**6.5**	7.0
Long-term interest rates (10Y)						
Eurozone	2.9	3.5	3.8	2.7	2.6	2.8
USA	3.2	3.7	4.0	3.1	2.9	3.3
ECB key interest rate	1.0	1.1	1.7	-	-	-
Exchange rate (USD/EUR)	1.33	1.36	1.30	1.33	1.39	1.39
Oil price (Brent, USD/bl)	79.9	95.5	94.6	79.9	88.9	90.8
Oil price (Brent, EUR/bl)	60.1	70.2	72.8	60.1	64.0	65.3

Source: MF SR, February 2011; EC - Autumn Forecast, November 2010

Prices of almost all commodities continued to rise in 2010, in reaction to soaring global demand. As with most other commodities, the price of oil continued to increase in both 2009 and 2010 from its record lows in December 2008 when it dropped to 34.1 USD per barrel. The price of oil exceeded 110 USD per barrel in February 2011, which represents a 200 % increase on December 2008. However, it still remains a third lower than at its record high of 150 USD per barrel in the summer of 2008. Besides the global recovery, oil prices have also been pushed upwards by U.S. quantitative easing and the recent political turmoil in North Africa. The formerly strong correlation between the development of oil prices and the EUR/USD exchange rate ceased to apply last year.

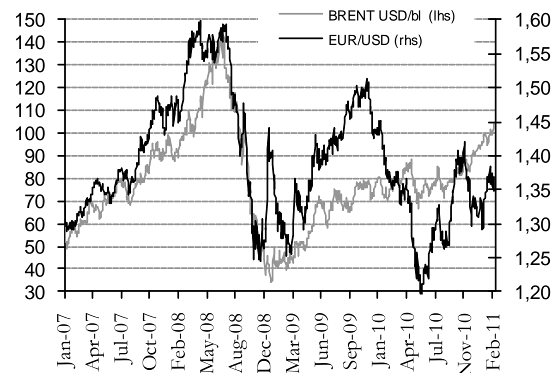
Global inflation increased at the end of 2010 and in January 2011, in particular as a result of high food and oil prices and thanks to the revitalisation of economic activity in emerging economies such as China and India. Inflationary pressures higher than the ECB would wish to see are also beginning to appear in the euro area, where prices in January increased by 2.4 % year-on-year, taking inflation above the 2 % inflation target for the second consecutive month. As a consequence of the poor global harvest and the trade policy restrictions applied by some countries, food prices are also hitting record levels on the world market. In January 2011, the FAO food index stood at 4.8% above the level attained during the 2008 food crisis.

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/USD exchange rate



Source: Reuters

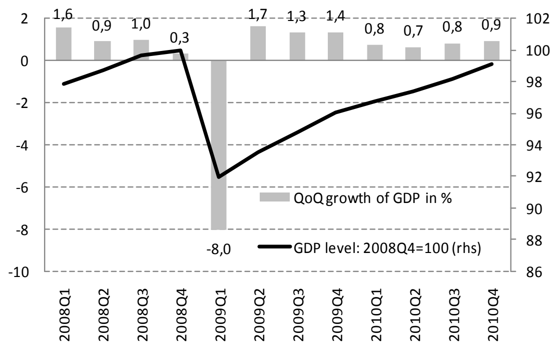
Most major central banks continued to pursue strongly expansive monetary policies in 2010. After a series of cuts, the FED maintained its interest rates at record lows throughout 2010. The FED key interest rate thus remained unchanged from December 2008 at 0.25%. In addition, at the end of 2010 the FED announced a second round of quantitative easing, involving the purchase of bonds to curb the rise in long-term interest rates despite the growing deficit, to partly depreciate the dollar, and slightly increase inflation. In the same way as the FED, the ECB held its key interest rates unchanged during 2010. The main refinancing operations rate stayed at 1%. In April of this year, the ECB increased its main interest rate by 0.25 percentage points and, in view of the growing inflationary risk, the ECB is expected to increase its main rates even further over the course of this year. However, the ECB continues to expect inflation to return below its target value in the second half of 2011.

II.2. Economic development in Slovakia during 2010

In 2010, the Slovak economy grew by 4%, eliminating most of its 2009 contraction when it was hit by the global economic downturn. After a 8% dive in the first quarter of the crisis year, GDP began to grow continuously, on average by more than 1% each quarter (on a seasonally-adjusted basis). The GDP is thus less than 1% short of its pre-crisis peak in Q4 2008. On the output side, the growth was mainly fuelled by accelerated industrial production in the sectors sensitive to the economic cycle (automobile, electronics and machinery sectors). In the category of services, the growth was particularly notable in real estate, rentals, commercial activities and 'other' services. In terms of the structure of demand, Slovakia's economic growth was primarily driven by net exports and fixed investments.

Following its decline by more than a fifth in 2009, gross fixed capital formation increased by 3.6% in 2010. Quarterly statistics show that economic growth was strongest in the fourth quarter; this was also confirmed by the year-end increase in corporate borrowing activity. The growth in investments was largely driven by capital expenditures on machinery and equipment and, to a lesser degree, by the construction of a motorway section financed through an ongoing PPP project. Although the increase in capacity utilisation indicates a need for new investments in future, it still remains below the pre-crisis level. Inventory restocking represented one of the most important contributions to GDP growth in 2010 but, again, it remains below the pre-crisis level. The remainder of domestic demand stagnated in 2010. After the slight increase achieved in the prior year (supported also by the car-scrapping scheme), household consumption dipped by 0.3% in 2010. In addition to higher unemployment, the lower household consumption is attributable to the curb on wage increases and reduced consumer confidence, which has been reflected in a higher level of savings. Consumption shrank mostly due to households cutting expenditures on services. Government consumption declined to 0.1%, due in particular to lower intermediate consumption on the part of general government. Net foreign demand's contribution to GDP growth represented 2 percentage points, thanks to the more rapid economic recovery in the external environment and the favourable price development in exports and imports, mainly as a consequence of surging oil prices compared to the previous year.

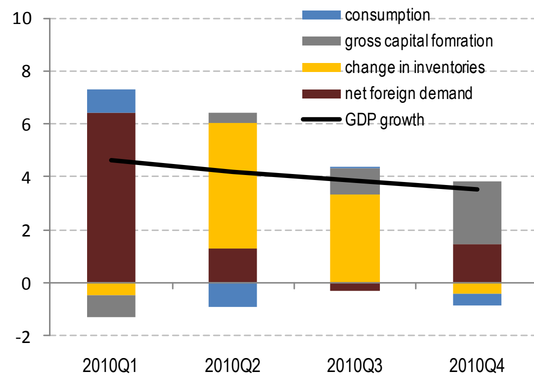
GRAPH 3 – GDP, adjusted for seasonal and one-off effects *



*GDP adjusted for cigarettes stockpiling

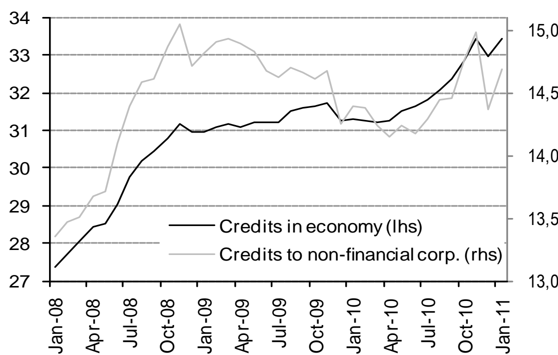
Source: SO SR, MF SR calculation

GRAPH 4 – Contributions to annual GDP growth in 2010



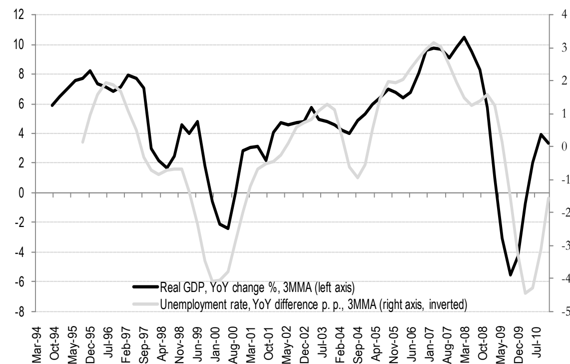
Source: SO SR

GRAPH 5 – Total credits and credits to non-financial corporations (end of month, EUR bn.)



Source: NBS

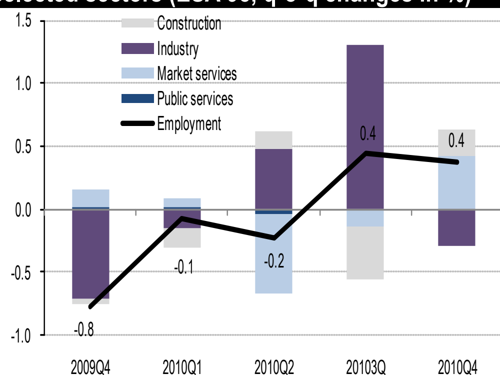
GRAPH 6 – GDP growth and unemployment rate (%)



Source: MFSR

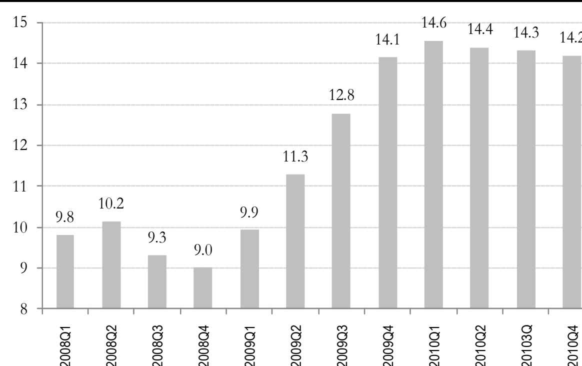
Notwithstanding the gradual economic recovery, the labour market in Slovakia continued in 2010 to be strongly affected by the consequences of the crisis. While more than 50,000 people lost their jobs in 2009, a further 30,000 became unemployed in 2010 (according to the ESA 95 methodology). The rate of employment in 2010 thus decreased by 1.4% year-on-year. Even though the first signs of gradual stabilisation are beginning to appear, with employment rising in the third and fourth quarters, the overall level of employment remains well below the pre-crisis mark. Employment in the manufacturing sector, the sector most heavily affected by the crisis, has been increasing since the second half of 2010 on a year-on-year basis, mainly as foreign demand continues to grow. The employment decline in the services and healthcare sectors was brought to a halt in the second half of 2010, when the number of those employed in these sectors increased on a quarterly basis.

GRAPH 7 – Structure of employment growth by selected sectors (ESA 95, q-o-q changes in %)



Source: SO SR

GRAPH 8 – Unemployment rate, seasonally adjusted (%)



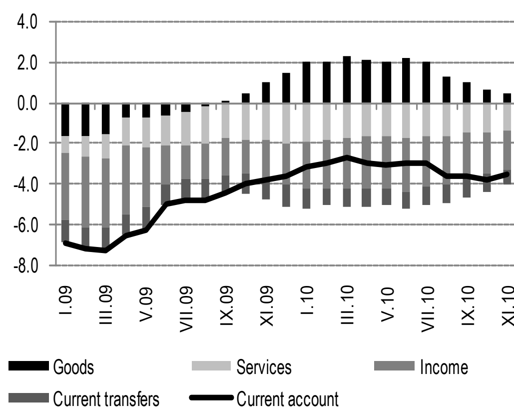
Source: SO SR

According to the LFS methodology based on the national concept, the number of unemployed in 2010 increased by 65,000 year-on-year. The rate of unemployment (LFS) thus attained 14.4% in 2010, compared to the pre-crisis level of 9.6% in 2008. In addition, the crisis exacerbates the problem of long-term unemployment, with the percentage of the long-term unemployed continuing to rise, reaching 59.3% of all unemployed in 2010. The 2010 wage development was influenced by low inflation, which kept the indexation of wages in the process of collective bargaining at a relatively moderate level. On the other hand, since the lay-offs predominantly affected low-qualified workers, the average wage in the economy increased. While the average nominal monthly wage in 2010 rose by 3.2% year-on-year, the real wage increase represented 2.2% thanks to very low inflation. As was the case in employment, the highest wage growth occurred in the manufacturing sector (up 5.4%), which was in accordance with the growth in productivity in the previous year. Wages in the construction and services sectors increased by 3.6% and 2.3%, respectively.

The 2010 trade balance was lower than in 2009, but still in surplus (0.2% of GDP). This was due to more rapid growth in imports than in exports. In 2010, imports grew especially in the category of industrial supplies and capital goods, associated with the building of new production capacities for subsequent years; hence, these imports do not pose any risks to the future development of the external trade balance. The export of metals recorded the highest increase (caused mainly by rising prices), followed by vehicles. Nevertheless, the car manufacturing sector in Slovakia still remains below the pre-crisis output. Total nominal exports of goods increased by 22.8% and imports by 25.5% year-on-year.

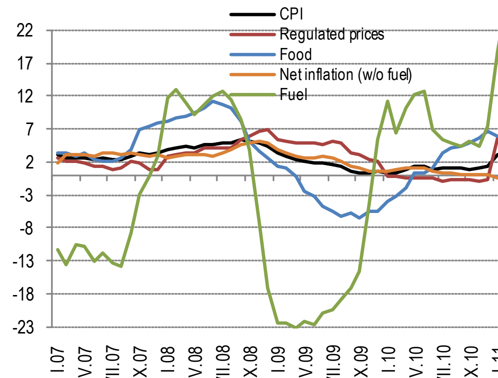
The current account of balance of payments achieved a deficit of 3.5% of GDP in 2010, compared with 3.6% in 2009. The less favourable development in the balance of goods was partly offset by the improved balance of services, amongst other things due to declining imports of financial services, and improved current transfers; the balance of income improved slightly.

GRAPH 9 – External imbalances - components of the CA of the BP (% of GDP, last 12 months)



Source: NBS, MF SR

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



Source: SO SR

The low level of inflation in 2010 was influenced by the weakening of global demand which curbed the rate of imported inflation. Declining unit labour cost also had a favourable impact on inflation. At the end of the year, rising world prices of oil and food exerted an upward pressure on inflation. The poor harvest, both locally and globally, raised food prices at the end of 2010 to their all-time-high since the summer of 2008. Inflation in the EU peaked in December 2010, reaching 2.2% year-on-year in the euro area. In December, the rate of inflation (HICP methodology) in Slovakia reached 1.3% year-on-year. At the year-end, Slovakia posted the second lowest inflation rate in the euro area, after Ireland.

II.3. Medium-term economic forecast

The latest official forecast by the Ministry of Finance dated February 8, 2011 projects a faster-than-expected recovery for Slovakia's most important trading partners in the first three quarters of 2010 and contains more optimistic expectations for their development in 2011 and 2012. In the coming two years, the economy's export performance will receive a boost from the completion of new production capacities in the automobile and electronic industries. In comparison to 2011, economic growth will slow to 3.4%, mainly as a consequence of the fiscal consolidation. Thereafter, economic growth is expected to accelerate to 4.8% and its structure should be more balanced as household consumption picks up when the labour market reaches a turning point.

TAB 3 – Forecast of the selected indicators of the Slovak economy

No.	Indicator		Actual		Forecast			
		unit	2009	2010	2011	2012	2013	2014
1	GDP, current prices	EUR bn.	63.1	65.9	70.2	75.3	81.2	87.5
2	GDP, constant prices	%	-4.8	4.0	3.4	4.8	4.8	4.8
3	Final consumption of households and NPISH[4]	%	0.3	-0.3	0.1	3.5	4.0	4.1
4	Final consumption of government	%	5.6	0.1	-5.3	-0.1	-0.8	2.5
5	Gross fixed capital formation	%	-19.9	3.6	4.8	5.9	3.4	4.7
6	Export of goods and services	%	-15.9	16.4	8.1	10.0	10.7	10.9
7	Import of goods and services	%	-18.6	14.9	5.7	9.0	9.5	10.7
8	Output gap (share of potential output)	%	-4.8	-2.1	-1.8	-1.3	-0.6	0.3
9	Average monthly wage in the economy (real growth)	%	1.4	2.2	0.2	2.5	2.2	2.8
10	Average employment growth, LFS	%	-2.8	-2.0	0.7	0.9	1.2	1.2

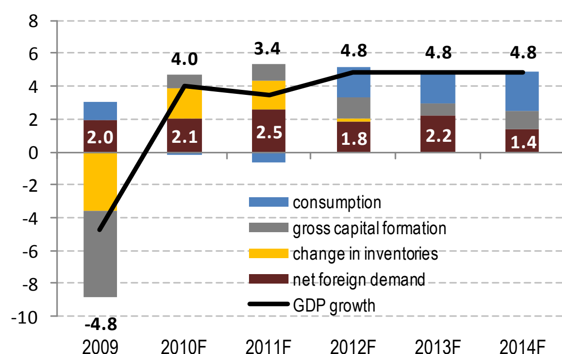
[4] In the following text households' consumption denotes consumption of households and non-profit institutions serving households (NPISH).

11	Average employment growth, ESA95	%	-2.5	-1.4	0.3	0.9	1.2	1.2
12	Average unemployment rate, LFS	%	12.1	14.4	13.9	13.3	12.5	11.8
13	Harmonized index of consumer prices (HICP)	%	0.9	0.7	3.4	3.0	3.6	3.7
14	Current account balance (podiel na HDP)	%	-3.6	-3.5	-2.2	-1.7	-0.6	-0.3

Source: MF SR

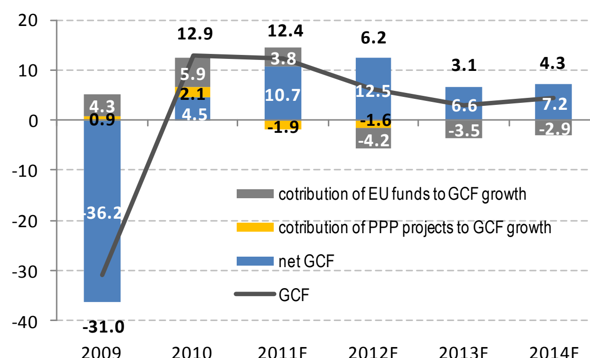
The 3.4% economic growth in 2011 should be positively influenced by fixed investments, inventory re-stocking and foreign demand. The slowdown will be largely attributable to the public finance consolidation effort, the effect of which on GDP is detailed in Box 1. The consolidation-related expectations have the effect of increasing consumer uncertainty which, coupled with the very slow recovery in the labour market, will cause household consumption to stagnate in 2011. In line with the public finance consolidation plan, final government consumption will have the most negative dynamics of all the GDP components and is expected to shrink by 5.3%. On the other hand, the improved performance in the external environment and the anticipated increase in the inflow of EU funds this year will have a positive effect on investments, which are expected to grow by 4.8%. Investments in infrastructure financed through a PPP project culminated in 2010. Its contribution to the overall investment growth in 2011 and 2012 should hence be negative. Foreign demand for goods and services will be largely influenced by the inflow of investments into Slovakia, expansion of existing export capacities, and the positive economic development of Slovakia's trading partners. According to the most recent forecast, exports should surge by 8.1% in 2011. The import forecast reflects the development of domestic demand and exports. In the subsequent years, GDP should accelerate and level off at about 4.8% over the remaining years of the period subject to forecast.

GRAPH 11 – Contributions to GDP growth in 2009-2014



Source: MF SR

GRAPH 12 – Contributions to gross capital formation (GCF)



Source: MF SR

BOX 1 – Impact of fiscal consolidation on GDP growth

In connection with the need to create conditions for long-term sustainability of public finances and the ongoing EDP procedure against Slovakia, the Government committed itself to reducing the general government deficit from 7.9% of GDP in 2010 to 4.9% GDP in 2011. ***The planned deficit reduction requires the adoption of fiscal measures at a level of 2.5% of GDP****, because an unchanged policies scenario would take the 2011 deficit to 7.4% of GDP. In terms of its negative impact on economic growth, the radical deficit reduction will be partly offset by higher drawing from EU funds, since the restrictive impact of the fiscal impulse represents 1.6% of GDP.* ***The 2011 impact of the fiscal consolidation on GDP growth is estimated at -0.5 percentage points.***

Expenditure measures and their impact

Up to 55% of the 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 general government, by reducing both employment and employee compensations. Reduced employee compensations will deflate general government consumption. Unemployment will increase as a consequence of reduced employment in general government, yet all of those made redundant are expected to remain active on the labour market, as this also pertained during the crisis. The slower growth in wages will reduce disposable income and deflate household consumption, but only partially, since the level of savings is expected to contract as well. As far as the final consumption and investments of general government are concerned, the negative impact of restrictions will be partially offset by more intensive drawing of EU funds. Reduced domestic demand will also affect import intensity through lower imports of goods and services.

Revenue measures and their impact

The revenue measures, which account for 45% of the fiscal package, will have a negative impact on inflation since 70% of these measures will affect prices directly. The overall impact of the fiscal package on average inflation in 2011 will represent 0.9 percentage points. Increases in consumer and producer prices will accelerate the dynamics of the deflators of the final household and government consumption, investments 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 again be softened by a reduction in the level of savings.

Impact of the fiscal consolidation on the economy in 2011 (p.p.)	
Impact on the inflation	
CPI	0.9
PPI	0.2
Impact on the labor market	
ESA employment	-0.3
Average monthly nominal wage	-0.8
Unemployment rate	0.3
Impact on the GDP	
contribution to annual change of households' consumption	-1.3
contribution to annual change of government consumption	-7.0
of that EU funds	*0.8*
contribution to annual change of investments	0.6
of that EU funds	*1.7*
contribution to annual change of imports	-1.7
contribution to annual change of GDP	**-0.5**
of that EU funds	*0.2*

Source: MF SR

Size of the fiscal multiplier

The implied fiscal multiplier reached 0.3. The following table compares the sizes of fiscal multipliers from literature[5], although it should be emphasised that only a few empirical studies exist for countries such as Slovakia.

Cumulative fiscal multiplier after 1 year

Country (number of studies)	G shock	GI shock	T shock
USA (9)	1.0 (0.2-1.5)	0.9 (0.5-1.2)	0.7 (0.2-1.2)
Germany (4)	0.5 (0.4-0.8)	-	0.2 (0-0.5)
Eurozone (2)	1.0 (0.5-1.5)	-	0.2
Ireland (1)	0.4	-	0.1
Netherlands (1)	0.4	-	0.1
Czech Rep. (1)	0.6	-	0
Slovakia (2)	0.1*, 0.3	-	0

**NBS study estimate of the multiplier of the balance of public finance* *Source: IMF, 2009*

Labour market

The labour market remains under the influence of the crisis and reacts to the output side of the economy with delay. The persistent adverse situation on the labour market, as well as its slow reaction to gradual economic recovery, have been reflected in the employment forecast. In addition, the slow revival in employment in 2011 will be negatively influenced by fiscal restriction in the form of lay-offs from public administration and state-owned companies. According to the ESA 95 methodology, employment in 2011 should increase by 0.3%. This year's liberalisation of access to the labour markets in Germany and Austria, as well as the gradual global economic recovery, should have a positive impact on the employment of Slovaks abroad. When Slovaks abroad are included, total employment (according to the Labour Force Survey) is expected to increase by 0.7%. In the subsequent years of the forecast, employment will gradually rise as the economy continues to expand. However, not even in 2014 will the number of those employed reach the pre-crisis level. Employment growth in 2011 will be driven mainly by the manufacturing sector; in the subsequent years, however, the services sector and revived domestic consumption should become the main drivers of growth. A positive feature for 2011 is the lower number of redundancies from state-owned companies than the number stated earlier this year. The adverse situation in employment has been fully reflected in the unemployment forecast. The unemployment rate is expected to decline from 14.4% to 13.9% in 2011 and then to gradually decrease to 11.8% in 2014.

The unfavourable development on the labour market and the cuts in payroll expenditures of public administration should hold wage growth at a relatively low level in 2011. In addition, the partial indexation of wages for the last year's low inflation (CPI) at 1.0% will attenuate pressures on wage increases. The average monthly nominal wage in 2011 is expected to increase by 3.7%. Real wages should increase by only 0.2%. In the following years, the nominal wage should increase at a faster rate as a consequence of higher labour productivity and rising inflation.

Inflation

CPI inflation for 2011 is estimated at 3.5%. Inflation increased more substantially at the beginning of the year under the influence of higher prices for food and energy, as well as the fiscal consolidation measures on the revenue side, involving the VAT increase to 20%, the increase in excise tax on tobacco products, the abolition of tax exemptions on biofuels, the introduction of fees payable to the State Material Reserves Administration and the National Nuclear Fund, and an increase in the prices of motorway stickers. The consolidation package is expected to contribute 0.9 percentage points to the 2011 increase in the prices of goods and services. The forecast anticipates that the unfavourable development in the world 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, regulated energy prices in Slovakia increased quite markedly in January 2011. The contribution of these increased energy prices to inflation represents as much as 1 percentage point in 2011. The 2011 increase in food prices can – partly also thanks to the base effect of cheap food at the beginning of 2010 – reach 6.1% year-on-year. The projected increase in food prices will represent the main contribution (by 1.1 percentage points) to the

[5] *IMF Staff Note: Fiscal Multipliers, 2009*

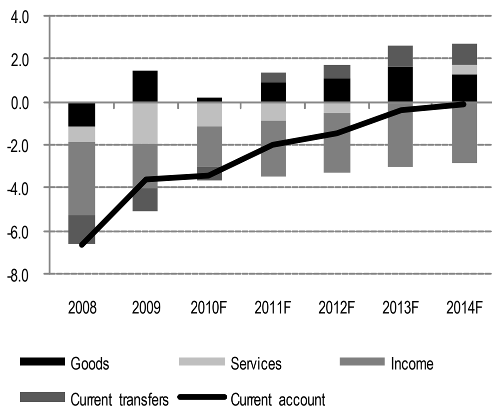
average inflation increase in 2011. On the other hand, since consumer demand remains slack, net fuel inflation will develop positively.

In the coming years, the inflation rate is expected to rise due to steadily mounting demand pressures which will contribute toward accelerating net inflation. By 2014, inflation should reach 3.7% on average. 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 6.5% by 2014.

External balance

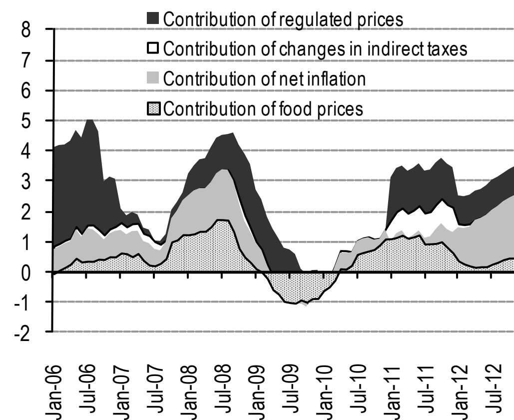
The recovery of foreign demand, anticipated for the coming years, will have a significant impact on Slovakia's external balance. Exports should grow by 8.1% in 2011 in real terms and accelerate moderately thereafter, in line with the GDP expansion of Slovakia's most important trading partners. The export forecast also takes into account planned new investments in the automobile and electronics industries (VW Up, AU Optronics). Due to weak domestic demand, imports will increase at a slower pace than exports, resulting in a surplus in the trade balance. In 2011, imports should grow by 5.7% and then accelerate, in the same way as with exports. The trade balance surplus should thus reach 0.8% of GDP in 2011 and continue to increase in the coming years. 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 2.2% of GDP. Nevertheless, gradual narrowing of the balance of services will reduce the deficit in the balance of payments.

GRAPH 13 – External imbalances - components of the current account (% of GDP)



Source: NBS, MF SR

GRAPH 14 – Structure of the consumer inflation (HICP)



Source: SO SR

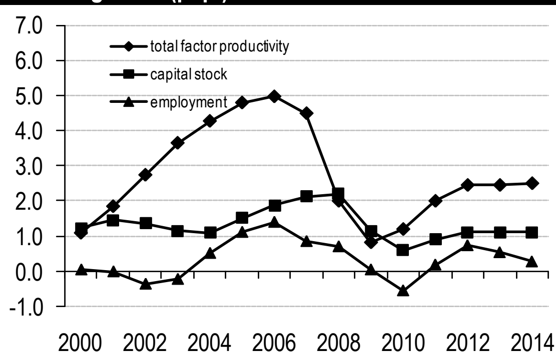
Main risks associated with the forecasts

The risks of the forecasts are fairly balanced. The positive risks include the fact that the economic recovery of Slovakia's main trading partners, especially Germany, may be more rapid than expected, especially in this year. Any such more rapid recovery could accelerate inflows of FDIs which constitute the basis of stable economic growth. The negative risks mostly relate to development on the financial markets and in the external environment. The uncertainty on the financial markets stems from the situation in the PIGS countries (Portugal, Italy, Greece and Spain), which are characterised by excessive public deficits and debts, in combination with bleak economic outlooks. The next risk resides in developments in commodity prices on the world market attributable to the political unrest in the Arab world. There is also the threat of a bubble-burst in the Asian economies which, if it occurs, could impede the economic recovery of Germany and, subsequently, Slovakia. On the domestic front, the risks include a heavier-than-expected impact of consolidation on GDP growth and higher price increases.

II.4. Cyclical development of the economy

The growth in potential output, which reached its historical low in 2010, is gradually gaining speed as a consequence of economic recovery. This is mainly attributable to the equilibrium employment, which even declined in the course of the year, reflecting an increase in NAIRU and presence of hysteretic effects. The crisis had a negative impact also on other production factors. In 2010, the growth of capital stock dropped to its minimum in 2010 due to a slowdown in new investments, while productivity growth slowly picked up after its slump in 2009. From 2011 onwards, all factors of potential output growth should regain momentum, despite the consolidation exercise. Although the growth in productivity and capital stock should gradually accelerate, the post-2012 demographic development will impede growth in the equilibrium employment.

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



TAB 4 – Contributions of production factors to potential growth

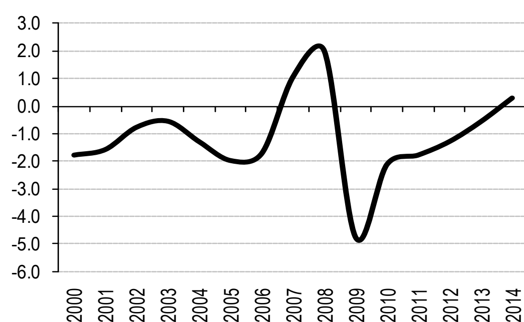
	Pot. growth, %)	TFP*	Capital stock	Equilibrium employment
2006	8.2	**5.0**	**1.9**	**1.4**
2007	7.4	**4.5**	**2.1**	**0.8**
2008	4.9	**2.0**	**2.2**	**0.7**
2009	2.0	**0.8**	**1.1**	**0.0**
2010	1.2	**1.2**	**0.6**	**-0.6**
2011F	3.1	**2.0**	**0.9**	**0.2**
2012F	4.3	**2.5**	**1.1**	**0.7**
2013F	4.1	**2.5**	**1.1**	**0.5**
2014F	3.9	**2.5**	**1.1**	**0.3**

** total factor productivity*

Source: MF SR

In 2010, real GDP continued to rise and significantly exceeded the growth of potential output. A similar scenario is expected also this year. That will partially narrow the negative output gap, from -4.8% of potential GDP in 2009 to -1.8% in 2011. Real GDP is expected to grow at a faster rate than the potential output throughout the forecast period, causing the output gap to narrow progressively. However, the gap will not be closed again earlier than in 2014.

GRAPH 16 – Output gap (% of potential GDP)



TAB 5 – Output gap

	GDP*) (real growth, %)	Potential GDP (growth, %)	Output (% pot. HDP)
2006	8.5	8.2	**-1.7**
2007	10.5	7.4	**1.1**
2008	5.8	4.9	**2.0**
2009	-4.8	2.0	**-4.8**
2010	4.0	1.2	**-2.1**
2011F	3.4	3.1	**-1.8**
2012F	4.8	4.3	**-1.3**
2013F	4.8	4.1	**-0.6**
2014F	4.8	3.9	**0.3**

**) Output gap is calculated from GDP adjusted for cigarettes' 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 regards GDP forecasts, the estimate of the Ministry of Finance for the period 2011-2012 is more on an optimistic side of the picture. That is mainly due to the more positive assumptions concerning external developments that will spur investments and export performance of the Slovak economy. When updating its forecasts, the Ministry of Finance took into consideration the most recent positive data from

business tendency surveys in Germany and from the upward revision of the global economic growth projection presented in the January 2011 IMF outlook.

TAB 6 – Comparison of forecasts of MF SR and other institutions

	Year 2010	Year 2011	Year 2012
Real GDP growth (%)			
MF SR	**4.0**	**3.4**	**4.8**
NBS	4.2	3.0	4.0
EC	4.1	3.0	3.9
OECD	4.1	3.5	4.4
IMF	4.1	4.3	-
HICP (%)			
MF SR	**0.7**	**3.4**	**3.0**
NBS	0.7	3.9	2.6
EC	0.7	3.2	2.8
OECD	0.8	3.4	2.9
IMF	0.7	1.9	-
Current account (% HDP)			
MF SR	**-3.8**	**-2.2**	**-1.7**
NBS	-3.1	-1.3	-0.4
EC	-2.9	-1.9	-1.7
OECD	-3.1	-0.9	-0.3
IMF	-1.4	-2.6	-

Source: MF SR (February 2011), NBS (December 2010), EC (November 2010), OECD (November 2010) and IMF (October 2010)

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. The importance of the fiscal policy has been confirmed by the global economic crisis, the consequences of which required a flexible and targeted response. Complying with the Council recommendations, the Government allowed a free play of automatic stabilizers in 2009, while taking additional temporary measures to support economic growth. The Government is aware of the fact that the current fiscal position is unsustainable in the long run and that the consolidation of public finances must take place. The ongoing improvement in the fiscal position is a prerequisite for stabilisation, followed by a reduction in the general government debt, which is indispensible to ensuring long-term sustainability of public finances.

The current strategy reflects the need to stabilise public finances by applying across-the-board measures with an immediate impact, particularly in 2011 and 2012. At the same time, some structural measures are already underway and while others, aimed at enhancing market flexibility and boosting potential economic growth, are being prepared. By means of stronger economic growth, these measures should have a lasting positive impact on the fiscal position. Measures that create conditions for a responsible economic policy towards future generations, particularly with regard to changes in the pension and healthcare systems and reforms of the fiscal framework, are of key importance in the long run.

III.1. Policy strategy and objectives

The strategy behind the fiscal policy is built around the principal objective, which is to safeguard the long-term sustainability of public finances, especially in the context of population ageing. Assuming that the **economy will develop in line with the baseline scenario presented in this programme**, the primary medium-term objective of the Government is to **reduce the general government deficit to 2.9% of GDP by 2013** and thus comply with the requirements of the excessive deficit procedure. The long-term sustainability of public finances hinges on the continuation of fiscal consolidation even beyond 2013 with the aim to attain Slovakia's medium-term budgetary objective of having a close-to-balanced budget.

Reduction of the general government deficit to 2.9% of GDP by 2013 will **require consolidation effort representing 5.0% of GDP on a cumulative basis within the period from 2011 through 2013**, with the most demanding part of consolidation taking place predominantly in the first year of that period. Despite the fact that this represents a very ambitious goal, necessitated by the severely deteriorated fiscal positions in 2009 and 2010, historical experience shows that its attainment is not unrealistic. Slovakia went through a successful consolidation episode in the 2002-2006 period, as described in detail in Box 2. The current consolidation is more complex due to the fact that, unlike in the mentioned period, the current external environment is affected by the crisis.

Under the influence of vigorous fiscal consolidation and negative output gap, which will progressively narrow, the fiscal policy will have a restrictive and pro-cyclical impact in the given period. While in 2011 these impacts will be partly offset by the higher drawdown of EU funds, this will not be the case in the next years as the inflow of EU funds will slacken due to the gradual depletion of funds available under the 2007-2013 programming period. **During that period, the restrictive fiscal impulse will reach an average level of 1.8% of GDP annually.**

TAB 7 – Development of general government balance and debt between 2009 and 2014 (ESA95, % of GDP)

	2009	2010	2011	2012	2013	2014
1. Net lending / net borrowing	**-8.0**	**-7.9**	**-4.9**	**-3.8**	**-2.9**	**-2.8**
2. Cyclical component	-1.4	-0.6	-0.5	-0.4	-0.2	0.1
3. One-off measures	0.0	-0.3	0.1	0.2	0.1	0.0
4. Cyclically adjusted GG balance net of one-offs (MTO) (1-2-3)	**-6.5**	**-7.0**	**-4.5**	**-3.6**	**-2.8**	**-2.9**
5. Impact of the implementation of the 2nd pillar of pension scheme	-1.3	-1.2	-1.2	-1.2	-1.2	-1.2
6. Interest expenditure	-1.4	-1.3	-1.8	-1.8	-2.2	-2.2
7. Adjusted primary balance (4-5-6)	**-3.8**	**-4.4**	**-1.4**	**-0.5**	**0.6**	**0.5**
Consolidation effort (y-o-y change in adjusted primary balance)*	**-4.3**	**-0.6**	**3.0**	**0.9**	**1.1**	**0.0**
Gross general government debt (Maastricht definition)	**35.4**	**41.0**	**44.1**	**45.3**	**45.3**	**45.2**

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

2011 - approved budget, 2012-2014 - GG Budget Framework

BOX 2 – Consolidation strategy between 2002 and 2006

Slovakia has already gone through a successful consolidation episode, back in 2002-2006. Although it entailed a significant deficit reduction from over 8% of GDP to less than 3% of GDP, the austerity measures taken had no negative impact on economic growth. The main non-Keynesian effects stemmed mainly from the higher credibility of Slovakia perceived by foreign investors, as well as from the elimination of many inefficiencies in the use of public resources. Furthermore, the external environment and monetary policy stimulated aggregate demand.

Positive effects were primarily attributable to the comprehensive consolidation strategy ("3S") that included the following:

Stabilisation phase: Hard budgetary constraints in the public sector and significant reduction of government consumption and particularly social transfers in real terms. The complexity of the consolidation package and the Government's determination were also appreciated by the financial markets, resulting in considerable savings of government debt interest expenditures. Austerity measures in state-owned enterprises and in the healthcare system prevented new debt from accumulation.

Structural reforms: In the period 2003-2005, Slovakia implemented a number of structural reforms that attracted the interest of the outside world. Probably the best known was the tax reform, which introduced a flat income tax of 19% and unified VAT rates to 19%. Moreover, the World Bank ranked Slovakia as the 2004 top business environment reformer. Other important structural adjustments included a new social policy, fiscal decentralisation and new financing scheme for the regional school system.

Sustainability: The reform of public finance management included a profound change in the fiscal policy framework. Multiannual and programme-based budgeting was introduced. Analytical capacities of the Ministry of Finance were augmented and, by establishing two advisory committees, political influence was eliminated from the process of macroeconomic and tax revenues forecasts preparation. Another important reform measure was the launch of the State Treasury and establishment of the Debt and Liquidity Management Agency. Among the systems sensitive to population ageing, pension system was reformed (substantial increase in the pension age and launch of a fully-funded pillar), while the accumulation of new debt in the healthcare system was curbed by funnelling more private funds into the system.

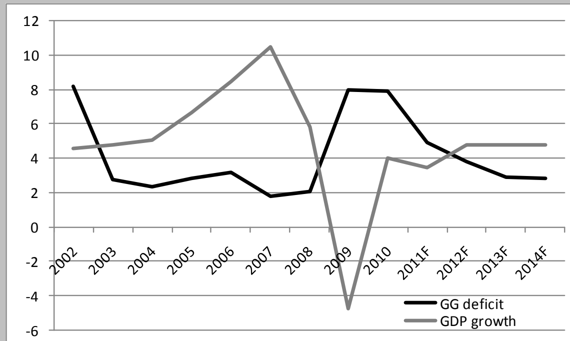
The results achieved in 2002-2006 show that the entire fiscal consolidation took place on the expenditure side. On top of that, the need to cut back expenditures was accentuated by a reduction in the tax burden.

Change in structural deficit net of one-off measures

	Change in 2002-2006 (net of one-off measures)
Tax revenues (decrease, against tightening)	+0.9
Interest payments	-2.1
State social benefits	-1.0
Pensions	-0.3
Sickness benefits	-0.4
Unemployment benefits	-0.2
Wages	-0.9
Reform of state enterprises	-0.5
Stabilisation of healthcare sector	-0.4
Other	-0.4
TOTAL	**-5.3**

As the graph shows, economic growth steadily accelerated during the consolidation period despite substantial reduction of the structural deficit. Regretfully, at present no such positive effects can be expected because the external environment has been affected by the financial crisis (slightly slower growth of the EU economy and less resources available for foreign direct investments) and the monetary policy is unlikely to be expansionary amidst consolidation. Neither can a drop in the risk premium similar to that in the years 2002-2006 be anticipated. However, a comprehensive consolidation strategy may substantially mitigate the negative effects of austerity measures.

GG deficit and economic growth (% of GDP)



Source: SO SR

Bribor 6M (2002-2006)

Source: NBS, Eurostat

The medium-term key fiscal objectives address the deteriorated fiscal positions in the years 2009 and 2010. The 2010 deficit target of 5.5% of GDP was not met. According to the latest Eurostat deficit and debt notification[6], its level reached 7.9% of GDP, i.e. a deficit higher by 2.4 percentage points than the approved 2010 budget. This higher deficit level reflects the interplay of three factors. The first is the impact of the global economic crisis and the consequent permanent loss of a part of the potential output that affected negatively the tax revenues and thus the general government balance. The second factor is the structure of economic growth where those growth components which are less tax-intensive, such as exports, improved. On the other hand, the labour market and household consumption, on which most of the general government's tax revenue depends, developed less favourably than projected. The third factor included underestimated risks and optimistic budgeting unaccompanied by adequate measures in the case of local governments, railway companies and hospitals. The gross general government debt reached 41% of GDP, an increase by almost a half over the past two years.

The high general government deficit in 2010 and the debt upsurge necessitated prompt reaction by the new Government, which drew up a package of consolidation measures for 2011. These measures totalled 2.5% of GDP which, compared to the unchanged policies scenario (deficit at 7.4% of GDP), slashed the deficit to 4.9% of GDP.

Should the Government choose not to adopt any additional measures in the coming years and macroeconomic development (higher growth, but heavily based on exports) would be the only factor influencing the general government balance, the general government deficit in 2012 and 2013 would reach the same level as in 2011. The unchanged deficit level is also associated with rising interest expenditures on government debt due to the need to finance increased deficits and a higher risk premium, compared to a situation where fiscal objectives were attained. In 2014, particularly under the influence of accelerating economic growth, deficit would reach 4.6% of GDP and gross general government debt would climb near to 50% of GDP. Under the assumption of unchanged policies, primary deficit would gradually improve, from 3.1% of GDP in 2011 to 2.2% of GDP in 2014.

The table below illustrates the need for consolidation measures. In order to achieve the defined target of 3.8% of GDP for general government deficit, measures of an overall magnitude of 1.0% of GDP have to be implemented for 2012. In 2013, the required effort will grow to 1.9% of GDP, prompting the adoption of additional measures

[6] The general government balance and debt figures notified by Eurostat were published on April 26, 2011.

worth 0.9% of GDP compared to 2012. Permanent measures adopted for 2013 will automatically ensure the attainment of the objective defined for 2014. The Government's aim is to prepare a package of measures effective from 2012 onwards that would secure the attainment of objectives for 2013 and 2014 without the need for any additional legislative interventions.

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

	2012	2013	2014
1. Primary GG balance - unchanged policies scenario	-3.0	-2.6	-2.2
2. Primary GG balance - 2012-2014 GG Budget Framework	-2.2	-1.6	-0.8
3. Primary GG balance - target	-2.0	-0.7	-0.6
Difference (3-2)	0.3	0.8	0.2
Difference (in EUR mill.)	203	673	166
Difference (3-1)	1.0	1.9	1.6
- y-o-y change (additional necessary measures)	-	0.9	-0.3
Difference (in EUR mill.)	**775**	**1 545**	**1 411**
- y-o-y change (additional necessary measures)	**-**	**770**	**-134**

Source: MF SR

The bulk of the necessary measures has already been incorporated into the General Government Budget Framework for 2012-2014. These measures include a freeze of wage expenditures (except for teachers), reduction of operating expenditures by 5%, and cuts in other core expenditures of the government. The measures that are yet to be approved will have to reach 0.3% of GDP in 2012 and an additional 0.6% of GDP in 2013.

Apart from the already incorporated measures, the General Government Budget Framework for 2012-2014 proposes additional measures. Their total impact amounts to 0.7% of GDP and exceeds the impact of the measures necessary to meet the fiscal objectives in 2012 and 2014. At the same time, the impacts of some measures on the general government balance have not been quantified yet, as they will crystallize only at a later stage. Measures will be discussed during the drafting period of the general government budget, and on that basis, the Government will select the most relevant ones with a view to meeting its fiscal objectives and priorities. As regards the impact on economic growth, it is important that by 2013 over 50% of the consolidation effort will occur on the expenditure side of the budget.

Successful attainment of the fiscal objectives is a prerequisite for stabilising the share of general government debt in GDP. The gross general government debt will increase from 41.0% of GDP at the end of 2010 to 45.3% of GDP at the end of 2012, dipping slightly towards the end of the forecast period close to 45% of GDP. Despite hovering significantly below the reference value set by the Treaty throughout the entire period, the long-term sustainability of public finances and the trust of investors require that conditions be put in place to decrease the debt ratio to GDP in future years.

The long-term sustainability of public finances is the primary objective of Slovakia's economic policy. A responsible fiscal policy should preclude current policies from passing excessive burdens onto future generations. For that reason, the government has prepared measures in the following key areas:

- **Reform of the tax and social contributions systems** – efficient collection of taxes and social contributions helps reduce distortions of economic decisions, discourages tax avoidance, and reduces compliance costs incurred by individuals and corporations. Moreover, it provides adequate revenues for public finances and contributes to boosting the competitive edge of a small and open economy in global competition. The principal drawbacks of the current mechanisms of collecting taxes and social contributions in Slovakia lies in its administrative complexity arising from different bases for calculating taxes and social contributions, and the insufficient fight against tax evasion. The aim of the reform process is to simplify the system of social contributions with the ultimate goal of having a more efficient system based on a unified collection of taxes, customs duties and social contributions and a joint tax and

social contributions settlement mechanism. The reform has been designed with a moderately negative impact on the general government budget and, provided that the budgetary objectives are met, the burden of social contributions gradually ease (for more, see section VI.2)

- **Pension reform** – in the context of population ageing, the long-term sustainability of public finances constitutes a key objective of Slovakia's fiscal policy. The Government has taken a holistic approach to this issue, introducing changes both in the pay-as-you-go pillar and in the fully-funded pillar of the pension system. The third area of the reform focuses on special pension systems employed mainly in the armed forces. Proposed measures in all the areas mentioned above should gradually stabilise the pension systems in Slovakia so that public finances are prepared for smooth transition to the period of significant demographic change (for more, see section VI.2).

- **Improved efficiency of state-owned enterprises** – improving the efficiency of state-owned enterprises by implementing austerity measures aimed at curbing debt, and by long-term leasing of these enterprises to strategic investors or selling the state equity participation. This mainly includes railway companies, the M. R. Štefánik Airport in Bratislava, heat distribution companies, Slovak Telekom and bus transport companies (SAD). The objective is to reduce the exposure of general government budget to the risk of financing of their debts (for more, see section VI.2).

- **Reform of the fiscal framework** – although economic growth in the pre-crisis years was very strong, many countries failed to use the years of abundance to consolidate their public finances and fell into the trap of high deficits and surging debt. To avoid history being repeated and ensure that countries become prepared well in advance for the costs associated with population ageing, the European Commission drafted six legislative acts that address fiscal policy as well as macroeconomic imbalances. As regards fiscal policy, the legislation proposes primarily amendments to the Stability and Growth Pact and the strengthening of national fiscal frameworks by defining minimum requirements for them. The prepared reform of the fiscal framework in Slovakia reflects the substance of these changes and, as a result, it is fully compatible with the initiative of the European Commission (for more, see chapter VII).

The Stability Programme is based on macroeconomic and tax revenue forecasts of February 2011. The macroeconomic scenario, as well as projected tax revenues, is subject to the scrutiny by committees comprised of national public and private sector experts.

III.2. General government balance in 2010 and its impact on 2011 budget

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 part contains basic information on the development of general government balance in 2010 and its impact on general government budget in 2011. Furthermore, it describes measures adopted in the course of 2010 with the aim of meeting the 2011 consolidation objective and laying the groundwork for further consolidation effort. Its final section provides up-to-date information on developments in 2011.

III.2.1. General government balance in 2010

Under the General Government Budget for 2010-2012, the Government's key fiscal objective for 2010 was defined as reaching the general government deficit level of 5.5% of GDP. The outcome, as notified by Eurostat on April 26, 2011, reached 7.9% of GDP, which means a deterioration by 2.4 percentage points.

In nominal terms, the general government deficit is EUR 1,501.3 million higher than budgeted. The identified factors that led to deficit deterioration totalled EUR 645.6 million (1.0% of GDP) on the revenue side and EUR

612.1 million (0.9% of GDP) on the expenditure side. Other general government entities, apart from the state budget and municipalities, accounted for the remaining EUR 243.6 million (0.4% of GDP).

TAB 9 – General government balance in 2010 (ESA 95)

	EUR mill.	% of GDP
GG balance after approval of individual budgets	**-3,705.8**	**-5.5**
Changes on the revenue side:	**-645.6**	**-1.0**
General government tax revenues	-637.2	-1.0
of which: state budget	-460.4	-0.7
of which: municipalities	-116.5	-0.2
Nerealizovanie odpredaja emisných kvót	-66.0	-0.1
Revenues from dividends	57.6	0.1
Changes on the expenditure side:	**-612.1**	**-0.9**
Covering the risks of the state budget	-566.5	-0.9
- expenditures related to floods	-112.6	-0.2
- recording the liabilities of state against railway companies and hospitals	-223.3	-0.3
- other expenditures	-230.6	-0.3
Municipalities	-449.3	-0.7
- deficit in 2009	-282.7	-0.4
- additional expenditures in 2010	-166.6	-0.3
General government interest payments	403.7	0.6
Other	**-243.6**	**-0.4**
GG balance	**-5,207.1**	**-7.9**
of which: change in GG balance by means of the GDP update		-0.2

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

On the revenue side, the dominant negative factor was the **shortfall in tax revenues** in the total amount of **EUR 637.2 million (1.0% of GDP).** The largest shortfall was reported for indirect tax revenues, namely for value-added tax at EUR 399 million (0.6% of GDP) and excise taxes at EUR 65 million (0.1% of GDP). The reason behind this development, despite higher economic growth than projected at the time of budget preparation, was essentially its structure. The economic growth in 2010 was driven by growing exports, while the labour market situation remained unfavourable throughout the year, adversely affecting household consumption. Excise tax revenues were also negatively affected by a change in legislation, reducing the excise tax rate on mineral oils in the course of 2010, the impact of which amounted to EUR 73 million (0.1% of GDP). Compared to the budget, the direct tax revenues, namely the personal income tax and corporate income tax, shrunk by EUR 101 million (0.2% of GDP) and EUR 51 million (0.1% of GDP), respectively. The shortfall in the corporate income tax revenue is mainly associated with the actual level of revenue in this tax category in 2009, which was significantly lower than the estimate fed into the 2010 budget.

The other factors affecting the revenue side included the **unsuccessful sale of emission allowances** amounting to EUR 66.0 million **(0.1% of GDP)** and **higher dividends from enterprises with state equity participation** by EUR 57.6 million **(0.1% of GDP)** than budgeted.

Four conflicting factors influenced the development on the expenditure side. On the one hand, the need for **covering unbudgeted risks in the state budget reached to EUR 566.5 million (0.9% of GDP), unrealistic budgetary assumptions for municipalities** (the deficit in 2009 stood at EUR 282.7 million representing **0.4% of GDP**) and **municipal budget overruns** going beyond the shortfall in their tax revenues and the previous year's deficit amounting to EUR 166.6 million (**0.3% of GDP**), were determinants with a negative impact. On the other hand, savings on **interest payments on the general government debt** amounting to EUR 403.7 million (**0.6% of GDP**) represented a positive factor.

The unbudgeted risks of the state budget that required coverage in the course of 2010 were threefold. The first group included expenditures prompted by unpredictable events such as floods. The flood-related expenditures covered by the state budget reached EUR 112.6 million (0.2% of GDP). The second group comprised reporting state liabilities towards ŽSR, a. s. (railway infrastructure management company) and ŽSSK, a. s. (passenger railway transport company) amounting to EUR 144 million (0.2% of GDP), as well as hospitals amounting to EUR 79.3 million (0.1% of GDP), as a consequence of their losses. The lack of sufficient measures in the past led to losses reported in these companies which the Government must now finance. The third group included the following unbudgeted expenditures:

- compensation related to the termination of concession agreements on PPP projects for the construction of the D1 motorway - EUR 94.0 million (0.1% of GDP),
- financial settlement of contributions payable by the state on behalf of certain categories of persons to the health insurance companies - EUR 55.0 million (0.1% of GDP),
- coverage of social benefits and expenditures under the active labour market policy - EUR 51.3 million (0.1% of GDP),
- funds set aside to pay outstanding past-due invoices - EUR 30.3 million (0.05% of GDP).

In the case of municipalities, the 2010-2012 General Government Budget anticipated a balance in 2010, failing to factor in the risks arising from their actual budgetary performance in 2009 (the deficit reached EUR 282.7 million) and the risk associated with the local government elections. Moreover, the adverse macroeconomic development undercut their tax revenues by EUR 116.5 million (0.2% of GDP) compared to what was budgeted. After deducting the shortfall in tax revenues of municipalities, which could be considered an objective factor, and rolling the negative balance from 2009 over to 2010 (under a conservative budgeting approach the elections should have been reflected in the 2010 budget at the least by considering performance as adverse as in 2009), the **budgetary policy of municipalities in 2010 contributed to the general government deficit in the amount of EUR 166.6 million (0.3% of GDP)**.

The level of the general government deficit in 2010 as notified by Eurostat indicates no need to revise the 2011 budgetary target as the 2011 budgetary framework was based on almost the same level of deficit (7.8% of GDP) as in 2010.

III.2.2. General government budget in 2011 and first package of fiscal measures

The general government budget in 2011 anticipates general government deficit at 4.9% of GDP. This target level was determined on the basis of the projected general government deficit in 2010 at 7.8% of GDP and the need for ambitious consolidation aimed at correcting the excessive deficit by 2013.

The scope of the 2011 consolidation package and the fiscal target in that year was built on the assumption of unchanged policies, which would result in the general government deficit of 7.4% of GDP in 2011. The difference between the level of 7.4% of GDP and the target level of 4.9% of GDP represents 2.5% of GDP, which basically quantifies the scope of the measures, referred to as the first package of fiscal measures, necessary to meet the fiscal target.

The proposal of specific measures was based on the principle that most of the measures should affect the expenditure side of public finances. The final version of the package proves that this principle has been upheld, as about 55% of the total deficit improvement will be attributable to expenditure cuts.

TAB 10 – First fiscal consolidation package - impact in 2011 (selected measures, compared to 2010, ESA95)	EUR mill.	% of GDP
General government expenditures	**956**	**1.4**
- compensation of employees in GG sector	154	0.2
- expenditures on goods and services	150	0.2
- current subsidies (Slovak Television, news agency, agriculture, housing)	143	0.2
- investment subsidies	76	0.1
- capital expenditures with low productivity (national football stadium, Bratislava castle, state reserves, other ministries)	80	0.1
- decreasing subsidies to municipalities	90	0.1
- savings in healthcare	85	0.1
- state funds (National Nuclear Fund, Environmental Fund)	50	0.1
- corrections on EU funds	38	0.1
- lower transfer to National Motorway Company due to increased prices of stickers	14	0.0
- other expenditures	78	0.1
General government revenues	**767**	**1.1**
- tax base broadening for income tax and social contributions	232	0.3
- VAT (increase in the basic rate from 19% to 20%)	185	0.3
- excise taxes (tobacco, abolition of exemptions)	120	0.2
- tax on excess emission allowances (impact decreased by the negative impact on CIT)	45	0.1
- non-tax revenues	185	0.3
Impact on the general government balance	**1,723**	**2.5**

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

General government expenditures

On the expenditure side, the measures focused on reducing government consumption, mainly through across-the-board cuts in wages and operating expenditures. In the case of current subsidies and capital expenditures, cuts were proposed selectively, i.e., the items assumed to be least effective were reduced (national top-up to direct payments to farmers, construction of a national football stadium, reconstruction of the Bratislava castle).

The general government budget in 2011 envisaged a **reduction in wage expenditures** by 10% relative to the level approved for 2010 (i.e., 13% in real terms). These cuts do not apply to teachers whose remuneration remained at last year's level, nor do they apply to the armed forces due to other cuts already made in the budget of the Ministry of Defence. Moreover, the reduction of wage expenditures has been made less strict for certain groups of civil servants, such as policemen, fire-fighters, or the research and scientific staff. For these groups, not the whole 10% was reduced. The cuts in wage expenditures were not commensurately reflected in the overall employment reduction in the public sector because each budgetary chapter could decide whether to make some of their staff redundant or reduce certain components of their pay.

As for the **operating expenditures on goods and services,** cuts amounted to 10% in individual chapters of the state budget, with the exception of a few specific items that had to be taken into consideration because, in their case, the 2011 budget was already set below the level of the approved 2010 budget at the time the General Government Budget for 2010-2012 was drawn up. In the 2011 budget of the Ministry of Defence, operating expenditures were reduced by almost 20% against the level in the approved 2010 budget.

The volume of **subsidies** to cover the operating expenditures of the Press Agency of the Slovak Republic and subsidies covering national top-ups to the direct payments to farmers was reduced by approximately 50% year-on-year. Subsidies for housing construction and refurbishment, provided from the state budget, declined by almost 30% compared to the previous year.

In the 2011 budget, **capital expenditures** with low effectiveness and expenditures already disbursed in 2010, such as expenditures for the construction of a football stadium and reconstruction of the hockey arena, have again not been provided for. Additionally, expenditures for the restoration of the Bratislava Castle site, expenditures of the State Materials Reserves of the Slovak Republic, as well as capital expenditures of the Ministry of Defense, were downsized dramatically.

Compared to the unchanged policies scenario, the **state budget transfers** to the National Motorway Company, which falls outside the general government sector, were **reduced** in response to the **increase in the prices of motorway stickers** for vehicles below 3.5 tonnes from EUR 36.5 to EUR 50. At the same time, the prices of weekly and monthly motorway stickers were also increased. Motorway stickers are required only for passenger cars below 3.5 tonnes from the beginning of this year. The positive impact on the general government budget in 2011 will reach EUR 14 million.

Apart from the government budget, also specific **State Funds** were subject to considerable expenditure cuts. The year-on-year reductions in expenditures reached 55% in the National Nuclear Fund, 45% in the Environmental Fund and 22% in the Slovak Land Fund. A fall in expenditures is to a certain extent expected in a number of other general government entities in 2011.

General government revenues
The aim of the measures on the revenue side was, first and foremost, to minimise the negative impact of tax increases on economic activity, i.e. preference was given mainly to broadening the tax bases by lifting unjustified exemptions (direct taxes and reduced VAT rate), increasing taxation of activities with negative externalities (excise tax on tobacco) and taxing unjust corporate profits (tax on excess emission allowances). The changes have also affected non-tax revenues.

- **Income tax and social contributions**

The purpose of the changes implemented in the system of **social contributions** is to eliminate exemptions and approximate their assessment bases to the tax base. As of January 1, 2011, the social contributions assessment base and tax base were unified in the case of severance payments, social fund contributions, and other employee benefits in-kind, as well as the income of executive representatives of limited liability companies, members of statutory bodies and supervisory boards. Furthermore, health contributions tied to dividends and profit sharing have been introduced. All changes in the system of health and social insurance will yield EUR 160.9 million for the budget in 2011.

The most important measures in the **personal income tax** system, effective as of January 1, 2011, include abolishing the tax allowance on supplementary pension insurance, life insurance and special-purpose saving schemes. In addition to that, the tax allowance on income from lease, capital assets and other income was abolished. As of January 2011, withholding tax is deemed settled upon its payment. Another important change is the reduction of flat-rate expenses for self-employed craftsmen, from 60% to 40%. The consolidation measures applicable to personal income tax will yield EUR 455 million for the general government budget in 2011.

As of January 1, 2011, the **corporate income tax system** no longer exempts municipalities and self-governing regions from tax on income from the sale and lease of their assets. Similarly as in the case of natural persons, withholding tax is deemed settled upon its remittance. The overall impact on tax revenues is expected to reach EUR 25.8 million in 2011.

- **Value-added tax**

Effective as of January 1, 2011, the standard **VAT** rate has been temporarily increased from 19% to 20%, but pharmaceuticals, selected medical aids and books continue to enjoy a reduced rate of 10%. The temporary aspect of this measure indicates that the increased rate will apply only as long as Slovakia remains subject to the excessive deficit procedure. In practical terms it means that if Slovakia corrects its excessive deficit within the planned period, i.e. in 2013, which should be confirmed in the deficit and debt notification of Eurostat in the spring of 2014, the standard tax rate would retract to its original level from the beginning of 2015. At the same time, the

reduced tax rate of 6% on goods in the category of farm-gate production, introduced on May 1, 2010, would be abolished. These measures will bring EUR 185.5 million into the 2011 budget.

- **Excise taxes**

Excise tax on tobacco will be increased in two steps, namely on February 1, 2011 and March 1, 2013, in order to ensure Slovakia's compliance with relevant EU legislation. In the first step the tax rate will be raised by 3.9% and then by 5.5%. These measures will increase tax revenues by EUR 15.9 million in 2011.

With regard to **excise tax on mineral oil**, on January 1, 2011 the reduced rate applied in the past to red diesel fuel, the kind used primarily in the agriculture and railway sectors, was discontinued, hiking the rate from EUR 225.71 to EUR 368 per 1000 litres. This move is projected to generate each year an additional EUR 44 million in tax revenue during 2011-2013.

Excise tax on **liquefied petroleum gas (LPG)** is to be introduced at a rate of EUR 182 per 1000 kg, generating annually EUR 8.2 million for the general government budget.

As of January 1, 2011 no more exemption is applied to excise tax on **biofuels** mixed with fossil fuels; instead excise tax rates applicable to petrol and diesel fuel are used. The basic excise tax rate is applied to petrol and diesel fuel containing an approved percentage of biofuels; where the designated percentage of biofuels is not attained, the rate is increased by 5% for diesel fuel and by 7% petrol. In 2011 the total positive effect on tax revenues is projected at EUR 43.6 million.

On January 1, 2011 the tax exemption applied to **compressed natural gas (CNG)** was discontinued and a rate of EUR 13.27 per 1 MWh was introduced. Effective on June 1, 2011, the exemption from excise tax applied to coal and natural gas used for heat generation in the housing sector will be lifted. In 2011 these measures will increase tax revenues by EUR 6.0 million.

- **Tax on excess emission allowances**

Tax on excess emission allowances will be introduced on a temporary basis. This tax will be assessed in 2011 and 2012 on the transfer and holding of excessive emission allowances at a rate of 80%, taking into consideration savings made as a result of investment in technology. Taking into account adverse implications for corporate income tax revenues, this measure will have a positive impact on the budget amounting to EUR 45 million.

- **Non-tax revenues**

The sale of CO_2 allowances is expected to generate significant revenues for the general government budget. The total revenues of EUR 100 million will be reduced by EUR 30 million that must be spent in 2011 on "green" projects.

In 2011 a new charge was introduced at a rate of EUR 3 per generated megawatt hour which will increase revenues of National Nuclear Fund by EUR 70 million. The whole amount is earmarked for decommissioning old nuclear facilities and spent nuclear fuel management.

Also in 2011, a charge was introduced earmarked for the State Material Reserves of the Slovak Republic (SMR). The charge will be levied at a rate of 1.7 cents per litre of petrol or diesel fuel sold, generating in 2011 EUR 45.1 million in general government revenues.

TAB 11 – Changes on the revenue side (ESA95, EUR mill.)

	2011	2012	2013
Income tax	**71**	**130**	**138**
Abolishing deduction from the tax base of the cost of health professionals' continued education	0	1	1
Abolishing tax allowances on supplementary pension insurance, life assurance and special-purpose savings schemes	14	66	66
Reduction of income tax allowance from 5 times the subsistence minimum to EUR 500	3	3	3
Abolishing tax allowance for lease revenue, capital gains and other revenues; withholding income tax deemed settled when paid except for stakes in asset funds and bonds (PIT)	23	24	24
Reduction of the flat rate expenses for self-employed craftsmen from 60% to 40%	5	8	13
Levying tax on per diem allowances related to business travel, including extra per diem amounts	0	0	0
Abolishing tax exemptions applied to revenue generated by local and regional self-governing authorities selling and leasing out assets	18	19	19
Withholding income tax deemed settled when paid except for stakes in asset funds and bonds (CIT)	7	10	12
Tax on excess emission allowances (impact reduced by adverse implications for CIT)	**45**	**45**	**0**
Contributions to social and health insurance schemes	**161**	**204**	**212**
Value-added tax	**185**	**196**	**209**
Increasing the standard rate from 19% to 20% while retaining reduced rate at 10%	183	194	207
Abolishing the 6% rate applied to farm-gate sales; now covered by standard VAT rate	2	2	2
Excise taxes	**120**	**132**	**156**
Raising the rate of tax on cigarettes, tobacco and cigars	16	21	42
Abolishing the reduced rate applied to red diesel fuel (excise taxes on mineral oils)	44	44	44
Introduction of EUR 182 per 1000 kg rate for LPG	8	8	8
Abolishing exemptions for CNG used as fuel, natural gas to produce CNG used as fuel	2	2	2
Abolishing exemption for biofuels in mixtures with fossil fuels	44	46	48
Abolishing exemptions from energy taxes – natural gas (used as fuel for heating in housing sector), coal – abolishing exemptions of heat generation in housing sector	6	12	12
Non-tax revenues	**185**	**187**	**189**
Introduction of a charge to SMR at a rate of 1.7 cent per 1 litre petrol and diesel fuel	45	47	49
Introduction of a charge to NNF at a rate of EUR 3 per 1 MWh generated electricity	70	70	70
Sale of CO_2 allowances (net impact)	70	70	70
TOTAL	**767**	**894**	**904**
TOTAL - as % of GDP	**1.1**	**1.2**	**1.1**

Source: MF SR

III.2.3. Developments in 2011

As the budgetary year has begun only recently, at the moment there are no comprehensive estimates of the general government balance development in 2011. The probability of the objectives being met may be ascertained and potential risks identified on the basis of as yet incomplete information derived from updated macroeconomic and tax revenue projections made in February 2011 and cash-basis state budget execution at the end of March 2011.

There have been no significant changes in macroeconomic and tax revenue projections compared to the forecasts carried out while drafting the 2011 budget. Data on cash-basis state budget execution are presented in the following table.

TAB 12 – State budget development in 2011 (cash, % of GDP)						
	Final	Final	Budget	Final	Performance in 2011 (%)	2011/2010 until March 31
	2010	until March 31, 2010	2011	until March 31, 2011		
State budget revenues	**16.5**	**3.8**	**18.7**	**3.9**	**20.9**	**1.096**
Tax revenues	12.1	3.0	12.5	2.8	22.7	0.995
Revenues from EU funds	2.5	0.6	4.8	0.9	19.0	1.690
Dividends	0.9	0.0	0.6	0.0	0.0	-
- current dividends	0.7	0.0	0.6	0.0	0.0	-
- superdividends	0.2	0.0	0.0	0.0	-	-
Other revenues	1.0	0.2	0.9	0.2	19.9	0.945
State budget expenditures	**23.3**	**5.3**	**24.2**	**4.9**	**20.1**	**0.975**
Interest payments	1.3	0.7	1.7	0.5	31.6	0.789
EU related expenditures	4.3	0.8	6.7	0.8	12.3	1.091
- EU funds	2.9	0.4	4.8	0.4	8.9	1.278
- co-financing	0.6	0.1	1.0	0.1	7.9	0.859
- transfer to the EU budget	0.8	0.4	0.9	0.3	34.1	0.967
Transfer to the SIA	2.2	0.5	2.3	0.6	25.0	1.324
Core expenditures of the state	15.5	3.3	13.5	2.9	21.7	0.938
State budget balance	**-6.7**	**-1.5**	**-5.4**	**-0.9**	**17.2**	**0.666**

Source: MF SR

In the first quarter the state budget posted a cash deficit of 0.9% of GDP, one third down on the same period in 2010 (an improvement of 0.6% of GDP). The better outcome was primarily a result of expenditures savings. On the expenditure side, core expenditures of the state declined by 6.2% year-on-year (amounting to 0.4% of GDP), reflecting the government's austerity measures. Revenues increased by 9.6% (0.1% of GDP) as a result of inflows from EU funds. Tax revenues remained roughly at the same level as last year. The transient stagnation of tax revenues may be attributed to two factors. One reflects possible stockpiling prior to the increase in excise tax on alcohol in 2010 and the other one corresponds to settlements with municipalities from personal income tax revenue transfers. In the upcoming period tax revenues are expected to revert to positive year-on-year growth.

Based on the updated macroeconomic and tax revenue projections dating back to February 2011 and the information about the cash-basis state budget execution after the first quarter of 2011, it appears that overall developments have been in line with budgetary assumptions, and no risks have been identified that might jeopardise the fiscal objective for 2011.

III.3. Medium-term budgetary outlook

The Government has drawn up the General Government Budgetary Framework for 2012-2014, including the definition of fiscal objectives. The objectives remain unchanged compared to the general government budget approved for 2011 to 2013. This means that in 2012 the general government deficit is projected at 3.8% of GDP and in 2013 at 2.9% of GDP, which would correct the excessive deficit in 2013. The fiscal objective for 2014 has been set, in terms of general government deficit, at a level of 2.8% of GDP.

This section aims to describe how the Government intends to attain the objectives by quantifying first necessary measures. The basic assumption is that the 2011 fiscal objective is met, implying a general government deficit of 4.9% of GDP. Following that and based on an unchanged economic policies scenario, medium-term estimates of the general government balance can be made. A comparison of this scenario with the general government balance targets makes it possible to quantify the magnitude of necessary measures.

III.3.1. Unchanged policies scenario

The first step in identifying necessary measures is to estimate developments in the general government balance provided there is no change in economic policies in 2011-2014. The scenario is drawn up taking as a point of departure the 2011 general government balance cleaned of items that will not recur in 2012-2014. Following that, projected macroeconomic parameters are applied to the amended 2011 balance items (for details of such assumptions, please refer to Box 3). This results in the scenario presented in the following table. Assuming unchanged policies, the general government deficit in 2012 to 2013 was estimated at 4.9% of GDP, and in 2014 it should decrease to 4.6% of GDP. These developments are closely related to higher interest payments due to rising need for financing the deficit and the risk premium increase compared to a situation where fiscal objectives are fulfilled. Assuming unchanged policies, the primary deficit would gradually improve from 3.1% of GDP in 2011 to 3.0% of GDP in 2012, 2.6% of GDP in 2013 and 2.2% of GDP in 2014.

BOX 3 – Assumptions used in drawing up an unchanged economic policies scenario

The scenario envisaging no change in the government's economic policies in 2011-2014 uses as a point of departure the 2011 general government balance cleaned of items presumed not to recur during the upcoming period (e.g. the value-added tax to be paid by the state in 2011 on account of the commissioning of three stages of the R1 expressway - a PPP project; the concessionaire will then pay the amount back to the state, resulting in a one-off increase in the general government's revenues and expenditures by EUR 150 million in 2011 only).

This adjusted balance will be used in 2012-2014 projections assuming the following:

- *No changes compared to current forecasts are assumed in the macroeconomic scenario except for the effects on interest rates of government securities;*
- *Tax revenues were projected without regard to changes in legislation that may be contemplated;*
- *Gross wage expenditures grow in line with projected average wage growth rate in the private sector;*
- *Expenditures on goods and services grow in line with the projected rate of inflation (inflation expressed as CPI) with the exception of expenditures where the development is already known (payments by the state for the availability of a PPP project - the R1 expressway);*
- *Expenditures on current transfers were divided into three groups: The first group comprises statutory expenditures subject to indexation set by legislation (e.g. old-age and disability pensions, state social benefits); the second group includes those assumed to grow in line with a projected rate of inflation (inflation expressed as CPI); and the third group represents transfers made to railway companies assuming the companies accumulate no more new debt;*
- *Interest expenditures on the general government debt are influenced by a higher general government deficit and by the fact that Slovak government securities earn a higher spread against the German ones compared to a situation where the fiscal objectives are fulfilled (macroeconomic projections predict a gradual decrease in the spread, whereas the unchanged policies scenario foresees a constant spread resulting from higher deficits);*
- *Capital expenditures were estimated in line with projected GDP growth except for projects where 2012-2014 expenditures are already known.*

TAB 13 – Unchanged policies scenario for 2012-2014 (ESA95, % of GDP)

	2011B	2012	2013	2014
TOTAL REVENUES	**33.3**	**31.7**	**31.1**	**30.4**
Tax revenue	**16.1**	**15.8**	**15.6**	**15.5**
Personal income tax	2.6	2.7	2.7	2.8
Corporate profit tax	2.5	2.7	2.8	2.8
Withholding tax on capital income	0.2	0.3	0.3	0.3
VAT	6.6	6.2	6.1	6.0
Excises	3.0	2.9	2.8	2.7
Import duties	0.0	0.1	0.0	0.0
Property tax and others	1.1	1.1	0.9	0.9
Social contributions	**11.9**	**11.7**	**11.5**	**11.3**

Non-tax revenue	**3.2**	**2.8**	**2.8**	**2.6**
Grants and transfers (mainly EU funds)	**2.1**	**1.4**	**1.2**	**1.0**
TOTAL EXPENDITURES	**38.2**	**36.5**	**36.0**	**35.0**
Current expenditure	**34.5**	**34.2**	**33.9**	**33.1**
Gross wages	6.2	6.1	6.0	5.9
Goods and services	10.5	10.5	10.0	9.2
- Health insurance companies	4.9	4.8	4.7	4.6
Subsidies and transfers	16.0	15.8	15.6	15.6
Interest	1.8	1.9	2.3	2.4
Capital expenditures	**3.7**	**2.4**	**2.1**	**1.9**
Capital assets	2.4	1.7	1.7	1.7
Capital transfers	1.3	0.6	0.4	0.2
GENERAL GOVERNMENT BALANCE	**-4.9**	**-4.9**	**-4.9**	**-4.6**
GENERAL GOVERNMENT PRIMARY BALANCE	**-3.1**	**-3.0**	**-2.6**	**-2.2**
p. m. GG balance - target	*-4.9*	*-3.8*	*-2.9*	*-2.8*
Primary GG balance - target	*-3.1*	*-2.0*	*-0.7*	*-0.6*

Note: B - General Government Budget for 2011-2013 *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 general government balance targets will simultaneously decrease interest payments compared to the unchanged policies scenario, it would be appropriate to compare primary balances. In view of the above, **measures will be necessary to improve the primary general government balance by a total of EUR 775 million in 2012, EUR 1,545 million in 2013 and EUR 1,411 million in 2014**.

TAB 14 – Comparison of unchanged policies scenario with the fiscal targets (ESA95, % of GDP)

	2012	2013	2014
1. Primary GG balance - target	-2.0	-0.7	-0.6
2. Primary GG balance - unchanged policies scenario	-3.0	-2.6	-2.2
Difference (1-2)	1.0	1.9	1.6
Difference (in EUR mill.)	**775**	**1,545**	**1,411**

Source: MF SR

III.3.2. Description and quantification of measures to attain fiscal objectives

In the preceding section the total amount of measures necessary to attain fiscal objectives was quantified. Taking into account this amount, the Government has drawn up the 2012-2014 General Government Budget Framework. The framework already included some of the proposed measures, and alternatives were suggested regarding the remaining portion of the necessary measures which will be discussed soon.

The budget framework incorporated the following expenditure side measures of the general government budget:

1. **Freezing wage expenditures except those on teachers**
   The general government budget framework preserves wage expenditures in 2012 at the 2011 budgeted level. An exception was made for teachers where wage expenditures are to grow by 3%. In 2013 wage expenditures of the state budget are to increase by 1% and in 2014 by 3% compared to 2012 level.

2. **Reducing operating expenditures**
   The general government budget framework aims to reduce the operating expenditures of the state budget by 5% compared to the 2011 budgeted level. The only exception was granted to the budgeting of payments towards the availability of the ongoing PPP project, the R1 expressway. Savings due to the consolidation measures were calculated compared to the standard development of operating

expenditures in 2011 and adjusted for inflation. The Government will consider taking into account specific reporting of capital expenditures in the Ministry of Defence.

3. **Reducing other core expenditures of the state**

Compared to the unchanged policies scenario, the positive implications of these measures for the general government balance total EUR 572 million (0.8% of GDP) in 2012, EUR 872 million (1.1% of GDP) in 2013 and EUR 1,245 million (1.4% of GDP) in 2014.

The 2012-2014 General Government Budget Framework also includes a 1 percentage point reduction of social contributions to be made by employees (compared to the present arrangements) in 2013 and 2014.

TAB 15 GG Budget Framework for 2012-2014 (ESA95, % of GDP)

	2011R	2012		2013		2014	
		level	diff.*	level	diff.*	level	diff.*
TOTAL REVENUES	**33.3**	**31.7**	**0.0**	**31.1**	**0.0**	**30.4**	**0.0**
Tax revenue	**16.1**	**15.8**	**0.0**	**15.6**	**0.0**	**15.5**	**0.0**
Personal income tax	2.6	2.7	0.0	2.7	0.0	2.8	0.0
Corporate profit tax	2.5	2.7	0.0	2.8	0.0	2.8	0.0
Withholding tax on capital income	0.2	0.3	0.0	0.3	0.0	0.3	0.0
VAT	6.6	6.2	0.0	6.1	0.0	6.0	0.0
Excises	3.0	2.9	0.0	2.8	0.0	2.7	0.0
Import duties	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Property tax and others	1.1	1.1	0.0	0.9	0.0	0.9	0.0
Social contributions	**11.9**	**11.7**	**0.0**	**11.5**	**0.0**	**11.3**	**0.0**
Non-tax revenue	**3.2**	**2.8**	**0.0**	**2.8**	**0.0**	**2.6**	**0.0**
Grants and transfers (mainly EU funds)	**2.1**	**1.4**	**0.0**	**1.2**	**0.0**	**1.0**	**0.0**
TOTAL EXPENDITURES	**38.2**	**35.7**	**-0.8**	**34.8**	**-1.2**	**33.4**	**-1.6**
Current expenditure	**34.5**	**33.5**	**-0.7**	**32.9**	**-0.9**	**31.7**	**-1.4**
Gross wages	6.2	5.9	-0.2	5.5	-0.4	5.2	-0.6
Goods and services	10.5	10.3	-0.2	9.9	-0.1	9.1	-0.2
- Health insurance companies	4.9	4.8	0.0	4.7	0.0	4.6	0.0
Subsidies and transfers	16.0	15.5	-0.3	15.3	-0.3	15.2	-0.4
Interest	1.8	1.8	0.0	2.2	-0.1	2.2	-0.2
Capital expenditures	**3.7**	**2.2**	**-0.1**	**1.9**	**-0.2**	**1.7**	**-0.3**
Capital assets	2.4	1.6	-0.2	1.5	-0.2	1.5	-0.3
Capital transfers	1.3	0.6	0.0	0.4	0.0	0.2	0.0
GENERAL GOVERNMENT BALANCE	**-4.9**	**-4.1**	**0.8**	**-3.7**	**1.2**	**-3.0**	**1.6**
GENERAL GOVERNMENT PRIMARY BALANCE	**-3.1**	**-2.2**	**0.8**	**-1.6**	**1.1**	**-0.8**	**1.4**

Note: B - General Government Budget for 2011-2013

** difference compared to the unchanged policies scenario*

Source: MF SR

After incorporating these measures into the 2012-2014 General Government Budget Framework, the total amount as a result of additional necessary measures significantly decreased.

TAB 16 Comparison of the 2012-2014 GG Budget Framework with the fiscal targets (ESA95, % of GDP)

	2012	2013	2014
1. Primary GG balance - target	-2.0	-0.7	-0.6
2. Primary GG balance - 2012-2014 GG Budget Framework	-2.2	-1.6	-0.8
Difference (1-2)	0.3	0.8	0.2
Difference (in EUR mill.)	**203**	**673**	**166**

Source: MF SR

The 2012-2014 General Government Budget Framework also proposes additional measures. The resulting amount exceeds what is necessary to achieve the fiscal objectives of 2012 and 2014. It should also be noted that the effect of some of these measures on the general government balance has not been quantified yet; it will only be ascertained later. As the general government budget is prepared, the measures listed in the table will be discussed further, making it possible for the Government to choose those deemed most appropriate in terms of attaining fiscal objectives and fulfilling priorities.

TAB 17 Potential consolidation measures for the 2012-2014 General Government Budget (ESA 95, EUR mill.)

		2012	2013	2014
A.	**Total expenditures**	**658.6**	**1,026.7**	**1,413.4**
1	Freezing wage expenditures except those on teachers (already in GG Budget Framework)*	165.0	349.9	553.7
2	Reducing operating expenditures (already in GG Budget Framework)*	119.3	79.6	138.7
3	Reducing other core expenditures of the state (already in GG Budget Framework)*	287.3	442.8	552.7
4	Reducing electronic toll payments	60.0	60.0	0.0
5	Change in the pension indexation mechanism	0.0	75.1	145.1
6	Reducing expenditures on state bonuses in building-society saving schemes	5.0	8.0	12.0
7	Refraining from insuring state assets by commercial insurance companies	2.0	2.0	2.0
8	Discontinuing the state budget transfer to the Press Agency of the SR	1.0	1.0	1.0
9	Lowering expenditures for regional schools for vaccination and rehabilitation purposes	19.1	8.2	8.2
10	Savings generated by investment stimuli compliance checks			
11	Reducing expenditures on the social security system of the armed forces			
12	Discontinuing certain budgetary and semi-budgetary organisations			
13	Streamlining levels of local administration			
	Total revenues (B+C+D)	**441.9**	**418.6**	**396.1**
B.	**State budget tax revenues**	**134.4**	**163.8**	**163.5**
14	Corporate income tax – uniform treatment of depreciation (monthly depreciation)	50.2	72.7	72.1
15	Introducing bank levy for financial institutions	40.0	40.0	40.0
16	Excise tax on beer – increasing tax rate	8.2	14.1	14.4
17	Excise tax on wine – increasing tax rate on still wine	20.0	21.0	21.0
18	Increasing revenues from gambling levies	16.0	16.0	16.0
C.	**Revenues of local governments**	**147.5**	**154.9**	**162.6**
19	Real estate tax - increasing tax rate by 50%	147.5	154.9	162.6
D.	**Improving financial management of state-owned assets**	**160.0**	**100.0**	**70.0**
20	Sale of Kyoto CO_2 quotas	50.0	0.0	0.0
21	Auctions of European CO_2 allowances	0.0	10.0	10.0
22	Increasing National Nuclear Fund revenues	20.0	20.0	20.0
23	Increasing Slovak Land Fund revenues from lease of agricultural land	2.0	2.0	2.0
24	Increasing Slovak Land Fund revenues from sale of land	3.0	3.0	3.0
25	Increasing dividends received from Transpetrol a. s.	15.0	15.0	15.0
26	Increasing dividends received from JAVYS a. s.	40.0	30.0	0.0

27	Improving performance and increasing amounts levied on š. p. Lesy	10.0	10.0	10.0
28	Improving performance and increasing amounts levied on š. p. Vodohospodárska výstavba	10.0	10.0	10.0
29	Revenue from renewing licences granted to mobile network operators	10.0	0.0	0.0
30	Revenues from leasing M. R. Štefánik Airport in Bratislava to strategic investor			
	Total impact of measures (A+B+C+D)	**1,100.5**	**1,445.3**	**1,809.5**
	- in % of GDP	**1.46**	**1.78**	**2.07**
	Measures not included in the GG Budget Framework	**529.0**	**572.9**	**564.3**
	- in % of GDP	**0.70**	**0.71**	**0.65**

*Note: * the table in the Stability Programme shows the impacts of these measures on the whole general government compared to the table presented in the General Government Budget Framework for 2012-2014 which shows only the impacts on the state budget*

Source: MF SR

In addition to the expenditure measures already incorporated in the 2012-2014 General Government Budget Framework (Measures 1 to 3), the following expenditures side measures are considered:

4. Reducing electronic toll payments

The National Motorway Company pays annually EUR 105 million for the construction and operation of the electronic toll system completed in 2009, of which EUR 41 million covers operating costs and EUR 64 million constitutes a payment for the capital expenditures incurred by the concessionaire in connection with the construction of the toll system; the latter payment is to be made annually in 2010 to 2013. The government will be seeking to propose a new capital expenditures payment schedule.

5. Change in the pension indexation mechanism

An arrangement for the adjustment of pension benefits is provided for in Section 82 of Act 461/2003 Coll. on social insurance as amended. Under the current wording of the law, pension benefits are increased on January 1 of the relevant calendar year by the percentage calculated as the sum of half of the percentage of the year-on-year increase in consumer prices and half of the percentage of the year-on-year growth of average wages in the Slovak economy as reported by the Statistical Office for the first six months of the calendar year preceding the relevant calendar year.

It is proposed that pension benefits be increased as of January 1 of the relevant calendar year by the percentage of the year-on-year increase of pensioners' consumer prices (pensioners' inflation) as reported by the Statistical Office for the first six months of the calendar year preceding the relevant calendar year. Accident benefits are to be adjusted by the same percentage as pension benefits.

6. Reducing expenditures on state bonuses in building-society saving schemes

On March 9, 2011, the Government approved a document "Proposed Changes in Funding Housing Support in the SR" and adopted a decision requiring that the Ministry of Finance submit, no later than on June 30, 2011, specific proposals for changes in legislation that regulates funding in this sector. New building-society savings legislation will be enacted and will come into effect no later than on January 1, 2012 in order to streamline state support and the building society savings scheme (some provisions regarding charges and levies will come into force on November 1, 2011). An important change will be to make the payment of state bonuses conditional on building societies cutting fees currently charged to customers. Another measure imposes constraints on the entitlement to state bonuses of natural persons participating in building-society saving schemes while drawing and repaying commercial bridging loans.

7. Refraining from insuring state assets by commercial insurance companies

In resolution 171/2011 the Government approved the "Proposal for a Systemic Solution Regarding the Coverage of State Assets in Commercial Insurance Companies", reflecting the need for a future systemic solution concerning the option of coverage of state assets by commercial insurance companies.

In preparing the 2012-2014 General Government Budget, the Ministry of Finance will cut 70% of the amounts actually spent by relevant state budget chapters in 2010 on insuring state assets and reallocate these amounts to the reserves.

The remaining amounts, i.e. 30% of the actual 2010 expenditures by the relevant chapter on insuring state assets, will be set aside in state budget chapters. It should be noted that those expenditures were substantially greater than the annual insurance settlement revenue over the past five years with the average rate of return being merely 20.7% of insurance spending.

8. **Discontinuing the state budget transfer to the Press Agency of the SR**
Under a service provision in the public interest agreement concluded in accordance with Section 6 of the Press Agency of the Slovak Republic Act, the Agency has been receiving an annual transfer from the state budget. It is proposed that the transfer be discontinued, so that the Agency can operate in a competitive environment like any other agency in a similar line of business.

9. **Lowering expenditures earmarked for regional schools for vaccination and rehabilitation purposes**
Act 317/2009 Coll. on teachers and professional employees in schools provides, effective as of January 1, 2012, for new care entitlements intended for teachers and other professionals employed in schools. The care entitlements include recuperation and therapy holidays as well as vaccination against hepatitis A and B. The total positive effects of the measure represent EUR 8.2 million a year as a result of discontinuing recuperation and therapy holidays as well as savings on account of discontinuing entitlements to vaccination against hepatitis A and B, totalling EUR 10.9 million every ten years.

10. **Savings generated by investment stimuli compliance checks**
Substantial amounts have been made available in the form of financial incentives to encourage investments as a source of boosting employment. Hence the need for consistent compliance checks of commitments assumed by investors. Any amounts generated as a result of compliance checks could be used to provide new incentives to new investors.

11. **Reducing expenditures on the social security system of the armed forces**
With the aim to ensure a just and sustainable fulfillment of legitimate pension provision claims of armed forces, the Government shall narrow the range of eligible recipients by further shifting a part of the armed forces to the civil sector. The Government will prepare a system reform that will affect newly admitted officers once the changes become effective.

12. **Discontinuing certain budgetary and semi-budgetary organisations**
In accordance with Task B.1 of Government Resolution 805/2010 of 17 November 2010, budget chapter administrators were asked to analyse the activities they oversee, including those performed by organisations reporting to them, and to draft a proposal for narrowing the scope of such activities. A relevant document was to be presented to the Government for deliberation before the end of February 2011. Although budget chapter administrators did submit required documents, their conclusions did not offer specific recommendations or quantify possible savings. In the upcoming months the Ministry of Finance will be holding discussions with all budgetary chapters concerning suggested austerity measures and will reflect the outcome in their draft of the state budget.

13. **Streamlining levels of local administration**
One of the measures suggested in the document describing proposals to streamline public sector functioning envisages adjustments in the structure of state administration performed at the local level. The structure of the administration should reflect its powers and responsibilities. In accordance with the government's Resolution concerning the relevant document, the Minister of Interior is to analyse documentation submitted by the agencies in question and to propose, by the end of June 2011, measures identifying possible savings.

Consideration is also being given to measures to increase general government budget revenues, including tax and non-tax revenues:

14. Corporate income tax - uniform treatment of depreciation (monthly depreciation)
Depreciation for tax purposes will no longer be done on an annual basis. Instead, assets will be depreciated on a monthly basis, similar to the procedure used for accounting purposes. Depreciation for tax purposes of assets acquired by way of financial leasing will be done using the same procedure as the one applied to other forms of acquiring tangible assets.

15. Introducing bank levy for financial institutions
Bank levy will be assessed on banks' total liabilities net of the banks' own capital and deposits protected under the deposits insurance scheme in accordance with Act 118/1996 Coll. on deposits protection. Banks will not be required to pay contributions from their own capital nor customer deposits in respect of which they are contributing to the Deposits Protection Fund. It is proposed that the levy be set at 0.2% of eligible liabilities.

16. Excise tax on beer - increasing tax rate
This proposal is based on the final recommendations made in 2010 that the excise tax rate be adjusted as follows:
- excise tax base rate of EUR 2.10/degree/Plato
- reduced excise tax rate applied to beer produced in small breweries in quantities of up to 100 000 hl at EUR 1.50/degree/Plato
- reduced excise tax rate applied to beer produced in small breweries in quantities of 100 000 hl to 200 000 hl at EUR 1.80/degree/Plato

17. Excise tax on wine - increasing tax rate on still wine
It is proposed that the rate of excise tax on still wine be increased from EUR 0/hl to EUR 33/hl. Introducing a positive rate of tax on still wine will partially eliminate discrimination in the tax treatment of alcoholic beverages. The same rate of taxation will be applied not only to locally produced wines but also to wines imported to Slovakia from other countries. Any adverse implications for local wine producers could be eliminated by better use of EU funds, i.e. operational programmes to support winegrowers and wine producers.

18. Increasing revenues from gambling levies
It is proposed that some terms and parameters of certain types of gambling be amended. More specifically, the rates and levies on lotteries, fixed-odds betting and videogames will be raised.

19. Real estate tax - increasing tax rate by 50%
In 2012 the shared tax income received by local governments will be decreased by an amount corresponding to a 50% increase in the real estate tax rate. Thus local governments will be receiving less money from the state. If they move to increase real estate tax by 50%, the impact on local governments will be neutral.

20. Sale of Kyoto CO_2 quotas
At present the Slovak Republic holds approximately 27 million tonnes of emission quotas that can be sold on the emission quotas market. Experts are discussing the possibility of selling the quotas; however, no information is available currently regarding pricing and quantities to be sold in the immediate future.

21. Auctions of European CO_2 allowances
Beginning in 2013, a new method of allowance allocation will be applied as described in Directive 2009/29/EC of the European Parliament and the Council amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community. The key change consists in the fact that allowances will be allocated with a view to the quantity of products produced. Emission allowances that companies will not receive for free, and which will have to be returned to the allowances register after their emission reports have been authenticated, will have to be bought at auctions.

22. Increasing National Nuclear Fund revenues
The decommissioning of nuclear facilities will place an enormous burden on Slovakia's public finances. The Fund is therefore trying to ensure that the its revenues and expenditures evolve in a way that will in the long run accumulate adequate funding for the final stage of the nuclear energy sector.

23. Increasing Slovak Land Fund revenues from lease of agricultural land
The Slovak Land Fund (SLF) manages the state's assets, the assets of unknown owners and leases those assets in accordance with applicable law. The revenues from the lease of assets managed by the SLF constitute SLF revenues; it is necessary to take steps to increase revenues from the lease of agricultural land.

24. Increasing Slovak Land Fund revenues from sale of land
The SLF manages the state's assets, the assets of unknown owners and sells those assets in accordance with applicable law. The revenues from the sale of assets managed by the SLF except those from the land of unknown owners constitute SLF revenues; it is necessary to take steps to increase revenues from the sale of such assets.

25. Increasing dividends received by the Ministry of the Economy - Transpetrol a. s. (crude oil transportation company)
In March 2004, following an preliminary injunction of the Supreme Court of the SR, the company was ordered to suspend the payment of dividends to shareholders. In 2009 the Slovak Republic bought back 49% of the shares from Yukos International UK B. V. and became the sole owner of 100% shares of the company held by the Ministry of the Economy. Earlier this year the Supreme Court revoked the injunction, allowing the payment of dividends. The budget framework does not envisage any revenue from dividends to be paid by the company.

26. Increasing dividends received by Ministry of the Economy - JAVYS a. s. (nuclear and decommissioning company)
The Government will take steps to streamline the operations of the company so as to generate revenue from dividends.

27. Improving performance of, and increasing amounts levied on, š. p. Lesy (state forest management company)
It is necessary to take measures to improve company operations and increase profitability so as to generate state budget revenues from profit levies.

28. Improving performance of, and increasing amounts levied on, š. p. Vodohospodárska výstavba (state construction company)
It is necessary to take measures to improve company operations and increase profitability so as to generate state budget revenues from profit levies.

29. Revenue from renewing licences granted to mobile network operators
In mid-2011 the validity of licences granted to two mobile network operators expires. In this connection it is expected that revenue will be generated as the licences of these network operators in the Slovak Republic are renewed.

30. Revenues from leasing M. R. Štefánik Airport in Bratislava to strategic investor
The Government has tasked the Minister of Transport, Construction and Regional Development to provide for Bratislava airport development by granting a concession to a strategic partner in an international tender. The winning bidder will be required to pay an annual licence fee for the concession, and the licence fee amount will be determined in the tender.

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 need for public finance consolidation in Slovakia has become even more pressing in view of the fiscal position deteriorating in 2009-2010 due to a combination of effects exerted on public finances by the economic crisis and an expansionary fiscal policy, prompting the government to define ambitious medium-term consolidation objectives.

The consolidation effort describes the path the government plans to take in order to meet its medium-term objective. The consolidation effort as presented in this document takes into account, in addition to the cyclical component of the budget and one-off effects, the costs associated with the launch of the fully-funded (named also as the 2nd pillar of pension system) pension pillar as an important structural reform contributing to the long-term sustainability of public finance, as well as the impact of interest payments. Box 4 describes an alternative method which, in addition to the factors described earlier, takes account of other effects, such as the economic crisis and items outside the general government balance.

TAB 18 – Consolidation effort between 2009 and 2014 (ESA95, % of GDP)

	2009	2010	2011	2012	2013	2014
1. Net lending / net borrowing	**-8.0**	**-7.9**	**-4.9**	**-3.8**	**-2.9**	**-2.8**
2. Cyclical component	-1.4	-0.6	-0.5	-0.4	-0.2	0.1
3. One-off measures	0.0	-0.3	0.1	0.2	0.1	0.0
- exit from the 2nd pillar of pension scheme	0.2	-	-	-	-	-
- stockpiling - excise taxes	-0.2	-	-	-	-	-
- expenditures related to floods	-	-0.2	-	-	-	-
- remission of receivables towards non-financial corporations	-	-0.1	-	-	-	-
- tax on excess emission allowances	-	-	0.1	0.1	-	-
- lower payments for electronic toll system	-	-	-	0.1	0.1	-
4. Implementation of the 2nd pillar of pension scheme	-1.3	-1.2	-1.2	-1.2	-1.2	-1.2
5. Interest payments	-1.4	-1.3	-1.8	-1.8	-2.2	-2.2
6. Cyclically adj. prim. balance net of one-offs and 2nd pillar (1-2-3-4-5)	**-3.8**	**-4.4**	**-1.4**	**-0.5**	**0.6**	**0.5**
Consolidation effort	**-4.3**	**-0.6**	**3.0**	**0.9**	**1.1**	**0.0**

(+ tightening, - loosening of fiscal policy)
2011 - approved budget, 2012-2014 - GG Budget 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 swings in economic activity. The Ministry of Finance has taken the sensitivity of the general government balance to changes in the output gap in full from European Commission estimates made using OECD methodology[7].

The second item comprises one-off and temporary measures taken by the government. In the period of 2009 to 2014 six one-off effects were identified:

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

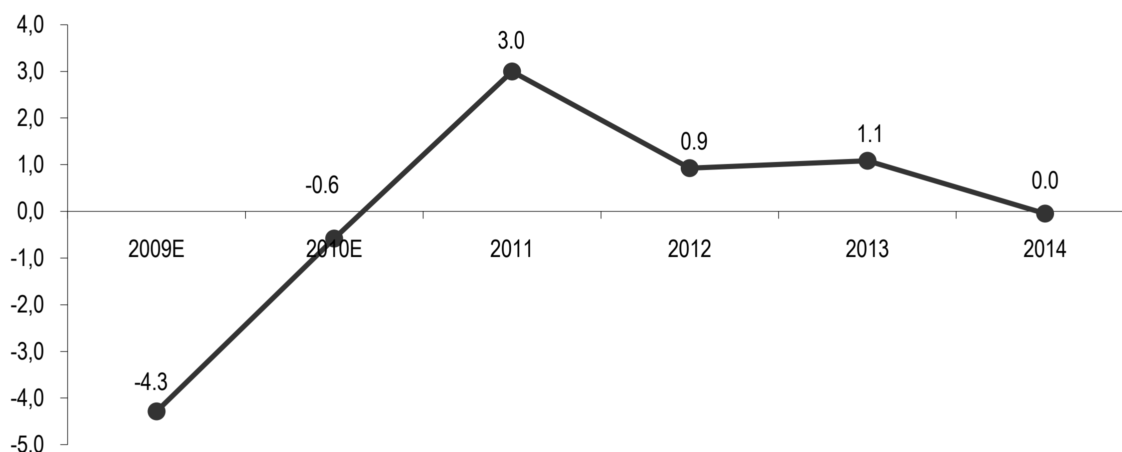
- The first factor was the decision to enable the entry into, and exit from, the 2nd pillar of the pension system during the period from November 15, 2008 to June 30, 2009. It means that if a pension saver decided to exit the 2nd pillar, the move was accompanied by the transfer of their savings from the fully-funded to the pay-as-you-go scheme. All assets accrued since their entry to the 2nd pillar were transferred, a portion of which, attributable to previous years, represented a one-off component. On that account, a one-off increase amounting to 0.2% of GDP occurred in 2009 in general government revenues.
- The second factor reflected the stockpiling effect in connection with increasing excise tax on tobacco, which occurred in February 2009. A stockpiling effect means that in the last months prior to the effective date of new tax rates, a large quantity of tobacco products subject to original tax rates are released into circulation and continue to be sold in the period following the effective date for new tax rates. This also results in one-off fluctuations in tax revenues which are not matched by variations in the final consumption of these products.
- The third effect reflects the floods that affected Slovakia in 2010. State budget spending on dealing with the aftermath of the floods amounted to 0.2% of GDP.
- The fourth factor is the remission of receivables towards non-financial entities amounting to 0.1% of GDP. They concern receivables of state from called guarantees and loans provided to companies that went bankrupt in the past years (the majority of them occurred in the 90´s of the previous century).
- The fifth factor represents the temporary application of tax on excess emission allowances levied on the transfer and holding of excessive CO_2 emission allowances in 2011-2012. This tax is projected to generate a one-off increase in general government revenues amounting to 0.1% of GDP each year.
- The last factor is the reduction of payments by the state for the electronic toll system. The plan is to decrease on a one-off basis payments towards recouping the capital expenditures of the concessionaire in connection with building the toll system in the amount of 0.1% of GDP in 2012 and 2013. Repayment of those expenditures will be shifted into the years not covered by the Stability Programme.

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. In 2009 pension reform costs totalled 1.3% of GDP, and the costs included transfers (due to people leaving the 2nd pillar) of the funds of pension savers accrued during the current year. They did not, however, incorporate the transfer of pension savers' funds accrued over previous years. Since this was a one-off transfer, it is reported among one-off effects. In the period between 2010 and 2014 these costs are equally estimated at 1.2% of GDP.

The last, 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 next graph clearly shows that expansionary fiscal policy in 2009 and 2010 will be followed by marked consolidation, notably in 2011. In the medium term, the consolidation effort will go beyond consolidation effort recommendations and in 2011 to 2014 will annually amount to 1.2% of GDP on average.

GRAPH 17 – Consolidation effort between 2009 and 2014 (% of GDP)



Source: MF SR

BOX 4 – Alternative method for calculating consolidation effort

In the opinion of the Ministry of Finance, the standard procedure used to calculate the consolidation effort fails to capture all factors affecting Slovakia's fiscal policy. In addition to the permanent effect of the economic crisis on potential output and thus on the general government balance, public finances are also influenced by items that, though not reflected in the general government balance, nevertheless constitute instruments of fiscal policy implementation. For this reason the balance used to calculate the consolidation effort should besides standard factors comprise the following items:

- ***Construction of motorways and expressways outside the general government balance –*** *this includes the effects of the PPP projects and motorway construction projects overseen by the National Motorway Company which does not constitute part of the general government sector. PPP projects typically feature a time mismatch between project implementation and an adverse impact on the general government balance in the form of payments made by a general government entity. 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. The general government balance used to calculate the consolidation effort should therefore be adjusted at the time of PPP project implementation rather than corresponding payments. With regard to the National Motorway Company, account should be taken of the financing of motorway construction through loans and following repayments of principal. The accumulation of the National Motorway Company debt as well as its repayments should be reflected in the consolidation effort despite the fact that the corresponding entity is classified outside the general government. The main reason is the fact that the government uses the this company to build up the motorways infrastructure.*

- ***Effects of the economic crisis on the general government's structural balance*** *– the economic crisis has resulted in a slowdown of potential output. Compared to a no-crisis scenario, there has been a permanent loss of potential output with adverse implications for the general government's structural balance. This impact can be estimated using the sensitivity coefficient of the general government balance to economic developments in a fashion similar to calculations of the cyclical component. Since this is a one-off effect on the Slovak economy, adjusting the balance for the crisis implications facilitates data comparison over the entire period.*

Allowing for all these factors, the consolidation effort in 2009 to 2014 would be as follows:

Alternative consolidation effort between 2009 and 2014 (ESA95, % of GDP)

	2009	2010	2011	2012	2013	2014
1. Net lending / net borrowing	**-8.0**	**-7.9**	**-4.9**	**-3.8**	**-2.9**	**-2.8**
2. Cyclical component	-1.4	-0.6	-0.5	-0.4	-0.2	0.1
3. One-off measures	0.0	-0.3	0.1	0.2	0.1	0.0
4. Implementation of the 2nd pillar of pension scheme	-1.3	-1.2	-1.2	-1.2	-1.2	-1.2
5. Interest payments	-1.4	-1.3	-1.8	-1.8	-2.2	-2.2
6. Highway construction outside the GG balance sheet	0.3	0.6	0.3	-0.1	-0.2	-0.2
- construction costs of PPP project	0.3	0.7	0.4	0.0	-	-
- availability payments for the PPP project	-	-	0.0	-0.1	-0.2	-0.1
- new loans taken by the NHO	0.1	-	-	-	-	-
- repayment of principal by the NHO	-0.1	-0.1	-0.1	0.0	0.0	0.0
7. Impact of the crisis on GG structural balance	-2.2	-3.4	-4.1	-4.4	-4.7	-4.9
8. Cyclically adj. balance net of other factors (1-2-3-4-5-6-7)	**-1.9**	**-1.6**	**2.4**	**4.0**	**5.4**	**5.6**
Consolidation effort	**-3.4**	**0.3**	**4.0**	**1.7**	**1.4**	**0.2**

(+ tightening, - loosening of fiscal policy)
2011 - approved budget, 2012-2014 - GG Budget Framework
Source: MF SR

The final shape of fiscal policy is somewhat different; notably as a result of the permanent loss of potential output due to the economic crisis, the budgetary objectives for 2011 to 2014 appear to be much more ambitious compared to the standard approach used to calculate the consolidation effort. According to this calculation method, the average annual consolidation effort in 2011-2014 will be as much as 1.8% of GDP.

The second part of this section discusses the fiscal impulse which 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 additional items that further specify the effects of fiscal policy on aggregate demand. They include financial links to the EU budget and the effects of motorway and expressway construction carried out outside the general government balance (the PPP project and expenditures of the National Motorway Company).

Financial links to 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 the expenditure sides).

The PPP project being implemented in the form of the R1 expressway represents an expansionary impulse. The project has been included in the fiscal impulse calculation as it will have implications for the economy at the time of its construction; however, it will only be reflected in the general government balance later as regular payments are made in respect of deliverables. This means that even though regular payments made in respect of project availability will have an adverse impact on the general government balance, they will not influence aggregate demand. Therefore, calculations are carried out with a view to the net effect of the PPP project, including the stage of construction and payments[8].

The fiscal impulse should also include the National Motorway Company's spending on motorway and expressway construction funded by borrowings less loan repayments. Despite the fact that it is classified outside the general

[8] Availability payments include reimbursements of costs incurred during the construction and costs connected with the maintenance of roads in the relevant period as well. This means that a certain portion of availability payments affects aggregate demand. Since, however, maintenance costs only account for a relatively small portion of overall availability payments, calculations do not take this impact into consideration.

government sector, the government is using the company to build up the motorways infrastructure, thus affecting aggregate demand.

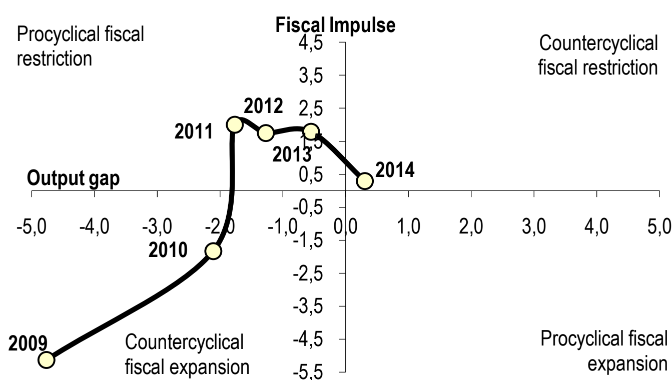
TAB 19 – Fiscal impulse (ESA 95, % of GDP)

	2009	2010	2011	2012	2013	2014
1. Net lending / net borrowing	**-8.0**	**-7.9**	**-4.9**	**-3.8**	**-2.9**	**-2.8**
2. Cyclical component	-1.4	-0.6	-0.5	-0.4	-0.2	0.1
3. One-off measures	0.0	-0.3	0.1	0.2	0.1	0.0
4. Implementation of the 2nd pillar of pension scheme	-1.3	-1.2	-1.2	-1.2	-1.2	-1.2
5. Interest payments	-1.4	-1.3	-1.8	-1.8	-2.2	-2.2
6. Cyclically adj. prim. balance net of one-offs and 2nd pillar (1-2-3-4-5)	**-3.8**	**-4.4**	**-1.4**	**-0.5**	**0.6**	**0.5**
7. Financial links to the EU budget	1.2	2.1	3.4	3.0	2.4	2.0
8. Construction of highways outside the GG balance sheet	0.3	0.7	0.3	-0.1	-0.2	-0.1
- construction costs of PPP project	0.3	0.7	0.4	0.0	-	-
- availability payments for the PPP project	-	-	0.0	-0.1	-0.2	-0.1
- new loans taken by the NHO	0.1	-	-	-	-	-
- repayment of principal by the NHO	-0.1	-0.1	-0.1	0.0	0.0	0.0
9. Aggregate balance including the EU effect and highways (6-7-8)	**-5.3**	**-7.2**	**-5.2**	**-3.4**	**-1.6**	**-1.3**
10. Fiscal impulse (+ restriction, - expansion)	**-5.1**	**-1.8**	**2.0**	**1.8**	**1.8**	**0.3**
p. m. Output gap	*-4.8*	*-2.1*	*-1.8*	*-1.3*	*-0.6*	*0.3*

Note: 2011 - approved budget, 2012-2014 - GG Budget Framework *Source: MF SR*

In 2011-2013 the government will be pursuing a restrictive and pro-cyclical fiscal policy, notably reflecting the vigorous fiscal consolidation (in response to the size of the deficit and the strain on the bonds market in the euro area) while gradually closing the negative output gap. Beginning in 2012, developments will also be influenced by deceleration of EU funds disbursements, as available financing allocated for the 2007-2013 programming period is gradually exhausted.

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



Source: MF SR

III.5. General government debt and its development

General government deficits projected for 2011-2014 will also be reflected in the gross debt. **The gross general government debt will grow from 41.0% of GDP at the end of 2010 to 45.3% of GDP at the end of 2012, while declining moderately close to 45% of GDP at the end of the forecast period**. During the entire period the general government debt will be significantly below the corresponding reference value of the Treaty. **At the end of the forecast period, the net debt of the general government will be 41.2% of GDP.**

TAB 20 – General government debt development between 2009 and 2014

		2009	2010	2011	2012	2013	2014
Gross debt (EUR mill.)		**22,331**	**26,998**	**30,971**	**34,083**	**36,729**	**39,576**
Gross debt (% of GDP)	(1)	**35.4**	**41.0**	**44.1**	**45.3**	**45.3**	**45.2**
Change in gross debt (p.p.)		7.6	5.5	3.2	1.1	0.0	0.0
growth in nominal GDP		1.7	-1.5	-2.5	-3.0	-3.3	-3.3
primary balance		6.5	6.6	3.1	2.0	0.7	0.6
interest payments		1.4	1.3	1.8	1.8	2.2	2.2
stock-flow adjustment		-2.1	-0.8	0.7	0.3	0.4	0.5
Liquid financial assets (% of GDP)	(2)	2.4	3.4	3.7	3.8	4.0	4.1
Net debt (% of GDP)	(1-2)	**33.0**	**37.6**	**40.4**	**41.4**	**41.3**	**41.2**
p.m. Implicit interest rate (%)		*4.9*	*4.0*	*4.7*	*4.5*	*5.2*	*5.2*

Source: MF SR

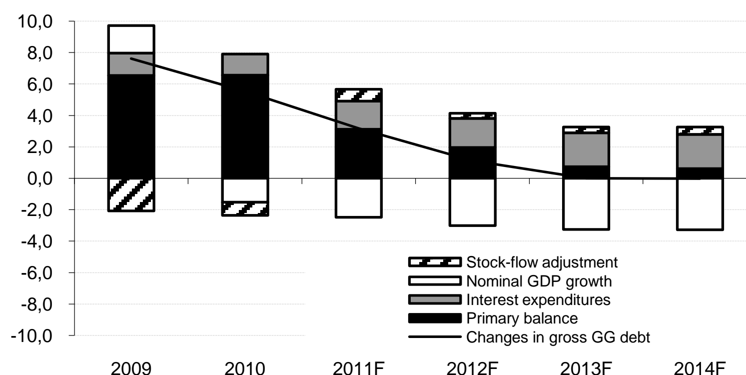
In nominal terms, the gross debt general government rose by EUR 4,667 million in 2010, the state debt being the principal contributor and increasing by EUR 4,462 million year-on-year. Also in the general government sector, the debt of municipalities increased by EUR 177 million and that of self-governing regions went up by EUR 27 million.

In the next few years the evolution of debt will be primarily influenced by the state budget cash deficit. As regards other general government entities, the largest contribution to increasing the debt will be made by credit facilities taken by municipalities and self-governing regions to implement their investment plans.

Debt projections envisage a stable level of borrowings from the State Treasury used to finance the debt with relatively small year-on-year fluctuations. At the same time, the projection does not take into account potential proceeds from the privatisation of enterprises with state equity participation. Those revenues will likely be used to reduce the debt accumulated by hospitals, railway companies, the Slovak Radio and Television and to make a cash contribution to the European Stabilisation Mechanism.

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, ranging in the forecast period between 0.3 and 0.7% of GDP. The only factor contributing since 2010 to a lower debt-to-GDP ratio has been nominal GDP growth, which in the course of 2013 and 2014 will fully offset the other previously mentioned adverse factors.

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



Source: MF SR

In 2011-2014, the value of the stock-flow adjustment will be influenced by differences between the cash-based and accrual methodology, with respect to the tax revenues and interest payments in particular. Another factor is the net increase in financial assets, notably in the form of the positive cash balances held by other general government entities. Since more than 99% of the gross general government debt is denominated in EUR, the forecast does not account for the impact of exchange rate fluctuations.

TAB 21 – Stock-flow adjustment (% of GDP)

	2010	2011	2012	2013	2014
Stock-flow adjustment	**-0.8**	**0.7**	**0.3**	**0.4**	**0.5**
Differences between cash and accruals	-1.1	0.1	0.1	-0.2	0.0
Net accumulation of financial assets	0.3	0.6	0.2	0.6	0.5
Appreciation (+) /depreciation (-) of foreign currency debt	0.0	0.0	0.0	0.0	0.0
Other	0.0	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 alternative scenarios based on simulations involving a faster recovery of the external economy, higher oil prices and higher ECB interest rates.

IV.1. Alternative scenarios and risks

Scenario 1. Faster recovery of the external economy

The scenario simulates a faster recovery of Slovakia's trading partners which should translate itself in faster Slovak exports growth. In 2011 the simulation envisages an additional increase in real foreign demand on the part of Slovakia's trading partners by 1 percentage point compared to the baseline scenario.

Improved profitability of export-oriented companies will accelerate the growth of investment (driven by the generally higher foreign demand and the resulting need to build new production capacities) and employment growth. This will be reflected in mounting household consumption and, together with higher investment growth, contribute to speeding up the rate of overall economic performance. Rising domestic demand and lower unemployment will increase inflationary pressures; however, their effects, and the impact on interest rates, will be minimal. Faster consumption and investment growth will boost imports, offsetting faster exports. Thus, the overall effect on the current account balance will be neutral. As the reference base rises, 2012 should see a lower rate of inflation and GDP growth compared to the baseline scenario.

TAB 22 – Scenario 1 – Acceleration of foreign demand growth by 1 p. p. in 2011
Cumulative change of parameters compared to baseline scenario in p. p.

	Households' consumption	Gross fixed investments	GDP	Unemployment rate	CPI	Short-term interest rates	CA balance (% of GDP)	GG balance (% of GDP)
2011	0.1	0.2	0.2	-0.1	0.0	0.0	0.0	0.1
2012	0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
2013	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
2014	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: MF SR

Scenario 2. Higher oil prices

This scenario takes account of the negative risks associated with higher oil prices in 2011, which in early April were at their highest in 2.5 years (USD 123/barrel). However, geopolitical developments in the Arab world, together with the ongoing recovery of global demand, increase the risk that the observed oil price increase may not be definitive. At present it is already evident that in 2011 oil prices will most probably be higher than USD 95.5/barrel assumption originally used by the Ministry of Finance in their projections. Therefore, the scenario envisages an increase in oil prices to the tune of USD 30/barrel in 2011. The USD/EUR exchange rate will remain unchanged compared to the baseline scenario.

The immediate result of the rise in oil prices would be an increase in the prices of fuel and gas and, subsequently, in household heating bills. The impact of this shock on inflation would be most visible at the beginning of the reference period. Since the price of oil influences the global economy, the simulation results take into account the general context of the economic development of the Slovak Republic within the global economy (using a multi-country model).

A global increase in inflation due to rising oil and oil product prices would prompt a higher prime interest rate in the euro area. Higher inflation would cause a reduction in real income in the short term and, in combination with

higher interest rates, would contribute to reducing household consumption. At the same time, higher interest rates would slow down investment growth. The overall slowdown of the real economy would lead to higher unemployment. An economic downturn resulting from the price shock and from declining demand from our trading partners would also have an adverse effect on the current account deficit and the general government balance. In the years to come, the performance of the economy will continue to grow but will remain below the baseline scenario by the end of the reference period.

TAB 23 – Scenario 2 – Oil price increase by 30 USD in 2011
Cumulative change of parameters compared to baseline scenario in p. p.

	Households' consumption	Gross fixed investments	GDP	Unemployment rate	CPI	Short-term interest rates	CA balance (% of GDP)	GG balance (% of GDP)
2011	-1.6	-1.7	-0.5	0.1	1.6	3.0	-1.6	-0.4
2012	-0.7	-1.0	-0.5	0.4	0.6	2.5	-1.0	-0.3
2013	-0.5	0.6	-0.2	0.5	0.4	2.5	-1.2	-0.2
2014	-1.0	-0.6	-0.2	0.5	0.9	3.6	-1.0	-0.2

Source: MF SR

Scenario 3. Increased interest rates

At present the rate of inflation in euro area countries is above the ECB inflation target, and the inflation growth has to a large extent been caused by cost factors (food and commodity prices). As a result, the ECB has resorted to increasing their key interest rate by one-fourth of a percentage point to 1.25%. Given concerns that oil prices may grow still further, the ECB is expected to continue tightening monetary policy this year. In 2011 the risk scenario therefore reckons with a simulated 1 percentage point increase in the ECB prime lending rate above the baseline scenario level.

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 general 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 24 – Scenario 3 – Increase of 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-term interest rates	CA balance (% of GDP)	GG interest payments (% of GDP)	GG balance (% of GDP)
2011	-0.2	-0.6	-0.2	-0.2	0.7	0.2	0.1	-0.2
2012	-0.2	-0.1	-0.2	-0.1	0.3	0.2	0.1	-0.2
2013	-0.1	0.1	-0.1	0.0	0.2	0.1	0.0	-0.1
2014	0.0	0.0	-0.1	-0.1	0.1	0.0	0.0	-0.1

Source: MF SR

IV.2. Comparison with the previous update

Stability Programme of the Slovak Republic for 2011-2014 comprises updated macroeconomic and fiscal objectives. Compared to last year's update of January 2010, fiscal indicators such as the general government debt and balance have deteriorated. These changes are clarified in chapter III.

TAB 25 – Comparison between the previous forecast and the updated forecast

	ESA code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
Real GDP growth (%)						
Previous update*		1.9	4.1	5.4	-	-
Current update		4.0	3.4	4.8	4.8	4.8
Difference		2.1	-0.7	-0.6	-	-
General government net lending (% of GDP)	EDP B.9					
Previous update*		-5.5	-4.2	-3.0	-	-
Current update		-7.9	-4.9	-3.8	-2.9	-2.8
Difference		-2.4	-0.7	-0.8	-	-
General government gross debt (% of GDP)						
Previous update*		40.8	42.5	42.2	-	-
Current update		41.0	44.1	45.3	45.3	45.2
Difference		0.2	1.6	3.1	-	-

*Note: * Stability Programme of the Slovak Republic for 2009 - 2012* *Source: MF SR*

V. SUSTAINABILITY OF PUBLIC FINANCE

In 2009 the Slovak Republic was included among the worst countries in terms of long-term sustainability of public finance by European Commission. To reach the sustainability, Slovakia should immediately and permanently decrease the general government deficit by almost 10% of GDP (based on the so-called S2 indicator). If no measures were adopted, government debt would reach 778% of GDP in 2060 (EUR 513 billion in 2010 prices). Fulfilling the goal to decrease the general government deficit below 3% of GDP in 2013 would decrease the need for further improvements by 4.3 percentage points to 5.6% of GDP. Additional progress toward public finances sustainability would be accomplished by reforming the pension system (decrease of S2 indicator by additional 3.9 percentage points). Achieving the consolidation targets in 2013 in combination with the pension reform will reduce the sustainability gap to 1.7% of GDP. This creates opportunity for the next government to permanently resolve the negative impacts of demographic trends on public finances with relatively mild improvements of the general government balance.

V.1. Policy strategy

The long-term sustainability of public finance 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. Carrying out a policy of high deficits and debts automatically means requiring future generations to pay the costs - usually through higher taxes.

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 7.9% of GDP in 2010 is therefore the central medium-term objective of fiscal policy. The approved General Government Budget for 2011-2013 and the General Government Budget Framework for 2012-2014 envisage a gradual decline in the general government deficit beginning in 2011 and aiming at 2.9% of GDP in 2013.

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 a relatively low and effective tax burden, a flexible 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 overall development of public finance. Its objective is to obtain comparable and the most complete information possible concerning risks associated with expected demographic changes. In 2009 the AWG and the European Commission came up with updated projections extending as far into the future as 2060[9].

[9] 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

In line with the requirements of the Code of Conduct, Member States are obliged to present projections produced by the AWG in their Stability Programmes. 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.

It needs to be mentioned with respect to the topicality of these projections that, since they were made during 2008 on the basis of the legislation effective from July 2008, they do not reflect the implications of re-opening the second pillar between November 15, 2008 and June 30, 2009. However, its effects were negligible in terms of long-term sustainability. The projections did not deal with the implications of the economic crisis either.

This section has two 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 presents sustainability indicators including the reform scenario. They represent quantified measures in the area of fiscal policy that will have to be adopted as of now to address the problem of public finance sustainability. Both parts present the most recent calculations of the Commission, i. e. the results of the projections of implications of population ageing for public finance in 2009 (Ageing Report 2009), as well as an assessment of sustainability for the same year (Sustainability Report 2009).

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 case of Slovakia, this is related to the shortfall in general government revenues resulting from the introduction of the fully-funded pillar of the pension system.

TAB 26 – 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

Commission 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 introduction of a fully-funded 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

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 European Commission uses so-called sustainability indicators[10]: 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.

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 case of Slovakia no consideration was given to such “qualitative” factors.

The S2 calculation is based on the 2009 data published in the EC 2009 Spring Forecasts. Important parameters of the calculation include current 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. An important assumption is that the European Commission takes into account only the current legislation (year 2008) that influences future growth of these expenditures. Consequently, planned changes and reforms are not reflected in the calculations. 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.

Reform scenario of long-term sustainability

The EC 2009 Sustainability Report classified Slovakia as a country with a high risk of long-term sustainability. Notwithstanding a relatively low general government debt in Slovakia, the unfavourable initial general government balance and the expected costs of population ageing will significantly jeopardise the living standards of future generations assuming an unchanged policies scenario. Responsibility vis-à-vis future generations is one of the main priorities of the current government which has set itself the ambitious goal of ensuring that in assessments of long-term public finance sustainability Slovakia is classified as a low risk country. The relevant plans are reflected in the National Reform Programme, including among the government’s quantitative objectives for 2020 the commitment to bring the long-term sustainability indicator down to zero by 2020 (for more details, please refer to Box 5).

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

BOX 5 – Long-term sustainability indicator (GAP)

The long-term sustainability indicator is defined as the difference between the current structural primary balance and one sustainable in the long-term. Long-term sustainability is assessed with a view to currently applicable legislation and long-term demographic and economic projections that impact general government revenues and expenditures.

Essentially, this is an indicator similar to S2, the difference being that the current structural primary balance also included the need to finance state and public companies; the calculation also reflects a number of other liabilities, such as PPP projects or contingent liabilities.

Updated 2009 calculations suggest a relatively small difference between GAP (9.5% of GDP) and the S2 indicator (9.3% of GDP).

The Stability Programme assumes that the S2[11] indicator will be reduced using two instruments. Significant consolidation by 2013 constitutes the first instrument and pension reform is the second one. **Provided these measures are implemented according to the Programme, the S2 indicator would decline from 9.9% of GDP in 2010 to 1.7% of GDP in 2013, and Slovakia could be ranked among countries that behave responsibly vis-à-vis future generations.**

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 actual data derived from the most recent notification (-5.1% of GDP). As a result, the reference S2 value for 2009 became 9.3% of GDP.

As in 2010 the structural balance deteriorated by 0.6% of GDP compared to 2009, the S2 value used as a reference for assessing programme-associated changes increased to 9.9% of GDP.

The first important objective of the government is to gradually reduce the general government deficit to 2.9% of GDP by 2013. Provided the austerity measures specified in the programme produce anticipated effects, the improvement in structural primary balance to -0.7% of GDP should bring down the S2 indicator to 5.6% of GDP.

The other key objective of the government is to stabilise Slovakia's pension system. Particularly relevant to the S2 indicators are the following five changes: (1) transition to an inflation-based mechanism of pension indexation, (2) introducing a link between the retirement age and life expectancy, (3) introducing a link between indexation of the current pension point value and the ratio of pension beneficiaries to pension contributors, (4) gradually reducing the weight of the merit component and (5) reintroducing the mandatory participation in the fully-funded pillar with an exit option valid for a limited period. All these measures in aggregate should bring down the S2 indicator by 3.9 percentage points more than envisaged under the consolidation scenario, namely to 1.7% of GDP.

[11] Since only indicative GAP calculations are available so far, the Programme presents standard S2 calculations.

TAB 27 – Sustainability indicators					Assumptions		
	S2	**LTC**	**IFP**	**S1**	**Final year**	**SPB**	**Debt**
Commission report – EC scenario (2009)	**7.4**	2.9	4.5	**5.7**	2010	-3.7	36.5
Amended EC scenario (2009)	**7.9**	2.9	5.0	**6.1**	2010	-3.7	36.7
Allowing for the final GG deficit (2009)	**9.3**	2.9	6.5	**7.6**	2010	-5.1	40.4
2010 scenario	**9.9**	2.9	7.0	**8.2**	2010	-5.7	41.0
Consolidation scenario	**5.6**	3.5	2.1	**3.9**	2014	-0.7	45.2
Consolid. and pension system reform scenario	**1.7**	-0.3	2.0	**0.9**	2014	-0.7	45.2

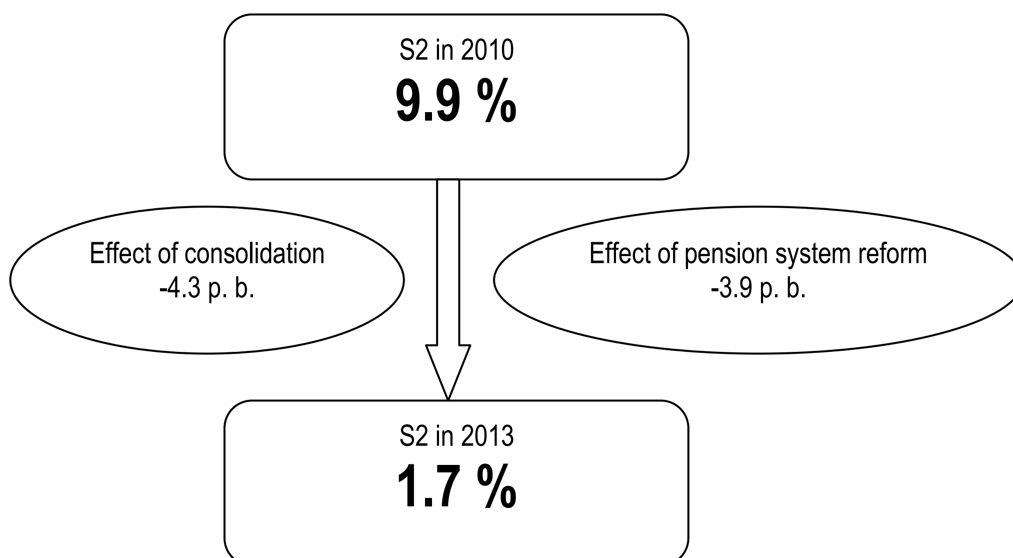
LTC – long-term costs

IFP – initial fiscal position

SPB – structural primary balance

Assumptions of the pension reform:

1. Change pension indexation from the Swiss to an inflation mechanism (pensioners' inflation) beginning in 2013.
2. Automatically adjust the retirement age as a function of life expectancy at 60 years of age. This change would apply once the retirement age of childless women is harmonised with that of men.
3. Automatically change current pension point value indexation. Wage indexation will be adjusted using a 5-year moving average of the percentage change in the ratio of the population below and above the retirement age.
4. Pensions will be calculated using an amended formula, where the Average Personal Wage Point (APWP) will be replaced by the (0.25+(APWP-0.25)*coefficient), the coefficient declining annually from 1 in 2015 by 0.011.
5. The entry rate of participation in the fully-funded pillar of people entering the labour market will be 80%.



VI. QUALITY OF PUBLIC FINANCE

A marked deterioration of fiscal positions during the economic crisis and the subsequent economic recovery highlighted the need for consolidation and long-term sustainability of public finance. At the same time, the key question arising in this context is how to improve fiscal positions in a lasting and adequate manner. The need for ambitious fiscal consolidation presents opportunities to identify and adopt measures to enhance efficiency and effectiveness of the revenue and expenditure side of public finance. Hence improving the quality of public finance has inevitably become the focus of current discussions about fiscal policy.

VI.1. Policy strategy

The Government is pursuing its strategy for improving the quality of public finance in the framework of ambitious fiscal consolidation, with most of the consolidation effort concentrated in 2011 and 2012. Measures have been adopted, or are being planned, that to a large extent will also influence the quality of public finance.

The government is looking to attain the fiscal policy consolidation objectives by adopting two packages of measures affecting the revenue and the expenditure side of the general government. These measures and their quantification were described in sections III.2 and III.3.

Moreover, the government is planning other measures, notably to improve the sustainability of public finance in the medium and long run while at the same time contributing to enhanced quality of public finance. In particular, the plan is to implement a comprehensive reform of the system of taxes and social contributions in order to enhance the efficiency of tax and social contributions collection; introduce changes in the pension system to address the effects of population ageing on public finances, and to boost the efficiency of companies with state equity participation, all of which should have indirect positive implications for the general government balance. The following sections describe the proposed structural measures in greater detail.

VI.2. Developments on the revenue side

The revenue side of the general government balance is influenced by partial changes in the systems of taxation and social contributions described in sections III.2 and III.3, as well as the upcoming reform of the tax and social contributions systems designed to enhance the efficiency of tax and social contributions collection.

Reform of the tax and social contributions systems
Efficient collection of taxes and social contributions helps to reduce distortions of economic decision-making, discourages tax avoidance and reduces compliance costs incurred by individuals and corporations. Moreover, it provides adequate revenues for public finances and contributes to boosting the competitive edge of a small and open economy in global competition. The principal drawbacks of the current mechanisms of collecting taxes and social contributions in Slovakia include different assessment bases used for calculating taxes and social contributions, the existence of multiple non-systemic deductible items and inadequate measures to counter tax evasion.

From the Government's point of view, the current taxation and contributions system is inefficient, ineffective and unsustainable. The reason is that the collection, administration and enforcement of taxes and social contributions are the responsibility of tax offices, health insurance companies and the Social Insurance Agency, with each institution maintaining its own registers. None of these institutions, however, has a consistent database featuring a uniform client profile. By the same token, various means used by natural persons to earn an income do not entail the same rate of social contributions; as a result, in some sectors the state offers incentives for workers to massively shift from one form of income generation to another, thus undermining collection of social contributions with particularly severe implications for the pension system. In the eyes of the public, the system imposes an excessive administrative burden, is complicated, disproportionately costly and unfair in terms of the overall tax and social contributions burden.

In view of the above, the Government has chosen to reform the taxation and social contributions system, focusing in particular on the following measures:

- Simplify the social contributions system in order to enhance its efficiency by applying uniform collection arrangements for taxes, customs duties and social contributions as well as introduce a uniform assessment base;
- Reduce the administrative burden imposed on taxpayers, and to significantly enhance IT infrastructure supporting the relevant institutions;
- Introduce a procedure for the joint annual settlement of personal income tax and contributions to health and social insurance paid by natural persons;
- Introduce the notion of comprehensive gross wages by adding to gross wages the contributions paid by employers to health and social insurance.
- These measures will have a moderately adverse impact on the general government budget (of up to 0.1% of GDP); however, the social contributions burden will be gradually reduced as a result. Provided the government's fiscal policy objectives are fulfilled, i. e. the budgeted general government deficit target is not exceeded, the rate of social contributions by employees will decrease annually by 1 percentage point (as expressed under the current system), or by 0.6 percentage point under the new system.

BOX 6 – Key parametric changes in the taxation and social contributions system:

- *Preserve the flat tax rate principle (applied to natural persons and legal entities) at a rate of 19%;*
- *Introduce a single rate of contributions on social insurance set at 19% for employees, 13% for the self-employed and 10% for people working under arrangements other than an employment contract; introduce a single rate of contributions on health insurance set at 9% for natural persons and 4.5% for the disabled;*
- *Income from dividends and profit sharing will entail contributions on health insurance at a rate of 9% and 13% for social insurance;*
- *The maximum assessment base used for social contributions will be replaced by an "insurance premium cap" linked to the subsistence level;*
- *Introduce a single base of assessment for tax and social contribution purposes applicable to all active income earned by all persons except those working under arrangements other than an employment contract; an amount will then be deducted from this base equal to 12 times the subsistence minimum;*
- *The minimum base of assessment applicable to the self-employed will be set at 3.3 times the subsistence level;*
- *The basic tax allowance will be adjusted from 19.2 times the subsistence level to 18 times the subsistence level (EUR 3 413.70 in 2012);*
- *The self-employed will have the option to set own rules for assets depreciation for taxation purposes.*

VI.3. Developments on the expenditure side

In addition to the packages of fiscal measures described above, general government expenditures will be affected by two major changes, namely pension reform and indirectly through better performance of enterprises with state equity participation.

Pension system reform

The public finances of Member States are forced to deal not only with the adverse effects of the economic crisis; they have to adapt their budgets to the negative implications of population ageing. According to Eurostat projections, in the next few decades the old-age dependency ratio in Slovakia will be growing faster than in all other EU countries. While at present, there are 6 people of productive age per one person of post-productive age, 50 years later the ratio will be a mere one and a half to one. Postponing the issue would only cause, the situation to deteriorate further, as the costs of inaction over a 5-year period amount to as much as 0.7% of GDP.

In the context of population ageing, the long-term sustainability of public finance constitutes a key objective of Slovakia's fiscal policy. The Government understands that this challenge should be addressed in a comprehensive manner and is proposing changes both in the pay-as-you-go pension pillar and the mandatory pension insurance scheme. The third area of reform targets the special pension systems of the armed forces. All

these measures should gradually stabilise the pension systems of Slovakia and prepare public finance for a smoother passage through the period of dramatic demographic changes.

Measures envisaged in the pay-as-you-go (first) pillar of the pension system with the intention to stabilise financial flows in the long run:

- The government will establish a statutory link between senior citizens' life expectancy and the retirement age. This measure will come into force once the retirement age of childless women is gradually increased to equal that of men.
- At the same time a link will be introduced between the annual increase in the current pension point value and changes in the ratio of pension contributors and beneficiaries in the pay-as-you-go pillar.
- Pension indexation will be modified by switching from the current Swiss system to an inflation-based method (pensioners' inflation).
- Also in the first pillar, a change is proposed in the weight of the merit component. The government will gradually increase the extent of solidarity in the pay-as-you-go pillar, so that it does not pay out pensions in excess of the average wage prevailing in the economy.
- The government is committed to significantly simplifying the revenue side of the pension system by reducing the administrative burden and introducing a single mechanism of tax and social contributions collection.
- The government will contemplate the introduction of a minimum pension.

Measures envisaged in the fully-funded (second) pillar with the intention to maximise savers' returns at an acceptable level of risks:

- Guarantees will only be retained in the bonds fund, where hold-to-maturity (HTM) valuation will be allowed provided credit risk is clearly identified.
- Joining the second pillar will become mandatory with the possibility of an opt-out within a year.
- The government will introduce index funds whose performance should reflect global equity indices; such funds would offer the benefit of lower fees.
- Investment strategy benchmarks will be defined to enable genuine differentiation between funds. Success fees will be introduced to encourage better performance.
- An arrangement will be introduced for the gradual transfer of pension savers to the bonds fund before they reach their retirement age (10 years).

Changes in the second pillar will be applied with full respect to citizens' rights.

With the aim to ensure a just and sustainable fulfillment of legitimate pension provision claims of armed forces, the Government shall narrow the range of eligible recipients by further shifting a part of the armed forces to the civil sector. The Government will prepare a system reform that will affect newly admitted officers once the changes become effective.

Improving the efficiency of state-owned enterprises

One of the Government's priorities is to boost the efficiency of enterprises with state equity participation by streamlining their operations in order to contain new debt accumulation, lease those enterprises out to strategic investors on a long-term basis, or to sell the state's ownership interest in them. The specific procedure will reflect the state's strategic goals in a given sector and the potential impact on public finance. These steps would implement market principles in the enterprises, reduce the scope for corruption, and prevent potential fiscal expenditures in the future that may be necessary to cancel their debt. The Government has decided to deal with the situation of state railway companies, Bratislava airport, heating distribution and telecommunication companies, as well as several smaller enterprises.

In the case of railway companies where 100% of equity is state-owned (ŽSR, a. s., ZSSK, a. s. and CARGO, a. s.), the government has adopted an austerity package envisaging inter alia the laying off up to 5,000 employees till 2014, electronic procurement, streamlining the companies' organisational structure and transport services they are required to provide as well as measures to raise earnings. On the other hand, the state has pledged to settle its own liabilities vis-à-vis those companies, as well as their outstanding losses dating back to 2004-2010. In the

CARGO, a. s. case, the idea is to privatise, once the planned measures have been implemented, at least 66% of the state's equity participation by mid-2012. Privatisation proceeds would make it possible for the state to pay the debt this company has accumulated vis-à-vis the state and ŽSR, a. s. The objective is to arrange for the other companies to break even by 2013 and to keep 100% of their equity in the hands of the state. Streamlining these companies' operations will put conditions in place to prevent future debt accumulation, entailing to the need for debt cancellation with negative implications for the general government balance.

In the case of Bratislava Airport, the government has opted for a different path. Taking into consideration the capital expenditures necessary to develop the airport, the current financial situation of the state and the airport's importance for the economy, the government has decided to lease out this company to an investor for a period of 30-50 years. The choice of a strategic investor should be finalised by mid-2012.

The state will sell its entire ownership interest in six heating distribution companies (100% state ownership), Slovak Telekom, a. s. (49% state participation) and some smaller companies, e.g. the minority holdings in bus transport companies (SAD). Proceeds from the privatisation of heating distribution companies will make it possible to reduce the debt accumulated in the healthcare sector.

VII. INSTITUTIONAL ASPECTS OF PUBLIC FINANCE

The economic crisis found the budgets of many countries to be in poor shape. Even though countries had reported substantial economic growth during the pre-crisis period, they had failed to take advantage of the opportunity to consolidate their public finance. Their problems had to be addressed by all EU member states through bailout measures and guarantee schemes. To prevent such situations in the future and to ensure that countries prepare themselves in advance for the costs of population ageing, the European Commission drafted six legislative acts that address fiscal policy as well as macroeconomic imbalances. As regards fiscal policy, the legislation proposes primarily amendments to the Stability and Growth Pact and the strengthening of national fiscal frameworks by defining minimum requirements applicable to them. The prepared reform of the fiscal framework reform in Slovakia reflects the substance of these changes and, as a result, it is fully compatible with the initiative of the European Commission.

VII.1. Fiscal framework reform

The most important part of the fiscal framework reform in Slovakia will be to approve a new Fiscal Responsibility Act which should, if possible, reflect a broad political consensus that **long-term sustainability is the fundamental objective of fiscal policy in Slovakia**. A substantially strengthened fiscal framework may increase Slovakia's credibility on international financial markets and contribute to smooth fiscal consolidation.

In contemplating a fiscal framework reform, it is necessary to take into account the need for political neutrality. The new system may not interfere with the political process. The setting of fundamental medium-term objectives and priorities or the choice of a consolidation method must remain in the hands of politicians. Despite diverging views on the role of the state in the economy, the requirement to match long-term revenues and expenditures of the public sector must not be subject to political decisions.

The fiscal institutions reform comprises six basic cornerstones: (1) greater emphasis on stock variables, particularly the state's net worth, (2) a cap on gross general government debt, (3) aggregate nominal expenditure ceilings, (4) stricter rules for local governments, (5) transparency rules and (6) an independent Fiscal Responsibility Council.

The purpose of these changes is to create a system penalising irresponsible behaviour. Penalisation would be applied using three channels:

- enhanced public awareness of potential hidden deficits and debts (reduce opportunities for creative accounting),
- reputation costs that will be incurred should the government fail to meet its objectives,
- political sanctions agreed in advance and applied should the country's debt approach or exceed a critical value.

The Government will be monitoring closely the net worth of the Slovak Republic, i.e. the difference between the total assets and liabilities of the state. On the one hand, net worth will serve as a transparency benchmark, and on the other hand, as a point of departure for calculating expenditure ceilings. The fundamental documents (budget and final accounts) should include information related to the total balance of general government assets and liabilities, including implicit and contingent liabilities. Thus the public will have a more comprehensive idea of the actual performance of the state and the room will be narrowed for wrong incentives.

Two fiscal rules are proposed, namely expenditure ceilings and a debt brake. The fundamental operational objectives would envisage binding three-year expenditure ceilings. This will force the government to decide how to allocate a predefined amount of resources to different priorities. Another advantage of expenditure ceilings is their ability to eliminate more successfully the pro-cyclical nature of fiscal policy by allowing free play of automatic stabilisers. The key requirement for defining expenditure ceilings is to ensure that they cover as much of the general government sector as possible and do not discourage structural or tax reforms. The aggregate ceiling

allocation between individual budget chapters would be decided by the government. A maximum debt level would be set in addition to expenditure ceilings. The government plans to impose a cap on gross general government debt. Debt approaching this cap would automatically trigger political sanctions, gradually escalating from soft to hard ones. The government, however, would retain the option to argue their potentially dissenting opinion. Importantly, and contrary to expenditure ceilings where sanctions are of a reputational nature, exceeding the debt cap should entail genuine political and economic sanctions. However, it is necessary to keep in mind that the debt brake is not intended for operational public finance management. If expenditure ceilings are not exceeded, sanctions need not be imposed.

An independent Fiscal Responsibility Council would not interfere directly with the budget preparation process. All decisions would remain in the hands of politicians. The Council would oversee independent public finance assessments and ensure that the public is given a coherent message reflecting complex underlying calculations. The Council would have access to an enormous amount of information and would present it to the public in a comprehensible manner, thus promoting a transparent fiscal policy. Other tasks of the Council might include analyses of long-term sustainability and calculations of the fiscal implications of major legislation proposals. It is important to ensure the Council's independence by applying a proper member selection procedure and a funding mechanism independent from the state budget.

The experience accumulated over the years suggests the need to improve the regulation of local government debt. Clearer fiscal performance rules will be set for municipalities and self-governing regions which, following an extensive fiscal decentralisation, have gained access to vast financial resources. Stricter controls will be imposed on local government debt accumulation and clearer rules will be set for restructuring local governments. Graduated sanction mechanisms will be applied to local government debt, similar to those envisaged for general government debt caps.

Increased transparency should also contribute to fiscal consolidation. Statutory requirements will stipulate the scope of mandatory disclosure to the public of information about the general government budget and final accounts of the general government. The same will apply to information concerning budget execution in the course of the year as well as disclosure of macroeconomic and tax revenue forecasts.

The government will also improve the existing institutions by enhancing the efficiency of programme budgeting at central and local government levels and will complete building-up a public finance reporting and accounting system compliant with international standards.

ANNEXES

Annex 1 – Required tables

Table 1a: Macroeconomic prospects (ESA95, EUR bn.)

	ESA code	2010 Level	2010 Rate of change	2011 Rate of change	2012 Rate of change	2013 Rate of change	2014 Rate of change
1. Real GDP	B1*g	49.8	4.0	3.4	4.8	4.8	4.8
2. Nominal GDP	B1*g	65.9	4.5	6.3	7.3	7.8	7.8
Components of real GDP							
3. Private consumption expenditure	P.3	26.7	-0.3	0.1	3.5	4.0	4.1
4. Government consumption expenditure	P.3	8.8	0.1	-5.3	-0.1	-0.8	2.5
5. Gross fixed capital formation	P.51	10.9	3.6	4.8	5.9	3.4	4.7
6. Exports of goods and services	P.6	47.2	16.4	8.1	10.0	10.7	10.9
7. Imports of goods and services	P.7	43.7	14.9	5.7	9.0	9.5	10.7
Príspevky k reálnemu rastu HDP							
8. Final domestic demand		-	0.7	0.1	3.1	2.7	3.5
9. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	1.9	0.6	0.2	0.0	0.0
10. External balance of goods and services	B.11	-	2.1	2.5	1.8	2.2	1.4

Source: SO SR, MFSR

Table 1b: Price developments (ESA95)

ESA code	2010 Level	2010 Rate of change	2011 Rate of change	2012 Rate of change	2013 Rate of change	2014 Rate of change
1. GDP deflator	1.3	0.5	2.8	2.4	2.8	2.9
2. Private consumption deflator	1.5	0.9	3.2	2.9	3.4	3.4
3. HICP	-	0.7	3.4	3.0	3.6	3.7
4. Public consumption deflator	1.4	0.6	3.2	3.1	3.5	3.5
5. Investment deflator	1.2	-0.5	2.6	2.2	2.6	2.6
6. Export price deflator (goods and services)	1.1	2.9	1.2	1.6	2.0	2.2
7. Import price deflator (goods and services)	1.2	4.9	1.9	1.9	2.0	2.2

Source: MF SR

Table 1c: Labour market developments (ESA95)

	ESA code	2010 Level	2010 Rate of change	2011 Rate of change	2012 Rate of change	2013 Rate of change	2014 Rate of change
1. Employment, persons (thousands) [1]		2,154	-1.4	0.3	0.9	1.2	1.2
2. Employment, hours worked (thousands)[2]		3,766.9	1.8	2.1	1.0	1.2	1.2
3. Unemployment rate (%) [3]		14.4	2.3	-0.5	-0.6	-0.8	-0.7
4. Labour productivity per persons (EUR) [4]		23,142	5.4	3.1	3.9	3.5	3.6
5. Labour productivity per hours worked (EUR) [5]		17,514	4.2	2.8	6.3	6.5	6.5
6. Compensation of employees (EUR mill.)	D.1	24,792	1.2	4.0	6.7	7.3	7.9
7. Compensation per employee (EUR)		11,519	2.6	3.7	5.8	6.0	6.6

[1] Occupied population, domestic concept national accounts definition.

Source: SOSR, MFSR

[2] National accounts definition.

[3] Harmonised definition, Eurostat; levels.

[4 Real GDP per person employed.

[5] Real GDP per hour worked.

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

	ESA code	2010	2011	2012	2013	2014
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-2.1	-0.7	-0.1	0.9	1.1
of which:						
- Balance on goods and services		-0.6	0.1	0.5	1.4	1.5
- Balance of primary incomes and transfers		-2.7	-2.1	-2.1	-2.0	-1.9
- Capital account		1.1	1.3	1.5	1.5	1.5
2. Net lending/borrowing of the private sector	B.9	5.8	4.2	3.7	3.8	3.9
3. Net lending/borrowing of general government	EDP B.9	-7.9	-4.9	-3.8	-2.9	-2.8
4. Statistical discrepancy						

Source: MF SR

Table 2: General government budgetary prospects *

	ESA code	2010	2010	2011	2012	2013	2014
		EUR mill	% GDP	% GDP	% GDP	% GDP	% GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-5,207	-7.9	-4.9	-4.1	-3.7	-3.0
2. Central government	S.1311	-4,595	-7.0	-4.9	-4.1	-3.8	-3.1
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-587	-0.9	-0.2	0.0	0.0	0.0
5. Social security funds	S.1314	-25	0.0	0.2	0.1	0.1	0.1
General government (S.13)							
6. Total revenue	TR	21,814	33.1	32.9	31.5	31.0	30.3
7. Total expenditure	TE [1]	27,021	41.0	37.9	35.6	34.7	33.3
8. Net lending/borrowing	EDP B.9	-5,207	-7.9	-4.9	-4.1	-3.7	-3.0
9. Interest expenditure	EDP D.41	883	1.3	1.8	1.8	2.2	2.2
10. Primary balance	[2]	-4,324	-6.6	-3.1	-2.2	-1.6	-0.8
11. One-off and other temporary measures	[3]	-190	-0.3	0.1	0.2	0.1	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		10,250	15.6	16.5	16.2	16.0	15.8
12a. Taxes on production and imports	D.2	6,672	10.1	10.7	10.0	9.8	9.6
12b. Current taxes on income, wealth, etc.	D.5	3,578	5.4	5.8	6.2	6.2	6.2
12c. Capital taxes	D.91	0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	8,253	12.5	11.9	11.7	11.6	11.4
14. Property income	D.4	625	0.9	0.8	0.6	0.6	0.6
15. Other	[4]	2,685	4.1	3.7	2.9	2.8	2.5
16 = 6. Total revenue	TR	21,814	33.1	32.9	31.5	31.0	30.3
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)	[5]	18,503	28.1	28.4	27.9	27.5	27.2
Selected components of expenditure							
17. Compensation of employees + Intermediate consumption	D.1+P.2	8,486	12.9	10.9	10.6	10.3	10.0
17a. Compensation of employees	D.1	5,202	7.9	6.6	6.4	6.3	6.1
17b. Intermediate consumption	P.2	3,284	5.0	4.3	4.2	4.0	3.9
18. Social payments		12,499	19.0	18.1	17.6	17.0	16.3
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	3,482	5.3	4.9	4.8	4.6	4.4
18b. Social transfers other than in kind	D.62	9,017	13.7	13.2	12.8	12.4	11.9
19. = 9. Interest expenditure	EDP D.41	883	1.3	1.8	1.8	2.2	2.2
20. Subsidies	D.3	894	1.4	1.0	1.0	1.0	0.9
21. Gross fixed capital formation	P.51	1,716	2.6	1.8	1.4	1.3	1.3
22. Other	[6]	2,543	3.9	4.2	3.2	2.9	2.6
23=7. Total expenditure	TE [1]	27,021	41.0	37.9	35.6	34.7	33.3
p.m.: Government consumption (nominal)	P.3	12,948	19.6	17.6	17.3	16.8	16.2

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

** Table reflects the 2012-2014 GG Budget 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 2012-2014.*

Table 3: General government expenditure by function (% of GDP)	COFOG code	2009	2014*
1. General public services	1	5.4	
2. Defence	2	1.5	
3. Public order and safety	3	2.6	
4. Economic affairs	4	5.2	
5. Environmental protection	5	0.7	
6. Housing and community amenities	6	0.8	
7. Health	7	7.8	
8. Recreation, culture and religion	8	1.1	
9. Education	9	4.3	
10. Social protection	10	12.2	
11. Total expenditure	**TE**	**41.5**	

**Due to an early stage of budget preparation, data for 2014 in COFOG classification are not available.* *Source: SO SR*

Table 4: General government debt developments (% of GDP)	ESA code	2010	2011	2012	2013	2014
1. Gross debt		41.0	44.1	45.3	45.3	45.2
2. Change in gross debt ratio		5.5	3.2	1.1	0.0	0.0
Contributions to change in gross debt						
3. Primary balance		6.6	3.1	2.0	0.7	0.6
4. Interest expenditure	EDP D.41	1.3	1.8	1.8	2.2	2.2
5. Nominal GDP growth		-1.5	-2.5	-3.0	-3.3	-3.3
6. Stock-flow adjustment		-0.8	0.7	0.3	0.4	0.5
Of which:						
- Differences between cash and accruals		-1.1	0.1	0.1	-0.2	0.0
- Net accumulation of financial assets		0.3	0.6	0.2	0.6	0.5
- Valuation effects and others		0.0	0.0	0.0	0.0	0.0
p.m. Implicit interest rate on debt		4.0	4.7	4.5	5.2	5.2
Other relevant variables						
7. Liquid financial assets		3.4	3.7	3.8	4.0	4.1
8. Net financial debt (8=1-7)		37.6	40.4	41.4	41.3	41.2

Source: MF SR

Table 5: Cyclical developments (% of GDP)	ESA code	2010	2011	2012	2013	2014
1. Real GDP growth (%)		4.0	3.4	4.8	4.8	4.8
2. Net lending of general government	EDP B.9	-7.9	-4.9	-3.8	-2.9	-2.8
3. Interest expenditure	EDP D.41	1.3	1.8	1.8	2.2	2.2
4. One-off and other temporary measures	[1]	-0.3	0.1	0.2	0.1	0.0
5. Potential GDP growth (%)		1.2	3.1	4.3	4.1	3.9
contributions:						
- labour		-0.6	0.2	0.7	0.5	0.3
- capital		0.6	0.9	1.1	1.1	1.1
- total factor productivity		1.2	2.0	2.5	2.5	2.5
6. Output gap		-2.1	-1.8	-1.3	-0.6	-0.3
7. Cyclical budgetary component		-0.6	-0.5	-0.4	-0.2	0.1
8. Cyclically-adjusted balance (2 - 7)		-7.3	-4.4	-3.4	-2.7	-2.9
9. Cyclically-adjusted primary balance (8 + 3)		-6.0	-2.6	-1.6	-0.5	-0.7
10. Structural balance (8 - 4)		-7.0	-4.5	-3.6	-2.8	-2.9

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

Table 6: Divergence from previous update	ESA code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
Real GDP growth (%)						
Previous update*		1.9	4.1	5.4	-	-
Current update		4.0	3.4	4.8	4.8	4.8
Difference		2.1	-0.7	-0.6	-	-
General government net lending (% of GDP)	EDP B.9					
Previous update*		-5.5	-4.2	-3.0	-	-
Current update		-7.9	-4.9	-3.8	-2.9	-2.8
Difference		-2.4	-0.7	-0.8	-	-
General government gross debt (% of GDP)						
Previous update*		40.8	42.5	42.2	-	-
Current update		41.0	44.1	45.3	45.3	45.2
Difference		0.2	1.6	3.1	-	-

*Note: * Stability Programme of the Slovak Republic for 2009-2012* *Source: MF SR*

Table 7: Long-term sustainability of public finances - 2009 scenario (% of GDP)	2007	2010	2020	2030	2040	2050	2060
Total expenditure	**34.4**	**38.0**	**39.1**	**43.0**	**48.8**	**57.5**	**68.8**
Of which: age-related expenditure	**15.2**	**14.9**	**14.5**	**16.1**	**17.5**	**19.2**	**20.4**
A. Pension expenditure	6.8	6.6	6.3	7.3	8.3	9.4	10.2
1. Social security pension	6.8	6.6	6.3	7.3	8.3	9.4	10.2
a) Old-age and early pensions	4.3	4.0	3.6	4.1	4.8	5.6	6.2
b) Other pensions (disability, survivors)	2.5	2.6	2.7	3.2	3.5	3.8	4.1
2. Occupational pensions (if in general government)	-	-	-	-	-	-	-
B. Health care	5.0	5.2	5.7	6.2	6.7	7.1	7.2
C. Long-term care	0.2	0.2	0.2	0.3	0.4	0.5	0.6
D. Education expenditure	3.1	2.8	2.2	2.2	2.1	2.1	2.3
E. Other age-related expenditures	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Interest expenditure	1.4	1.6	3.1	5.5	9.8	16.9	26.9
Total revenue	**32.5**	**32.5**	**32.2**	**32.1**	**32.0**	**31.9**	**31.9**
Of which: property income (D.4)	1.5	1.4	1.2	1.1	1.1	1.1	1.0
Of which: from pensions contributions	11.8	12.0	11.7	11.6	11.5	11.4	11.4
Pension reserve fund assets	2.5	5.5	16.5	28.4	41.7	53.4	61.2
Of which: consolidated public pension fund assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Assumptions							
Labour productivity growth	5.3	4.7	3.1	2.7	1.7	1.7	1.7
Real GDP growth	6.4	6.2	3.4	2.0	0.5	0.2	0.5
Participation rate males (aged 15-64)	76.6	77.7	79.1	78.2	75.7	75.5	76.2
Participation rate females (aged 15-64)	61.2	62.9	66.7	67.5	65.3	65.2	66.1
Total participation rates (aged 15-64)	68.8	70.3	72.9	72.8	70.5	70.4	71.2
Unemployment rate	11.1	11.0	6.2	6.2	6.2	6.2	6.2
Population aged 65+ over total population (in %)	11.9	12.3	16.4	21.3	25.3	31.6	36.1

Table 8: Basic assumptions	2010	2011	2012	2013	2014
Short-term interest rate (annual average)	0.8	1.2	2.0	3.2	3.6
Long-term interest rate (annual average)	2.8	3.5	3.8	4.2	4.3
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.33	1.36	1.30	1.24	1.22
World excluding EU, GDP growth	5.3	4.5	4.6	4.6	4.6
EU GDP growth	1.8	1.8	2.0	2.1	2.2
Growth of relevant foreign markets	2.4	2.3	2.5	2.6	2.7
World import volumes, excluding EU	14.0	8.1	7.3	7.6	7.6
Oil prices (Brent, USD/barrel)	79.9	95.5	94.6	98.1	100.0

Source: Common external assumptions, MF SR

Annex 2 – Forecast of the Ministry of Finance - key macroeconomic and fiscal indicators

Estimate up to 2014						
	unit	2010	2011F	2012F	2013F	2014F
GDP; constant prices	%	4.0	3.4	4.8	4.8	4.8
Final consumption of households	%	-0.3	0.1	3.5	4.0	4.1
Final consumption of government	%	0.1	-5.3	-0.1	-0.8	2.5
Gross fixed capital formation	%	3.6	4.8	5.9	3.4	4.7
Export of goods and services	%	16.4	8.1	10.0	10.7	10.9
Import of goods and services	%	14.9	5.7	9.0	9.5	10.7
Harmonised index of consumer prices (HICP) growth	%	0.7	3.4	3.0	3.6	3.7
Current account balance	% HDP	-3.5	-2.2	-1.7	-0.6	-0.3
Employment growth LFS	%	-2.0	0.7	0.9	1.2	1.2
Unemployment rate LFS	%	14.4	13.9	13.3	12.5	11.8
Real wages per employee	%	2.2	0.2	2.5	2.2	2.8
GG balance (ESA 95)	% HDP	-7.9	-4.9	-3.8	-2.9	-2.8

Source: MF SR

Annex 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 2011, the majority of its members assessed the medium-term macroeconomic forecast by the Ministry of Finance as realistic:

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

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

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

in % if not indicated otherwise	2010	2011		2012		2013		2014	
		MFC	MoF	MFC	MoF	MFC	MoF	MFC	MoF
GDP; real growth	4.0	3.4	3.4	4.2	4.8	4.4	4.8	4.2	4.8
GDP; current prices; bn. EUR	65.9	70.2	70.2	75.5	75.3	81.0	81.2	87.1	87.5
Final consumption of households; real growth	-0.3	1.0	0.1	3.2	3.5	3.6	4.0	3.4	4.1
Final consumption of households; nominal growth	0.6	4.5	3.2	6.3	6.5	6.9	7.5	5.9	7.6
Average monthly wages (real growth)	2.3	0.7	0.2	2.4	2.5	2.9	2.2	3.4	2.8
Average monthly wages (nominal growth)	3.3	4.2	3.7	5.6	5.8	6.2	6.0	5.8	6.6
Average employment growth, LFS	-1.1	0.4	0.3	1.3	1.0	0.8	1.2	0.9	1.2
Consumer price index, (average growth)	1.0	3.5	3.5	3.2	3.1	3.3	3.7	3.3	3.7
Current account balance (% of GDP)	-3.5	-2.9	-2.2	-2.8	-1.7	-2.5	-0.6	-2.9	-0.3

Source: Committee for macroeconomic forecasts

Annex 4 – Committee for Tax Revenue Forecasts

Following the Macroeconomic Forecasts Committee meeting, the Tax Revenue Forecasts Committee held its session on February 14, 2011. At the session the Ministry of Finance presented its updated medium-term forecast of tax revenues for 2011-2014. The medium-term forecast of tax revenues and social insurance contributions by the Ministry of Finance was described as realistic by all Committee members with the exception of *Infostat*. *Infostat* considers the Ministry of Finance forecast to be conservative.

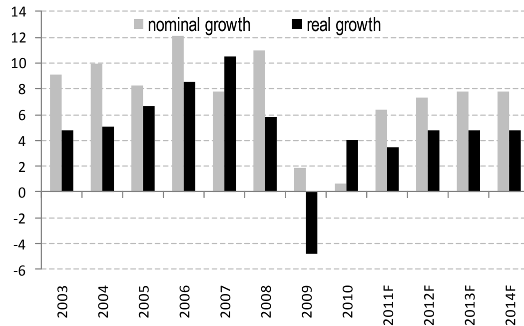
Assessment of MoF´s forecast by members of Tax Revenue Forecasts Committees

Member	Assessment
NBS	realistic
Infostat	conservative
ING Bank	realistic
Tatra banka	realistic
ČSOB	realistic
SLSP	realistic
UniCredit Bank	realistic

Source: Tax Revenue Forecasts Committee

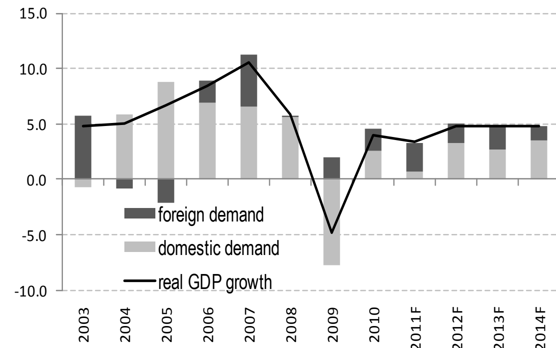
Annex 5 – Graphs

GDP growth (v %)



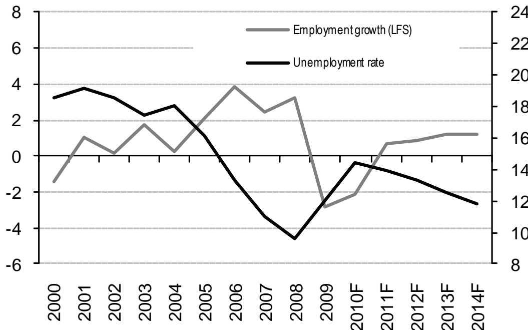
Source: SO SR, MF SR

Contributions to GDP growth (p. p.)



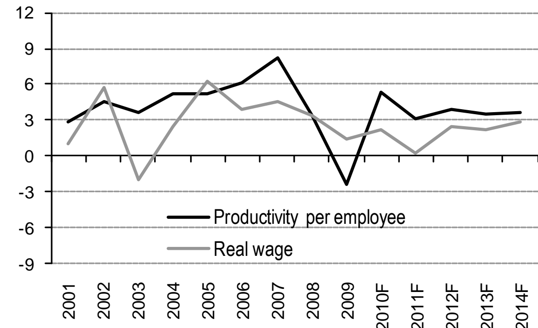
Source: SO SR, MF SR

Economic activity, LFS, %



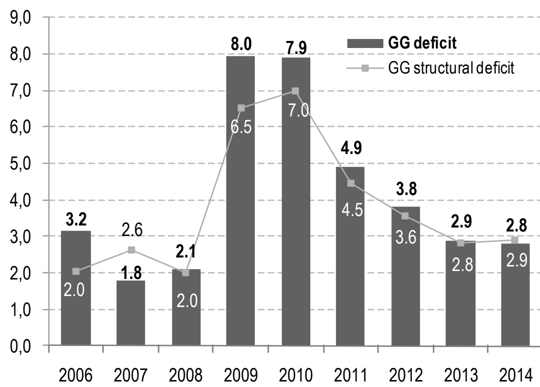
Source: SO SR, MF SR

Real wages and labour productivity growth (%)



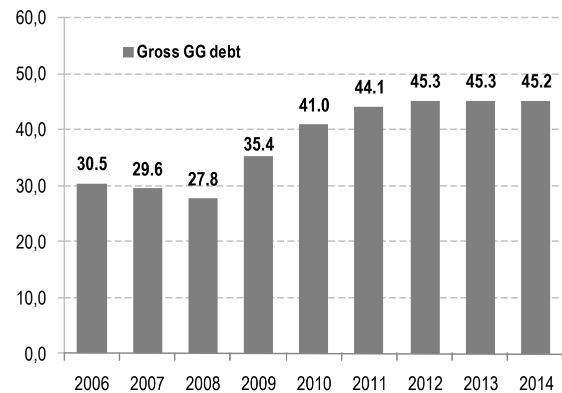
Source: SO SR, MF SR

General government deficit (% of GDP)



Source: SO SR, MF SR

Gross general government debt (% of GDP)



Source: SO SR, MF SR