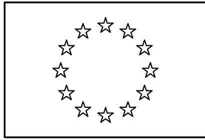

COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

Slovakia

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

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1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its Spring 2004 forecasts. According to these forecasts, which took into consideration data reported by Slovakia and validated by Eurostat in March 2004, the general government deficit in Slovakia reached 3.6% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value.

Table 1: General government balance and debt (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
General government balance	-3.8	-7.1	-12.3	-6.0	-5.7	-3.6	-4.1	-3.9
General government gross debt	28.6	43.8	49.9	48.7	43.3	42.8	45.1	46.1

Source: Eurostat and Commission Spring 2004 forecasts.

At this stage, the estimated figure for the 2003 deficit provides evidence on the existence of an excessive deficit in Slovakia, in the sense of the Treaty and the Stability and Growth Pact. The Commission therefore has decided to initiate the excessive deficit procedure (EDP) for Slovakia.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria[1], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. …"

The present report prepared by the Commission according to Article 104(3) assesses recent and current budgetary developments in Slovakia and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

[1] The criteria are (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3%, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; (b) whether the ratio of government debt to gross domestic product exceeds the reference value of 60 %, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

2. RECENT MACROECONOMIC DEVELOPMENTS AND PROSPECTS

After a period of strong economic expansion, real GDP growth fell to 1.5% in 1999. Fiscal and monetary stabilisation, which became necessary after Slovakia recorded large external imbalances raising issues of sustainability, contributed to the slowdown. Thereafter, in parallel with a shift to market-oriented structural reforms, growth gradually accelerated to levels above 4% in 2002 and 2003. The Commission Spring 2004 forecast expects robust growth to continue at about the same rate in 2004 and 2005. Per capita income in purchasing power standards has increased since 1998 and reaches now almost half of the EU-15 average.

The composition of growth has varied considerably. In 1999/2000, the external growth contribution became positive and ensured continued GDP growth in the face of restrained domestic demand. In 2001/2002, strong domestic demand became the driving force behind growth and contributed to a consumption-driven widening of the external account deficit (to almost 8% of GDP in 2002). The year 2003 witnessed surging exports, as new FDI-induced export capacity came on stream, and a remarkable narrowing of the external account deficit to below 1% of GDP. External demand ensured growth above 4% in spite of a negative domestic contribution. In 2004 and 2005, the Commission forecasts expect domestic demand to become again the main source of growth.

Table 2: Macroeconomic developments and outlook

	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.2	1.5	2.0	3.8	4.4	4.2	4.0	4.1
Contributions: Domestic demand	9.7	-6.8	-2.2	7.1	3.6	0.1	3.0	4.1
Change in inventories	-2.0	-0.2	2.3	0.4	0.9	-2.3	0.7	0.5
External trade	-3.5	8.4	1.9	-3.7	0.0	6.5	0.3	-0.5
Unemployment rate (% of labour force)	12.5	16.7	18.7	19.4	18.7	17.1	16.5	15.9
Unit labour costs (% change)	7.2	3.1	8.5	3.0	4.4	3.8	3.0	2.6
HICP (% change)	6.7	10.4	12.2	7.2	3.5	8.5	8.2	4.5
External account[a] (% of GDP)	-8.9	-3.5	-2.5	-7.4	-7.7	-0.7	-2.0	-3.4
GDP/capita, PPS (% of EU-15 avg.)	43.4	42.9	43.7	44.7	47.1	48.3		

[a] Net lending/borrowing vis-à-vis the rest of the world = current account + capital account

Source: Eurostat and Commission Spring 2004 forecasts.

After 1998, as a consequence of accelerated enterprise restructuring, the unemployment rate ratcheted up to a peak of more than 19% in 2001. Since 2002, the government has been tackling the deep-seated structural problems in the labour market more decisively. In particular, it has been strengthening incentives both to work and to create new jobs by reforming the social benefit and pension systems and by a comprehensive tax reform. The unemployment rate has gradually been falling to currently around 17% and is forecast to drop by a further percentage point by 2005. Slovakia's inflation performance has been dominated by increases in administered prices. With the acceleration of their pace after 1998, inflation rates surged to double digits in 1999 and 2000. In the election year 2002, administered price

increases came to a halt and inflation fell to 3½%. Major hikes in administered prices, coupled with higher indirect taxes, resumed in 2003 and still continue in 2004. Thereafter, this process is expected to come to an end and inflation is forecast to drop significantly in 2005 provided that second-round effects are kept under control. Monetary policy has been pursuing annual inflation benchmarks, combined with a managed float against the euro. Core inflation, which abstracts from the effects of rising indirect taxes and administered prices, has been contained at levels between 4% and 6% even in the years with double-digit headline inflation. Since 2002, it has fallen to levels around 2-3%. This has been supported by a strong Slovak crown, which has appreciated from levels around 44 SKK per euro before the elections in September 2002 to currently almost 40 SKK per euro. Apart from 2002, real wage growth has been moderate or negative and is expected to develop similarly in 2004 and 2005.

3. THE SITUATION OF GOVERNMENT FINANCES

In a context of continued robust growth, the general government deficit has significantly declined from its peak in the year 2000. However, at 3.6% of GDP in 2003, it remained above the 3% of GDP reference value. In addition, both in the Commission's and the authorities' view, it is expected to stay above this value in 2004-2005. The debt-to-GDP ratio remains below the 60% of GDP reference value.

The analysis of budgetary developments is hampered by still existing data gaps. In particular, a consistent series of fully consolidated ESA95 data on general government revenues and expenditures over recent years is not yet available, reflecting, inter alia, compilation difficulties in an environment of fiscal decentralisation.

3.1. Recent budgetary developments until 2002

The time profile of the general government deficit since 1998 has been heavily influenced by the fiscal consequences of past economic policies, which had in particular led to an accumulation of bad loans in the banking sector and of government guarantees. To deal with these legacies from the past, the government restructured the three largest, then still state-owned, banks in 1999 and 2000 by injecting capital and transferring bad loans to government consolidation agencies. Subsequently, a large part of these loans was cancelled, corresponding to deficit-increasing capital transfers of some 3½% of GDP in 1999 and some 5½% of GDP in 2000. Capital transfers due to debt assumptions resulting from called-on or likely-to-be-called-on government guarantees were also particularly high in each of these two years – at around 2½% of GDP. These two factors explain the surge in the general government deficit in 1999/2000. In the two following years, only capital transfers resulting from government guarantees were still significant – at 1.2% of GDP in 2001 and 0.8% of GDP in 2002, while in 2003 no further guarantee-related debt assumptions were reported. The issuance of new state guarantees has been substantially limited.

Subtracting these exceptional deficit components from the headline deficit figures indicates that fiscal consolidation efforts strengthened in 1999 as part of the mentioned macroeconomic stabilisation package but weakened again in the run-up to the election 2002. Fiscal consolidation efforts during this period were of a rather ad-hoc nature and not sufficiently embedded in a medium-term fiscal framework. The government pursued a policy of personal and corporate income tax reductions and reduced the GDP share of these taxes by roughly 2 percentage points from 1998 to 2002. This was only partly compensated by an increased GDP share of other revenues, so that the consolidated overall revenue-to-GDP ratio fell by roughly

1½ percentage points in the same period.[2] Compensating measures on the expenditure side were limited and were not of a structural and sustained nature. On the contrary, expenditure overruns, notably in social transfers, were frequent and the attainment of budgetary targets sometimes depended on across-the-board cuts or compression of the least protected expenditure categories, including gross fixed capital formation, during the budget year.

The time profile of the primary deficit mirrors the development of net borrowing, although the share of interest outlays increased from 2½% of GDP in 1998 to around 4% of GDP in 2000 and 2001 and fell steadily thereafter (back to 2½% of GDP in 2003). This profile resulted mainly from the dynamics of the debt stock (see section 3.4) but reflected also interest rate developments.

The general government deficit was predominantly driven by central government net borrowing.

Table 3: GDP growth and general government balance and debt

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.2	1.5	2.0	3.8	4.4	4.2	4.0	4.1
General government balance	-3.8	-7.1	-12.3	-6.0	-5.7	-3.6	-4.1	-3.9
Primary balance	-1.4	-3.8	-8.2	-2.0	-2.1	-1.2	-1.4	-1.0
Total expenditures[a]	*A consistent series of fully consolidated ESA95 data is not yet available.*							
of which: gross public investment	4.0	2.9	2.8	3.1	3.3	3.0	2.7	2.5
Total revenues[a]	*A consistent series of fully consolidated ESA95 data is not yet available*							
General government gross debt	28.6	43.8	49.9	48.7	43.3	42.8	45.1	46.1

Source: Eurostat and Commission Spring 2004 forecasts.

3.2. Budgetary developments in 2003

The target for general government net borrowing in 2003 of 5.0% of GDP, which had remained unchanged since 2002, was substantially undershot and the actual outcome amounted to 3.6% of GDP.

The budget planning for the year 2003 took place in the environment of an election year and the transition to a new government after the elections in September 2002. Budgetary projections were complicated by structural changes, which became effective in 2003 as initial steps of the new government's comprehensive reform agenda. The key macroeconomic assumptions underlying the budgeting process turned out to be on the conservative side. In

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[2] On a GFS-1986 basis (Government Finance Statistics Manual 1986). In this context, this means in particular that the tax- and revenue-ratios are measured on a cash basis and consolidated (data source: IMF Slovak Republic 2003 Article IV Consultation – Statistical Appendix, Table 14).

particular, GDP growth, both in real and nominal terms, was around ½ percentage point higher than assumed.

Table 4: Successive targets for the 2003 general government balance and estimated outcome

	Real GDP growth assumption (%)	General government balance (% of GDP)
August 2002: Pre-Accession Economic Programme	3.7	-5.0
December 2002: budget for 2003	3.7	-5.0
August 2003: Pre-Accession Economic Programme	4.0	-5.0
April 2004: Commission Spring 2004 forecasts	4.2	-3.6

Source: Commission services .

In spite of this higher growth, the general government revenue-to-GDP ratio was 2.4 percentage points lower than planned.[3] In particular, tax receipts were considerably overestimated and their amount was some 7% lower than budgeted. This is predominantly explained by a shortfall in VAT revenues, which were particularly difficult to project due to changes of the tax rates and of the requirements for refunds. The advancement of excise tax increases from 2004 to August 2003 compensated only partly for the lower VAT revenues. Social security contributions had also been somewhat overestimated. As a consequence of these developments (and the higher GDP), the GDP share of taxes and social security contributions was 2.9 percentage points below expectations. Higher non-tax revenues, mainly due to higher than expected interest income from the government's deposits at the National Bank of Slovakia, mitigated this effect, as the non-tax revenue-to-GDP ratio was 0.5 percentage points higher than budgeted.

The general government expenditure-to-GDP ratio[4] was 3.8 percentage points lower than envisaged. The following expenditure items contributed to this result broadly equally, as each of their shares in GDP was roughly between ½ and 1 percentage points smaller than foreseen: (1) social transfers, in which, in a clear break with past experience, overruns were avoided and several items performed slightly better than predicted. In particular, tighter registration requirements for unemployed and stronger GDP growth had a favourable effect on unemployment and social assistance benefits, while co-payments for health services, effective since mid-2003, seem to have been an important factor in containing health care expenditures; (2) the wage bill, due to lower wage increases at the non-central government level; (3) interest outlays, owing to lower than expected interest rates; (4) subsidies; and (5) capital expenditures. Part of the savings in subsidies and capital expenditures resulted from spending postponements, including due to delays in the implementation of EU sponsored projects.

[3] At an estimated 37.4% of GDP in consolidated terms.
[4] At an estimated 41% of GDP in consolidated terms.

3.3. Prospects for 2004

The budget for 2004, which was passed by parliament in December last year, targets a general government deficit of 4.0% of GDP. At that time, this represented a narrowing of the deficit from the expected outcome for 2003 by 1 percentage point. However, in light of the more favourable result in 2003, this now amounts to a widening of the deficit by 0.4 percentage points, which is envisaged to result exclusively from an increase in the expenditure-to-GDP ratio. Against the backdrop of far-reaching reforms both on the revenue and expenditure side, the Commission 2004 Spring forecasts project that the government will broadly meet its target – with a forecast deficit of 4.1% of GDP.

On the revenue side, the budget incorporates a comprehensive tax reform effective from January 2004. It introduces a flat corporate and individual income tax and a unified value-added tax, all at a rate of 19%. Before, the corporate income tax rate was 25%, personal income tax rates ranged from 10% to 38% and the value added tax rates were 14% and 20%. The tax reform package increases transparency, leads to a shift from direct to indirect taxation and is expected to strengthen incentives and growth. In addition, health and social insurance contribution rates have been reduced, albeit to a less significant extent, i.e. to a still relatively high total level of close to 48% of gross wages. Mostly as a consequence of the latter measure, the share of taxes and social contributions in GDP is planned to fall by roughly 1 percentage point compared to the 2003 outcome. However, this is roughly compensated by the development of the GDP shares of various other revenue items. Hence, in consolidated terms, the overall revenue-to-GDP ratio is planned to remain broadly constant.

On the expenditure side, the government has continued to implement incentive-enhancing structural reforms in the area of social transfers. The most important reforms areas are: pay-as-you-go pensions (with a funded pillar to be introduced in 2005); sickness benefits; social assistance and social benefits (e.g. child benefits); and health care. As a result, the GDP share of social transfers is planned to decrease by almost 1 percentage point compared to the 2003 outcome. However, this is more than offset by the development of the expenditure-to-GDP ratios of various other expenditure items. Altogether, the expenditure-to-GDP ratio increases by 0.4 percentage points compared to the actual outcome in 2003.

3.4. Recent debt developments and prospects

The debt-to-GDP ratio remains below the 60% of GDP Treaty reference value. The dynamics of the debt ratio between 1998 and 2003 were dominated by two main factors: first, the bank restructuring operations and debt assumptions related to government guarantees, which led to a sharp increase of the debt ratio in 1999 and 2000 from below 30% to almost 50% of GDP; and, second, major privatisation operations, which mitigated the increase in the debt ratio and contributed to its fall in 2001 and 2002 to around 43% of GDP. In 2004, an increase in the debt ratio by roughly 2½ percentage points is expected, predominantly owing to stock-flow adjustments. These are mostly caused by a lower accrual than cash deficit, which is due to a delay in the collection of value-added and excise taxes on imports from other EU Member States resulting from changed administrative procedures upon accession.

Table 5: Debt dynamics

(% of GDP)	1998	1999	2000	2001	2002	2003	2004	2005
Government gross debt	28.6	43.8	49.9	48.7	43.3	42.8	45.1	46.1
Change in debt ratio (1= -2+3+6)	-0.1	15.2	6.1	-1.1	-5.5	-0.5	2.4	0.9
Primary balance (2)	-1.4	-3.8	-8.2	-2.0	-2.1	-1.2	-1.4	-1.0
Snow-ball effect (3=4+5)	-0.1	1.2	-0.1	0.3	-0.3	-1.1	-1.1	0.1
Interest expenditure (4)	2.4	3.4	4.1	4.0	3.6	2.4	2.7	2.9
Contribution of nominal GDP growth (5)	-2.5	-2.1	-4.2	-3.7	-3.9	-3.5	-3.8	-2.8
Stock-flow adjustment (6)	-1.3	10.2	-2.0	-3.4	-7.2	-0.6	2.1	-0.1

Source: Eurostat and Commission Spring 2004 forecasts.

4. OTHER RELEVANT FACTORS

4.1. Medium term prospects

According to Slovakia's pre-accession economic programme submitted in August 2003, the government planned to reduce the general government deficit to below the Treaty reference value of 3% of GDP by 2006. However, this objective did not yet take into account the revenue loss for general government that will arise from 2005 onwards as a result of the diversion of pension contributions from the pay-as-you-go pillar to a new mandatory funded pillar[5] – estimated at 0.7% of GDP in 2005 and at 1% of GDP in 2006 and in 2007. The authorities have indicated that, in light of the associated additional deficit, they intend to postpone the attainment of the Treaty reference value for one year to 2007. The introduction of the funded pension pillar contributes to the medium- and long-term sustainability of the pension system.

4.2. Investment

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure". From 1999, the general government deficit of Slovakia consistently exceeded general government gross fixed capital formation (see table 3), which has been hovering around 3% of GDP. This is only somewhat above the EU-15 average of 2.3% of GDP over the same period. This positive – albeit relatively small – difference has to be assessed against the background of the investment needs linked to the economic catching-up process of Slovakia and against forthcoming co-financing commitments for EU-sponsered projects. .

[5] See Eurostat decision on the classification of funded pension schemes (Eurostat News Release 30/2004).

4.3. External account

In 1998, the external account deficit[6] reached 9% of GDP, contributing to severe exchange market pressures. The authorities abandoned Slovakia's exchange rate peg and implemented a monetary and fiscal stabilisation package, which more than halved the external account deficit in 1999 and 2000. A negative private savings-investment balance, together with the fiscal deficit, corresponded to an increasingly consumption-driven widening of the external account deficit to around 8% of GDP in 2001 and 2002. The reduction in the general government deficit in 2003 created a conducive environment for interest rate cuts by the National Bank of Slovakia, which were implemented to mitigate appreciation pressures and a potential loss in external competitiveness. This was supportive to exports, which surged by some 22% in real terms on the back of an FDI-induced expansion in export capacity. In consequence, the external account deficit narrowed remarkably to less than 1% of GDP in 2003. Over the Commission Spring forecast horizon, i.e. until 2005, the external account deficit is projected to widen again to 3½% of GDP, owing to increasing domestic consumption and investment and, hence, a reduction in private net savings. In the years thereafter, as domestic consumption and investment picks up further, a return of the external account balance into less sustainable territory cannot be excluded and may, by itself, impose constraints on the size of the fiscal deficit.

5. CONCLUSIONS

In a context of continued robust growth, Slovakia's general government deficit decreased to 3.6% of GDP in 2003, above the 3% reference value. The excess of the general government deficit over the 3% of GDP reference value does not result, in the sense of the Stability and Growth Pact, from an unusual event outside the control of the Slovak authorities, nor is it the result of a severe economic downturn.

According to the Commission Spring 2004 forecasts as well as the Slovak authorities, the general government deficit will, at around 4% of GDP, be well above 3% of GDP in 2004. The debt-to-GDP ratio is forecast to increase by some 2½ percentage points to around 45% of GDP in 2004.

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[6] Net lending/borrowing vis-à-vis the rest of the world = current account + capital account. In the current system of national accounts, this is what corresponds to the concept of the "balances of payments on current account" mentioned in Article 121(1) of the Treaty.