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COVER NOTE

From:	Peter Palus, Financial Counsellor, Permanent Representation of the Slovak Republic to the EU
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To:	Mr Carsten PILLATH, Director General, Council of the European Union
Subject:	Slovakia: Draft Budgetary Plan of Slovakia for 2015, as laid down in Article 6(1) of Reg. (EU) 473/2013 on Common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the member states in the euro area

Delegations will find attached the first part of Draft Budgetary Plan of Slovakia for 2015 in English.

This document is aimed for discussion in the **Eurogroup.**

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Draft Budgetary Plan of the Slovak Republic for 2015

October 2014

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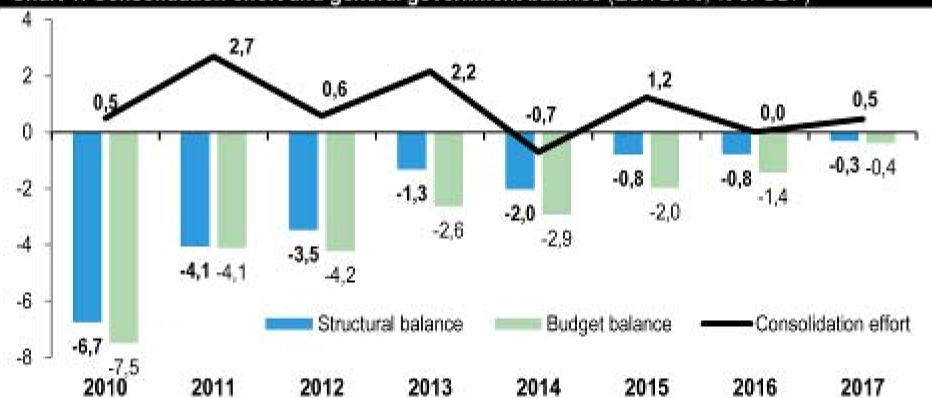
SUMMARY

The public finance deficit in 2013 decreased to 2.6% of GDP and the structural deficit reached its lowest historical value of 1.3% of GDP. Slovakia exited the excessive deficit procedure. Over the medium-term the government will continue in revitalising public finances towards achieving a structurally balanced budget. The budget proposal for 2015 is more ambitious than required by European rules and national fiscal legislation. It is based on a budget deficit of 1.98% of GDP, which corresponds to a structural consolidation of 1.2% of GDP. Developments during 2014 indicate a risk of 0.3% of GDP but the original target of 2.64% of GDP remains in place. If no changes in economic policies were made, the deficit in 2015 would reach a level of 3.5% of GDP. Nearly three quarters of the consolidation efforts in 2015 are focused on the expenditure side of the budget. Gross debt in 2013 did not breach the 55% of GDP threshold in 2013 and will gradually decrease in the coming years. The net debt is expected to stabilise at a level of around 50% of GDP.

After significant consolidation efforts over the past years, Slovakia exited the excessive deficit procedure in June 2014 as the public finance deficit decreased below the 3% of GDP threshold in a sustainable manner. Slovakia achieved one of the highest consolidation efforts amounting to 2.2% of GDP in 2013. Based on the preliminary data from the autumn notification, the deficit decreased to 2.6% of GDP, which implies an improvement of 0.3% of GDP compared to the original budget target. **The structural deficit according to the methodology of the European Commission reached 1.3% of GDP, the lowest value, in Slovakia's history.** Average consolidation efforts from 2010 to 2013 reached a level of 1.5% of GDP, higher than the 1% of GDP recommended by the Council of the European Union.

The primary objective of the fiscal policy of the Slovak Republic is to ensure effective and sustainable public finances that facilitate further improvement in the quality of life in Slovakia, which demands continued efforts towards revitalising public finances in the next years. Following the successful exit from the excessive deficit procedure, budget policy strategy will focus on achieving **the medium-term budgetary target** of a structural deficit of 0.5% of GDP in 2017.

Chart 1: Consolidation effort and general government balance (ESA 2010, % of GDP)



Source: MoF SR

The government's general government budget proposal for 2015 is drawn up with **a deficit of 1.98% GDP**, which corresponds **to structural consolidation of 1.2% of GDP** (compared to the current balance estimate in 2014). The submitted general government budget for 2015 is more ambitious than required by European rules and their transposition into national legislation. The fiscal space created with respect to the fiscal target shall function as a reserve for macroeconomic developments and may be used to cover the costs of health contribution allowance reform (the introduction of a deduction covering health insurance contributions for low-income employees) and

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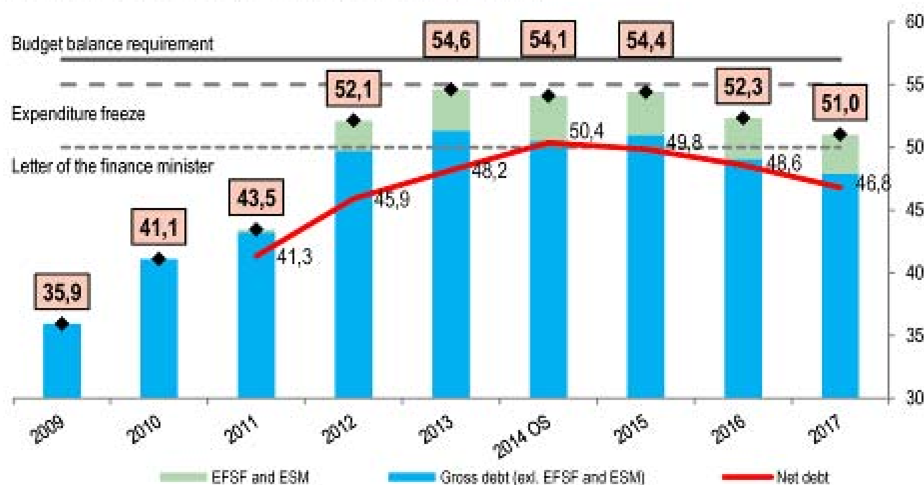
other potential needs with regards to collective bargaining, in particular in the education sector. If the approved budget target for 2014 of 2.64% of GDP is met then a deficit of 2.49% of GDP for 2015 will comply with required annual improvement of the structural balance of approximately 0.5% of GDP.

The general government budget deficit risk for 2014 is 0.3% of GDP compared to the approved budget target of 2.64% of GDP; however the original target remains valid. If such risk materializes, the deficit in 2014 would stand at 2.93% of GDP. The main negative factors are the refusal to acknowledge non-tax revenues from dividends as accrued revenues in ESA 2010 methodology, less favourable fiscal performance of local governments, the shortfall of other non-tax revenues, the EU corrections and higher health insurance expenditures. These risks are **significantly mitigated by improved collection of taxes and social security contributions.**

Assuming no changes in economic policies (No-Policy-Change Scenario, NPC)**, the general government deficit in 2015 would reach a level of 3.5% of GDP**. The difference in the general government balance between the no-policy-change scenario and the budget proposal for 2015 represents 1.6% of GDP. **The savings compared to the NPC are 1.1% of GDP on the expenditures side.** These savings should be achieved through ESO public administration reform and through the reduction of various public expenditures, including those related to the third level of the debt brake. **The overall positive impact on the revenue side against the NPC is 0.4% of GDP.** The most significant measures are the wide-ranging amendment of the Income Tax Act, the elimination of various exceptions and the broadening of the tax base along with the value-added tax rate maintained at 20%.

General government gross debt reached a level of 55.4% of GDP in 2013 according to the original April Eurostat notification. GDP revision resulting from the new ESA2010 methodology and changes in the classification of entities into the general government sector has likely ensured that **the share of debt to GDP for 2013 in the October notification will not exceed 55% of GDP** and sanctions from breaching the debt brake limit need not to be applied in this case. Debt should decline in 2014 for the first time since 2008 and should reach a level of 54.1% of GDP. Subsequently debt should continue to drop to 51% of GDP in 2017. The decline in debt is driven by improvements in the primary balance (general government deficit net of interest expenses) and GDP growth. Given the on-going consolidation, primary general government budget surplus is expected in 2016. Net debt at the end of 2013 reached 48.2% of GDP, which is significantly below the level of gross debt and will stabilise in this year just below a level of 50% of GDP.

Chart 2: Development of gross debt (ESA 2010, % of GDP)



Source: MoF SR

Planned structural and expenditure measures are focused on supporting economic growth and employment while increasing the efficiency of public expenditures. The most significant measures from the perspective of expenditures include ESO public administration reform, increasing efficiency in the healthcare sector and the construction of new nurseries. A majority of structural measures are focused on the labour market, currently the greatest challenge of the Slovak economy. The concurrence of material need benefits and wages should help increase employment of low-income employees.

Over the medium-term the draft budgetary plan is based on the general government budget proposal for 2015 to 2017 as approved by the Government of the Slovak Republic on 15 October 2014. The draft budgetary plan is prepared under the requirements introduced through Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (part of the so-called Two-Pack), approved in May 2013.

The aim of the Regulation is to improve the coordination of fiscal and structural policies while taking into account the rules of the Stability and Growth Pact and the Europe 2020 strategy. The submission of the draft budgetary plan, which presents the development of fiscal position, the expected development of the economy and a description of budget policy measures to achieve defined medium-term targets is a specific monitoring instrument. The presented data enable a more detailed assessment of the development of public finances in the coming year, which are based upon the current general government budget proposal as opposed to the Stability Programme. The European Commission will subsequently publish its opinion on budgetary plan; if a serious breach of the Stability and Growth Pact is identified, the Commission may request that the concerned Member State to redraft its budgetary plan.

The content and the format of the document are in full compliance with the guiding principles of the European Commission. Similarly to the stability programme, the draft budgetary plan has been prepared in accordance with the documents specifying the minimum requirements for draft budgetary plans - updated Specification on the implementation of the Two Pack and Guidelines on the format and content of draft budgetary plans, economic partnership programme and debt issuance report.

I. Macroeconomic assumptions of the budget proposal

The pace of recovery of Slovakia's main trading partners remains slow, in particular due to the on-going geopolitical conflict in the Ukraine and the anchoring of inflation at low levels. Monetary policy in the euro area remains relaxed. The euro area has been helped slightly by the performance of the American economy. Expected growth in Slovakia remains at a solid level, primarily thanks to the recovery of household consumption and fixed investments. The dynamics of growth in real wages were the highest in the last seven years due to the lowest inflation in history. Household consumption has also been supported by the creation of new jobs, which has also been reflected in declining unemployment rate. The economic growth of the Slovak Republic will accelerate gradually and reach 3.5% by the end of the forecast period. GDP, compared to the no-policy-change scenario, will grow at a rate that is 0.5 percentage points slower, primarily as a result of expenditure consolidation.

I.1. External assumptions in the forecast

Recovery of the external environment will slow down as a result of increased uncertainty. The economic recovery of our business partners in the euro area will be slow and gradual. Economic growth in the most important economy in the euro area, Germany, will remain at a level below 1.5% during 2014-2015. The recovery of foreign economies has been slowed, primarily as a result of the uncertainty associated with the conflict in Ukraine and the anchoring of inflation at low levels. The on-going economic imbalances and structural problems likewise restrict the potential for significant growth in the euro area.

Financial markets have been dominated over the last few months by diverging monetary policies of the European Central Bank (ECB) and the Federal Reserve (FED). The ECB has lowered rates to a new historic minimum (a base rate of 0.05% and refinancing rate of 0.3%) in an environment of decreasing inflation expectations in the euro area. The unprecedented step among large central banks was a decrease in the deposit rate to a negative level (-0.2%), which along with conducting targeted LTRO programmes and the purchases of asset-backed securities (ABS) has been set to stimulate inflation expectations in the future and improve the monetary policy transmission channel. The FED was encouraged by positive reports from the American economy and continued in a controlled tightening of loose monetary policy (known as tapering) and officially announced a rate increase in 2015.

Equity markets reached new highs, but short-term volatility increased again significantly due to the Russia-Ukraine conflict. Yields on European bond markets decreased slightly from the previous year due to inflation expectations significantly below the target level of 2% and the relaxed monetary policy of the ECB. The situation in peripheral countries has been stabilised to a large degree and all of them have returned to the financial markets (Greece is still primarily financed from the financial programme). The differences in the banking sectors of the Eurozone states and their structural problems resulted into the positive developments in financial markets not being reflected equally in all the countries. The slow recovery in credit financing of large companies was partially offset by corporate bond issuances on the financial markets. The price of Brent crude oil over the last four months has dropped significantly (from US$115 per barrel to US$97 per barrel). The euro also weakened significantly against the dollar as a result of the measures adopted by central banks and remains at a level below €1.30 per dollar.

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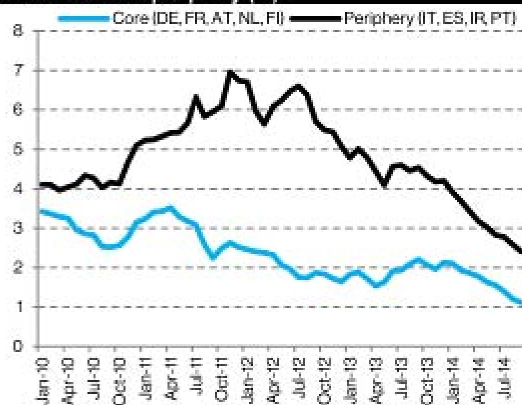
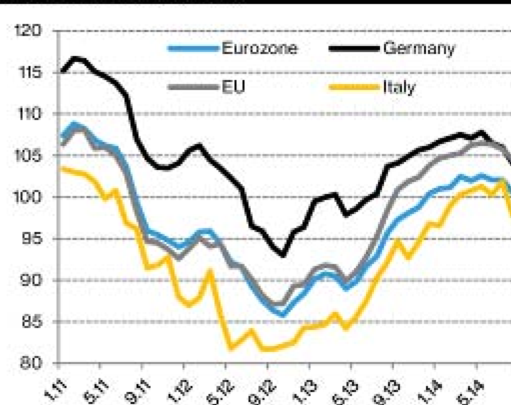
Chart 3: Comparison of the revenues of countries in the core and on the periphery (%)



Source: Bloomberg

Chart 4: Development of confidence indicators in the countries of the euro area



Source: Eurostat, European Commission

The euro area economy stopped growing in the second quarter. The on-going recessions in large countries such as France and Italy signal their continued structural problems. The second quarter delivered a surprise with a decline in the strongest economy in the euro area, Germany. Early indicators forecast a minimum of acceleration in economic activity in the second half of the year. IFO and ZEW indicators point to continued stagnation in Germany as well.

Prospects for economic growth in 2015 have deteriorated. The recovery of the euro area will be a slow process. Growth is expected at a level of 1.3% in 2015 (compared to 0.7% in 2014). Uncertainty associated with developments in the conflict in Ukraine and anchoring inflation at low levels are expected to have a negative impact on the expected economic growth in the euro area.

I.2. Macroeconomic forecast - growth to also be driven by household consumption

GDP continued its positive development in the second quarter. Quarterly growth of 0.6% ranked Slovakia among the fastest-growing countries in the euro area. As opposed to previous years, the driving force behind such economic growth was domestic demand, which grew at its fastest rate since the crisis broke out at the end of 2008. Growing household consumption was supported by a drop in consumer prices, favourable lending conditions and positive developments on the labour market in particular. Investments also accelerated growth, in particular in non-financial corporations and in services with higher added value. Growth of domestic demand also supported gains in employment and wages. On the other hand, growth in exports slowed above the rate of worsening foreign demand, which indicates a slower speed of gaining export market shares has been recorded in the past. Growth in domestic demand led to an increase in the growth of imports with net exports ultimately working against GDP growth.

The Slovak economy will grow by 2.4% this year and GDP growth is expected to accelerate in 2015 to 2.6%. A slowdown in foreign demand is expected in the second half of this year and resulting effects should be fully felt in 2015. In addition, the economic growth will be dampened by further consolidation efforts and the decrease in government consumption will be the most significant since 2011. The pace of growth of private consumption will slow slightly under pressure from slower growth in the creation of new jobs and investment growth will gradually recover. A slowdown in the growth of domestic demand shall lead to slower growth in imports and foreign demand shall once again contribute to positive growth. In the following years the economic growth will accelerate and its structure will be balanced with a slight predominance of foreign demand.

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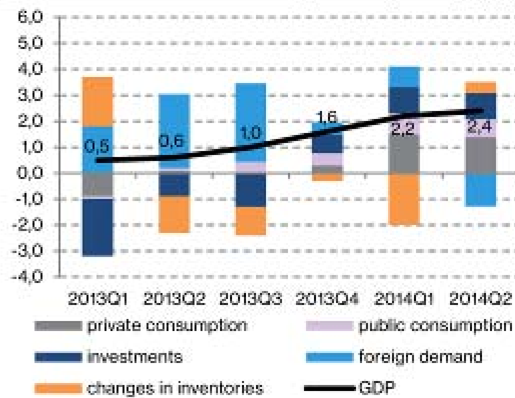
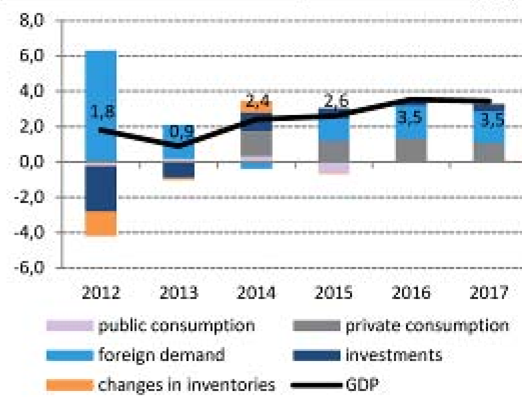
Chart 5: Contributions to GDP growth - quarterly (p.p.)



Source: MoF SR

Chart 6: Contributions to GDP growth - forecast (p.p.)



Source: MoF SR

Unemployment rate this year will drop to 13.5% and will decrease further in the following year. The recovery of economic growth in this year will translate into employment gains, in particular in the sectors of market services and manufacturing as well as in general government. Conversely negative developments in employment in the construction sector are expected to continue.

Real wages will increase by more than 4% in 2014, which is the highest rate in the past seven years. The reasons for such significant growth are a zero increase in prices and above-average growth in nominal wages. Growth of real wages will slow down in the following years and their development will match labour productivity. Increasing wages are primarily seen in manufacturing and market services, while such increases in the public sector will be dampened by on-going consolidation.

Inflation this year will be at the lowest level since the establishment of the Slovak Republic The expected year-on-year increase in consumer prices this year is 0.1%. The slowed growth of prices is the result of positive developments in cost factors and weak reaction to demand signals. The disinflation signal from the cost side is primarily due to decreases in the prices for energy and primary materials on global markets. The dynamics of costs factors are expressed through decreases in the prices for goods, foodstuffs and energy sources. In the following year we expect an acceleration of price dynamics as a result of improved results on the labour market and stronger price reactions to recovering demand. As a result, inflation in the following year should reach the level of around 1.0%.

Box 1: Macroeconomic forecast in ESA 2010 national account methodology

The macroeconomic forecast was completed based on preliminary ESA 2010 data and past estimates of the Ministry of Finance. The annual national accounts will be published this year in October and the seasonally adjusted quarterly time series will follow at a later time. At the time the forecast was being completed the Ministry of Finance only had preliminary data available for the annual national accounts in current and constant prices for 2005. The basis for the forecast in ESA 2010 was the forecast completed using the standard modelling approach in ESA 95 methodology for this reason. Due to the unavailability of the quarterly profiles, estimated annual GDP growth and its individual components (in constant and current prices) were transposed onto new preliminary levels of the requisite indicators in ESA 2010 modified by Ministry of Finance estimates. The Macroeconomic Forecasting Committee approved the forecast in ESA 2010 methodology including past Ministry of Finance estimates and estimates in constant prices for 2005.

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The introduction of ESA 2010 methodology had a positive impact on the level of GDP. Based on the data approved by the Macroeconomic Forecasting Committee, GDP in 2012 increased by €1.01 billion (1.5%) over the data in ESA 95 methodology and increased by €1.46 billion (2%) in 2013. The primary changes compared to ESA 95 methodology include the reclassification of expenditures for research and development, military expenditures and small tools.

Table A: Estimate of impact of major methodology changes on GDP (% change)

	2011	2012
Research and development	0.4-0.6	0.5-0.7
Military expenditures	0-0.1	0-0.1
Sector classification	0-0.1	0-0.1
Small instruments	0.7-0.9	0.7-0.9
Other	0.1-0.2	0.1-0.2

Source: SO SR

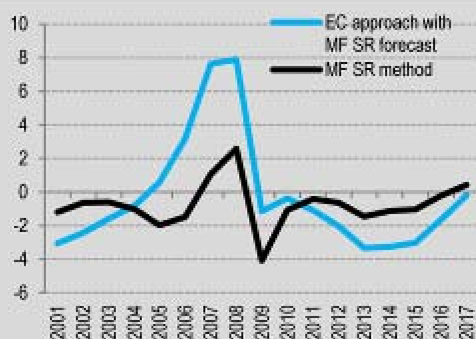
Box 2: Estimate of the output gap for 2014 and 2015

According to the forecast of the Ministry of Finance, which was prepared in accordance with the European Commission's methodology, Slovakia's output gap for 2014 and 2015 is estimated to reach -3.3% and -3.0% respectively. A slight reduction in the cyclical component is expected in 2015 but the economy will remain under its potential. According to the methodology of the Ministry of Finance, the output gap for 2014 and 2015 is estimated to reach -1.1% and -1.0% respectively.

The aim of the presented output gap forecast is to converge, in terms of methodology, to the estimate of the European Commission used to assess Slovakia's structural balance. Hence the Ministry of Finance applied the its methodology for output gap estimation. The data on the conditions of the economy after 2014 are based on the September forecast of the Ministry of Finance. The goal is to replicate the output gap based on the latest forecasts of the Ministry of Finance using the European Commission's uniform methodology.

The European Commission's methodology consists of two steps. Firstly, the estimates and forecasts are made for the trend unemployment rate which is consistent with a stable growth in wages in the economy (so-called NAWRU) and for the trend component of total factor productivity (so-called trend TFP). For this purpose, **the European Commission uses the publicly available GAP programme** which uses the Phillips curve and Kalman filter to break down the unemployment rate and total factor productivity into a trend component and a cyclical component. Since the most recent settings of the European Commission's model are not yet available, the Ministry of Finance used the NAWRU and trend TFP contained in the European Commission's spring forecast. In the next step, the estimated trend components of unemployment (NAWRU) and total factor productivity (trend TFP) are used as inputs to forecast the actual output gap in the CONV programme. The CONV programme output gap estimate model is based on the decomposition of the production function of the economy into labour, capital and total productivity factor contributions.

Chart A: Output gap development (as % of potential GDP) **– EC approach and MoF methodology**



Source: MoF SR

Table A: Contributions of production factors to the potential GDP growth - EC approach

	Pot. GDP (growth, %)	TFP*	Capital stock	Labour
2009	3.7	**2.7**	**0.3**	**0.6**
2010	3.6	**2.6**	**0.4**	**0.5**
2011	3.7	**2.4**	**0.8**	**0.5**
2012	2.8	**2.3**	**0.2**	**0.3**
2013	2.3	**2.2**	**-0.1**	**0.2**
2014F	2.3	**2.1**	**0.1**	**0.1**
2015F	2.3	**2.0**	**0.2**	**0.1**
2016F	2.1	**2.0**	**0.2**	**-0.2**
2017F	2.0	**2.0**	**0.3**	**-0.3**

*Total factor productivity Source: MoF SR

The Ministry of Finance's estimate of the potential output and the output gap differs methodologically from European Commission estimates. The Ministry of Finance publishes its estimate using its internal methodology at regular meetings

of the Macroeconomic Forecasting Committee. **According to Ministry of Finance methodology, the output gap for 2014 and 2015 is estimated to reach -1.1% and -1.0% respectively.**

The differences in Ministry of Finance and European Commission methodologies affect nearly every calculation component, even though the basic method is the same. Both institutions calculate the potential output using the Cobb-Douglas production function. **The greatest difference is in the historical data for total factor productivity (TFP).** The Ministry of Finance increases the potential product in 2005-2008 so as to correspond to the structural changes in the economy, which cannot be captured by the the common method of the European Commission. An excessively high output gap in 2007-2008 is given by the European Commission's method, nevertheless no other indicators of imbalance have been confirmed (net inflation, the current account deficit of the balance of payments and unit labour costs). Likewise, the magnitude of underperformance in 2013 compared to 2009 is larger according to the European Commission's methodology, which does not correspond to the relative magnitude of demand shocks in these two "V" in the post-crisis period.

I.3. Consolidation effects

Consolidation in 2015 should slow GDP growth down by 0.5 p.p. Measures with identified direct effect on GDP amount to 1.3% of GDP, with 0.9% of GDP attributed to expenditures and 0.4% of GDP attributed to revenues.

Assuming the no-policy-change scenario (NPC), the general government deficit in 2015 would reach a value of 3.5% of GDP. The general government budget proposal includes measures equal to 1.6% of GDP (€1.211 billion) compared to the no-policy-change scenario. As a result the general government budget deficit should reach a value of 1.98% of GDP in 2015. This section quantifies the overall effect of consolidation on the key macroeconomic indicators. The consolidation measures without a direct effect on GDP have not been included in the calculation of the consolidation package's impact on GDP. Health contribution allowance reform and a slight increase in the teachers' wages have been included on top of the measures stated in the draft budgetary plan.

Table 1: Size of consolidation measures (ESA 2010, as % of GDP)

	2015
1. General government balance under the NPC scenario*	-3.54
2. General government balance - budget	-1.98
3. Size of the consolidation measures (2-1)	**1.6**
- in € million	**1,211**
4. Size of the measures with a direct effect on GDP	**1.3**
- in € million	**986**

** NPC does not factor in possible changes in debt risk premiums.*

Expenditure measures with a direct effect on GDP amount to €697 million, which represents 0.9% of GDP. In terms of current expenditures these cuts primarily involve intermediate consumption (€213 million) and savings in employee compensation based on ESO reforms. Other current expenditures (€52 million) have the opposite effect. The most significant savings are the capital expenditures, which amount to €389 million, where the primary source of savings is expected to come from local governments. Expenditure measures will have an impact on the economy through decreased government consumption, lower growth of employment in the public sector and decreased public investments.

Table 2: Budgetary measures with effect on GDP (in € million, ESA 2010, differences against NPC)

	Category	Macroeconomic effects	2015
Increase in revenues with a direct effect on GDP, total (1-3)	**R**	**compensations, I, CPI**	**289**
(in % of GDP)			***0.4***
1. Maintaining the VAT rate at 20%	R	CPI	270

2. Changes in other taxes from production and imports	R	CPI, PY	-35
3. Changes in corporate income tax legislation	R	Compensations, I, PY	213
4. Changes in personal income tax legislation	R	Compensations, C	7
5. Withholding tax	R	Prices, I, compensations	5
6. Health contributions reform	R	Prices, I, compensations	-152
7. Non-tax revenues	R	Prices, I, compensations	103
8. Grants and transfers	R	Prices, I, compensations	-122
Decrease in expenditures with a direct effect on GDP, total (4-8)	**E**	**Compensations, G, I**	**697**
(in % of GDP)			***0.9***
9. Cuts in public sector's payroll expenditures	E	Compensations, G	62
10. Expenditures cuts in central government's intermediate consumption	E	G	213
11. Changes in healthcare expenditures	E	G	85
12. Cuts in general government investments (local governments)	E	I	389
13. Other changes in expenditures	E	G	-52
A. Total changes with a direct effect on GDP[1)]	**R+E**		**986**
(in % of GDP)			**1.3**
B. Total changes (revenues + expenditures) compared to NPC	**R+E**		**1,211**
(in % of GDP)			***1.6***

Note: This describes the effect on general government balance, i.e., (+) means an improvement and (-) a deterioration in balance.
Abbreviations: R – revenues, E – expenditures, I –fixed investments, G –general government consumption, Compensations – effects on employment and wages
1) Measures including collective bargaining, in particular in education and the introduction of the health contribution allowance deduction for low-income employees.

The 2015 general government budget proposal contains additional **revenue measures** with a direct effect on GDP **amounting to €289 million (0.4% of GDP).** Revenue measures should have an impact on the economy through a minor rise in prices and decreasing compensations and profits in the economy, which should translate into decreased private investments.

Consolidation in 2015 should slow GDP growth down by 0.5 p.p. The anticipated size of the consolidation package for the purposes of estimating the effects of fiscal consolidation on the economy is 1.3% of GDP, with 0.9% of GDP attributed to expenditures and 0.4% of GDP attributed to revenues. The estimated fiscal multiplier for 2015 reaches 0.4. For comparison purposes, the package multiplier was estimated at 0.4 in 2011, 0.2 in 2013 while in 2014 it is at a level of 0.4[1]. The package will have the most significant impact on government consumption and fixed investments. The effect on wages, employment and household consumption is expected to be moderate. A slowdown in the economic activity should also weaken the growth of imports. The effect on price development is also minor.

Table 3: Effect of measures on GDP (p.p.) according to the IFP macro-model

		2015
Measures with a direct effect on GDP		**-1.3**
Contribution to a year-on-year change in GDP		**-0.5**
- Of which:	Household consumption	-0.1
	Government consumption	-1.6

[1] Estimates for 2011 and 2013 are based on the average values of multipliers according to the Institute for Financial Policy (IFP) macroeconomic model, SVAR analysis in the Estimated Impacts of Fiscal Consolidation on GDP Growth in Slovakia, the Ministry of Finance's DSGE model. Estimates for 2011 and 2013 were based on real figures, while public finance development forecast was used to make estimates for 2014.

Fixed investments	-0.9
Imports	-0.3
Contribution to the change in CPI	-0.1
Employment	-0.2
Wages	-0.1

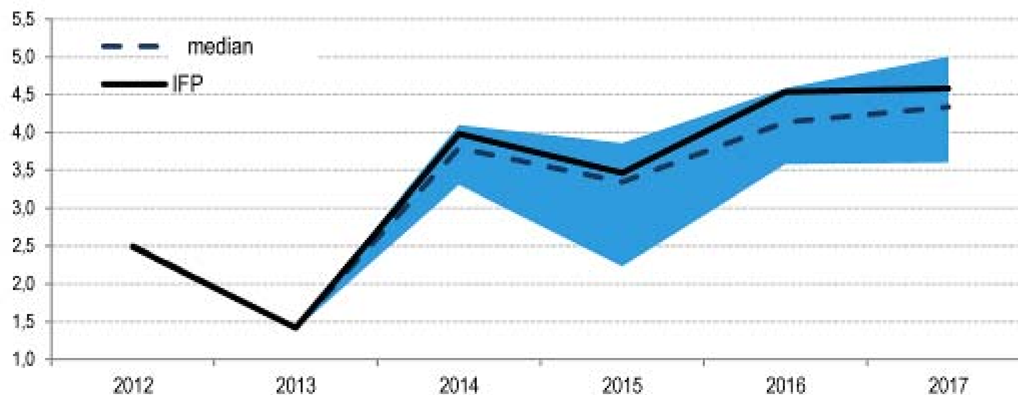
Source: MoF SR

I.4. Forecast assessment by the Macroeconomic and Tax Revenue Forecasting Committees

All members of the Macroeconomic Forecasting Committee (NBS, Slovak Academy of Sciences, Infostat, Tatra banka, UniCredit, SLSP, VÚB, ČSOB and Sberbank) **assesed the current medium-term macroeconomic development forecast** prepared by the Ministry of Finance of the Slovak Republic **as realistic.**

The Ministry of Finance's forecast is very close to the median of the Macroeconomic Forecasting Committee members in terms of effects on budget revenues in 2015. The effect is expressed as a weighted average of individual relevant bases for budget revenues, where weights are given by the share of individual taxes in total budgetary revenues[1].

Chart 7: Comparison of forecasts of macroeconomic bases[2] for budget revenues with MFC members



Source: MoF SR

The updated tax revenue forecast, prepared by the Ministry of Finance of the Slovak Republic and included in the budget proposal, is a follow-up to the macroeconomic forecast; which was evaluated by **all members** of the Tax Revenue Forecasting Committee (NBS, Infostat, ČSOB, SLSP, Tatra banka and UniCredit Bank) as **realistic**.

The Macroeconomic Forecasting Committee (MFC) and the Tax Revenue Forecasting Committee (TRFC) were established under the constitutional Fiscal Responsibility Act (Act No. 493/2011) as advisory bodies to the Minister of Finance. The role of the committees is to ensure greater transparency, objectiveness and quality of macroeconomic and tax revenue forecasts. Both committees prepare their forecasts at least twice a year, by 15 February and 30 June of the current fiscal year. In exceptional cases, the committees may be convoked either by the committee chairman, Minister of Finance or by a simple majority of the committee members.

[2] Macroeconomic bases for budgetary revenues (the weight of indicators depends on the share of individual taxes in the total tax and social contribution revenues); Wage base (employment + nominal wage) – 51.1%, Nominal private consumption – 25.7%, Real private consumption – 6.6%, Nominal GDP growth – 9.9%, Real GDP growth – 6.7%

In addition to the Ministry of Finance officials, the committees consist of representatives of institutions independent from government (NBS, Slovak Academy of Sciences, Infostat and private banks). The Macroeconomic Forecasting Committee members assess the Ministry of Finance's macroeconomic forecast using the terms *conservative, optimistic* or *realistic*. The Ministry of Finance's tax revenue forecast is assessed by the Tax Revenue Forecasting Committee members by submitting their own forecasts; the final assessment is calculated automatically, based on a deviation between the two. ***A Ministry of Finance's forecast is accepted by the MFC or the TRFC if graded as conservative*** **or** ***realistic*** **by a simple majority of its members.** In the absence of such grading, the Ministry of Finance of the Slovak Republic is required to redraft its forecast and submit it to the Committee for re-assessment. The procedure is repeated until the Ministry of Finance's forecast is accepted by the MFC or the TRFC as its own forecast.

II. Budgetary objectives

The primary objective of the fiscal policy of the Slovak Republic is to ensure effective and sustainable public finances that enable continued improvement in the quality of life in Slovakia, which demands on-going efforts towards revitalising public finances in the following years. Budget policy strategy after successfully exiting the excessive deficit procedure in 2013 anticipates ***the achievement of the medium-term budget target of 0.5% of GDP in 2017****. Taking this into account, the target for the general government deficit was set at 2.64% of GDP in 2014. The current estimate anticipates a slightly higher deficit of 2.93% of GDP, however the original target remains in place. Details regarding the changes compared to the approved budget are presented in the Section II.1.*

The general government budget proposal anticipates a continued decrease in the general government deficit, though at a more gradual pace than during the excessive deficit procedure. The current budget proposal anticipates a deficit at a level of 1.98% of GDP in 2015. This target is in line with national fiscal rules and is more ambitious than required by European rules.

Gross debt will likely be revised for 2013 to a level of 54.6% of GDP*. The GDP revision decreased debt by 1.1 p.p. and the reclassification of entities into the general government sector slightly increased debt by 0.3 p.p. This represents a decrease in the estimate compared to the notification from April when gross debt reached 55.4% of GDP. The current budget targets anticipate a decrease in* ***gross debt at the end of 2014 to a level of 54.1% of GDP.*** *Throughout the entire forecast period, general government debt shall remain below the 55% of GDP threshold, which is also below the reference value defined by the Stability and Growth Pact. The gross debt will gradually decrease in the next years. The fiscal space is limited by the constitutional Fiscal Responsibility Act, which goes beyond the requirements of the Stability and Growth Pact, and constraints the Slovak fiscal policy in the medium-term (more details are provided in Chapter II.4).*

II.1. Recent development in public finances

The general government budget proposal for 2015 takes into account recent developments in the general government balance as well. This balance is calculated on the basis of macroeconomic and tax forecasts from September 2014. **The estimated general government budget deficit in 2014 was 2.93% of GDP, illustrating a risk of 0.3% of GDP compared to the approved budgetary target of 2.64% of GDP. Nevertheless,** the original target remains in place.

Table 4: Current estimate of general government balance in 2014 (difference against the approved budget)		
Approved general government budget deficit (ESA 95)	**-2,000**	**-2.64**
Changes compared to approved budget	**-199**	**-0.3**
Positive effects decreasing general government balance (+)	**1,081**	**1.4**
General government tax and social security contribution revenues (including penalties)	498	0.7
Blocking of 3% of adjusted state budget expenditures (debt brake)	305	0.4
Savings on expenditures for co-financing and to the EU budget	234	0.3
Antimonopoly Office's fine to the transportation cartel	45	0.1
Negative effects increasing the general government balance (-)	**-1,280**	**-1.7**
Unrecognised revenues from dividends	-571	-0.8
Fiscal performance of local governments including local transportation companies (new general government entity)	-183	-0.2
Lower revenue from sales of emission allowances and state budget capital revenues	-128	-0.2
Increased expenditures in public health insurance	-117	-0.2
Lower revenue from the sales of digital dividends	-86	-0.1

EU corrections	-81	-0.1
Expected economic performance of healthcare facilities	-60	-0.1
Other effects	-54	-0.1
Expected actual general government deficit (ESA 2010)	**-2,199**	**-2.93**

Source: MoF SR

Expenditure effects:

- General government gross debt reached 55.4% of GDP at the end of 2013 (based on the results of the spring notification in ESA 95). This led to the activation of measures based on the constitutional Fiscal Responsibility Act. One of the measures was that the Ministry of Finance **was required to block 3% of all adjusted state budget[3] expenditures**. Beginning in May 2014 the Ministry of Finance blocked a total of €305 million (0.4% of GDP) as a result.
- **Savings from decreased drawing of EU funds** and from the transfer to the EU budget. Decreased co-financing expenditures in the amount of €191 million (0.3% of GDP). This was related to the decrease in the estimate for drawing EU funds by €0.8 billion compared to the budget. Slovakia also paid in €43 million less into the EU budget for 2014. Total savings from the change in EU funds equals €234 million (0.3% of GDP).
- With respect to **other general government entities**, public health insurance is expected to have a greater effect, by €117 million (0.2% of GDP). **The fiscal performance (net of taxes) of** local governments will be worse by €28 million.[4] Other risks include the expenditures of public transportation companies (in Bratislava, Banská Bystrica, Žilina and Košice), which are financed primarily by transfers from these cities.
- Based on an audit of EU funds a **financial EU correction** amounting to €81 million (0.1% of GDP) must be made in the national accounts. This amount represents an increase in capital transfers according to ESA 2010 methodology.
- Based on current developments, we assume **that healthcare facilities**, which are reclassified in the public sector will have a negative income statement, amounting to €60 million (0.1% of GDP).

Tax and social security contribution revenues

In comparison to the approved budget it is expected that tax and social security contribution revenues of general government in ESA 2010 methodology will be higher by €498 million (0.7% of GDP), with tax revenues higher by €322 million and social security contributions by €210 million. At the same time a reserve for increasing tax and social security contribution revenues from collective bargaining has been included in the tax forecast (€34 million).

The general government budget proposal for 2015 to 2017 has been prepared using ESA 2010 methodology, while the approved budget for 2014 applied ESA 95 methodology. In terms of tax revenues a difference can be seen in the methodologies of recording tax credits directly in tax revenues, which are subsequently recorded on the expenditure side with no impact on the deficit. The total effect of this change in the methodology equals to a difference of €263 million, which is analytically removed when considering differences against the approved budget.

[3] This process involves blocking 3% of expenditures from the approved State Budget Act for the given year less expenditures for servicing state debt, European Union funds, co-financing funds, transfers to the EU budget, transfers to the Social Insurance Agency and expenditures to remedy damages caused by natural disasters.
[4] Unconsolidated local government's fiscal performance is negative compared to the approved budget by €117 million.

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Table 5: Tax and social security contribution revenues of the general government in 2014 (difference against the approved budget, including penalties, in € million)	
Total (1+2+3)	**498**
1. Tax revenues	**322**
- Corporate income tax	207
- Excise taxes	70
- Personal income tax	38
- Value-added tax	20
- Other, including penalties	-13
2. Social security contributions	**210**
- Public health insurance, including penalties	58
- Social insurance, including penalties	151
3. Expected impact of collective bargaining on tax and social security contribution revenues	**-34**

Source: MoF SR

Non-tax revenues dividends

The most significant negative impact compared to the budget is based on the shortfall in ordinary dividends according to ESA 2010 from the Slovenský plynárenský priemysel (SPP) and the Slovenská elektrizačná a prenosová sústava (SEPS). **The total shortfall in SPP's ordinary dividends compared to the approved budget for 2014 represents €467 million.** The approved budget for 2014 anticipated revenues from SPP's ordinary dividends amounting to €735 million, which comprised two components[5]: €365 in profits from 2012 and €370 million in profits from 2013. A similar situation occurred in the case of SEPS dividends. The shortfall in SEPS's ordinary dividends according to ESA 2010 methodology represented a total of €63 million (0.1% of GDP) in 2014.

Other non-tax effects include:

- Lower revenues are expected due to declining prices for **emissions allowances** on the European exchange at a level of €61 million. Expected revenues in the approved budget were €117 million. There was also a shortfall in general government capital revenues amounting to €67 million. The total shortfall in capital revenues is €128 million (0.2% of GDP).
- An **electronic auction for frequency bands, known as the digital dividend,** was held in 2014. Mobile operators paid a total of €164 million in a market auction for these frequencies. The estimated budgeted amount for the auction was €250 million, which led to a shortfall in state budget revenues of €86 million (0.1% of GDP). Another source of budget revenues are the fines issued by the Antimonopoly Office of the Slovak Republic against six construction companies for concluding **a cartel agreement** amounting to nearly €45 million (0.1% of GDP).

II.2. Structural balance and expenditure benchmark

Two analytical indicators are used to monitor fiscal targets that better capture the fiscal position of the government than a simple comparison of the general government balance. The first indicator is the **consolidation effort** which illustrates the trajectory that the government plans to use to meet its medium-term

[5] The general assembly of SPP approved in December 2013 the proposed distribution of profits for 2012 and the payment of a dividend in 2014 amounting to €365 million. Of this amount, €186 million (a 51% share) belonged to the state, specifically the National Property Fund, with accrual impact in 2013. The second portion of the profit from 2012 amounting to €179 million (49% share held by a private shareholder) was paid out on the basis of a decision of the general assembly held in 2014 as cash revenue of the State Treasury. This revenue does not represent accrued revenue of the state according to ESA 2010 methodology and has no impact on the deficit in ESA 2010. Compared to the approved budget for 2014, this led to a shortfall in dividends from 2012 profits amounting to €365 million in ESA methodology. At the same time the shortfall in SPP's ordinary dividends totalled €102 million compared to the expected €370 million. Only ordinary dividends stemming from profits in 2013 amounting to €268 million (0.4%) will be paid out in 2014.

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budgetary target. The second is the **expenditure benchmark** that serves to assess the pace of growth in general government expenditures. These are key analytical indicators in the assessment of the draft budgetary plans[6], which is prepared by the European Commission.

II.2.1. Structural balance

The first step in calculating the consolidation effort is to adjust the general government balance for the effects of economic cycle (boom or recession) on general government revenues and expenditures, i.e., the cyclical component. The Ministry of Finance uses estimates of the sensitivity of the general government balance to changes in the output gap, which is based on OECD methodology[7], which is fully in line with the European Commission methodology. The method used for calculating consolidation effort according to the European Commission is described in the box. **In the second step, the general government balance is adjusted for one-off and temporary measures.** Based on the definition provided in the General Government Budgeting Rules Act, a one-off effect is understood as any such revenue or expenditure that is not permanent or recurrent in nature and that has a temporary impact on the general government's budget balance. The Ministry of Finance published a manual[8] defining rules for identifying one-off measures that led to their revision for past year as well.

These adjustments result in a structural balance that reflects the situation of public budgets assuming that the economy performs up to its potential level of output net of one-off effects. A change in the structural balance compared with the previous year describes the consolidation effort in the given year. The estimated development in the general government structural balance is defined in the preventive arm of the Stability and Growth Pact and serves as the basis for defining fiscal policy targets.

In an effort to consider growth supporting investments in the Member States, the European Commission prepared the so-called investment clause that allows Member States to temporarily deviate from the consolidation effort required in the preventive arm of the Pact when specific conditions are met. Once the investment clause is triggered, the consolidation effort in the first year will be adjusted for the sum of expenditures on national co-financing and expenditures on the Common Agricultural Policy and Common Fisheries Policy. In the subsequent years, adjustments are only made for a year-on-year increase in these funds. According to the European Commission's assessment[9] the investment clause can only be applied in 2014 with respect to the forecasted improvement of economic development in the euro area and in particular the closure of the negative output gap in 2015.

Five criteria must be met in order to activate the investment clause, based on which the Member States can request the application of this clause in the preventive arm of the Pact. According to current estimates, **Slovakia meets the criteria needed for the investment clause and has sought its application in the Draft Budgetary Plan for 2014.** The table below provides an overview of criteria and their fulfilment for Slovakia in 2014.

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[6] Vade Mecum on the Stability and Growth Pact, European Economy. Occasional Papers. 151. May 2013. Brussels.

[7] The original methodology was presented in Girouard, N., André, Ch. (2005): Measuring cyclically-adjusted budget balances for OECD countries. The process of updating methodology and including new data for calculating elasticity took place in 2014. The methodology was adopted by the Member States in September 2014.

[8] https://www.finance.gov.sk/Default.aspx?CatID=9595

[9] Review of the implementation of the investment clause in the preventive arm of the Stability And Growth Pact, Note for the Economic and Financial Committee, Ares (2014) 1693085 - 23/05/2014

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Table 6: Fulfilment of Stability and Growth Pact investment clause criteria for Slovakia

Investment clause criteria	Fulfilment for Slovakia
Negative GDP growth or growth far below the potential growth level	A negative output gap at the level of 3.2% of potential GDP is estimated for 2014, indicating a considerable cooling of the economy and growth below the country's potential. According to the European Commission's preliminary assessment[10] in the autumn 2013 forecast, Slovakia met the condition for "bad" economic times. According to the spring 2014 forecast, the negative output gap estimate worsened.
The country was outside of the corrective portion of the Pact, meaning it had a deficit below 3% of GDP and debt below 60% of GDP (or, in case of countries with debt above 60% of GDP, debt is decreasing at a sufficient speed)	Slovakia exited the excessive deficit procedure in June 2014.
Maximum deviation from the required consolidation effort will be directly linked to the amount of expenditures on co-financing EU projects implemented under the Structural and Cohesion Policies, TEN and CEF	In 2014 funds for co-financing relevant EU projects based on current estimates should reach €448.4 million (0.6% of GDP). A more detailed overview for the individual operational programmes is shown in Annex 2.
In case economic growth is forecasted (or closing of the negative output gap), any deviation due to the application of the investment clause is assumed to be compensated for so that the calendar of reaching the medium-term budget objective is not affected	According to the general government budget proposal for 2015-2017, the deviation for 2014 shall be compensated by increased consolidation in 2015. At the same time, and despite an unfavourable macroeconomic environment and the unexpected shortfall in revenues, significant consolidation was achieved in 2013. 2017 remains valid as a year for reaching the medium-term budget target in line with the recommendations made by the Council of the European Union from June 2013.
In addition to meeting these conditions, a Member State should also demonstrate direct positive effects of co-financed projects on the long-term sustainability of public finances, including their effects on the potential economic growth, as well as evidence that national investments are not replaced by investments co-financed from EU funds, i.e., that no decrease has occurred in the general government gross fixed capital formation.	The investments supported by co-financing contribute towards economic growth and have a positive effect on fiscal policy in the medium-term horizon. The current estimate of the Ministry of Finance anticipates a year-on-year increase in public investments by 17% in 2014.

Slovakia exited the excessive deficit procedure in June 2014 after extensive consolidation efforts in previous years. One of the highest consolidation efforts since entry into the EU amounting to 2.2% of GDP was achieved in 2013. The deficit dropped below the 3% of GDP threshold to 2.6% of GDP and the annual average consolidation effort from 2010 to 2013 reached 1.5% of GDP, which was higher than 1% of GDP required by the recommendations of the Council of the European Union. According to the spring forecast from the European Commission, the general government deficit shall be kept below the 3% threshold level in 2014 and 2015 as well.

Following significant consolidation since 2009, **a temporary relaxation of fiscal policy shall occur in 2014**, given the on-going unfavourable macroeconomic situation with GDP below the level of potential and the need to adopt measures to restart economic growth. Taking into account the improved results for 2013 based on the preliminary data from the autumn notification and the fulfilment of the budget target for 2014, fiscal expansion will reach 0.4% of GDP. According to the estimated general government balance, there is a risk that structural expansion could reach 0.7% of GDP in 2014 if the budget target is not met. This would lead to a reduction in the consolidation effort by 0.4% of GDP compared to the estimated consolidation effort in the Stability Programme

[10] The investment clause in the preventive arm of the Stability And Growth Pact: preliminary assessment of eligibility, Note for the Economic and Financial Committee, Ares (2013) 3540113 – 22/11-2013

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2014 -2017 due to an improved general government final balance for 2013 and worse than expected development of public finances in 2014. Structural expansion is restricted to a single year and is compensated by a markedly consolidation effort in the following year. This preserves the original deadline for achieving the medium-term budget target. No major deviation from the required consolidation based on the Stability and Growth Pact rules should occur when considering the application of the investment clause.

The planned stronger consolidation effort in 2015 shall compensate for the expected developments in 2014. The government's general government budget proposal is drawn-up with a deficit of 1.98% of GDP which corresponds to structural consolidation of 1.2% compared to the expected deficit for 2014. The budget proposal is more ambitious than required by European rules and their transposition into national fiscal legislation. The fiscal space created with respect to the fiscal target shall function as a reserve for macroeconomic developments and may be used to cover the costs of health contribution allowance reform (the introduction of a tax deduction covering health insurance deductions for low-income employees) and other potential needs with regards to collective bargaining, in particular in the education sector. In all of the considered scenarios the consolidation effort in 2015 complies with the requirements of the Pact. According to the specific recommendations approved by the Council of the European Union, Slovakia's continued advances towards the medium-term target should reach 0.1% of GDP in 2015 while taking into account all expected negative economic conditions.

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