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COVER NOTE

From:	Peter Palus, Financial Counsellor, Permanent Representation of the Slovak Republic to the EU
date of receipt:	29 October 2014
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 second part of Draft Budgetary Plan of Slovakia for 2015 in English.

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

Table 7: Consolidation effort (ESA 2010, % of GDP)

	2012	2013[11]	2014 E	2015
1. Net lending/borrowing	**-4.22**	**-2.63**	**-2.93**	**-1.98**
2. Cyclical component	-0.8	-1.3	-1.3	-1.2
3. One-off effects[12]	0.1	0.0	0.4	0.0
4. Structural balance – cyclically-adjusted balance net of one-off effects (1-2-3)	**-3.5**	**-1.3**	**-2.0**	**-0.8**
Consolidation effort according to the EC (year-on-year change 4)		**2.2**	**-0.7**	**1.2**
- Investment clause – national co-funding			**0.6**	
Consolidation effort adjusted for the amount of national co-funding			**-0.1**	
p.m. scenario of minimal consolidation effort [2.93% of GDP in 2014 compared to deficit from original requirement in EU rules for 2015 (2.49% of GDP)]			-0.7	0.7

Source: MoF SR

Box 3: Consolidation efforts according to the preventive arm of the Stability and Growth Pact

According to the rules of the preventive arm of the Pact the countries of the euro area[13] which have not yet achieved their medium-term budgetary target must meet a consolidation effort of 0.5% of GDP on the annual basis. According to the new interpretation of Regulation No 1466/97 that has been presented by the European Commission[14] the required consolidation efforts must be differentiated by the cyclical position of the country, the amount of its debt and the risk of fiscal sustainability.

- Consolidation is not required in the given year if economic growth is negative or if the negative output gap exceeds -4% of GDP.
- Consolidation effort must exceed 0.5% of GDP annually (i.e. a minimum of 0.6% of GDP), if debt exceeds 60% of GDP or if there is a significant sustainability risk for debt measured using the S1 sustainability indicator.
- In good economic times, i.e. with an output gap exceeding 1.5% of GDP, the consolidation effort should also exceed 0.5% of GDP on an annual basis. Conversely; consolidation effort should be less than 0.5% of GDP per year, but at least 0.1% of GDP, in the case of a negative output gap that is higher than -1.5% of GDP.

	Required consolidation effort for countries that have not achieved the medium-term budget target according to the Pact (% of GDP)	
	Gross debt < 60% and low or moderate sustainability risk (S1 indicator)	**Gross debt > 60% or high sustainability risk (S1 indicator)**
No need for consolidation: Real growth < 0% or output gap below -4% of potential GDP	**No need for consolidation**	
"Bad" economic times: Output gap between -4% and -1.5% of potential GDP	**> 0**	**≥ 0.5**
"Neither good nor bad" economic times: Output gap between -1.5% and 1.5% of potential GDP	**0.5**	**> 0.5**
"Good" economic times: Output gap > 1.5% or slightly lower than 1.5% but rapidly approaching a value over 1.5% of potential GDP	**> 0.5**	

[11] Data for 2013 is from the second round of autumn EDP deficit and debt notification to Eurostat.

[12] A more detailed overview of one-off effects is provided in Annex 1.

[13] Regulation No 1466/97 does not specify the required consolidation effort for countries outside of ERMII and the euro area with debts below 60% of GDP and without a high sustainability risk but according to the European Commission's interpretation, such effort should be 0.5% of GDP annually if there is no other reason.

[14] The Significant Deviation Procedure In The Preventive Arm Of The SGP, Note for the Alternates of the Economic and Financial Committee, Ares(2014)1051386 - 03/04/2014

The table below provides an overview of the required consolidation effort for euro area countries that have not achieved their medium-term budget targets. Consolidation effort required by the Pact for countries such as Slovakia must be at least 0.1% of GDP in 2014 and 2015 given debt levels below 60% of GDP, moderate sustainability risk of public finances based on the S1 indicator and a negative output gap exceeding 1.5% of GDP based on the European Commission's spring forecast. According to the specific recommendations approved by the Council of the European Union[15] in June 2014, Slovakia's trajectory towards the medium-term target should reach 0.1% of GDP in 2015 while taking into account expected negative economic conditions.

II.2.2. Expenditure benchmark

The revised Stability and Growth Pact introduced the expenditure benchmark as a supplementary instrument for analysing the fiscal position. It shows the growth of the expenditure aggregate net of the revenue measures which enables the assessment of the progress achieved in fiscal consolidation, when compared against the expenditure growth reference rate

The expenditure benchmark is applied differently depending on whether the country concerned has accomplished its medium-term target. Slovakia has not met its individual medium-term target[16] since 2005, the year of its inclusion in the revised Stability and Growth Pact. This means that the adjusted primary general government expenditures net of the revenue measures, should grow in real terms at a slower pace than the average potential growth of the economy in order to ensure that the structural balance improves annually by 0.5% of GDP. The expenditure benchmark is taken from the European Commission documents[17].

The expenditure benchmark is compared with the expenditure analytically adjusted for factors beyond the Government's reach and those not affecting the general government balance. These include interest expenditures, changes in unemployment benefit expenditures unrelated to government policies, expenditures funded by EU funds and expenditures covered by the measures on the revenue side. At the same time, considering a high year-on-year volatility of government investments (which is, in particular, the case of small EU member states), the average amount of investments for the past three years and the current year is taken into account. The nominal growth of expenditures adjusted in this manner is converted to real growth using the GDP deflator so that it could be compared against the expenditure benchmark.

Table 8: Expenditure benchmark (ESA 2010, € million)

	2013	2014 E	2015
1. Total expenditure	**30,193**	**29,680**	**29,622**
2. Interest expenditures	1,393	1,387	1,327
3. Gross fixed capital formation	2,193	2,661	2,224
4. Gross fixed capital formation (average for t-3 through t)	2,271	2,378	2,315
5. Expenditure on EU programmes fully matched by revenues from EU funds	957	1,453	1,682
6. Cyclical unemployment benefit expenditure	28	28	27
7. Expenditures fully matched by revenue increases mandated by law	0	0	0
8. Primary expenditure aggregate (1-2-3+4-5-6-7)	**27,892**	**26,528**	**26,677**
9. Year-on change in primary expenditure aggregate (8_t-8_{t-1})	993	-1,364	149
10. Change in revenues due to measures	1,272	63	283
11. Nominal year-on-year growth of expenditure aggregate net of revenue measures ((9_t-10_t)/8_{t-1})	-1.0	-5.1	-0.5

15 http://ec.europa.eu/europe2020/pdf/csr2014/csr2014_council_slovakia_sk.pdf
16 Based on recommendations from the Council of the European Union from 2013, Slovakia should meet its medium-term target (structural general government deficit of 0.5% of GDP) by 2017.
17 Vade Mecum on Stability and Growth Pact, page 30

12. Real year-on-year growth of expenditure aggregate net of revenue measures	**-2.9**	**-6.9**	**-1.4**
13. Expenditure benchmark – expenditure growth reference rate	**2.9**	**2.6**	**2.6**
14. Deviation from expenditure benchmark (12-13)[1]	**-5.8**	**-9.5**	**-4.0**
p. m. GDP deflator[2]	*1.9*	*1.9*	*0.9*
p.m. Actual growth in expenditure aggregate net of revenue measures at general government deficit pursuant to original requirements of EU rules equal to 2.49% of GDP in 2015			*0.1*

[1] A negative value represents fulfilment of the expenditure benchmark

Source: MoF SR

[2] Average of two European Commission forecasts

Expenditure development in 2014 and 2015 should **comply with the expenditure benchmark**. A significant real decrease in expenditure aggregate (-6.9%) should occur in 2014 based on current expectations. A more modest decrease in expenditure aggregate (-1.4%) is expected in 2015. Public expenditure development in 2014 and 2015 should comply with the expenditure benchmark.

II.3. General government gross debt forecast

General government gross debt[18] reached a level of 55.4% of GDP[19] at the end of 2013 according to the original April Eurostat notification. The GDP revision that occurred after the change in methodology is likely responsible for the fact that share of gross debt to GDP will not exceed a level of 55% of GDP in 2013[20]. **Under the assumption that budgetary targets are met, the share of debt to GDP throughout the forecast period shall remain below the 55% of GDP threshold.**

Debt should decline in 2014 for the first time since 2008 and should reach a level of 54.1% of GDP. **A slight temporary increase to 54.4% of GDP is expected in 2015, but this will be followed by gradual declines in the following years, ultimately reaching 51% of GDP in 2017.** The decline in debt is contingent upon improvements in the primary balance (general government deficit net of interest expenses) and GDP growth. Given the on-going consolidation, a primary general government budget surplus is expected in 2016.

Table 9: General government gross debt (% of GDP, ESA 2010, figures as of 31 December)

	2012	2013	2014 E	2015	2016	2017
General government gross debt	**52.1**	**54.6**	**54.1**	**54.4**	**52.3**	**51.0**
- Sovereign debt (net of international commitments)	47.7	48.9	48.9	49.5	47.8	46.9
- Slovakia's share in the EFSF facility debt	2.1	2.6	2.7	2.6	2.5	2.3
- Contribution to the ESM	0.4	0.7	0.9	0.8	0.8	0.8
- Debt of other general government entities	2.0	2.4	1.6	1.4	1.2	1.0
p.m. Change in gross debt ratio	8.7	2.5	-0.5	0.3	-2.1	-1.3

Source: MoF SR, SOSR

The change in general government debt **is primarily due to the amount of the state budget cash deficit**, which will decline beginning in 2015. The cash deficit of the state budget in 2014 is expected to reach a level of €2.6 billion (3.5% of GDP), followed by €2.8 billion (3.6% of GDP) in 2015.

On the other hand, most of the other effects will drive down the level of debt. One significant factor is the **financing from the State Treasury.** In 2015 revenues from the planned sale of state assets (in particular the

[18] All indicated values are calculated based on the methodology applied in the assessment of compliance with the Maastricht criterion for general government gross debt, the so-called Maastricht general government gross debt

[19] According to the provisions of the constitutional Fiscal Responsibility Act (Act No. 493/2011 Coll.) the government had to execute a number of preventive measures in order to avoid debt levels increase (described in more detail in Chapter II.4) once gross debt exceeded 55% of GDP threshold.

[20] Data for 2013 is from the second round of autumn EDP deficit and debt notification to Eurostat.

sale of a minority ownership interest in Slovak Telekom) are expected with an impact on cash equal to €1 billion (1.3% of GDP).

No additional impacts on a year-on change in debt in 2015 are expected from Slovakia's international obligations to the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Slovakia's debt was previously impacted by EFSF obligations that arose in conjunction with the provisioning of financial assistance. The EFSF will no longer participate in the new financial programmes; however, it will continue to administer the assistance provided to the debtor countries until it is repaid in full. Until then, the EFSF commitments will be directly rerouted into the debt level based on Slovakia's share in the EFSF debt. In the case of ESM, such contributions reduce the funds available to the State Treasury to finance government's operations, thus contributing to an indirect increase in debt.

The debt calculation also considers **changes in methodology as well as the discount at the issuance and redemption of bonds**. The discount in the issuance of state bonds and treasury bills increases the debt as state commitments increase at the moment the bonds are issued by the nominal value of such bonds. The state does, however, receive a lower amount in cash (decreased by this discount). Conversely, the discount has a positive effect on debt upon redemption of such state bonds. The reason for this is that the increase in debt occurs upon issuance of the bonds in the nominal value of such bonds and not at redemption. The overall effect of both factors will decrease debt in 2015.

Based on Eurostat recommendations[21], a **loan for the Emergency Oil Stock Agency** amounting to €465 million (0.6% of GDP), which was used to finance the purchase of strategic oil reserves from the State Material Reserves, was included in public debt for 2013, which had a fundamental influence on exceeding the 55% debt threshold in 2013 based on the April Eurostat notification. According to ESA 2010, the EOSA was reclassified in its entirety into the public sector while the total balance of EOSA loans in 2013 totalled €520 million (0.7% of GDP). The gross debt will be decreased by a corresponding amount if the EOSA loan is repaid to the consortium of banks in 2014.

Other changes in the debt forecast are connected to exchange rate differences and a change in the deposits of State Treasury clients outside of the general government.

Table 10: Impact on the general government gross debt (in € million)

	2012	2013	2014 E	2015	2016	2017
A. General government gross debt (as at 1 January)	**30,485**	**37,618**	**40,178**	**40,612**	**42,374**	**42,967**
B. Total year-on-year change in the general government gross debt	**7,134**	**2,560**	**434**	**1,762**	**593**	**1,221**
- Cash-based state budget deficit[22]	3,811	2,023	2,642	2,841	1,996	1,498
- State Treasury funds used for the financing of government operations	2,051	-463	-1,870	-944	-1,285	-259
- Slovakia's share in the EFSF facility debt	1,321	401	121	0	0	0
- Slovakia's contributions to the ESM	264	264	132	0	0	0
- Discount upon issuance of debt instruments	151	51	9	1	46	151
- Bond repayment (discounts)	-311	-68	-114	-84	-56	-66
- Balance of loans to other general government entities	-131	318	-572	-102	-103	-103
of which: ŽSR (Railways of the Slovak	-1	-131	-4	0	0	0

[21] This recommendation is available on the Eurostat website - http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/SK-Recording_of_sale_of_oil_reserves.pdf

[22] Slovakia's cash deficit from 2014 to 2017 is estimated in line with the conservative approach to debt forecasting. The state budget deficit should be lower if the deficit target of 1.98% of GDP in the general government budget proposal for 2015 is met.

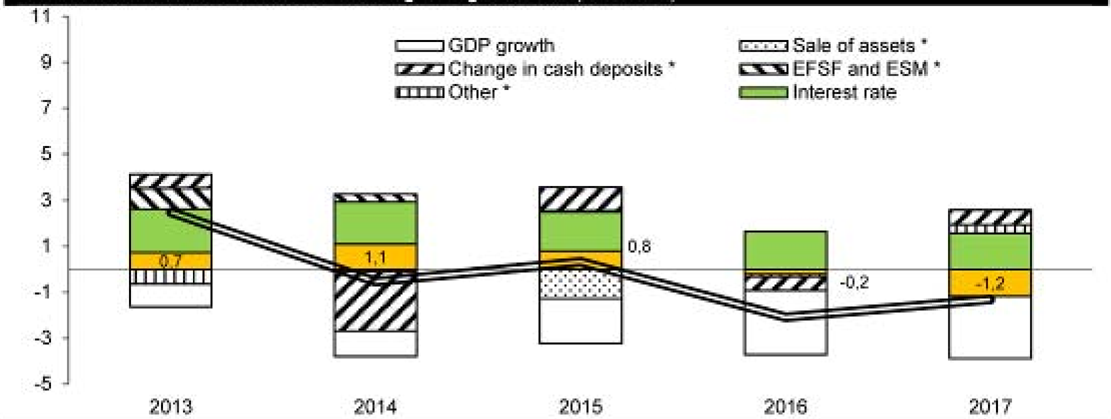
Republic)						
of which: NDS (National Motorway Company)	-37	-37	-37	-37	-37	-37
of which: EOSA	0	520	-520	0	0	0
- Fiscal performance of hospitals *	-1	0	60	50	0	0
- Deposits of State Treasury clients outside of the general government.	-8	17	0	0	0	0
- Other	-15	19	25	0	-4	-1
C. General government gross debt (as at 31 December)	**37,618**	**40,178**	**40,612**	**42,374**	**42,967**	**44,188**
in % of GDP	**52.1**	**54.6**	**54.1**	**54.4**	**52.3**	**51.0**

Note: Positive amounts increase the general government debt as at 31 December of the relevant year, negative amounts decrease the debt.
** With respect to reclassification, no data on the fiscal performance of hospitals for subsequent years is yet available. A reserve has been budgeted beginning in 2014 to cover any losses.*

Source: MoF SR

An analytical overview of the contributions of individual factors to a change in debt illustrates that a decrease in debt is conditioned upon an improvement in the primary balance (the general government balance net of interest expenses) and upon nominal GDP growth. Given on-going consolidation, a primary budget surplus is expected for the first time in 2016.

Chart 8: Contributions of factors to changes in gross debt (% of GDP)



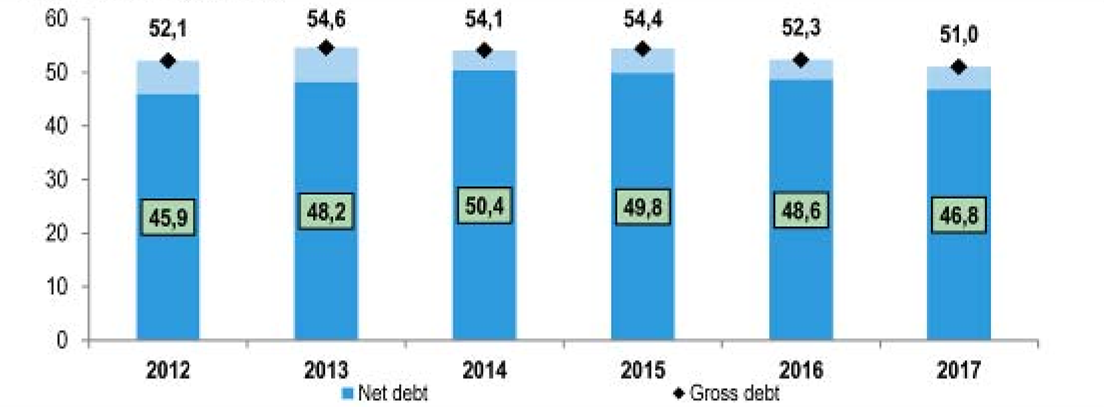
*Note: * Marked items indicate the debt and deficit stock flow adjustment, i.e. how much the debt will change on top of the change in the general government balance.* *Source: MoF SR*

The stock-flow adjustment has an impact on debt levels. In the forecast period, this contribution is influenced by the development of State Treasury funds and the difference between cash and accrual recording of the general government balance.

From an analytical perspective it is more useful to monitor real indebtedness through the development of net debt, which is net of liquid financial assets and in particular cash deposits. The Ministry of Finance presents net debt as defined in the European Commission's manual for compiling the stability programme and the draft budgetary plan.

The chart illustrates annual development in net debt expressed as the difference between gross debt and liquid financial assets. The increase in liquid financial assets in 2012 is conditioned primarily by an increase in the cash reserve. Net debt at the end of 2013 reached a level of 48.2% of GDP and will culminate in 2014 at just over 50% of GDP and will then recede. Net debt from 2014 to 2017 averages 4 p.p. less than gross debt.

Chart 9: Net debt (% of GDP)



Source: MoF SR, Eurostat

Box 4: Impact of ESA 2010 revision of national accounts on public debt

The new ESA 2010 system of European national accounts entered into force in September 2014. This change in methodology decreased debt as a share of GDP thanks to an increase in the level of nominal GDP in all years, including those past and future. Conversely, the reclassification of a number of entities into the general government sector increased gross debt. As a result, the Eurostat debt notification based on the new methodology will be finalized on 21 October, i.e. after submission of the government's general government budget proposal for 2015 to 2017. The presented forecast is compiled on the basis of preliminary Ministry of Finance information for the past years and available information on the fiscal performance of those entities that are likely to be reclassified.

The transition to ESA 2010 methodology has resulted in the inclusion of a number of entities into the general government sector. According to the latest information, the National Motorway Company (NDS), the Emergency Oil Stock Agency (EOSA), healthcare facilities (i.e. public hospitals), local public transportation companies and Exim Banka are to be reclassified as other general government sector entities. These entities have unpaid loans or repayable financial assistance that will be included into general government debt after their reclassification. Likewise their fiscal performance in the future will also have an effect on the general government deficit. The reclassification of NDS is likely to have the most substantial impact in terms of a debt increase but these effects should be fully compensated by an increase in nominal GDP.

We anticipate that **healthcare facilities (public hospitals)** will also be classified as a part of the general government sector in line with Eurostat recommendations. The decision was made in 2011 to reclassify accounting liabilities[23] of hospitals into loans after consultations with Eurostat. The fiscal performance of hospital is part in the public finance sector in the new methodology and the state is directly responsible for any losses. After the hospitals are reclassified, the procedure used for calculating debt should be harmonised with other entities classified within general government sector and the previous reclassification of hospital liabilities should be removed from debt. Hospital debt should decrease as Maastricht debt is only affected by fiscal performance of hospital. Within the budget, it is assumed that hospital will contribute to the general government budget by €50 million (0.1% of GDP). With respect to the current reclassification, no data is available for fiscal performance of hospitals in the for subsequent years.

[23] This concerns other liabilities that are not considered as part of Maastricht debt. On the other hand, loans are recorded as debt.

Table A: Effect of revision on gross debt (€ million)	2012	2013	2014	2015	2016	2017
Gross debt forecast (as at 31 December)	**37,618**	**40,178**	**40,612**	**42,374**	**42,967**	**44,188**
in % of GDP	**52.1**	**54.6**	**54.1**	**54.4**	**52.3**	**51.0**
of which: Changes from reclassification of entities into general government sector	**179**	**202**	**136**	**97**	**55**	**12**
- NDS	372	335	297	260	223	186
- EOSA		55	-	-	-	-
- Public transportation companies		-	26	25	20	14
- Exim Banka	2	25	25	25	25	25
- Healthcare facilities	-194	-212	-212	-212	-212	-212
p.m. decrease in debt due to change in level of GDP (in % of GDP)	*-0.8*	*-1.1*	*-1.1*	*-1.1*	*-1.1*	*-1.0*

Source: SOSR, MoF SR

II.4. Application of the constitutional Fiscal Responsibility Act

Slovakia's general government gross debt at the end of 2013 was published by Eurostat in April 2014. Gross debt reached a level of 55.4% of GDP. Based on the provisions of the constitutional Fiscal Responsibility Act (Act No. 493/2011 Coll.), the government has the obligation to submit proposed measures to reduce debt to the National Council if gross debt exceeds 55% of GDP. The sanction mechanism for exceeding the debt threshold of 55% of GDP was activated in the spring of 2014.

Changes related to the implementation of the new ESA 2010 methodology for national accounts will very likely cause the debt for 2013 to drop below the level of 55% of GDP. Debt for 2013 reached only 54.6% of GDP according to the preliminary data[24] from Eurostat's autumn notification. Debt is forecasted to remain below the 55% threshold in the entire forecast period if budget targets are met. There will be no need to apply the sanction mechanism following the finalisation of the autumn notification.

The government has the obligation to submit proposed measures to reduce the debt to the National Council of the Slovak Republic if gross debt exceeds 55% of GDP in order to ensure decreasing debt levels. At the same time the constitutional Fiscal Responsibility Act stipulates a decrease in the wages of all members of the government to the level of the previous year, which was met considering a freeze in wages for the members of the government at their 2013 levels. Another planned restriction is the cancellation of provision of funds from the government and prime minister's reserve, which occurred in May 2014.

Two restrictions based on exceeding the 55% of GDP threshold have a more significant fiscal effect. One obligation is to block 3% of the adjusted state budgetary expenditures. Beginning in May 2014 the Ministry of Finance blocked a total of €305 million.

The other major restriction is that the **government cannot submit a budget proposal for 2015 to the National Council of the Slovak Republic that would contain a year-on-year increase in nominal general government expenditure**[25] and the local governments are also required to approve budgets for 2015 not above the level up to a maximum of the expenditures approved in the budgets for 2014[26].

[24] Data for 2013 is from the second round of autumn excessive deficit procedure deficit and debt notification to Eurostat.
[25] Except for expenditures for servicing state debt, European Union funds, co-financing funds, transfers to the EU budget and expenditures with regards to damages caused by natural disasters.
[26] Except for EU funds and co-financing and expenditures with regards to damages caused by natural disasters.

The general government budgets for 2014 and 2015 are incomparable given the reclassification of multiple entities and methodology changes due to the transition to ESA 2010 methodology. For this reason the approved budget for 2014 can only be compared to the 2015 budget net of these changes. A more detailed calculation of consolidated expenditures is provided in Annex 4.

The anticipated local government expenditures based on the government's budget proposal respect the constitutional debt brake in place for local governments according to their approved budget for 2014.

III. Revenue and expenditure targets of the general government budget

The general government deficit for 2015 would reach a level of 3.5% of GDP if no changes were made in economic policies in 2015. The general government deficit in the budget proposal for 2015 is 1.6% of GDP lower (€1,.211 million) compared to the no-policy-change scenario and nearly three-quarters of this reduction is attributable to reduced expenditures.

The difference in expenditures compared to the no-policy-change scenario (NPC) is 1.1% of GDP. Such difference is primarily based on ESO public administration reform (0.3% of GDP). Local governments should contribute 0.4% of GDP primarily based on the application of the constitutional Fiscal Responsibility Act. Savings will be transposed into a significant decrease in general government expenditures in terms of GDP from 39.5% in 2014 to 38.0% in 2015.

Revenue increase will shrink the general government deficit by 0.4% of GDP compared to the NPC. The priority of Slovakia's government in the area of taxation remains combating tax evasion and new tax legislation is expected to generate estimated revenues of around 0.6% of GDP. Revenues in terms of GDP will decline year-on-year from 36.6% of GDP in 2014 to 36.0% of GDP in 2015.

III.1. Revenue targets of the general government budget

III.1.1. Combating tax evasion

The priority of Slovakia's government in the area of taxation remains combating value-added tax evasion and such efforts will expand into tax evasion involving corporate income taxes. Measures to combat VAT evasion adopted at the end of 2012 have helped to reverse long-term negative developments. VAT collection efficiency has risen for seven consecutive quarters and reached the level last seen in 2009. Improved VAT collection efforts compared to 2012 have generated €241 million in additional revenues (0.3% of GDP) in 2013 and €514 million (0.7% of GDP) in 2014. In 2014 the most important measure in the area of combating tax evasion was the introduction of a control statement to increase the efficiency of auditing excess credits. Given the complexity involved in auditing such excess credits, the average duration of this process is 6 to 9 months. The impact of the introduction of the control statement may take longer to appear in VAT revenues but may also represent a positive risk with regards to current VAT forecast.

Chart 10: Development of the effective VAT rate (2008-2014)

Source: MoF SR

III.1.2. General government revenues in 2014 and 2015

General government revenues according to the budget should equal 36.0% of GDP in 2015 compared to 36.6% of GDP based on latest expectations for 2014. The decrease in general government revenues in terms of GDP is attributed to a decrease in the level of grants and transfers.

Measures in the general government budget proposal contribute to the stabilisation of tax revenues in terms of GDP. Revenues from VAT as a percentage of GDP would drop by 0.3% if the VAT rate was not kept at its current rate of 20%. Slower growth in household consumption below GDP growth in 2015 used to forecast these taxes shall also contribute to the decreases in excise taxes and VAT in terms of GDP. Without adopting further measures, revenues from corporate income taxes are also expected to drop by 0.1% of GDP. The forecast for corporate income taxes includes the developments from past years, which indicate that the economic growth in 2015 will not be sufficient enough to translate into the same level of growth of profits.

Table 11: General government revenues in 2014 and 2015 (% of GDP, ESA 2010)

	2014 E	2015	Difference
General government revenues, total	**36.6**	**36.0**	**-0.5**
1. Tax revenues	**17.0**	**17.0**	**0.0**
- Taxes on production and imports	10.5	10.0	-0.5
- Value-added tax	6.5	6.2	-0.3
- Excise taxes	2.7	2.6	-0.1
- Current taxes on income, wealth, etc.	6.5	6.3	-0.2
- Corporate income tax	2.8	2.7	-0.1
- Capital taxes	0.0	0.0	0.0
- Tax measures incorporated into the general government budget proposal for 2015	0.0	0.6	0.6
2. Social security contributions	**13.4**	**13.2**	**-0.1**
3. Non-tax revenues	**2.8**	**2.9**	**0.1**
4. Grants and transfers	**3.3**	**2.9**	**-0.5**

Source: MoF SR

III.2. Expenditure targets of the general government budget by function[27]

General government expenditures in 2015 should reach 38.0% of GDP, representing a decrease of 1.5 p.p. of GDP in comparison with the expected outcome for 2014. The largest share in total public expenditures (TE) is attributed to social security (35.3%), followed by general public services (16.8%) and healthcare (14.1%).

Table 12: General government expenditures based on COFOG

Functions	COFOG Code	2014 E		2015	
		% of GDP	% of TE*	% of GDP	% of TE
1. General public services	1	6.65	16.84	5.45	14.35
2. Defence	2	0.94	2.39	0.95	2.49
3. Public order and safety	3	2.02	5.11	1.91	5.02
4. Economic affairs	4	4.37	11.06	4.99	13.14
5. Environmental protection	5	0.51	1.29	0.47	1.24
6. Housing and community amenities	6	0.55	1.40	0.41	1.07
7. Health	7	5.57	14.11	5.31	13.97

[27] Note: The methodology for recording expenditures based on the classification of the functions of government may vary between individual countries. As a result, the same item may contain different data for different countries (for instance, taxable and non-taxable pensions). COFOG classification also does not account for expenditures made through the tax system.

8. Recreation, culture and religion	8	1.07	2.71	0.89	2.34
9. Education	9	3.86	9.77	3.71	9.76
10. Social protection	10	13.96	35.33	13.92	36.62
Total expenditure	**TE**	**39.51**	**100.00**	**38.02**	**100.00**

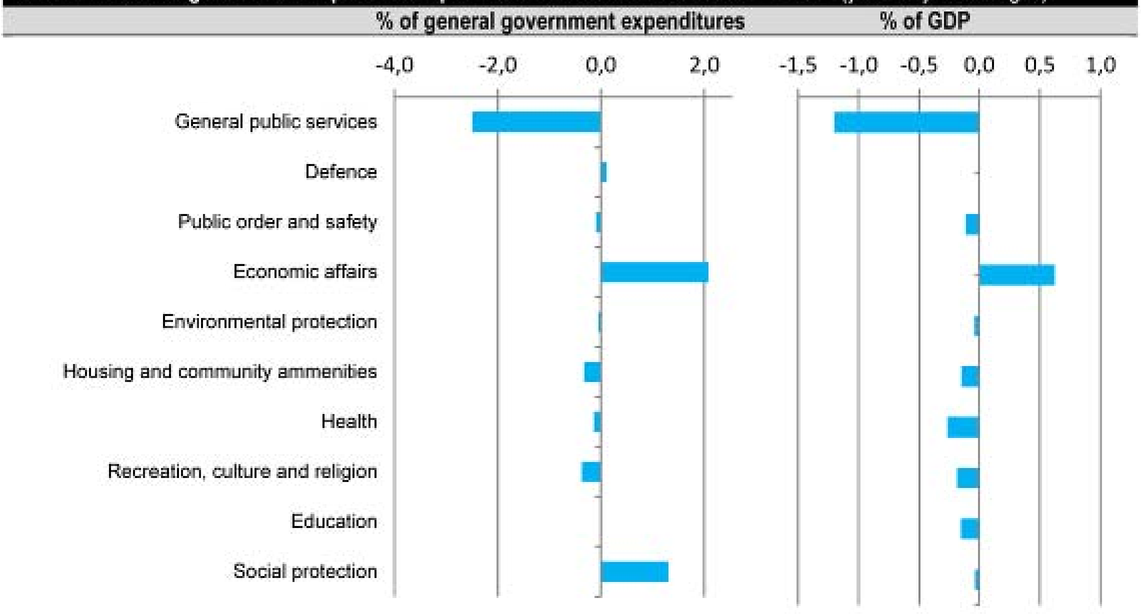
* TE - Total general government expenditures

Source: MoF SR

The most significant year-on-year changes are in general government services and in economic affairs. **Expenditures for general government services, i.e. primarily the costs of public administration, should decrease significantly in the next year by 2.5 p.p.** of total expenditure. Net of the effects of amendments to Statistical Office of the Slovak Republic decrees regarding COFOG classification (Box 5), this decrease will be a bit lower, at a level of 2.1 p.p. TE. The share of expenditures for economic affairs relative to the overall budget shall increase by 2.1 p.p. The effect of the amended Statistical Office of the Slovak Republic decree is negligible in this category.

Public expenditures on education and healthcare remain practically unchanged in 2015 in terms of their share of overall expenditures. Other expenditures in areas such as public order and safety, environmental protection and others stagnate or slightly decline in comparison to total expenditure and GDP. Defence expenditures rise slightly (based on NATO methodology, not COFOG, Slovakia's defence expenditure will reach 1.03% of GDP in 2015).

Chart 11: General government expenditures pursuant to COFOG classification in 2015 (year-on-year changes)



Source: MoF SR

Box 5: Amended Statistical Office of the Slovak Republic decree and methodology instructions regarding COFOG classification

The manual for classifying general government expenditures by function (COFOG) will change effective in October 2014 based on decree issued by the Statistical Office of the Slovak Republic (SO SR). The manual is published on the Statistical Office's website and is the official manual for general government entities for classifying expenditures. Changes will appear in the budget for 2015 to 2017. The changes represent a response to the most frequent errors as identified by the Statistical Office of the Slovak Republic in analysing source data, in particular:

- Expenditures were frequently classified in a single COFOG division but no more detailed classification was made (50% of expenditures)
- Some expenditure with economic classifications that could be clearly classified to a specific COFOG division were reported incorrectly in different COFOG division (66% of expenditure)
- A significant portion of expenditure was reported in the "otherwise unclassified expenditure" group (31% of expenditure)

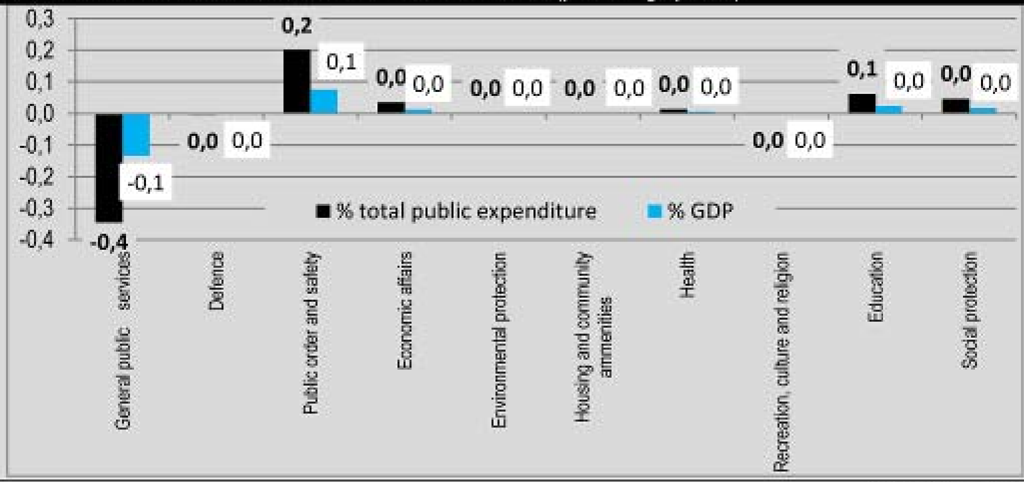
The manual underwent two basic amendments:

1. Four levels of expenditure categories are used in classification where the fourth level previously represented institutions or types of institutions. Expenditures in this category frequently include expenditures of the entire institution, regardless of function. The fourth level was left in place but only for use in cases where it represented a function or was changed to do so.

2. The Statistical Office of the Slovak Republic then published its expansion for the methodology for classifying expenditures. It undertook to respond to specific requests from entities to classify expenditures. The answers will be published as case studies that can be used by other entities. A total of 35 case studies from the COFOG manual issued by Eurostat were also published. The measure responds to error where entities classified an excessive amount of expenditures into the "otherwise unclassified expenditures" category, likely due to the inability to define a more appropriate classification.

In addition to these two primary changes, the explanations for the individual categories of expenditures were also revised. The changes are intended to more precisely guide general government entities towards the correct classification of expenditures.

Chart A: Effects of amendments to Statistical Office decree (percentage points)



Source: Eurostat, MoF SR

III.3. General government balance under the no-policy-change scenario

The no-policy-change scenario[28] is based on the current estimate of the general government deficit in 2014 of 2.93% of GDP. **The general government deficit for 2015 would reach a level of 3.5% of GDP assuming no changes were made in economic policies in 2015[29]**. The difference in the general government balance

[28] The no-policy-change scenario is prepared in line with the manual published by the Ministry of Finance of the Slovak Republic. When compared to the Stability Programme of April 2013, the baseline methodology remained unchanged. The only difference is that the final balance of general government revenues and expenditures is expressed in key ESA items.

[29] The overall specification of the difference between the budget and the no-policy-change scenario does not consider the impact of changes in interest expenses. In other words, interest expenses will also change if budgetary targets are met.

between the no-policy-change scenario and the budget proposal for 2015 represents 1.6 of GDP (€1,211 million). **The difference on the expenditure side of the budget is 1.1% of GDP compared to NPC.** The decrease in current expenditures shall equal 0.6% of GDP. Capital expenditures shall decline by 0.5% of GDP, primarily due to a lower budget for local governments. **The overall effect compared to NPC on the revenue side is 0.4% of GDP, with tax revenues to increase by 0.6% of GDP thanks to new legislation.** In the case of statutory health insurance deductions, a lower transfer from the state budget is expected.

Table 13: Comparison between the balance of expenditures and revenues and the no-policy-change scenario in 2015 (% of GDP)

	ESA 2010 code	2015 NPC (1)	2015 GGB (2)	GGB - NPC (2-1)
1. Total revenues	**TR**	**35.6**	**36.0**	**0.43**
1.1. Taxes on production and imports	D.2	10.0	10.4	0.30
1.2. Current taxes on income, wealth, etc.	D.5	6.3	6.6	0.29
1.3. Capital taxes	D.91	0.0	0.0	0.00
1.4. Social security contributions	D.61	13.4	13.2	-0.13
1.5. Property income	D.4	0.7	0.7	0.00
1.6. Other [1]		5.1	5.1	-0.02
p.m.: Tax burden [2]		29.8	30.2	0.46
2. Total expenditure	**TE [3]**	**39.1**	**38.02**	**-1.12**
2.1. Compensation of employees	D.1	7.1	7.0	-0.14
2.2. Intermediate consumption	P.2	4.8	4.6	-0.27
2.3. Total social payments	D.62,D.632	18.0	17.8	-0.27
of which, unemployment benefits [4]		0.2	0.2	0.00
2.4. Interest expenditures	D.41	1.7	1.7	0.00
2.5. Subsidies	D.3	0.8	0.8	0.00
2.6. Gross fixed capital formation	P.51g	3.3	2.9	-0.48
2.7. Capital transfers	D.9	0.8	0.7	-0.02
2.8. Other [5]		2.6	2.7	0.07
General government balance	**B.9**	**-3.53**	**-1.98**	**1.55**
- in € million		**-2,751**	**-1,541**	**1,211**
p.m. Primary general government balance		*-1.83*	*-0.27*	*1.55*

Note: GGB – General government budget proposal for 2015 - 2017; NPC - no-policy-change scenario Source: MoF SR
[1] P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (others as D.91rec)
[2] The tax burden is calculated as D.2+D.5+D.61+D.91-D.995
[3] TR-TE = B.9
[4] Includes social benefits other than D.62 and D.632 in connection with unemployment benefits
[5] D.29p + D.4p (except D.41p) +D.5p +D.7p +P.52+P.53+NP+D.8.

III.4. Description of measures

The following sections quantify and describe the effects of measures incorporated into the budget proposal. Budget changes are also transposed into the difference between the NPC and the general government budget proposal beyond the framework of specified measures. The following section describes the incorporated measures including quantification. The most significant measures include maintaining value-added tax rate at a level of 20% and a wide-ranging amendment of the Income Tax Act. ESO public administration reform is the major measure on the expenditure side. A difference between the NPC and the budget proposal appears above the framework of the identified measures, in particular other non-tax revenues (-0.07% of GDP) and other changes compared to NPC on the expenditure side (0.64% of GDP).

Table 14: Measures included in the general government budget proposal (ESA 2010, comparison to NPC)

Measure	Sub-sector	ESA 2010 code	2015 (% of GDP)
1. Maintaining the VAT rate at 20%	**S.1311**	**D.211R**	**0.30**
2. Changes in tax depreciation of property			**0.20**
- Extension of depreciation for office buildings from 20 to 40 years	S.1311	D.51R	0.09
- Restricting accelerated depreciation to manufacturing machinery and installations	S.1311	D.51R	0.04
- Cancellation of preferential depreciation for leasing	S.1311	D.51R	0.02
- Depreciation of unclaimed expenditures using a coefficient for VAT deduction	S.1311	D.51R	0.05
3. Measures to increase the effectiveness of tax collection (ECR and pharmaceutical companies)			**0.07**
- Expansion of obligation to maintain records of revenues in electronic cash registers (ECR)	S.1311	D.51R	0.07
- Withholding tax for pharmaceutical companies on financial and non-financial benefits provided to physicians	S.1311	D.51R	0.00
4. Introduction of thin capitalisation rules	**S.1311**	**D.51R**	**0.07**
5. Deduction of research and development expenditures from the tax base	**S.1311**	**D.51R**	**-0.03**
6. Audit of tax deductible expenditures and other	**S.1311**	**D.51R**	**0.02**
of which: increasing and harmonising social security contribution discount for students	S.1314	D.61R	0.00
Other non-tax revenues			**-0.07**
- Lower state budget revenues from FOV and EOSA fees	S.1311	D.29A	-0.04
- Higher municipal and higher territorial unit administrative fees	S.1311	P.11	0.15
- State budget and general government administration grants and transfers	S.1311	D.7R	-0.07
- Other lower revenues from state budget refunds	S.1311	D.7R	-0.09
- Other non-tax revenues	S.1311	P.11	-0.02
7. Priority government measures			**-0.05**
- Compensations	S.1311	D.1P	-0.01
- Intermediate consumption	S.1311	P.2	-0.01
- Subsidies	S.1311	D.3P	-0.02
- Capital expenditure	S.1311	P.5+D.9	-0.01
8. ESO + state contributory organizations from budgetary funds			**0.27**
- Compensations	S.1311	D.1P	0.17
- Intermediate consumption	S.1311	P.2	0.10
9. Healthcare			**0.13**
- Transfer for VšZP (Health Insurance Agency), received	S.1311	D.62P	0.13
- Transfer for VšZP (Health Insurance Agency), paid	S.1314	D.61R	-0.13
- Social transfers in kind	S.1311	D.632P	0.13
Other changes compared to NPC on expenditure side, of which			**0.64**
State budget	S.1311		0.10
Public universities	S.1311		0.05
Other general government services	S.1311		0.07
Local governments	S.1313		0.40
Health and social insurance	S.1314		0.03
Total			**1.55**
- Tax and social security contribution revenues			0.50
- Non-tax revenues			-0.07
- Current expenditure			0.62

- Capital expenditures	0.50

Note: (+) indicates increased revenue or decreased expenditures — Source: MoF SR

Revenue measures

1. The amendment of the **Value-Added Tax Act will be maintained at the current tax rate at 20% from 2015.**

2. Multiple **changes have been introduced in the tax depreciation of property**, the common goal of which is to increase the efficiency of tax collection efforts by restricting currently very advantageous depreciation conditions when compared on an international basis. All of the changes in depreciation are applied to property that is currently subject to depreciation. These measures include increasing the depreciation period for office buildings from the current 20 years to 40 years. The previous depreciation period for these buildings did not reflect their actual lifespans and actual utility. Additionally, this period was excessively short when compared to neighbouring countries where the depreciation period is set to 50 years (with the exception of Poland where they are included in the 40 year depreciation group). Preferential depreciation for leasing contracts is also cancelled.

3. In order to **increase the efficiency of tax collection efforts,** the obligation to **record revenues in electronic cash registers into new economic sectors** will be expanded (to hotels and restaurants, professional scientific and technical activities, general practitioners, specialist physicians, dentists, etc.) and an **obligation to tax financial and non-financial benefits from pharmaceutical companies in the form of a withholding tax** will also be introduced.

4. The introduction of **thin capitalisation rules** is a step towards restricting potential tax evasion and diversion of profits between economically-related or personnel-related companies **(transfer pricing).** Thin capitalisation rules represent a standard instrument in nearly all developed countries. With this change Slovakia is joining the ranks of countries actively combating the unfair practices of transferring profits abroad for the purposes of decreasing tax liabilities. The tax-deductible cost of interest on loans from dependent entities will be capped to a maximum of 25% of EBITDA[30]. Measures are also applied to interconnected domestic companies that consolidate their profits and losses within a holding.

5. The introduction of a deduction for research and development expenditures from the tax base will have a positive effect on **investments into research and development** in Slovakia. Measures include a direct deduction of 25% of the total amount of such expenditure, along with 25% of the year-on-year increase in expenditure and 25% of the expenditure on wages for newly hired graduates.

6. The draft amendment of the Income Tax Act proposes limiting selected tax-deductible expenditures on the basis of a **tax audit**. For instance, an upper limit will be applied on the acquisition price of motor vehicles and income from contractual fines will be taxed. Another measure includes increasing and harmonising the social security contribution discount for students.

Expenditure measures

7. Expenditure for the **priority measures** of the government were also incorporated in the budget proposal amounting to €37 million (0.05% of GDP), in particular:

    - Beginning on 17 November 2014 several groups of residents **will be afforded free travel on railways**. Free travel ticket will be provided to children, pupils, students under the age of 26 and pensioners. The estimated cost of this measure equals to €13 million.

[30] EBITDA - earnings before interest, taxes, depreciation and amortisation.

- In order to fulfil the requirements in the amendment to the Material Need Assistance Act, 840 new positions for field workers who work directly with beneficiaries will be created at Labour Offices in 2015. The anticipated costs are approximately €9 million.
- The allocation for **teacher assistants in regional education** will be increased by €7 million in 2015. Such funds are to cover wage expenses for new teacher assistants who will be assigned as needed to schools with disadvantaged children. This should completely cover demand from schools.
- The government has also set a target of expanding **capacity in preschool facilities** with the objective of increasing the employment of women and the integration of children from socially-disadvantaged environments. A total of €5 million was dedicated in the budget for 2015 for this use.
- In order to support the long-term unemployed, 2015 will see the introduction of the ability to **simultaneously receive assistance in material need and wage**. Long-term unemployed individuals or inactive job seekers will be eligible for this benefit after taking up a job (with at least half-time employment) if they are also the member of a household that receives material need assistance or one that no longer receives such assistance as a result of being employed. Income from employment has to be at least at the amount of the minimum wage and maximum of two times the minimum wage. Such an employee will receive €126.44 over the first six months with this amount dropping to €63.07 for the second half year. Currently individuals lose their claim to material need assistance immediately after being employed, even at the level of minimum wage. The costs to cover the increased general government expenditures will be approximately €3 million in 2015.

8. Within on-going **ESO public administration reform**, the government undertook to rationalise the number of state organisations, improve their service processes and increase their effectiveness. Changes in budgetary and contributory organisations will generate savings of €206 million in 2015 compared to NPC. The planned measures and savings within this reform are described in Box 5.

9. **Growth in public health expenditures** in 2015 will damped by measures amounting to 0.13% of GDP compared to the NPC, despite continued rise of resources in healthcare. Healthcare measures are focused on achieving the highest possible efficiency without threatening the accessibility or quality of treatment and care. Their primary focus is on halting the accumulation of debts by 13 state university and general hospitals, optimising their total in-patient bed capacities and making investments into the construction and renovation of new and more efficient hospitals. An integrated model for providing healthcare will be introduced and treatment procedures will be unified. The financial management of hospitals shall be configured to reward performance and increased efficiency. Hospitals should achieve balanced financial management by the end of 2015. In terms of providing healthcare, treatment procedures will be unified for all diagnoses, which should lead to increased pressure on quality of care and enable the transition to diagnostic group (DRG) payment by 2017.

Potential measures not included in the budget proposal

The government is also preparing health contribution allowance reform above the framework of the presented measures targeted at strengthening low-income labour supply and demand for low-income job seekers. This reform is based on tax deduction covering health insurance deductions for low-income employees that fully compensates for the planned increase in the minimum wage (a year-on-year increase of nearly 8%). Given the on-going discussions to the draft legislation, the final parameters of such plan are not yet known and therefore the impacts of such measure cannot be quantified. The introduction of the health contribution allowance also follows these targets:

- Preserving the cost of labour for minimum wage at its current level;
- Decreasing the cost of labour and thereby increasing demand for labour above the level of the minimum wage (low-income employees);
- Increasing the net wages of low-income employees;
- Increasing the consumption of low-income employees.

The maximum health contribution allowance is proposed an the same rate than minimum wage (€380 in 2015). The health contribution allowance will be gradually phased out as income increases (the complete loss of such claim will depend on the final parameters of the health contribution deduction). The estimated number of affected employees as well as the fiscal effects will also depend on the configuration of the final parameters.

Following wage increases in regional education by 5% in 2013 and 2014, the issue of wage increases in the public sector and in particular in regional education in the following years has not yet been closed. Negotiations on a collective bargaining agreement of a higher degree for 2015 are currently under way.

Box 6: ESO public administration reform

The Government of the Slovak Republic approved the ESO programme (effective, reliable and open public administration) in April 2012 as a component of general government reform. Heretofore adopted measures have primarily involved the following steps:

- A large part of local public administration was merged into integrated district offices through reform. Client centres have been established in the District Offices to provide simpler and more convenient contact with residents.
- Supporting services (such as building administration, accounting, technical and material assurance, human resources and IT services) were also separated and are now conducted by 8 support centres in the regional capitals; a call centre for residents also came into service. Integration of local public administration offices enabled the optimisation of general government services and a simplification of processes.
- Data is being collected on the activities of these offices and the performance of employees through the use of a queuing system and a registry system.
- The reform includes applying pressure to increase the efficiency of public administration. 23 subordinate state budget organisations were merged or cancelled in 2014 with additional savings achieved through internal efficiency measures within the organisations themselves.

Multiple steps as a component of ESO reform are prepared for the following period:

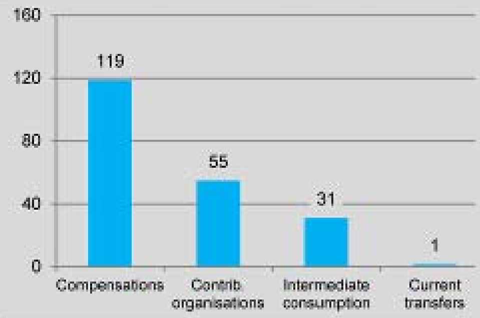
- There will be a need to connect the queuing systems and registry systems to enable monitoring and analysis of progress in handling assigned agendas from the first moment of contact between a resident and the office through complying with requests and closing case files. Data will also be used to identify potential indicators to be introduced and monitored to increase efficiency and quality in the monitoring, assessment and management of offices.
- Reforms will continue in those parts of local public administration that are not integrated into the merged offices. A total of 46 Offices of Labour, Social Affairs and Family will lose legal subjectivity in 2015 and will transfer under the direct management of Central Offices of Labour, Social Affairs and Family. This will provide the government with better control over office expenditures as well as their dissolution and establishment. This will increase the flexibility of human resources management, which will be better able to respond to differences in demand for capacities to deliver employment services in the individual regions. In addition to changes in local public administration, the Slovak Academy of Science will be transformed into new independent legal entities, public research institutions.

An integral part of ESO reforms is the rationalisation of processes and increasing the internal efficiency of all state organisations. The transformation of state budgetary and contributory organisations is under way (e.g. merging or dissolution) in order to decrease their numbers. The budget proposal includes savings amounting to €150 million compared to the no-policy-change scenario (NPC) on the expenditures of budgetary organisations and €55 million on the expenditures of contributory organisations of the state budget. Savings were identified on the basis of analysis of expenditures, processes and activities of budgetary and contributory organisations, in particular by comparing expenditures on wages and on goods and services per individual employee. These figures represent savings in the broadest sense of the word as the difference between all of the budgeted expenditure for wage costs and for goods and services and the NPC. Only specific expenditure line items have been left out of the savings calculation, for instance expenditures for the Slovak Information Service (SIS) and the National Security Office (NBÚ), payment for availability of PPP motorways, special goods for the Ministry of Defence and election expenditures.[31]

[31] The General ledger of the general government budget applies different methodology and calculates ESO as the €96 million committed in the budget proposal for 2014 - 2016.

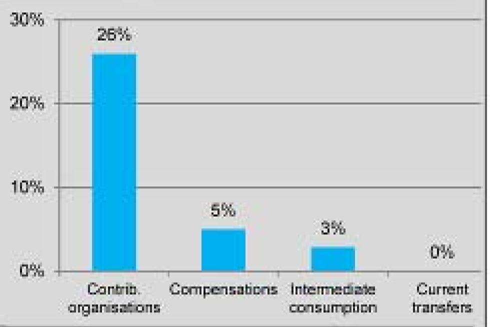
- The largest portion of these savings is accounted for by employee compensations, which decreases by €119 million compared to NPC. This decrease is made possible by freezing wages and reducing the number of positions at the Ministry of Agriculture and Rural Development (151 persons), the Slovak Academy of Sciences (266 persons) and in multiple contributory organisations (134 persons).
- Savings on intermediate consumption (in particular goods and services) total €31 million through reduced overhead and operating costs. Significant savings were also realised in budgetary funds for state contributory organisations (€55 million compared to NPC). Other current transfers are decreased by almost €1.5 million.
- In terms of percentages, transfers for contributory organisations decrease the most, dropping by around a quarter compared to NPC. The compensation package will be decreased by five per cent and intermediate consumption by three per cent. The decrease in current transfers due to ESO is negligible.

Chart A: Savings by ESA category (€ million)



Source: MoF SR

Chart B: Savings relative to NPC

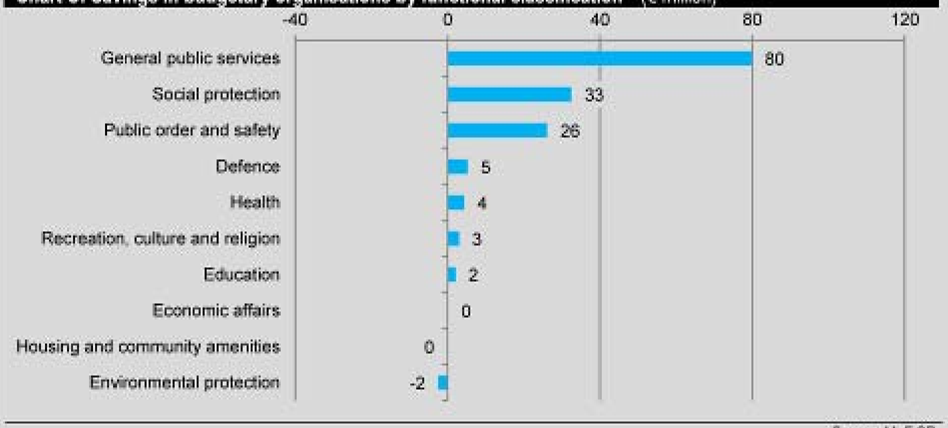


Source: MoF SR

Disregarding contributory organisations, whose expenditures largely depend on their own funding, total savings from ESO in the chapters of the state budget and their subordinate budgetary organisations exceed €150 million.

- In terms of expenditures by function, it is important that the largest decrease (by €80 million compared to the NPC) is observed in general government services, i.e. administrative services.
- Due to internal re-organisation and increasing efficiency, operating expenditures for social security (€33 million), public order and safety (€26 million) and to a lower degree other functions (total of €15 million) also decreased.
- Conversely expenditure on environmental protection and on housing and community amenities will slightly increase on the basis of measurements.

Chart C: Savings in budgetary organisations by functional classification[32] (€ million)



Source: MoF SR

[32] Adjusted for the known effects from the modified decrees and methodology guidelines for COFOG classification.