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COMMISSION STAFF WORKING DOCUMENT

Analysis of the 2016 Draft Budgetary Plan of SLOVAKIA

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of SLOVAKIA

{C(2015) 8113 final}

Analysis of the 2016 Draft Budgetary Plan of SLOVAKIA

1. INTRODUCTION

Slovakia submitted its Draft Budgetary Plan (DBP) for 2016 on 14 October 2015 in compliance with Regulation (EU) No 473/2013 of the Two-pack. Slovakia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2015 autumn forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2015 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2015-2016 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact (SGP). Section 5 provides an analysis of implementation of reforms in the area of fiscal governance in response to the latest Country-specific Recommendations (CSRs) adopted by the Council on 14 July 2015, including those to reduce the tax wedge. Section 6 concludes.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

After picking up in 2014, economic growth in Slovakia has further accelerated in 2015, driven by a substantial recovery in investment and robust household consumption. According to the DBP, real GDP is set to increase by 3.2% y-o-y in 2015 (see Table 1), with up to a third of overall growth resulting from an intensified drawing of EU funds. The Slovak economy is forecast to expand by 3.1% y-o-y in 2016, with the expected decline in overall investment and government consumption largely offset by accelerating private consumption and strongly positive net exports. The DBP expects labour market conditions to improve further, with the unemployment rate falling close to 10% in 2016. Driven by robust domestic demand and solid wage growth, inflation would turn positive in 2016 and gradually increase thereafter.

Compared with the latest Stability Programme, the DBP scenario was revised upwards in 2015, reflecting more-buoyant-than-expected investment growth and a stronger positive contribution of changes in inventories in the first half of the year. On the other hand, the expansion in 2016 was revised downwards, mainly due to the anticipated downturn in investment spending.

The macroeconomic scenario underlying the DBP is broadly in line with the Commission 2015 autumn forecast in terms of headline figures, with the latter assuming only a marginally slower pace of economic expansion in 2016. However, the differences are more pronounced with regard to the composition of growth. Compared with the DBP scenario, the Commission 2015 autumn forecast assumes a significantly weaker contribution of net exports to overall growth in 2016. At the same time, the Commission forecast expects total investment and government consumption to contribute positively to growth in 2016, albeit by less than in the previous year, whereas the DBP expects both to record a negative contribution to growth.

The overall risks to the DBP scenario as well as to the Commission forecast are assessed as balanced and apply to both equally. Weaker exports of products related to the automotive industry due to faltering EU-wide sales represent a downward risk to the forecast. At the same time, plans for new foreign investment (Jaguar Land Rover deal) could boost private investment in 2016 and 2017. Overall, the macroeconomic assumptions underpinning the DBP appear to be plausible in both years.

Box 1: The macro economic forecast underpinning the budget in Slovakia

Slovakia's DBP is based on the macroeconomic forecast published by the Institute for Financial Policy (IFP) of the Ministry of Finance at the end of September and endorsed by the Macroeconomic Forecasting Committee (MFC).

The constitutional act on budgetary responsibility, adopted in December 2011, formally endowed the MFC with the responsibility for assessing macroeconomic forecasts produced by the government. According to the statutes, in its deliberations the MFC is independent and free from the government's influence. The MFC consists of a chairman (the Director of the IFP) and members from nine independent institutions entitled to vote (the Central Bank, the Academy of Science, the Institute of Informatics and Statistics and six commercial banks). There are three other members of the MFC who are in the role of observers without voting rights (the Council for Budgetary Responsibility, the National Statistical Office and one commercial bank).

The MFC assesses whether the draft forecast submitted by the IFP is "conservative", "realistic" or "optimistic". The draft forecast is accepted by the MFC if the majority of voting members assesses the forecast as "conservative" or "realistic". The draft macroeconomic forecast for the DBP was deemed "realistic" by a majority of the voting members of the MFC at a meeting held on 16 September 2015, according to the minutes published on the website of the IFP. The macroeconomic forecast underpinning the DBP for 2016 is more conservative compared to the draft macroeconomic forecast assessed by the MFC members.

Table 1. Comparison of macroeconomic developments and forecasts

	2014	2015			2016		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.5	2.9	3.2	3.2	3.6	3.1	2.9
Private consumption (% change)	2.3	2.8	2.1	2.2	2.7	2.7	2.9
Gross fixed capital formation (% change)	3.5	3.7	7.6	7.5	1.8	-0.7	2.2
Exports of goods and services (% change)	3.6	1.4	6.1	5.1	5.9	5.6	4.6
Imports of goods and services (% change)	4.3	1.0	7.1	5.5	4.5	3.9	4.2
Contributions to real GDP growth:							
- Final domestic demand	3.1	2.7	3.4	3.4	2.0	1.2	2.4
- Change in inventories	-0.2	-0.3	0.2	0.0	-0.1	0.0	0.0
- Net exports	-0.4	0.5	-0.5	-0.2	1.6	1.9	0.5
Output gap[1]	-1.9	-2.6	-1.1	-1.2	-1.8	-0.3	-0.8
Employment (% change)	1.4	0.6	1.8	1.8	0.7	1.0	1.2
Unemployment rate (%)	13.2	12.9	11.5	11.6	12.2	10.6	10.5
Labour productivity (% change)	1.1	2.3	1.3	1.3	2.9	2.1	1.6
HICP inflation (%)	-0.1	0.0	-0.2	-0.2	1.6	0.9	1.0
GDP deflator (% change)	-0.2	0.0	-0.2	0.2	1.5	0.9	1.1
Comp. of employees (per head, % change)	1.8	2.6	2.1	2.1	3.9	3.0	2.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.2	3.2	0.3	-0.2	4.2	1.9	-1.3

Note:
[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:
Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The general government deficit target for 2015 in the DBP is 2.7% of GDP, slightly higher than the 2.5% of GDP presented in the Stability Programme. The main reason for the increase is higher-than-budgeted spending on healthcare, public wages and intermediate consumption and financial corrections related to the EU-financed projects. These negative factors are expected to outweigh higher-than-budgeted tax revenue (e.g. better collection of corporate income tax and VAT and higher social contributions due to lower drawing of healthcare allowance for low-paid). The Commission 2015 autumn forecast projects the 2015 deficit to reach 2.7% of GDP. Uncertainty on the final amount of the EU financial corrections is the main risk to the forecast.

For 2016, the DBP targets a general government deficit of 1.9% of GDP, which is in line with the Stability Programme (Table 2). The expected drop by 50% in drawing on EU funding (amounting to some 1.2% of GDP) will reduce the expenditure and revenue ratios. This is the main factor behind the decline of revenue and expenditure aggregates, while the overall balance is impacted only to the extent of the decline in the government's co-financing[1]. The adjustment in 2016 comes mainly from the expenditure side as the expenditure-to-GDP ratio is foreseen to fall by 3.3 pps. to 39.7%[2]. Once the impact of the expected decline in the EU financing and national co-financing is netted out, intermediate consumption is still expected to decline by 0.3% of GDP and investment by some 0.4% of GDP. Revenue expressed in terms of GDP is projected to decline by 2.5 pps. to 37.7%[3] also because of a decrease in social contributions[4].

The Commission 2015 autumn forecast projects the general government deficit in 2016 to reach 2.4% of GDP, 0.5 pp. higher compared to the DBP. The difference is largely driven by three items. First, the Commission forecast assumes a smaller decline in intermediate consumption in the absence of explicit measures. Second, the Commission projects the public wage bill to be higher in nominal terms as a result of a higher assumed base in 2015 and the envisaged wage increases in the public sector. Third, given that no substantial measures have been taken to limit expenditure growth in healthcare, the Commission forecast also assumes that these expenditures would increase in line with previous years. In addition, the Commission has identified risks stemming from the already announced 'third social package', which is to be detailed in December, and from up-front costs for the planned PPP project of the Bratislava ring.

Based on the Commission 2015 autumn forecast, the structural balance in 2015 is estimated to remain unchanged. Conversely, the (recalculated) structural balance in the DBP deteriorates by 0.4% of GDP in 2015[5]. The difference is largely explained by the fact that the in the Commission forecast, the sizeable financial corrections to EU funds in 2014 and 2015 are considered as 'one-off' on the basis of a preliminary assessment, whereas this is not the case in the DBP[6]. In 2016, the structural balance is projected to remain broadly unchanged based on

1 The budget balance is impacted only to the extent of the fall in co-financing, which is budgeted to decline by 0.3% of GDP.

2 Netting out EU funding and national co-financing implies a decline in expenditure-to-GDP ratio by 1.6 pps. in 2016.

3 Excluding EU funding leads to a decline in revenue-to-GDP ratio of 1 pp. in 2016.

4 This is related to the slow take up on the measure reducing healthcare contributions for low paid, which was introduced in 2015 but has so far been used only by a small share of the eligible workers.

5 Cyclically-adjusted budget balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the DBP, using the commonly agreed methodology.

6 Financial corrections in case of programmes and projects supported through EU structural and investment funds occur frequently, whenever the Commission reviews the eligibility and the respect of conditionality. As a rule, these corrections do not qualify as 'one-off' as meant by the SGP. In exceptional cases, however sizeable financial corrections may be recorded in a given year in ESA2010, addressing irregularities that had been accumulating over a protracted period of time in the past. If (i) a single exceptional event outside the control of the government can be identified (e.g. a large scale audit), (ii) the associated budgetary impact is estimated at above 0.1% of GDP and (iii) it can be seen as temporary and non-recurrent, i.e. the correction takes place at most over two years, then it can qualify as 'one-off'. According to currently available

the Commission 2015 autumn forecast, while an improvement of some 0.7% of GDP is envisaged based on the figures from the DBP. The classification of one-offs is an important explanatory factor for the difference also in this case in addition to the differences in headline deficits.

information, in Slovakia, following a broad-based suspension of almost all operational programmes and a Commission audit in 2014, financial corrections of 0.3% of GDP have been recorded in 2014 and an additional 0.3% of GDP are being settled in 2015. These figures have been treated as 'one-off' in the Commission 2015 autumn forecast but the amounts and one-off nature may be reviewed at a later stage in light of new information.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2014	2015			2016			Change: 2014-2016
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**38.9**	**38.3**	***40.2***	**39.9**	**36.6**	***37.7***	**37.4**	**-1.1**
of which:								
- Taxes on production and imports	10.6	10.5	*10.7*	10.6	10.2	*10.5*	10.4	-0.1
- Current taxes on income, wealth, etc.	6.8	6.8	*7.1*	7.0	6.8	*7.1*	7.0	0.3
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	13.6	13.3	*13.8*	13.7	13.2	*13.5*	13.4	-0.1
- Other (residual)	7.8	7.7	*8.6*	8.6	6.4	*6.6*	6.5	-1.2
Expenditure	**41.6**	**40.9**	**43.0**	**42.7**	**38.5**	**39.7**	**39.8**	**-2.0**
of which:								
- Primary expenditure	39.7	39.2	41.3	41.0	37.0	38.1	38.2	-1.6
of which:								
Compensation of employees	8.7	8.1	8.4	8.6	7.9	8.5	8.5	-0.2
Intermediate consumption	5.3	5.7	5.9	5.6	5.5	4.9	5.1	-0.3
Social payments	19.0	18.6	18.8	18.7	18.0	18.5	18.5	-0.5
Subsidies	0.9	0.8	0.8	0.8	0.7	0.8	0.8	-0.2
Gross fixed capital formation	3.6	3.0	4.3	4.3	2.5	2.8	2.8	-0.9
Other (residual)	2.2	3.0	3.1	3.2	2.4	2.6	2.5	0.5
- Interest expenditure	1.9	1.7	1.6	1.6	1.6	1.5	1.6	-0.4
General government balance (GGB)	**-2.8**	**-2.5**	**-2.7**	**-2.7**	**-1.9**	**-1.9**	**-2.4**	**0.8**
Primary balance	**-0.9**	**-0.9**	**-1.1**	**-1.1**	**-0.4**	**-0.4**	**-0.8**	**0.5**
One-off and other temporary measures	0.0	0.1	0.1	-0.2	0.0	-0.1	0.0	-0.1
GGB excl. one-offs	**-2.8**	**-2.6**	**-2.8**	**-2.5**	**-1.9**	**-1.9**	**-2.4**	**0.9**
Output gap[1]	-1.9	-2.6	-2.6	-1.2	-1.8	-1.8	-0.8	1.5
Cyclically-adjusted balance[1]	-2.0	-1.5	-1.7	-2.3	-1.2	-1.2	-2.1	0.3
Structural balance (SB)[2]	**-2.1**	**-1.6**	**-1.8**	**-2.1**	**-1.2**	**-1.2**	**-2.0**	**0.4**
Structural primary balance[2]	-0.1	0.1	-0.2	-0.5	0.3	0.4	-0.5	0.0

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

Box 2: Impact of the current low interest rate environment on compliance with the SGP

Identifying an interest rate windfall/shortfall for 2016

Sovereign bond yields have fallen sharply since end-2013 and reached historical lows in the first half of 2015, before increasing somewhat during the summer months. However, yields in Slovakia still remain well below their long-term averages of 4.9%, with current 10-year rates standing at around 0.9%. As a result of lower interest rates, total interest payments by the general government have also decreased over the last few years. Interest expenditure in Slovakia is expected to fall from 1.8% of GDP in 2012 to 1.6% in 2015, and is projected to decrease further, to 1.5% of GDP, in 2016, based on the information provided in the DBP. For 2016, interest expenditures are expected to follow a downward path also in the Commission 2015 autumn forecast. The biggest year-on-year change is expected in 2015, with interest expenditure declining by around 0.3% of GDP. This development has been driven by favourable developments in financial markets, which led to a downward shift in the yield curve and narrowed the risk premium compared with the German bunds to 20 basis points (down from over 150 basis points in mid-2012).

Prospects and vulnerability

About a third of Slovakia's outstanding sovereign debt matures over the 2016 to 2018 horizon. The amount of maturing government bonds that need to be refinanced could point to further savings stemming from a rollover of debt in a context of low interest rates. Almost all maturing debt is held as long-term bonds, where possible savings on interest expenditure are more pronounced, though still limited.

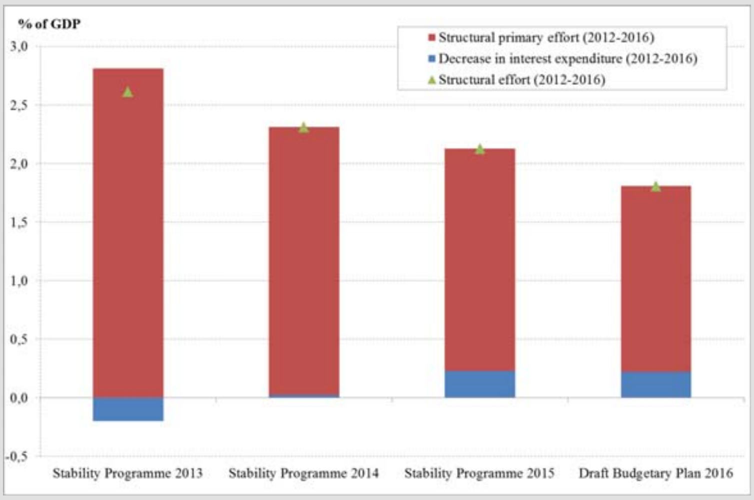
Consequences for public finances

Comparing the interest expenditure projections across different vintages of Stability and Convergence Programmes and the DBP sheds more light on the (unexpected) interest windfall since the fall in interest rates (see Chart)[7].

The starting point is the Stability Programme published in April 2013, which is considered a benchmark for the size of interest rate windfalls. This is based on the assumption that after the mid-2012 peak in sovereign bond yields of some 3 %, a steady return to normal pre-crisis levels was factored into the interest rate forecast. By the end of 2014, the yield declined to around 1 %. The subsequent vintages capture the effect of falling interest expenditure, which appear mostly in the 2015 Stability Programme. The scope for an additional decline in interest expenditure in 2016 is limited, because rates already incorporate monetary easing and historically low inflation. The structural effort in cumulative terms between 2012 and 2016 was largely driven by other factors than the decrease in interest expenditures.

[7] Note that, while it is likely that revisions in the interest expenditure projections across different vintages primarily reflect changes in interest rates, other factors such as debt dynamics, the maturity profile of debt and statistical reclassifications (e.g. the switchover to the ESA2010 standard of national accounts) may also have played a role.

Structural effort and decrease in interest expenditures between 2012 and 2016 based on government plans



Source: Stability programmes, Draft Budgetary Plan 2016 and AMECO

3.2. Debt developments

The DBP projects the general government debt to decline to 52.8% of GDP in 2015, some 0.6 pp. lower compared to the 2015 Stability Programme (Table 3). The revision is mainly due to the expected lower State budget deficit and lower indebtedness of various general government entities (e.g. National Motorway Company). An important factor contributing to the reduction of the debt-to-GDP ratio in 2016 is a negative stock-flow adjustment also due to proceeds from the sale of shares in the Slovak Telecom. In 2016, the DBP projects the debt-to-GDP ratio to decrease further to some 52% on the back of the envisaged consolidation efforts and the impact of the growth in nominal GDP on the denominator. Based on the information in the DBP, Slovakia would in both years breach the threshold of the national debt brake set at 50% of GDP[8]. The Commission 2015 autumn forecast projects the debt ratio in 2016 to be some half percentage point higher compared to the DBP mainly because of the difference in projected general government deficit.

8 When the debt-to-GDP ratio exceeds 50% of GDP (but remains below 53% of GDP), the Ministry of Finance has to send a written letter to the parliament explaining reasons behind the high debt and propose measures to ensure its reduction.

Table 3. Debt developments

(% of GDP)	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**53.5**	**53.4**	**52.8**	**52.7**	**52.8**	**52.1**	**52.6**
Change in the ratio	-1.1	-0.1	-0.7	-0.8	-0.6	-0.7	-0.1
Contributions[2] *:*							
1. Primary balance	**0.9**	**0.9**	**1.1**	**1.1**	**0.4**	**0.4**	**0.8**
2. "Snow-ball" effect	**0.7**	**0.2**	**0.1**	**-0.1**	**-1.0**	**-0.5**	**-0.4**
Of which:							
Interest expenditure	1.9	1.7	1.6	1.6	1.6	1.5	1.6
Growth effect	-1.3	-1.5	-1.7	-1.6	-1.8	-1.6	-1.5
Inflation effect	0.1	0.0	0.1	-0.1	-0.7	-0.5	-0.5
3. Stock-flow adjustment	**-2.6**	**-1.1**	**-1.9**	**-1.8**	**0.1**	**-0.5**	**-0.5**
Of which:							
Cash/accruals difference		-0.6	-1.6		-0.1	-0.4	
Net accumulation of financial		-0.8	-0.4		0.2	-0.2	
of which privatisation proceeds		-1.3	-1.0		0.0	0.0	
Valuation effect & residual		0.1	0.2		0.0	0.1	

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the Draft Budgetary Plan

The DBP envisages all consolidation effort in 2016 to be concentrated on the expenditure side (Table 4). Major savings (vis-à-vis the no-policy-change scenario provided in the DBP) are expected in terms of intermediate consumption and investment (including capital transfers). Investment cuts have been often used as an important consolidation tool in the past, so this budgetary strategy is also reflected in the Commission 2015 autumn forecast. However, the proposed cuts in the intermediate consumption are not backed by explicit measures and are hence not taken up in the Commission 2015 autumn forecast[9]. Additional expenditure measures presented in the DBP are deficit-increasing. These include the envisaged increase in wages for a part of public sector employees and healthcare staff, measures of the second

[9] The Commission 2015 autumn forecast assumes – similar do the DBP – that there would be no further increase in liabilities in 2016.

social package (e.g. subsidies for thermal insulation of houses and school field trips, increase of maternity leave and contributions for childcare etc.) and reimbursements to households for high gas prices[10]. The DBP also presents several revenue measures; but their largely deficit-increasing impact is small. The already adopted reduction of the VAT rate on basic foodstuffs such as fresh meat, milk, bread, etc. from 20% to 10% will have a negative impact on revenues but the DBP records this measure on the expenditure side[11]. Several of these measures focus on improving tax collection thus contributing to meeting the 2015 CSR in this area. However, no measures are presented to improve functioning of the healthcare sector.

The DBP considers only one one-off measure on the revenue-side in 2015, related to an extraordinary pay-off of a loan by the freight railway company Cargo. In 2016, the reimbursement to the households for high gas prices is considered as a one-off on the expenditure side. In turn, the Commission 2015 autumn forecast, based on a preliminary assessment, includes in 2015 the EU financial corrections among one-off measures[12] and, in 2016, a one-off correction in the contribution to the EU budget related to the retroactive implementation of the 2014 Own Resources Decision with reference to years 2014 and 2015. The gas-prices related reimbursements are not considered to be a one-off in 2016 as they are deficit-increasing and under the direct control of the government.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by general government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	**2016**	**2017**
Taxes on production and	0	0.0	0
Current taxes on income,	0	0.0	0
Capital taxes	n.a.	n.a.	n.a.
Social contributions	0	0.0	0
Property Income	n.a.	n.a.	n.a.
Other	0	0.0	0
Total	0.0	0.0	0.0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2016

[10] This measure was a part of the first social package.

[11] While this measure has a negative impact on tax revenues, the DBP reports it on the expenditure side. This is because the details of the measure became known too late to be included in the official September tax revenue forecast of the Ministry of Finance, which always has to be approved also by the Tax Revenue Forecast Committee.

[12] See footnote 6 for more details.

B. Discretionary measures taken by general government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	**2016**	**2017**
Compensation of employees	0	0.2	0
Intermediate consumption	0	-0.6	0
Social payments	0	0.1	0
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	0	0.0	0
Gross fixed capital formation	0	-0.1	0
Capital transfers	0	-0.2	0
Other	0	0.1	0
Total	0.0	-0.4	0.0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2016

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Slovakia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO.

The structural balance reached -2.1% of GDP in 2014 and remained well below the MTO set at -0.5% of GDP. In 2015, Slovakia is required to avoid a deterioration in the structural balance. The (recalculated) structural balance in the DBP suggests a deviation of 0.4% of GDP from the requirement, pointing to a risk of some deviation. Unlike the Commission 2015 autumn forecast, the DBP does not consider financial corrections to EU funds to be one-off expenditures neither in 2014 nor 2015[13]. As these corrections are reflected in the estimation of the 2014 structural balance in the Commission 2015 autumn forecast, which is the starting point for the recalculation of the change in the structural balance based on the DBP, this recalculated change in the structural balance is considered to be underestimated. This also impacts the two-year average of the change in structural balance, which shows the risk of a significant deviation. Based on the projections in the DBP, the expenditure benchmark is respected in 2015 both in that year and over the two-year horizon. The difference between the two pillars is mainly explained by the development of EU funded investments. In particular, the expenditure benchmark smoothens investment and is therefore less influenced by the temporary surge in investment in 2015. The expenditure benchmark therefore appears to

[13] The issue is explained in detail in footnote 6.

better reflect the fiscal effort at the current juncture. Information provided in the DBP thus points to compliance in 2015.

Based on the Commission 2015 autumn forecast, the structural balance requirement would be respected in 2015 looking at a one-year horizon, while some deviation is observed over the two-year horizon. In terms of the expenditure benchmark pillar, Slovakia would respect the requirements for both time horizons. The discrepancy vis-à-vis the DBP in terms of the structural balance pillar relates to the issue of one-offs explained above. Assessing the two pillars for 2015 suggests compliance with the underlying requirements. When looking at the two-year average, the difference between the two indicators is explained by two main factors. In 2014, the effort as measured by the expenditure benchmark is not affected by inflationary shocks while the structural balance indicator reflects the actual GDP deflator which turned out much lower than previously forecast[14]. This element continues to play a role in 2015 but to a lesser extent. Moreover, as mentioned above, the exceptional and temporary increase in public investment in 2015 fully impacts the structural balance while it is smoothed out in the expenditure benchmark. Exceptionally high investment is not expected to be repeated in the future. On these grounds, the expenditure benchmark is deemed to be a more appropriate indicator. The overall assessment hence points to compliance with the adjustment path towards the MTO in 2015.

Regarding 2016, based on the information in the DBP, the recalculated structural balance is expected to improve by 0.7% of GDP, thus above the required adjustment of 0.25% of GDP. Similarly, the DBP projects net expenditure to comply with the required maximum growth under the expenditure benchmark pillar. Information provided in the DBP thus points to compliance in 2016. The Commission 2015 autumn forecast projects a limited improvement in structural balance in 2016, implying a gap of -0.2% of GDP vis-à-vis the required effort. In addition, based on the Commission 2015 autumn forecast, the growth rate of government expenditure, net of discretionary revenue measures, in 2016 will exceed the applicable expenditure benchmark rate (2.2%) showing a deviation of 0.3% of GDP. Both indicators point to a risk of some deviation. Therefore, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2016.

On 10 November 2015, the Slovak authorities sent to the Commission and the Eurogroup and publicly disclosed[15] a letter containing additional information on the Draft Budgetary Plan to further clarify the main drivers of the envisaged expenditure declines in 2016. The authorities explain that the implementation of measures in the area of healthcare and the introduction of spending reviews would contribute significantly to lower expenditure in 2016 vis-à-vis the expected spending in 2015. Furthermore, the letter contains information about positive risks with respect to revenue collection in 2015 that are expected to translate also into higher revenue in 2016. The Commission has assessed this information and has concluded that an additional 0.2% of GDP expenditure cuts in 2016 can be considered with respect to the Commission 2015 autumn forecast. The envisaged cuts lead to an additional improvement of some 0.2% of GDP in the structural balance compared to the estimate in the Commission 2015 autumn forecast – bringing the change in structural balance in line with the required effort. The deviation of the expenditure benchmark from the requirement declines to some

[14] As explained above, the expenditure benchmark is not affected by the deflationary shocks.

[15] The letter is published on the website of the Slovak Ministry of Finance http://www.finance.gov.sk/Default.aspx?CatID=38&id=798

0.1% of GDP in 2016, hence still pointing to a risk of some deviation. This calls for an overall assessment. The evaluation based on the expenditure benchmark is negatively affected by the significant drop in EU-funded investment in 2016. Indeed, the growth rate of net expenditure is calculated by excluding the EU-funded expenditures and at the same time smoothing total investment expenditure. However, government investment projects (GFCF) in Slovakia are to a large degree funded by EU programmes. As EU-funded investments are expected to decrease substantially in 2016, the expenditure benchmark pillar overestimates the net expenditure growth. Correcting for this element, the expenditure benchmark points to compliance[16]. Therefore, the overall assessment points to compliance.

Following an overall assessment of Slovakia's DBP, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, the adjustment path towards the MTO seems to be in line with the requirement of the preventive arm of the Pact in 2015 and 2016.

[16] This element has been influencing the expenditure benchmark in the opposite direction in 2015. Correcting for this factor, the expenditure benchmark still points to compliance in 2015 albeit with a smaller margin.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2014	2015		2016	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-2.1	-2.1		-2.0	
Structural balance based on freezing (COM)	-2.0	-1.9		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2014**	**2015**		**2016**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.25	
Required adjustment corrected[5]	-0.4	0.0		0.25	
Change in structural balance[6]	-0.6	-0.4	0.0	0.7	0.0
One-year deviation from the required adjustment [7]	-0.2	-0.4	0.0	0.4	-0.2
Two-year average deviation from the required adjustment [7]	n.a. (in EDP in 2013)	-0.3	-0.1	0.0	-0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	4.1	2.9		2.2	
One-year deviation [9]	0.8	1.1	1.1	0.0	-0.3
Two-year average deviation [9]	n.a. (in EDP in 2013)	0.9	0.9	0.5	0.4
Conclusion					
Conclusion over one year	Overall assessment	Overall assessment	Compliance	Compliance	Overall assessment
Conclusion over two years	n.a. (in EDP in 2013)	Overall assessment	Overall assessment	Compliance	Overall assessment

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.

5. IMPLEMENTATION OF REFORMS IN THE AREA OF FISCAL GOVERNANCE

The DBP mentions measures designed to ensure budgetary responsibility of local governments which were put in place since January 2015. The local governments are now subject to a fine in case their debt exceeds 60% of current revenues in a year preceding the assessment. This measure is designed to limit fiscal risks beyond the direct control of the central government.

Box 3 reports the latest country specific recommendations in the area of public finances.

Box 3. Council recommendations addressed to Slovakia

On 14 July 2015, the Council addressed recommendations to Slovakia in the context of the European Semester. In particular, in the area of public finances the Council recommended to Slovakia to improve the cost-effectiveness of the healthcare sector, including by improving the management of hospital care and strengthening primary healthcare and take measures to increase tax collection.

In response to the CSRs in July 2015, the DBP discusses measures related to the on-going efforts to fight against tax evasion and fraud. Specifically, the Action plan to fight tax evasion was updated and the reverse charge mechanism in the construction sector will be applicable from 2016. On the contrary, the DBP does not cite any measures related to the fiscal-structural recommendation on cost-effectiveness of the healthcare sector indicating a limited progress in this respect.

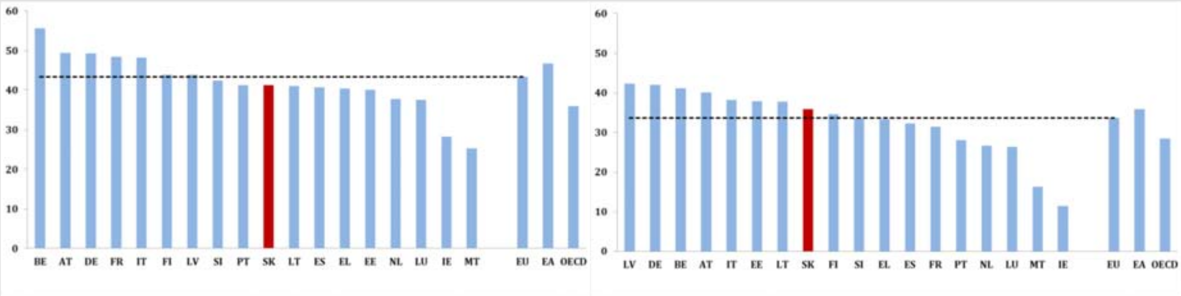
A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the CSRs adopted by the Commission in May.

Box 4. Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to screen euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability. Furthermore, the Eurogroup expressed its intention to take stock of the state of play in the reduction of the tax burden on labour when discussing the DBPs of euro area Member States.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Slovakia for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Slovakia at the average wage and a low wage (2014)



Notes: Data for Latvia, Lithuania and Malta is for 2013. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.
Source: European Commission Tax and Benefit Indicator database based on OECD data.

This screening is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Low-earners in Slovakia have a higher tax wedge than the EU average. Since January 2015, Slovakia reduced the tax-wedge for low-paid workers by cutting their healthcare contributions. While the impact of this target measure is not yet reflected in the presented charts, it can potentially benefit up to 600,000 employees. Since November 2013, the government also introduced a suspension of social and healthcare contribution when hiring long-term unemployed workers with below average earnings. The contributions do not have to be paid during a period of one year. While this measure had a positive impact on the attractiveness of hiring long-term unemployed it has not helped to significantly reduce the overall long-term unemployment. The DBP does not include any new measures affecting the tax wedge on labour.

6. OVERALL CONCLUSION

According to the DBP, the fiscal effort is planned to be in line with the required adjustment path towards the MTO in 2015, on the basis of an overall assessment, In turn, on the basis of the Commission 2015 autumn forecast, Slovakia's structural balance is projected to remain unchanged and the adjusted government expenditure appears to be contained. Following an overall assessment, the adjustment path towards the MTO in 2015 hence seems to be appropriate.

In 2016, the DBP envisages a marked improvement in the general government deficit that is driven by reduction of expenditure. On that basis, the required adjustment towards the MTO seems to be adhered to. The Commission 2015 autumn forecast does not expect such a noticeable reduction in government expenditure. However, considering additional information provided by the authorities, the overall assessment suggests that Slovakia would adhere to the required adjustment path towards the MTO.