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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of the Slovakia

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Slovakia

{C(2018) 8027 final}

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COMMISSION STAFF WORKING DOCUMENT

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COMMISSION OPINION

on the Draft Budgetary Plan of Slovakia

1. INTRODUCTION

Slovakia submitted its Draft Budgetary Plan for 2019 on 10 October in compliance with Regulation (EU) No 473/2013. 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 Draft Budgetary Plan and provides an assessment based on the Commission 2018 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2018 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2018-2019 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of the structure of the public finances and of the implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2018, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

In 2017 Slovakia's economy expanded by 3.2% in 2017, principally driven by domestic demand. According to the Draft Budgetary Plan (Table 1), real GDP growth is forecast to accelerate to 4.1% in 2018 and 4.5% in 2019. Further improvements in the labour market and low credit costs imply that private consumption will remain a key contributor to economic expansion, as was already the case in 2017. A surge in investment activity in 2018 is expected to make its contribution to GDP growth the largest of all expenditure categories in 2018. This investment spending is driven mainly by private investment in the automotive industry while public investment is expected to remain subdued. The positive effect of new investment on Slovakia's export capacities and trade performance is expected to lift economic growth in 2019 slightly above the 2018 rate. The unemployment rate is expected to gradually fall to a historic low of 6.4% in 2019, with employment gains likely to remain strong and broad-based across sectors. Consumer price inflation is expected to pick up in 2018 and 2019 to well above the 2017 figure, reflecting rising wage pressures and erratic developments in prices of food and fuels.

The pace of economic growth expected in the Draft Budgetary Plan is broadly in line with the latest Stability Programme. The composition of growth in 2018 is, however, different, owing to surprisingly swift growth in fixed investment in the first half of the year compared to the

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Stability Programme. Similarly, projected growth of government consumption is also slightly higher in the Draft Budgetary Plan. On the other hand, the data for the first half of 2018 suggests that private consumption is likely to lag behind the expectations in the Stability Programme despite stronger outcomes in the labour market. The growth contribution from net trade has also been revised downward in the Draft Budgetary Plan reflecting slowing foreign demand. The assumed composition of growth in 2019 is very similar in both documents.

Table 1: Comparison of macroeconomic developments and forecasts

	2017	2018			2019		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.2	4.2	4.1	4.0	4.5	4.5	4.1
Private consumption (% change)	3.5	3.5	2.9	2.9	3.2	3.2	3.2
Gross fixed capital formation (% change)	3.4	5.2	9.6	12.4	3.3	3.1	2.2
Exports of goods and services (% change)	5.9	7.9	6.8	5.4	8.5	7.9	8.0
Imports of goods and services (% change)	5.3	7.1	6.6	5.7	7.2	6.8	6.8
Contributions to real GDP growth:							
- Final domestic demand	3.0	3.1	3.4	4.7	2.6	2.8	2.5
- Change in inventories	-0.5	0.0	-0.5	-0.6	0.0	0.2	0.2
- Net exports	0.7	1.2	0.6	-0.1	1.9	1.7	1.4
Output gap[1]	0.2	0.2	0.9	0.7	0.7	1.8	1.3
Employment (% change)	2.2	1.6	2.0	1.7	1.0	1.1	1.0
Unemployment rate (%)	8.1	7.3	6.9	6.9	6.7	6.4	6.3
Labour productivity (% change)	1.0	2.5	2.1	2.3	3.4	3.3	3.1
HICP inflation (%)	1.4	2.0	2.6	2.6	2.0	2.5	2.6
GDP deflator (% change)	1.2	1.8	2.3	2.6	2.0	2.5	2.7
Comp. of employees (per head, % change)	5.2	5.3	6.3	5.0	5.3	6.2	6.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-0.8	0.0	-0.6	0.2	0.9	0.1	1.6

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 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

The macroeconomic scenario underlying the Draft Budgetary Plan is broadly in line with the Commission 2018 autumn forecast, with the latter projecting a slower pace of economic expansion in both 2018 and 2019, by 0.1 and 0.4 percentage points, respectively. The differences are somewhat more pronounced with regard to the composition of growth. In contrast to the Draft Budgetary Plan scenario, the Commission forecast expects a weaker contribution of net trade to overall growth in both years, reflecting lower expectations of

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global trade growth. A comparatively weaker export performance in the Commission forecast is broadly offset by a higher contribution from investment in 2018. On the other hand, the Commission forecast expects a slightly smaller growth contribution from investment in 2019 which, together with a lower contribution of net trade, accounts for the 0.4 percentage point difference between the two sets of forecasts. Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan appear to be plausible in 2018 and somewhat favourable in 2019.

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

Slovakia's Draft Budgetary Plan is based on the macroeconomic forecast published by the Institute for Financial Policy (IFP) of the Ministry of Finance in September and endorsed by the Macroeconomic Forecasting Committee (MFC). The latter foresees that in its deliberations the MFC is independent and free from the government's influence.

According to the minutes published on the website of the IFP, the macroeconomic forecast underpinning the Draft Budgetary Plan was deemed "realistic" by four voting members of the MFC and "optimistic" by two voting members at the meeting held on 12 September 2018.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The Draft Budgetary Plan targets a general government deficit of 0.6% of GDP in 2018, some 0.2 percentage points lower compared to the Stability Programme, when the headline deficit was projected at 0.8% of GDP. The lower deficit is due to better than projected tax collection, mainly in relation to value added tax, corporate income tax and better labour market developments affecting social contributions and personal income tax. By contrast, non-tax revenues are lagging in comparison with 2017 budget outcomes due to lower revenues from sales and property income. On the expenditure side, spending increases on social benefits, intermediate consumption and, notably, public investment by municipalities, public transport enterprises and other public entities are anticipated. Lower national co-financing caused by a drop in other current transfers from the EU, in particular from direct payments to farmers, also helped to lower the deficit compared to the Stability Programme.

The Commission 2018 autumn forecast also projects a 2018 deficit of 0.6% of GDP. In contrast to the Draft Budgetary Plan, the Commission 2018 autumn forecast does not factor in higher expenditure from capital transfers for debt relief of hospitals, and also nets out countervailing increases in revenues from health insurance premia. In the Commission 2018 autumn forecast, higher expenditure on compensation of employees and gross fixed capital formation is expected, but the latter item is partly compensated by lower levels of other current transfers.

The Draft Budgetary plan also lowers the headline deficit target for 2019 by 0.2 percentage points compared to the Stability Programme, resulting in a general government deficit target of 0.1% of GDP. The Draft Budgetary Plan presents this lower deficit target as reflecting improved projections for value added tax, income taxes and social security contributions, which is mainly driven by the improved macroeconomic scenario. However, the Draft Budgetary Plan shows that more buoyant revenues from taxes on production and income, as well as from social contributions, will be used to finance the increasing wage bill, government

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intermediate consumption, social benefits and subsidies. The Draft Budgetary plan expects lower gross fixed capital formation than the Stability Programme. Overall, the general government deficit reduction in 2019 appears to be mainly driven by revenue growth outstripping the rate of expenditure increases. At the same time, both the revenue and expenditure ratios are growing more slowly than nominal GDP, with the ratio of revenue to GDP declining by 0.8 percentage points to 38.4% of GDP in 2019. The ratio of expenditure to GDP is projected to fall by 1.3 percentage points to 38.5% in 2019, largely on account of curbing growth of gross fixed capital formation. The benign development of the expenditure-to-GDP ratio is based mainly on the assumption of a relatively slow drawdown of EU funds and commensurately lower level of national co-financing.

The Commission 2018 autumn forecast projects a deficit of 0.3% of GDP in 2019, slightly higher than in the Draft Budgetary Plan. The Commission projects lower revenues from taxes on production and higher revenues from social contributions and income taxes. Furthermore, it expects a higher drawdown on EU funds. On the expenditure side, the Commission forecast assumes faster growth in the wage bill and social benefits, as well as higher gross fixed capital formation, due to an assumed gradual acceleration of EU funds drawdown associated with higher national financing. Unlike the Draft Budgetary Plan, the Commission forecast does not assume the (deficit-neutral) provision of reserves on the expenditure side.[1]

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Slovakia currently standing at 1.0%.[2] As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Slovakia is expected to fall from 1.4% of GDP in 2017 to 1.3% in 2018 and is projected to decrease further in 2019 to 1.2% of GDP, well below the 1.8% recorded in 2012 at the peak of the euro area sovereign debt crisis. This interest expenditure outlook from Slovakia's Plan is broadly confirmed by the Commission forecast.

[1] This treatment is in line with previous fiscal assessments of Slovakia's public finances by the Commission. For a more detailed explanation, see the Staff Working Document accompanying the assessment of Slovakia's 2018 Stability Programme, https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/stability-and-convergence-programmes/assessment-programmes-2018_en#slovakia.

[2] 10-year bond yields as of 24 October 2018. Source: Bloomberg.

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Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018			2019			Change: 2017-2019
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**39.4**	**38.2**	***39.2***	**39.3**	**37.7**	***38.4***	**38.9**	**-1.0**
of which:								
- Taxes on production and imports	10.9	10.8	*11.1*	10.8	10.8	*11.0*	10.7	0.1
- Current taxes on income, wealth, etc.	7.4	7.1	*7.3*	7.3	7.0	*7.4*	7.5	0.0
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	14.8	14.7	*15.0*	15.0	14.3	*14.5*	14.9	-0.3
- Other (residual)	6.4	5.6	*5.8*	6.3	5.6	*5.5*	5.9	-0.9
Expenditure	**40.2**	**39.0**	**39.8**	**39.9**	**38.0**	**38.5**	**39.3**	**-1.7**
of which:								
- Primary expenditure	38.8	37.8	38.5	38.6	36.8	37.3	38.1	-1.5
of which:								
Compensation of employees	9.2	9.1	9.1	9.3	8.8	9.2	9.4	0.0
Intermediate consumption	5.7	5.4	5.5	5.6	5.3	5.6	5.5	-0.1
Social payments	18.5	18.1	18.2	17.9	17.3	17.4	17.5	-1.1
Subsidies	0.4	0.4	0.4	0.4	0.4	0.5	0.4	0.1
Gross fixed capital formation	3.2	2.5	3.2	3.6	2.7	2.4	3.6	-0.8
Other (residual)	1.8	2.3	2.1	1.8	2.3	2.2	1.8	0.4
- Interest expenditure	1.4	1.3	1.3	1.3	1.2	1.2	1.2	-0.2
General government balance (GGB)	**-0.8**	**-0.8**	**-0.6**	**-0.6**	**-0.3**	**-0.1**	**-0.3**	**0.7**
Primary balance	**0.6**	**0.5**	**0.6**	**0.7**	**0.9**	**1.1**	**0.8**	**0.5**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.8**	**-0.8**	**-0.6**	**-0.6**	**-0.3**	**-0.1**	**-0.3**	**0.7**
Output gap[1]	0.2	0.2	0.9	0.7	0.7	1.8	1.3	1.7
Cyclically-adjusted balance[1]	-0.9	-0.9	-0.9	-0.8	-0.6	-0.8	-0.8	0.0
Structural balance (SB)[2]	**-0.9**	**-0.9**	**-0.9**	**-0.8**	**-0.6**	**-0.8**	**-0.8**	**0.0**
Structural primary balance[2]	0.5	0.4	0.4	0.4	0.6	0.4	0.3	-0.2

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/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 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

According to the national legislation related to the Fiscal Compact, Slovakia is required to run a balanced budget, defined as a structural deficit of 0.5% of GDP – this target also constitutes Slovakia's MTO. Based on the information in the Draft Budgetary Plan, the structural balance[3] as recalculated by the Commission using the commonly agreed methodology on the basis of the macroeconomic scenario for Slovakia is projected to marginally decline from

[3] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

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0.9% of GDP in 2018 to 0.8% of GDP in 2019. This implies that Slovakia would not reach the MTO in that year, in contrast to the projections presented in the Stability Programme. The Commission 2018 autumn forecast expects the same structural balance as the Draft Budgetary Plan for 2019, and expects it to remain stable from the level of 0.8% of GDP in 2018.

On 20 November 2018 the Slovak authorities publicly announced a revision to the budgetary target for 2019. This revision consisted of a lowering of government expenditure levels in 2019 through structural spending measures equating to 0.1% of GDP. According to the Slovak authorities, these would ensure the achievement of a balanced budget in nominal terms in 2019 and would be likely to ensure a meeting of the MTO in that year. These changes were approved by Slovakia's budgetary and financial committee on 20 November 2018.

3.2. Debt developments

The Draft Budgetary Plan projects the general government debt to decline to 48.7% of GDP in 2018, 0.6 percentage points lower compared to the Stability Programme (Table 3). The difference is driven by the projected impact of a lower-than-expected primary balance, stronger inflation and a weaker positive stock-flow adjustment resulting from a higher-than-projected use of state treasury liquidity. In 2019, the Draft Budgetary Plan projects the debt-to-GDP ratio to decline to 47.3%, which is less than in the Stability Programme (by 0.7 percentage points). This is mainly due to the higher-than-expected net accumulation of financial assets and cash/accrual differences. The Commission 2018 autumn forecast projects very similar developments in the debt ratio in 2018 and projects it to decline somewhat more rapidly in 2019, to 46.4% of GDP. This divergence is mainly due to a smaller assumed stock-flow adjustment compared to the Draft Budgetary Plan. Based on the Draft Budgetary plan, the gross debt ratio, net of the state liquid assets, is expected to follow the same declining path as gross debt, with the ratio of liquid assets to GDP projected to remain broadly stable in 2018 and decline faster than gross debt in 2019. Information in the Draft Budgetary Plan suggests that Slovakia would be below the national debt brake threshold for the debt-to-GDP ratio in 2018 and 2019.[4]

The Draft Budgetary Plan also presents contingent liabilities identified in Slovakia in 2016 and reported to the Eurostat. The Slovak general government provided guarantees in the amount of 0.03% of GDP. Slovakia is among the Member States with the highest value of public-private partnership (PPP) projects in the EU (3.1% of GDP). Two projects are identified in the Plan, both of which are in the field of transport infrastructure and are recorded outside the general government's balance sheet. Liabilities of companies controlled by the state were reported to the amount of 1.3% of GDP at the end of 2016. The share of non-performing loans is around 0.1% of GDP.

[4] The Slovak debt brake defines five thresholds. Once the public debt-to-GDP ratio exceeds these ceilings specific sanction and/or correction measures apply. As of 2018, the debt brake thresholds are set to decline by 1 percentage point annually, until the lowest and highest ceiling reach 40% and 50% of GDP, respectively, in 2028. When the debt-to-GDP ratio exceeds 50% (or 49% in 2018) the Ministry of Finance has to send a letter to the parliament explaining the reasons behind the high debt and proposing measures to ensure its reduction.

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Table 3: Debt developments

(% of GDP)	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**50.9**	**49.3**	**48.7**	**48.8**	**46.5**	**47.3**	**46.4**
Change in the ratio	-0.8	-1.7	-2.2	-2.2	-2.7	-1.4	-2.4
Contributions[2] *:*							
1. Primary balance	**-0.6**	**-0.5**	**-0.6**	**-0.7**	**-0.9**	**-1.1**	**-0.8**
2. "Snow-ball" effect	**-0.8**	**-1.6**	**-1.8**	**-1.9**	**-1.8**	**-2.0**	**-1.9**
Of which:							
Interest expenditure	1.4	1.3	1.3	1.3	1.2	1.2	1.2
Growth effect	-1.6	-2.0	-2.0	-1.9	-2.1	-2.0	-1.9
Inflation effect	-0.6	-0.9	-1.1	-1.2	-0.9	-1.1	-1.2
3. Stock-flow adjustment	**0.6**	**0.4**	**0.2**	**0.4**	**0.0**	**1.7**	**0.4**
Of which:							
Cash/accruals difference		0.4	-0.1		0.5	1.2	
Net accumulation of financial		0.3	0.2		-0.5	0.6	
of which privatisation proceeds		0.0	0.0		0.0	0.0	
Valuation effect & residual		-0.1	0.0		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 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan presents several measures for 2019 on both the revenue and expenditure side of the budget. For 2019, revenue measures amount to 0.66% of GDP.[5] Revenues are expected to increase thanks to the introduction of a levy on retail business chains and measures linked to the online electronic evidence of sales ('e-Kasa') and nano-markers' additives in car fuels, as well as due to the abolition of the health insurance allowance for employers.

The Commission 2018 autumn forecast incorporates all revenue measures mentioned in the Draft Budgetary Plan, but factors in a lower level of additional revenues related to the nano-markers and e-Kasa introduction. Furthermore, the impact of currently discussed measures

[5] The obligatory Table 5a provided in the Annex to the Draft Budgetary Plan does not seem to reflect all the discretionary measures adopted for 2018, but only those that were approved in 2017.

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proposed by the current coalition cabinet members, such as free lunches for pupils, the exception of accommodation services from value added tax, and holiday vouchers, were taken into account as discretionary measures in the Commission forecast. These measures are not reported in the Draft Budgetary Plan as discretionary measures but their impact on the deficit is included by creating commensurate reserve on the expenditure side. The Commission forecast accounts for these negative impacts directly on the revenue side as the measures were credibly announced and sufficiently specified.

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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)		
	2018	**2019**	**2020**
Taxes on production and	0.0	0.2	0.3
Current taxes on income,	-0.1	0.1	0.1
Capital taxes	0.0	0.0	0.0
Social contributions	0.0	0.1	0.1
Property Income	0.0	0.0	0.0
Other	0.0	0.3	0.2
Total	-0.1	0.7	0.6

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 2019

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2018	**2019**	**2020**
Compensation of employees	0.0	0.4	0.7
Intermediate consumption	0.0	0.2	0.4
Social payments	0.0	0.1	0.1
Interest Expenditure	0.0	0.0	0.0
Subsidies	0.0	0.0	0.0
Gross fixed capital formation	0.0	0.0	-0.3
Capital transfers	0.0	0.1	0.0
Other	0.0	0.2	0.1
Total	0.0	0.9	1.1

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. The budgetary impact of expenditure discretionary for 2018 measures was not presented in the DBP.
Source: Draft Budgetary Plan for 2019

On the expenditure side, the Draft Budgetary Plan includes mainly expansionary measures for 2019 that amount to 0.91% of GDP compared to the no-policy change scenario. The main measures are higher outlays for civil servants' pay (10% increase in statutory pay) and an increase in remunerations for teaching staff and university teachers as well as an increase in intermediate consumption as a reserve for covering the impact of new legislation relating to the revenue side. Additionally, social transfers in kind and other current transfers to support the reduction of final electricity prices for enterprises are higher than in the no-policy change scenario. Finally, public investment levels are projected below the no-policy change scenario in the Draft Budgetary Plan, which is explained by the fact that advances for the future supplies of military technology will be recorded at the time of delivery and not at the time of cash spending, according to the ESA 2010 methodology.

The Commission forecast takes into account all expenditure measures presented in the Draft Budgetary Plan. However, the Commission forecast neither includes a reserve for lower tax and non-tax revenues nor a reserve for the negative impact of currently discussed measures. The Commission forecast notably includes the impacts of the decreased value added tax rate for accommodation services, of the tax and contribution exemption on travel vouchers, the cost of free school meal for pupils, double tax bonuses for pensioners as well as additional outlays linked to increases of spa care expenditure etc. The expenditure-to-GDP ratio thus decreases less in the Commission forecast than in the Draft Budgetary Plan.

Neither the Draft Budgetary Plan nor the Commission forecast assume any one-off measures in 2018 and 2019.

According to information included in the Draft Budgetary Plan, the amendment of the Act on Budgetary rules was approved by the Cabinet. According to this amendment, each subsequent government will be obliged to carry out and publish spending reviews covering an amount equivalent to at least half of the expenditure volume in the general government budget over a four-year period. Reviewing the implementation of the recommendations from these spending reviews will be a mandatory part of the budgetary documentation.

4. Compliance with the provisions of the Stability and Growth Pact

Slovakia is a subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country specific recommendations in the area of public finances.

Box 2. Council Recommendations[6] addressed to Slovakia

On 13 July, the Council addressed recommendations to Slovakia in the context of the European Semester. In particular, in the area of public finances the Council recommended that Slovakia ensure that the nominal growth rate of net primary government expenditure does not exceed 4.1% in 2019, corresponding to an annual structural adjustment of 0.5% of GDP.

In 2019, for Slovakia to comply with the requirement of the preventive arm, and in view of the Commission autumn 2018 forecast projecting a closer position to the MTO than in spring 2018, the nominal growth rate of government expenditure, net of discretionary measures and one-offs, should not exceed 4.6%, corresponding to an annual structural adjustment of the structural balance by 0.3% of GDP.

[6] OJ C 320, 10.9.2018, p. 107–111.

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4.1. Adjustment towards the MTO

The Commission Communication on the 2017 European Semester of May 2017[7] stated that the Commission stands ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment is particularly significant. The Country-Specific Recommendation adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. Following the Commission's assessment of the strength of the recovery in Slovakia while giving due consideration to its sustainability challenges, carried out in the context of its opinion on Slovakia's 2018 Draft Budgetary Plan, a fiscal structural effort of at least 0.5% of GDP is required for 2018, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary government expenditure not exceeding 2.9%. According to the recalculated information provided in the Draft Budgetary Plan, the nominal growth rate of net primary government expenditure in 2018 will exceed the applicable expenditure benchmark rate of 2.9%, leading to a one-year deviation of 1.1% of GDP. The two-year average deviation on the expenditure benchmark also signals the risk of a significant deviation. The structural balance pillar confirms the risk of significant deviation in light of a one-year deviation of -0.6% of GDP, while it points to some deviation over two years. On the basis of the information provided in the Draft Budgetary plan, an overall assessment, which favours the expenditure benchmark as capturing more accurately the fiscal effort of Slovakia, points to a risk of significant deviation in 2018.

The Commission 2018 autumn forecast confirms this conclusion for 2018, as the expenditure benchmark pillar also points to a risk of significant deviation when looking at both one-year and two-year deviations. The structural balance pillar indicates some deviation in a one-year assessment and compliance when taking 2017 and 2018 together. This requires an overall assessment. As the expenditure benchmark is not affected by the savings from the projected decline in interest expenditure, smooths out gross fixed capital formation volatility, and relies on a lower, more appropriate medium-term potential growth rate, it appears to capture more accurately the fiscal effort of Slovakia at the current juncture. In summary, the overall assessment thus points to a risk of significant deviation in 2018 when judging by the Commission forecast.

In 2019, for Slovakia to comply with the requirements of the preventive arm, and in view of the Commission autumn 2018 forecast projecting a closer position to the MTO than in spring 2018, the nominal growth rate of government expenditure, net of discretionary revenue measures and one-offs, should not exceed 4.6%, corresponding to an annual structural adjustment of the structural balance by 0.3% of GDP.

Although the structural balance is projected to slowly approach the MTO, neither the (recalculated) figures from the Draft Budgetary Plan nor the Commission 2018 autumn forecast expect Slovakia to reach its MTO in 2019.

[7] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

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Table 7: Compliance with the requirements of the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-0.9	-0.8		-0.8	
Structural balance based on freezing (COM)	-1.4	-0.8		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.5	0.5		0.3	
Required adjustment corrected[5]	0.5	0.5		0.3	
Change in structural balance[6]	0.9	-0.1	0.0	0.1	0.0
One-year deviation from the required adjustment [7]	0.4	-0.6	-0.5	-0.2	-0.3
Two-year average deviation from the required adjustment [7]	0.5	-0.1	0.0	-0.4	-0.4
Expenditure benchmark pillar					
Applicable reference rate[8]	1.3	2.9		4.6	
One-year deviation adjusted for one-offs [9]	-0.1	-1.1	-0.9	0.1	-0.1
Two-year average deviation adjusted for one-offs [9]	0.1	-0.6	-0.5	-0.5	-0.5

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 38.).

[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 20XX-1) was carried out on the basis of Commission 20XX 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, revenue increases mandated by law and one-offs 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 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations.

Based on the information in the Draft Budgetary Plan, the expenditure benchmark suggests compliance with the preventive arm of the Pact in 2019 when looking at the single-year deviation alone. However, in view of the large deviation projected for 2018, the expenditure benchmark pillar suggests a risk of significant deviation when taken over 2018-2019 together (a gap of 0.5% of GDP). The structural balance pillar, meanwhile, suggests the risk of some deviation in 2019 alone but a significant deviation when looking at 2018-2019 together. An overall assessment, which favours the expenditure benchmark as capturing more accurately the fiscal effort of Slovakia, points to a risk of significant deviation with respect to the required adjustment towards the MTO. This conclusion principally results from fiscal slippages expected in 2018 not being adequately compensated for in 2019. Overall, there appears to be a risk of a significant deviation over 2018 and 2019 together according to information provided in the Draft Budgetary Plan.

The Commission 2018 autumn forecast confirms these compliance findings relating to 2019. Both the expenditure benchmark and the structural balance indicator point to a risk of some deviation in 2019 alone and to a risk of a significant deviation when taken over 2018-2019 together. Analogous to the Draft Budgetary Plan, an overall assessment based on the Commission forecast therefore indicates the risk of a significant deviation over 2018 and 2019 taken together.

In light of the Commission's assessment of additional information about a planned reduction in government expenditure equivalent to 0.1% of GDP in 2019, which was publicly announced by the Slovak authorities and agreed by Slovakia's budgetary and financial committee on 20 November 2018, the Commission considers that the (recalculated) structural balance is expected to be close to the medium-term budgetary objective in 2019. On this basis, the overall assessment points to a risk of some deviation from the medium-term budgetary objective in 2019. However, if the structural balance is no longer projected to be close to the medium-term budgetary objective in future assessments for 2019, the overall assessment of compliance will need to take into account a possible deviation from that requirement.

The overall assessments based on both the Draft Budgetary Pan and the Commission's 2018 autumn forecast, point to a risk of some deviation from the adjustment path towards the MTO in 2019.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

In the Draft Budgetary Plan, most of the fiscal adjustment in 2018 and 2019 takes place on the expenditure side. The expenditure ratio is projected to decline at a faster pace than the revenue ratio, by 0.2 percentage points of GDP in 2018 and 0.5 percentage points in 2019. In 2019, declines in the ratio of social contributions to GDP and other revenues shares to GDP are expected according to the Draft Budgetary Plan. The shares of taxes on production and imports and current taxes on income are expected to remain broadly the same. Part of the fiscal improvement is generated through declining interest outlays reflecting falling interest rates in 2019. Even though the impact of deficit-increasing discretionary expenditure measures is higher than that of discretionary measures on the revenue side (by 0.3 percentage points of GDP), the fiscal adjustment appears to stem mainly from the expenditure side in 2019 as expenditure growth is considerably lower than that of nominal GDP.

While the ratio of total investment to GDP decreased only marginally during the past 10 years, the share of total public spending has declined by more than 1 percentage point. In terms of public spending shares over the past ten years, investment has given way to higher spending on public wages bill, intermediate consumption and social expenses. Increases in salaries of teachers, healthcare staff and civil servants have driven up spending on the public

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wage bill. This is expected to endure in 2018 and mainly in 2019, when the share of public wages in total spending is set to increase by 1 percentage point on year on year basis according to the Draft Budgetary Plan. These developments reflect the fact that investment is an expenditure item that can be – in case of a need – cut most easily. This deterioration, nevertheless, hides temporary hikes in investment, especially in 2015, which were related to massive increase in the drawdown on EU funds in view of the finishing 2007-2013 programming period and are likely to be repeated in the current programming period. This also illustrates the dependence of Slovak public investment on EU funds. The decline in public investment is projected to continue in 2019 according to the Draft Budgetary Plan.

In 2018, the Ministry of Finance carried out spending reviews under the 'Value for Money' project in following areas: agriculture and rural development, groups at risk of poverty and social exclusion, healthcare II, and the remuneration in public administration. The results of these revisions will be taken into account when preparing the budget for the years 2020 to 2022.

During the past 10 years, revenues and expenditure ratios have grown by 4.9 percentage points and 4.0 percentage points of GDP, respectively. On the revenue side, this was driven mainly by growth in social contributions and, on the expenditure side, by social benefits and compensations of employees. Levels of both ratios were substantially lower than the EA19 averages.

The tax structure remains almost the same in years 2018 and 2019 in comparison with 2017. The majority of discretionary revenue measures presented in the Draft Budgetary Plan are focused on tax revenues and social contributions. The introduction of new online electronic evidence of sales, nano-marker's additives in fuels and taxation of non-life insurance are likely to strengthen tax collection and make the tax structure less detrimental to growth. For measures that affect the tax wedge on labour, see to Box 4.

Box 3. 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 benchmark 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.

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 at low wage (2016)

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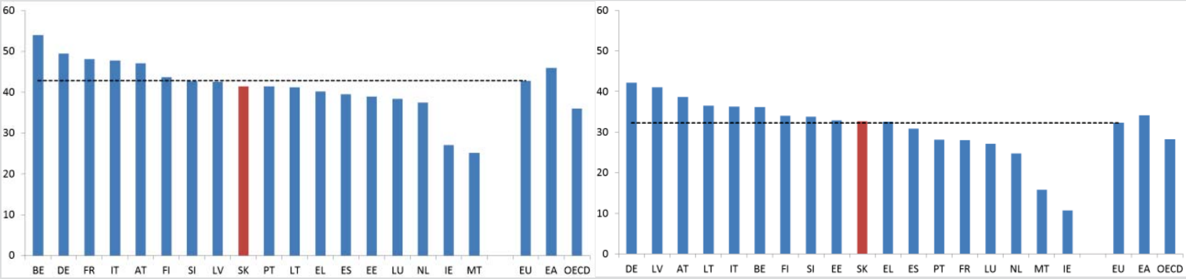

Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking 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.

Slovakia's Draft Budgetary Plan contains the following measures that affect the tax wedge on labour. The government introduced a voluntary 13th and 14th salary in 2018 which will be exempted from personal income tax and social security contributions in the final phase of implementation (2021). Since January 2018, health insurance allowances for employers were abolished, which will increase labour costs for employers. In addition, the income of pensioners (up to a certain ceiling) working on 'contract agreements' are also exempted from social security contributions from the mid-2018 onwards. As of 2021, tax settlements from social contributions will be performed on an annual basis (instead of monthly). Using annual settlements allows a smoother taxation over time and reduces possible optimization strategies. These measures correspond to stated government priorities and do not constitute a more general tax shift. The introduction of these measures is possible thanks to the strong cyclical position of the economy, which generally supports tax revenues.

In the context of the European Semester, the Council addressed a number of country-specific recommendations to Slovakia on 13 July 2018. These included the recommendation to implement measures to increase the cost-effectiveness of the healthcare system and develop a more effective healthcare workforce strategy in 2018 and 2019. In response, the Draft Budgetary Plan reports a fall in health outlays by EUR 108 million due to the implementations of measures proposed in the first phase of the health care spending review. In 2018, the diagnosis-related groups (DRG) payment mechanism was operationalised with a five-year convergence process for statutory cost rates for individual hospitals into one single nationwide rate. Additional resources in the budget for 2019 will be used for increasing wages for nurses and health personnel, upgrading technology and constructing new facilities. A new concept for hospitals' service stratification was introduced in 2018 with the aim to improve inpatient healthcare by 2030. The authorisation for hospitals to provide specialised healthcare will be granted only after the certain performance indicators have been met. By the end of 2018, the preliminary report of the second round of the healthcare spending review will be released.

A comprehensive assessment of progress made in the implementation of the country-specific recommendations will be made in the 2019 Country Reports and in the context of the country-specific recommendations to be adopted by the Commission in May 2019.

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6. OVERALL CONCLUSION

The Draft Budgetary Plan points to a risk of a significant deviation from the required adjustment path towards the MTO in 2018. Following an overall assessment, this conclusion was confirmed by the Commission 2018 autumn forecast. Regarding 2019, and in addition to the Draft Budgetary Plan, the Slovak authorities publicly announced a planned reduction in government expenditure equivalent to 0.1% of GDP in 2019, which has been agreed by Slovakia's budgetary and financial committee on 20 November 2018. The Commission's assessment of this additional information suggests that the (recalculated) structural balance is expected to be close to the medium-term budgetary objective in 2019. On this basis, the overall assessment of both the Draft Budgetary Pan and the Commission's 2018 autumn forecast points to a risk of some deviation from the medium-term budgetary objective in 2019. However, if the structural balance is no longer projected to be close to the medium-term budgetary objective in future assessments for 2019, the overall assessment of compliance will need to take into account a possible deviation from that requirement.

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