

**Ministry of Finance of the SR**

**CONVERGENCE PROGRAMME OF  
SLOVAKIA  
FOR YEARS 2006 TO 2010**

**Update 2006**

**November 2006**



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## INTRODUCTION

The presented updated version of the Convergence Programme of Slovakia by the year 2010 builds on objectives and measures specified in the first Convergence Programme of Slovakia drawn up in May 2004 and its updated versions from November 2004 and 2005. The content and format of the document fully comply with the European Commission guidelines. The guidelines are based on the documents '*Specification on the implementation of the Stability and Growth Pact*' and '*Guidelines on the format and content of Stability and Convergence Programmes*'. These documents were prepared in 2005 in order to improve the implementation of the Stability and Growth Pact, constituting a basis for the macroeconomic framework of the Economic and Monetary Union (EMU). The Convergence Programme of Slovakia takes into consideration discussion, materials and recommendations of the Economic and Financial Committee that serves the Ecofin Council.

Economic policy of the new Government of the Slovak Republic that has arisen from the parliamentary elections of 17 June 2006 and that has been established on 4 July 2006 maintains continuity with the previous Government in all the fundamental issues of future development and direction of the Slovak Republic within the context of the EMU common objectives, while it builds its programme on balance between responsibility of an individual and social solidarity. The Government has undertaken to execute the economic policy according to its Programme Declaration that declares the effort to make the economic system more solidary and more socially fair, however not at the expense of a sound economic growth.

It is important to emphasize that the main fiscal targets presented in the historically first Convergence Programme remain unchanged. The Government still deems the fiscal deficit reduction to be of importance not only from the perspective of the convergence criteria and Pact's rules but notably for reason of the long-term sustainability of public finance.

The current Convergence Programme presents three main objectives in the fiscal, monetary and labour market policy:

1. The main fiscal objective is to reduce the general government deficit including the pension reform costs to below 3% of GDP in 2007 and thus to meet the criterion for entry into the Eurozone. Another main objective is to reduce the cyclically adjusted general government deficit adjusted for one-off and temporary effects to the level of 0.9% of GDP by 2010. This objective falls within the range recommended by the European Commission as the medium-term objective for Slovakia within the frame of the revised Stability and Growth Pact. According to the analyses of the Ministry of Finance of the Slovak Republic, if the necessary measures are taken, the conditions for achievement of the long-term sustainability of the public finance will be created.

2. As regards the monetary area the Eurozone entry is the main objective. At present Slovakia belongs to the EMU member countries with a temporary exception granted for the use of the single Euro currency, while the full membership of the SR in the EMU is still expected to begin in 2009. The Slovak koruna entered the Exchange Rate Mechanism (ERM



II) on 28 November 2005, while the central parity of the Slovak koruna against Euro was set at the level of 1 Euro = 38.455 SKK with the standard fluctuation band of  $\pm 15\%$  .

3. The main medium-term objective of the labour market is to increase the employment rate by 1 to 2% per annum.

These three objectives have been formulated in the following Government-approved documents:

- the Convergence Programme of Slovakia by the year 2010,
- the Euro Adoption Strategy of Slovakia, and its implementation,
- The National Reform Programme of Slovakia for the years 2006-2008 building on the SR Competitiveness Strategy by the year 2010 (National Lisbon Strategy).
- Report on progress in the implementation of the National Reform Programme of the SR (NRP) for 2006-2008

With regards to the content of the Convergence Programme of Slovakia, it is build on the *General Government Budget for the years 2007 to 2009* that has been approved by the Government. With regards to the institutional aspect, the Convergence Programme of Slovakia is a binding document approved by the Government and submitted to the National Council of the SR for discussion. The Convergence Programme deadline of submission to the European Commission is 1 December 2006.



## I. FRAMEWORKS AND OBJECTIVES OF ECONOMIC POLICY

### I.1. Main Objectives of Economic Policy

Objectives of the economic policy of the Slovak Government remain unchanged. The achievement of a high and sustainable growth in the economy remains the top priority, as it is a necessary prerequisite for acceleration of the growth of living standards, and convergence to those of the developed EU Member States. New Government accentuates, more significantly, the effort to make the economic system more solidary and more socially fair however not at the expense of a sound economic growth. Economic objectives are achieved by suitable selection, coordination and thorough implementation of macroeconomic and structural policies. Macroeconomic policies secure stability of the economic environment and structural policies contribute to increase in the economic potential and, after all, to increase in the citizens' living standards. The main objectives and principles of the economic policy of the Slovak Republic are as follows:

- **fiscal policy** – it is based on the three principles that have already been pronounced in the first Convergence Programme of Slovakia. These include transparency, responsibility and effectiveness. The main fiscal objective is to reduce the general government deficit inclusive of the pension reform costs to below 3% of GDP in 2007 and thus to meet the criterion for entry into the Eurozone. This objective has been defined in the three-year General Government Budget for the years 2007-2009, based on the legislative framework in force and based on the legislative changes in the field of taxes prepared to be approved by the end of 2006. Another key objective is to reduce the cyclically adjusted general government deficit adjusted for one-off and temporary effects to the level of 0.9% of GDP until 2010. This deficit falls within the range recommended by the European Commission as the medium-term objective for Slovakia within the frame of the revised Stability and Growth Pact. According to the analyses by the Ministry of Finance of the Slovak Republic, if the necessary measures are taken, conditions for achievement of the long-term sustainability of public finance will be created. The necessary measures include parametric changes within the pension scheme, additional consolidation effort in 2010 of 1.0% of GDP and such policy set-ups that would assure increase in public expenditure in accordance with the growth of economy in the future.
- **monetary and exchange rate policy** – since 2005 performance of the monetary policy has been defined as *inflation targeting under the ERM II conditions*; the central bank NBS presents Medium-term Forecast regularly, on quarterly basis, whereby it provides individual economic subjects with more transparent and more unambiguous framework for formulation of their expectations and objectives over longer terms. Medium-term objectives are still specified consistently with 1) obligations arising from the EU membership; 2) the objective to create conditions for Euro adoption; and 3) the Government's obligations in respect of the fiscal deficit reduction. The inflation objective was set as a year-to-year inflation rate below <sup>1</sup> 2.5% as of December 2006, and below 2% as of December 2007 and 2008. With regard to the fact that Slovakia is a small and open economy, the exchange rate

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<sup>1</sup> measured by harmonized index of consumer prices



represents a significant channel of the monetary policy transmission mechanism. The development of the exchange rate and its deviations from the balanced path within ERM II is assessed by the NBS in relation to the defined inflation objective during the entire period up to the adoption of the Euro. The ERM II exchange regime should provide a suitable framework for nominal convergence and real convergence: 1) certain degree of the exchange rate stability; 2) pressure on macroeconomic discipline; and, at the same time, 3) sufficient space for adjustments to shocks and economic development.

▪ *policy of employment and education, microeconomic policies*

One of the top priorities of economic policy of the new Government is to assure a dignified living standard for everybody. This priority should be ensured by social policy and employment policy guarantying sustainment and development of human, economic, social and cultural rights. The Slovak Republic is interested in maintaining the employment growth rate at least by 1 % per annum together with ensuring growth of employment of women and elderly persons. The most serious disparity that still has to be solved by the SR is the unbalance in the labour market – the difference between supply and demand – and therefore it will be necessary to focus on maintaining the current growth of new job vacancies especially by means of general support of business, improvement of the business environment and the conditions of doing business, elimination of legislative and administrative burdens, support of job creation in regions with a high unemployment rate and on elimination of insufficient availability of physical infrastructure in the country. The tools of the active labour market policy also containing educational and retraining activities are used to increase capability to employ and allocation of labour force with emphasis on marginal group on the labour market (e.g. young peoples, elderly persons, long-term unemployed, disabled). Regional average should be improved by realisation measures focused on increase of regional mobility and improvement in quality of education in accordance with the needs of regional labour market. Relatively high unemployment rate in the disadvantaged regions and a high share of citizens with low qualifications among the job applicants (75.5% in 2005) are the reasons for giving the top priority to the educational system reform and supporting investments into human capital within employment policy of the SR.

The growth of the innovative potential of the Slovak economy will continue to be enforced within the four NRP priority areas perceived as a uniform unit in terms of the needs of the country – *education and employment, business environment, research and development and innovations, information society*. The Government will endeavour to set these structural policies so that they would lead to ecologically suitable innovations, introduction of environmental technologies and a reduction in energy costs.

## **I.2. Fiscal Policy**

From the macroeconomic stability point of view, the main objective of the fiscal policy is to reduce the general government deficit by 2007 to below 3% of GDP inclusive of the costs of the the launching the fully-funded pillar (second pillar) of the pension scheme. The Government's consolidation efforts over a longer medium-term period are directed towards the creation of conditions for a long-term sustainability of the public finance, which



primarily means adjusting the general government budget to the consequences of ageing of the population. Reflecting this long-term objective in a specific medium-term interim objective means the reduction of the cyclically adjusted general government deficit adjusted for one-off and temporary effects to below 1% of GDP by 2010. The current estimate of the Ministry of Finance of the Slovak Republic (MF SR) allows for the cyclically adjusted deficit of 0.9% of GDP in 2010. This objective falls within the deficit range of 0.5 - 1.0% of GDP set as the medium-term objective for Slovakia within the framework of the revised Stability and Growth Pact<sup>2</sup>. Though the Slovakia's medium-term objective set by the Pact results from the transitive methodology which only takes into consideration the expected potential product growth and the initial general government debt level<sup>3</sup>, according to analyses by the MF SR, the cyclically adjusted deficit of 0.9% in 2010 is sufficient also in terms of the long-term sustainability of public finance, if necessary measures would be taken. The necessary measures include particularly parametric changes within the pension scheme, additional consolidation effort in 2010 of 1.0% of GDP and such policy set-ups that would assure increase in public expenditure in accordance with the growth of economy in the future.

The consolidation of public finance is the Government's principal medium-term objective. Its success is the main prerequisite for the efficient functioning of automatic stabilisers in the future. The Government's current priority in the stabilisation policy area is to assure that consolidation objectives will not threaten the sound economic growth, and will support the effective performance of the monetary policy. An increased efficiency of the stabilisation policy is also induced by structural reforms, in Slovakia primarily by the labour market reforms.

Consolidation objectives are important from the perspective of financial stability, however the Government is also well aware of the key importance of the qualitative aspect of the public finance. A successful continuation of fulfilment of the medium-term objectives enables to focus on this issue in particular. Therefore it is a political priority for the next periods to improve efficiency and effectiveness of the use of public resources and their orientation towards promotion of the potential growth of economy. This is the key purpose of permanent improvement of the programme budgeting as one of main priorities for the upcoming period.

Interconnection of fiscal objectives with the Lisbon strategy objectives is an important aspect of the public finance quality. From the budget perspective, it is important for the structural policies and reforms to respect the Government's fiscal objectives, which determine the financial framework of the policies. Coordination and interconnection of the Convergence Programme with the Implementation Strategy of the National Reform Programme has to be assured on the level of political objectives and Government's obligations. This issue is dealt with in a separate chapter in the section on the public finance quality for the first time in this Convergence Programme of Slovakia.

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<sup>2</sup> 'The definition of country-specific medium-term objectives in the revised Stability and Growth Pact', EFC, 14 September 2005

<sup>3</sup> During 2006 discussion on methodology that enables to set the country-specific medium-term fiscal objectives reflecting the aspects of long-term sustainability of public finance has continued.



Thus, the fiscal policy will continue to head towards ensuring of the long-term sustainability, macroeconomic stability, economic growth support, as well as efficiency in the use of public resources.

### I.3. Monetary and Exchange-rate Policy

In connection with the process of integration of the Slovak Republic into the Eurozone, the National Bank of Slovakia took a decision at the end of 2004 to change the principal monetary policy framework. With the aim to meet the Maastricht criteria in 2007 - 2008, starting from 2005 the NBS began to apply a policy, the performance of which was defined in its Monetary Programme by 2008 as **inflation targeting under ERM II conditions**. A nominal anchor of the current monetary policy is represented by the binding targets for a year-to-year change in the end-of-year inflation, measured by the harmonised consumer price index, set by the NBS at the level of 3.5% +/- 0.5% for 2005, below 2.5% for 2006, and below 2.0% in the subsequent two years. Since the monetary policy measures can influence only development of several inflation impacts, in particular of demand character, the NBS considered it necessary to set exemptions from inflation objective meeting:

- 1) discontinuance in the process of fiscal deficit decreasing according to the set trajectory to the level of below 3% in 2007 (including the costs of pension reform), when the higher fiscal deficit or overall change of the fiscal policy direction could threaten meeting the inflation criterion,
- 2) impact of administrative interventions in price level exceeding 1.0 p.p. in 2005, 0.6 p.p. in 2006, 0.8 p.p. in 2007, 1.1 p.p. in 2008,
- 3) significant variations in energy prices,
- 4) significant variations in exchange rate (especially SKK/USD exchange rate) that does not relate to the monetary policy measures and development of economic fundamentals,
- 5) food prices (as a result of unexpected climatic conditions, possible changes within common agricultural policy)
- 6) vast natural disasters.

In parallel with a shift to explicit inflation targeting, the NBS ceased publishing its annual monetary programmes and began publishing the Quarterly Medium-term Forecasts in the form of consistent unconditioned economic development forecast taking account of meeting the inflation objectives. Such clearly and bindingly defined objectives and their evaluation will result in a higher degree of transparency of the monetary policy performance, with a positive impact on the formation of inflation expectations.

At present, the exchange rate policy is performed in the ERM II regime in accordance with the expected date of adoption of the Single European currency as of 1<sup>st</sup> January 2009. On 28<sup>th</sup> November the Slovak koruna has entered the ERM II exchange rate mechanism. Central parity was set at the level of 38.4550 SKK/EUR with the standard fluctuation band of  $\pm 15\%$ . Slovakia's membership in the ERM II should not restrict meeting the inflation targets. Just contrary, this exchange regime should provide a suitable framework for nominal and real convergence: On one hand, the ERM II represents a certain degree of the exchange rate





stability and a discipline framework for macroeconomic policies and, on the other hand, it leaves sufficient scope for adjustments to shocks and economic development.

#### **I.4. Structural Policies**

The National Reform Programme of the SR for the years 2006 – 2008 is drawn up on two pillars – on completion of the structural reforms and maintenance of their results and on development of the knowledge economy. The first implementation report by the NRP was prepared short after formation of the new Government that has based its programme on balance between the individual's responsibility and social solidarity. The new Government continues in the efforts of Slovakia in all crucial fields, especially in the field of further convergence of the Slovak economy to the average of the EU and in fulfilment economic objectives of the EMU. This implementation report respects the conclusions of the European Spring Council meeting from March 2006 and it directs its efforts at the top priority measures focused especially on investments in education and innovations, increase the number of job opportunities and heading towards the efficient and integrated energy policy of the EU. At the same time it identifies itself with the EC recommendations regarding stimulation of research, development and innovations, solutions of the regional inequality and structural unemployment and elimination of the existing obstacles in integration of the marginal groups of citizens.

The Government intends to create all institutional, personnel and financial conditions for drawing up the integrated *"Medium-term and long-term development strategy of the Slovak Republic"*, to achieve a wide political agreement for the strategy and thus to secure continuity and stability of strategic direction of Slovakia regardless the programmes of the following consecutive Government coalitions.

*The strategy* will respect the main objectives of development in the whole Europe and it will support increase competitiveness of the Slovak economy. In the field of the industrial policy, the Government of the SR will focus on creation of short-term and medium-term programmes for increase in the industry competitiveness so that they would contribute to the strong European basis and increase the potential of the SR regions at the same time. The field of power industry is considered to be the basic pillar of economy and the key factor influencing all other economic fields. Therefore, the focus of any decision-making process shall be to secure advantageous conditions for business activities in the power industry, for stable and safety power supplying and operation of the power systems and networks, and setting an optimal regulation in this field.

Pursuant to the principles of the medium-term Lisbon strategy assessment, the Government has defined the field of science, research and innovations as one of its development priorities. Preparation of the strategic documents – long-term objective of the national and science technical policy by 2015 and other programme documents in this field – will be based on the condition analysis of the Slovak research and development potential. The current legislative conditions in the field of innovations desperately needs several legislation measures to be taken, in particular to adjust the implementation process of innovations.



The improvement of the state of environment and economical use of scarce sources will be integrated part of the growth economic policy through improving environmental infrastructure in the SR in accordance with the rules of the SR and the EU and enforcement of environmental part of sustainable development.

Attention in the field of business will be paid to the evaluation process of effects of the adopted legislation on the business environment and to the establishment of integrated service business centres.



## II. ECONOMIC PERSPECTIVES AND ASSUMPTIONS

Updated version of the Convergence Programme continues to confirm that the Slovak economy remains on a good path of high and stable growth. Employment is growing at a fast rate, particularly in the private sector, and, according to all the available indices, the unemployment rate drops significantly. The current account deficit, as well as the public finance deficit and the inflation rate head towards sustainable or target levels.

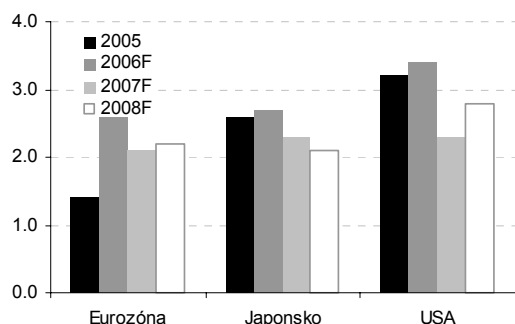
### II.1. Development of the Global Economy

After slowing down in 2005 the global economy revived and it will grow at a faster rate in 2006. The growth has been influenced by inflation development; after long-term deflation, Japan has recorded a slight inflation for the first time. The absolute numbers say that the biggest growth is maintained in developing economies such as China and India. Despite the high oil prices, the highest acceleration (in percentage points) has been achieved by Europe.

Also in 2006 the development of oil prices was highly dynamic and unstable and it remains to be a risk factor of the global economy in spite of the sharp drop of prices in the last months. From the middle of March until the middle of September the oil prices were above 60 USD/bl., while from the end of June until the end of August the prices were hovering even behind 70 USD/bl.

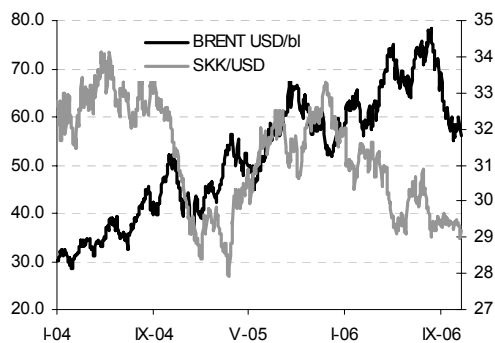
The retrospect implies that the crucial aspect for global economy development is whether the increase in the oil price is caused by the demand side or the supply side. During the last two years, the oil prices were increasing especially due to the rising demand. Expectations of the further possible drop of the oil prices are based especially on improvement of the supply side, as well as on slowdown of the American consumption expenditures. After slowdown of the American housing market, the American consumers have started saving. The Chinese export-based growth can be endangered by the weakened American. As well, it is an impact of the sketched plans of the NDRC (National Development and Reform Commission; the Chinese supreme planning body) that showed more effort for stabilization and restructuring of economy than for support of high growth.

Expected growth of selected countries (%)



Source: EC Economic Autumn Spring 2006

BRENT Oil (USD/bl) and trends of the crown exchange rate



Source: REUTERS



Despite high oil prices throughout major part of the year, the Eurozone countries managed to grow. The growth was caused especially by the accelerating domestic demand. Germany with its 2.1% increase in the real GDP was the main drive. This drive will probably be slowed down by the 3% increase in the value added tax in 2007. Driven by the domestic demand, this revival has its counterpart on the supply side, especially in accelerating productivity as well as in more and more flexible, although still relatively rigid, labour market. Growth in the whole Eurozone will be damped by higher short-term interest rates, more strict fiscal policies (especially in Germany and Italy), as well as by the expected decrease in the American foreign trade. However, China and India play an important role in the global trade and shaping of the price level of commodities and labour. It also explains why the high prices of oil did not continue increasing the global inflation as much as could have been expected. Low labour costs in the fast-developing countries have mitigated upward inflation pressures. Especially both biggest central banks, ECB and FED, were striving to assure the global price stability. After the fifth increase from the end of the previous year, the president Trichet thinks that the basic refinancing interest rate is still low and it still supports the economic expansion. Further expected increase by 25 basis points to 3.5% in December is supported especially by the medium-term inflation forecast within the European area above 2%, as well as the continuing economic growth. Thus, the ability of the European economy performance to stand on its own feet even without any aid from the central bank will be subject to testing. It seems that the FED is with the FFR (Federal Fund Rate) reaching 5.25% at the end of the cycle of increasing the interest rates. This is also indicated by the housing market downturn, incoming drop of consumption expenditures and increased unemployment.

The openness of the Slovak economy predetermines its dependency on the development of the global economy. Global revival of the economies in 2006 was positively manifested also at the most important business partners of Slovakia. However, according to the OECD<sup>4</sup> forecasts, the noticeable acceleration should be followed by a slowdown even of the most important business partners in 2007. The export-weighted real GDP growth<sup>5</sup> should slow down from 3.0% in 2006 to 2.8% in 2007. The risks can be seen especially in deceleration of the German economy that was significantly driven by the domestic demand in 2006 that will be, however, damped by 3% increase in the value added tax. However, this can be partly alleviated by the positive effects of costs reduction that stems from restructuring and fusions of German companies. Positive risk can also be expected in possible drop of the oil prices, even though it is necessary to remark that estimation of prices of this commodity is a very problematic field due to high sensitiveness of geopolitical risks and significant speculative effects. The average price expectations of this commodity should be between 62 – 70 USD/bl.; the SR cautiously assumes that in the following years; the trend should be about 67 USD/bl. Weakened domestic demand in the USA as well as slight slow-down of the Chinese economy can be the impulse for decrease in the prices of oil.

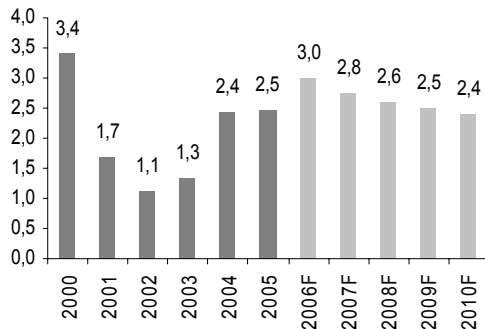
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<sup>4</sup> EC presents forecasts for shorter time horizon, OECD forecasts cover the horizon up to 2010

<sup>5</sup> Weights used include shares of the relevant countries in Slovakia's export. The weights of 2005 were used for years 2006-2010

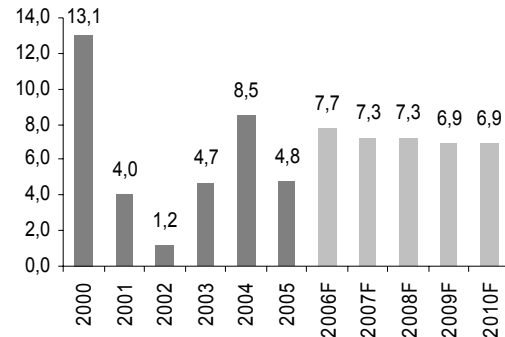


**Weighted GDP growth of Slovakia's trade partners (%)**



Source: OECD, Ministry of Finance of the Slovak Republic

**Weighted import growth of Slovakia's trade partners (%)**



Source: OECD, Ministry of Finance of the Slovak Republic

**Selected indices of trend external assumptions**

	2006	2007	2008
Short-term interest rates, Eurozone (% p.a.)	3.0	3.7	3.6
Long-term interest rates, Eurozone (% p.a.)	3.3	4.1	4.2
Short-term interest rates, USA (% p.a.)	5.3	4.4	3.8
Long-term interest rates USA (% p.a.)	4.8	4.4	4.2
EUR/USD	1.25	1.28	1.28
GDP, world ex EU, real growth (%)	5.7	5.2	5.2
GDP, USA, real growth (%)	3.5	2.3	2.8
GDP, Japan, real growth (%)	2.7	2.3	2.1
EU export markets, ex EU (goods, %)	9.9	8.6	7.9
Global exports, ex EU (goods, %)	9.1	8.2	7.9
World import prices (goods, %)	5.6	3.6	1.7
Price of oil (Brent, USD/bl)	65.6	67	67
Prices of non-oil commodities (USD, %)	23.7	4.3	-1.4

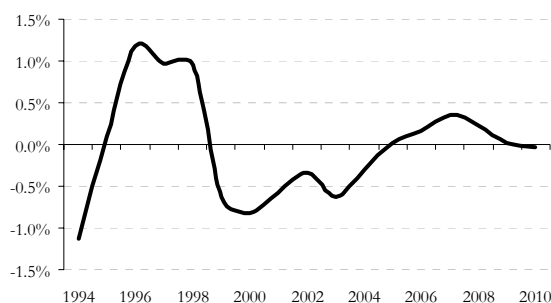
Source: European Commission Common External Assumption, October 2006  
Ministry of Finance of the SR

## II.2. Cyclical Development and Current Perspectives

The analyses of the previous development of the Slovak economy and the current predictions by a number of domestic institutions (MF SR, NBS, commercial banks) indicate that the Slovak economy in 2006 is closely above its potential product. MF SR estimates that the output gap will be 0.2% of the Slovak potential product this year. Growth of the economic potential should achieve 6.5%, i.e. 0.1 percentage points (p.p.) less than the predicted real economic growth of the SR in 2006. Strong growth of the potential and real GDP should be supported especially by the positive development of the overall productivity, as well as by growth of the capital stock.



**Output gap development (% of potential output)**

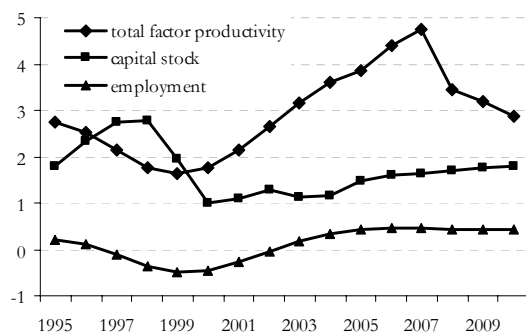


	GDP growth (%)	Growth of potential output (%)	Output gap (% of pot. output)
2001	3.2	3.0	-0.6
2002	4.1	3.9	-0.3
2003	4.2	4.5	-0.6
2004	5.4	5.1	-0.3
2005	6.1	5.8	0.0
2006F	6.6	6.5	0.2
2007F	7.1	6.9	0.4
2008F	5.5	5.6	0.2

Source: Ministry of Finance of the SR

Strong growth of the capital stock and of the total factor productivity (TFP) is expected in year 2006. In its long-term perspective the highest contribution of the TFP to the potential product growth of as much as 4.4 percentage points should be achieved in 2006, i.e. more than assumed in the previous update of the Convergence Programme of Slovakia. The growth in total factor productivity and potential employment in 2006-2008 should be positively influenced by inflows of foreign direct investment (FDI), from the EU funds and, from the medium-term perspective, especially by effects of the implemented reforms. In 2006-2008, the Slovak economy will probably produce slightly above the level of its potential product. Subsequently, the gap should be eliminated.

**Growth of potential output and contributions of its main factors (percentage points)**



	Pot. GDP growth (%)	TFP*	Capital stock	Equilibrium employment
2001	3.0	2.1	1.1	-0.3
2002	3.9	2.6	1.3	0.0
2003	4.5	3.1	1.1	0.2
2004	5.1	3.6	1.2	0.3
2005	5.8	3.9	1.5	0.4
2006F	6.5	4.4	1.6	0.5
2007F	6.9	4.8	1.6	0.5
2008F	5.6	3.5	1.7	0.4

\*Total factor productivity

Source: Ministry of Finance of the SR

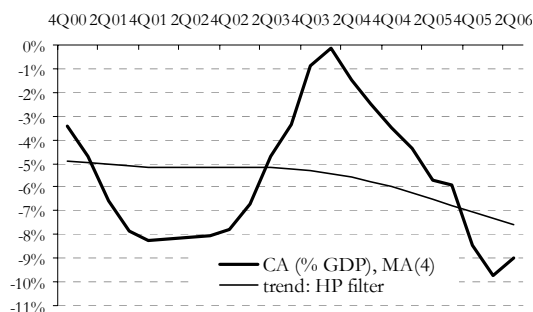
The output gap estimation was calculated by the production function method recommended by the European Commission. However, the way of incorporation of impacts of foreign direct investments into the total productivity within economy is an important methodology aspect used in the SR - the calculations assume that the total productivity growth of the production factors in 2006-2007 should leave its trend level (about 3%) and increase to the average annual level of over 4% as a consequence of launching production in the PSA Peugeot-Citroën and KIA Slovakia plants. The assumption of such a significant productivity growth in the mentioned period causes record TFP contributions to the potential product growth especially in 2006, which are significantly higher than the ones assumed in the previous update of the Convergence Programme.



The inflow of the EU funds will be a positive impulse for the potential output growth in the following years. It is expected that these funds will increase the investments and, as a result, the capital stock, and particularly the economy's TFP. A significant share of the funds will be used for infrastructure development, support of innovation activities in plants, transfer of knowledge and technologies acquired by research and development into practice and development of services, what will support especially the labour productivity increase as well as the existing capital.

With regard to the uncertainty involved in the quantification of the output gap, in the case of small and open economies, it is useful to monitor a series of important indicators that may indicate whether the economy is above or below its potential. These indicators include, for example, net inflation, the share of the current account deficit in the GDP, the number of vacancies per unemployed person, or the capacity utilisation from business surveys. The current account deficit and the net inflation can be deemed as the most illustrative indicators sensitive to unbalances in economy on both, the external and internal sides. The following graphs show their development and output gap indicators derived from them, which indicate that at present and in the near future the Slovak economy should be probably very close above its potential. It is necessary to emphasize that these indicators are used only for illustration<sup>6</sup> and that, from the interpretation perspective, they can be used to help evaluating the output gap development direction, however not its exact value.

Current account deficit (% of GDP), moving average (last 4 quarters)



Source: Ministry of Finance of the SR

Deviation of the current account deficit from trend (in p. p.)

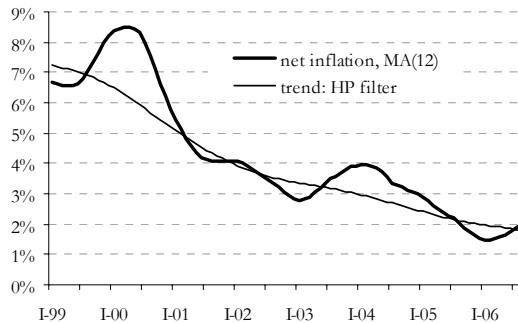


Source: Ministry of Finance of the SR

<sup>6</sup> For example, while judging current account relative to GDP as an indicator of positive output gap, it would be necessary to take into account the included reinvested profits (allocated just from 2005 onwards) and imported investment goods, the negative effect of which is not caused by excessive domestic demand as an effect of positive output gap

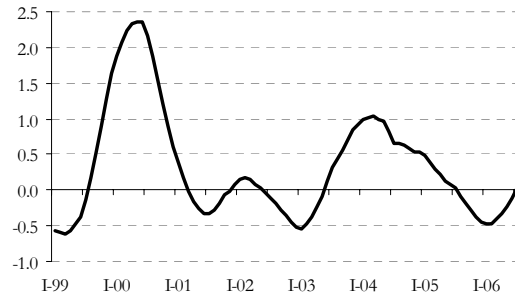


Net inflation ex fuels (in %), annual moving average (last 12 months)



Source: Ministry of Finance of the SR

Deviation of net inflation from trend (in p. p.)



Source: Ministry of Finance of the SR

### II.3. Medium-term Scenario

Aiming at permanent increase of objectiveness, transparency and, in particular, the likelihood of meeting the medium-term macroeconomic projections and, as a result, public finance projections, again the approved form of assessing the medium-term forecasts by the Macroeconomic Forecasts Committee was applied<sup>7</sup>. In September 2006, the submitted scenario was discussed and confronted with the opinions of seven representatives of independent institutions that regularly compile their own forecasts of the Slovak economy development. The presented final Government's forecast was evaluated as realistic, which provides a sound basis for correct set up of the medium-term fiscal objectives of the SR.

#### *Brief characteristics of the current development of the economy*

The latest interim data of quarterly national accounts<sup>8</sup>, as well as economic and financial indicators known on a monthly basis until October 2006, confirm the main development trends and expectations of a **positive direction of the Slovak economy** as presented in the Updated Convergence Programme of Slovakia for Years 2005 – 2010. They also confirm the assumed factors influencing the development of the various areas of the economy. For the above-mentioned reasons, the further sections of this document place greater emphasis on those aspects of the current development of economy that may more significantly influence the numerical estimates for 2006, or that are essential for the monitoring of sustainable economic growth.

**Growth of the Slovak economy** during the first half of 2006 has considerably exceeded the initial expectations reaching the level of 6.5% (moreover, 6.7% after the revision of GDP data in november 2006) . At the same time, it can be said that high economic growth does not bring any risks to the further stable development of economy. Higher inflation rate at low demand pressures continues to reflect especially the negative oil price development in the

<sup>7</sup> The Committee was established by the MF SR, and has been in the third year of its successful incumbency

<sup>8</sup> while processing this document, the latest data were available for 2Q 2006





previous period, regulated price adjustments implemented at the beginning of the year and increase of indirect taxes. The current account deficit amounts 8% of GDP, however, it is safely covered by the financial and capital account surplus. The public finance deficit also develops in accordance with the fiscal objectives and, as a result, good conditions for implementation of the economic policy consistent with the monetary policy of NBS are established.

The increasing performance of the economy has been supported by a combination of the **labour productivity growth** and **the employment growth**. The labour productivity <sup>9</sup> increased by 4.2% in the first two quarters and was accompanied by a strong 2.2% increase in employment (according to ESA95). The positive employment trend is reflected also in the fact that, from the demand perspective of economy, the GDP is still stimulated by a strong growth, although slowdown of the **domestic consumption** and **investments**. However the latest published data also indicate an incoming trend of positive contribution of the net foreign trade to the GDP growth.

The structure of the GDP growth showed **a shift from the domestic demand** (domestic consumption and investments) **towards the foreign demand** (export) in the 2<sup>nd</sup> quarter of 2006, since the real net export contributed with 2.2 percentage points (after the revision, 2.9p.p.) to the 6.7% GDP growth, while in the last two years the foreign trade contribution was almost always negative. More noticeable shift in the GDP growth structure towards the foreign demand is expected in the second half of 2006 in connection with more significant launching of car exports. Until then, domestic demand supported by a combination of the private consumption and still significant fixed investments will be the main drivers of the high economic growth.

Increase in the **final consumption of households** by 6.3% in the 1<sup>st</sup> half of 2006 was enabled by increase of real wages by 3.3% in accordance with the productivity growth and thus no demand inflationary pressures would arise. However, in spite of the positive labour market development, the dynamics of the household consumption development continued to slow-down gradually, as observable since the end of 2005. The slowdown was brought about especially by saturation or base effect, as well as by change of supermarket price policies<sup>10</sup>, growth of interest rate and, at the same time, of the citizens' savings, as well as by the need of investments in households in order to reconstruct or build flats and houses (limited life of the old panel houses and establishing new families by the strong generation groups). According to the latest data, the growth rate of investments slowed down as well; **gross fixed investments** increased by 6.9% in the 2<sup>nd</sup> quarter of 2006 (3.6% after the revision respectively), what means that the double-digit growth rates from previous quarters returned to more moderate values after the effect of one-shot investments in the automobile industry expired. However, arrival of foreign investors, inflow of the EU funds, as well as higher profitability of firms should continue creating good conditions for reasonable growth of investments, although on lower levels, and thus supporting the growth potential of the Slovak economy.

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<sup>9</sup> as GDP at constant prices per employee in economy of SR total

<sup>10</sup> Prices in supermarkets have stabilized gradually on percievably higher levels, in comparison with the period of massive price competition among the flagship supermarkets a couple of years ago



Real growth of **exports** of goods and services reached a high level of 17.8% (after the revision 17.9%) in the 1<sup>st</sup> half of 2006, real imports increase by 18.2% YoY (after the revision 16.6%). As regards the structure, the positive real contribution of services to the total foreign trade balance has been increased annually. Slight worsening in the nominal balance of goods on the side of import was caused especially by the negative development of the global oil price and continuing high investment inflows. A surprisingly positive development was achieved by exports of durable consumption goods, especially electronics. Overall, both sides of the foreign trade reached unexpectedly high growth dynamics in 2006 so far, thanks to which the **openness** of the Slovak economy attained 171.5% of GDP.

*Forecast of the development of real economy*

The forecast update consists in consideration of the latest development of the Slovak economy and updated forecasts of the further development of the global economy elaborated by the EC and OECD. Gradual fulfilment of the declared objectives of the economic policy of the SR and preferred orientation of the fiscal policy on fulfilment of the Maastricht criteria are assumed. As a result of the recent as well as the current global market developments and expectations, the forecast of price of oil in 2006 shifts to 65 USD per barrel; price of 67 USD per barrel is assumed for the later period. Technical methods and general principals adopted during preparation of projections for the Convergence Programme of the SR remain unchanged, while the database from the period prior to the national accounts revision in November 2006 was used.

According to the forecast update, the **potential growth** of the Slovak economy should reach the average value of 6.3% in 2006-2008. It is assumed that the high dynamics should be moderated during the following two years; however, the potential growth will probably continue exceeding 5%. Increasing productivity and capital stock as well as the structural employment should be the sources of growth in particular. These factors should support the required process of real convergence.

An estimation of the year-to-year growth of the real GDP for 2006 is 6.6% with expected further growth and culmination of dynamics in 2007 (above the level of 7%). It becomes increasingly certain that after 2006, **economic growth should be driven by a combination of domestic and foreign demand again**. In 2006-2008, net foreign trade of goods and services should contribute to the average 6.4% real GDP growth with up to 1.8 percentage points. After 2006, slightly lower but stable positive contribution of the domestic demand to the economic growth should be supported by stabilization of the real wage growth and, as a result, the growth of household consumption.

The started trend of slowed-down **private consumption**<sup>11</sup> dynamics will be reflected in more moderate but still high annual growth on the level of 5.7% in 2006. The reason for slowing-down will include not only the above-mentioned effects of saturation but also higher-than-anticipated inflation and higher interest rates. The real wage will increase by 3.1% in 2006 and its growth should reach 3.6 - 4.0% by 2010. Thus, within the whole monitored horizon, the real wage trend should reflect the labour productivity growth - it should not exceed it

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<sup>11</sup> Final consumption of household



and it should not create demand inflationary risks. Thus, wage growth together with the positive development of employment should ensure private consumption growth at the levels of 4.1 – 5.7% p.a. in 2006-2010.

**The government consumption**<sup>12</sup> will further develop in line with meeting of its main objectives and measures of the fiscal policy<sup>13</sup>. In consequence, the government consumption remains the slowest increasing item of the GDP; in 2006 it should increase by 3.9% and in the following years its growth should be 3% or below.

In consequence of expiry of the period rich in large-volume investment inflows in the starting automobile production, return of the **investment** growth to one-digit numbers can be anticipated from 2006 onwards. In 2006, fixed capital formation should increase by 8.2% and its year-to-year growth should be about 5 – 6% by 2010. However, the real course of investments will depend on the timing of the new planned investment inflow and on the final date of launching the new production facilities.

**Foreign demand for goods and services** will be, to a large extent, influenced by investment inflows into Slovakia, and by an improvement in the existing export capacities and competitiveness of the SR, as well as by the strength of economic growth within the EU. Current estimates of the export and import growth in 2006 and 2007 reflect the high dynamics in the foreign trade and are above 10%. The contribution of net exports to the real GDP growth should be positive over the entire forecast horizon. It will reach its highest level probably in 2007 while contributing to the GDP growth by more than its one third.

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<sup>12</sup> Final consumption of government

<sup>13</sup> decreasing general government deficit in accordance with Maastricht criteria and revised Pact of stability and growth



<b>Growth and related factors (% , unless otherwise indicated)</b>						
	2005	2006F	2007F	2008F	2009F	2010F
GDP growth in fixed market prices	6.1	6.6	7.1	5.5	5.1	5.0
GDP level in current market prices, bn SKK	1,472.1	1,623.8	1,787.7	1,912.0	2,042.5	2,184.2
GDP deflator (year-to-year growth)	2.4	3.5	2.8	1.3	1.6	1.9
CPI change (annual average)	2.7	4.5	3.1	2.0	2.4	2.4
Employment growth*	1.4	2.0	1.5	0.8	0.8	0.8
Labour productivity growth**	4.7	4.5	5.5	4.6	4.2	4.1
<b>Demand impulses of growth: percentage changes at constant prices</b>						
1. Private consumption expenditure	7.0	5.6	5.3	4.4	4.2	4.1
2. General government consumption expenditure	0.5	3.9	2.0	3.0	2.8	2.8
3. Gross fixed capital formation	13.8	8.2	6.0	5.0	5.0	5.5
4. Change in reserves and net acquisition of valuables expressed in % of GDP***	2.4	1.4	0.7	0.7	0.6	0.6
5. Exports of goods and services	13.5	17.6	14.2	8.5	7.3	6.9
6. Imports of goods and services	15.5	15.2	11.2	7.3	6.4	6.3
<b>Contributions to GDP growth</b>						
7. Final domestic demand	7.5	6.1	4.9	4.3	4.1	4.1
8. Change in inventories and net acquisition of valuables (=4)***	0.7	-1.0	-0.6	0.0	-0.1	0.0
9. Balance of foreign trade of goods and services	-2.0	1.5	2.7	1.2	1.1	0.8

\* According to ESA 95 methodology

\*\*GDP at constant prices per employee in economy of SR total

\*\*\* Including statistical discrepancy

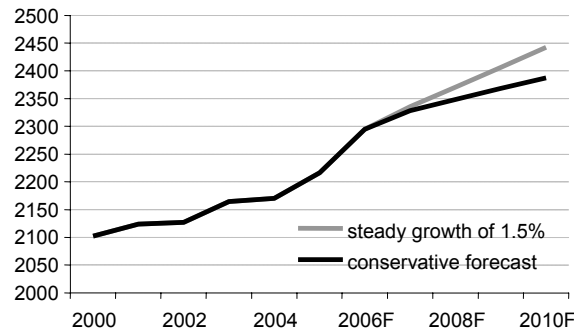
Source: Statistical Office of the SR, Ministry of Finance of the SR data from the period prior to the national accounts revision in November

### *Development on the labour market*

High growth of economy in the year 2006 will bring a growth in **employment** with possible year-to-year increase of as much as 3.5% (according to the Labour Force Survey (LFS) methodology). The data published for the first half of the year 2006 were very favourable (4.1%), and therefore we increased the forecast for the entire year 2006. From the perspective of status in employment, the overall growth was significantly supported by employees (3.7 percentage points), contribution of entrepreneurs (0.4 percentage points) was more moderate than in the previous year. The year-to-year drop of employees in the public sector continues (-7%) and is compensated by growth of employees in the private sector (11.8%). In the first half of the year, strong year-to-year growth of employees working abroad continued (28.9%), while their contribution to the overall growth of employment was 1.5 percentage points. Compared with the first half of 2005, the number of employed in Slovakia increased by 2.7% and thus contributed to the overall growth with 2.5 percentage points. The basic scenario for the following years 2006-2010 expects gradual moderation of employment growth to the deliberate level of 1.5 - 0.8%. This is a conservative estimate, avoiding risks for the fulfilment of fiscal objectives. In case of the successful implementation of government objectives aiming at increasing attractiveness of business environment preferring less developed regions, creating new jobs and ceteris paribus current effective functioning of labour market policies (refer to the National Reform Programme of the SR) the annual employment growth rate could be 1% to 2%.



People working in the national economy (in thousands of people)



Source: Statistical Office of the SR, Ministry of Finance of the SR

In 2006, very positive **unemployment rate** trends are observed. In the first half of the year, the number of the unemployed dropped (according to the LFS methodology) by a strong 15.1% on a year-to-year basis, and therefore the unemployment rate decreased to 14.2%. Comparing with the first half of 2005, this is a significant decrease by 2.7 percentage points. Therefore the annual unemployment rate estimate for 2006 was adjusted to 13.8%, which is 2.3p.p. decrease in comparison to 2005. The main factor behind the positive development of unemployment is the growth of employment *per se* that contributed to the decrease of unemployment<sup>14</sup> by 2.9 percentage points. The participation rate<sup>15</sup> that should not be changed and - similarly as in 2005 - should stay on the level of 69%, inhibited decrease of unemployment rate by 0.2p.p. (impact of early retirements and stricter conditions for registration of the unemployed, and on the other hand, stronger growth of employment). Growth of working age population slows down the fall of unemployment rate by 0.3 percentage points.

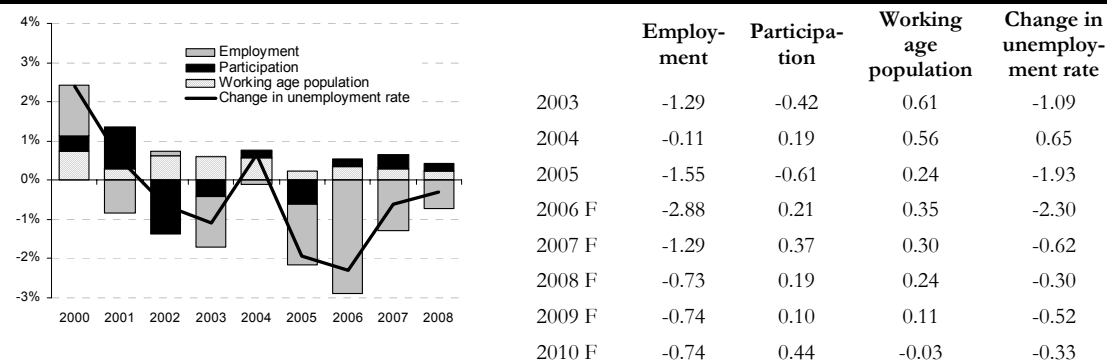
It is expected that slight decline in the unemployment rate will continue in the next period. We assume that the participation rate, as well as working age population will not further decline. The above-mentioned factors will have moderately adverse effects on unemployment; the rate of reduction in the unemployment rate will primarily depend on the capability of the economy to generate new job vacancies. Therefore, it is assumed that unemployment according to LFS, will drop to 12.9% in 2008, and will be below 12.0% by 2010. According to the national methodology (disposable number of registered unemployed), unemployment should drop approximately to 9% by 2010.

<sup>14</sup> the ratio of the number of unemployed to economically active population, i.e. the total number of employed and unemployed

<sup>15</sup> the ratio of number of employed and unemployed in the age of 15-64 to total population aged 15-64 (working age population)



Contributions of particular factors to change in the unemployment rate (in p.p.)



Source: Statistical Office of the SR, Ministry of Finance of the SR

The average nominal **monthly wage** in the national economy (NE) increased by 8.0%<sup>16</sup> in the first half of 2006 on a year-to-year basis. Higher inflation was the main reason behind slower increase of real wages (3.3% while compared with the same period in 2005). Monthly indicators confirm the expected gradual moderation of the nominal wage growth dynamics; thus, wages could increase by an average of 7.8% in 2006. The growth rate of real wages could reach 3.1% in 2006 due to higher inflation rate. Regarding the relatively low inflation rate in the following years and the prevailing mechanism of the collective wage bargaining according to the previous inflation rate, a lower growth of nominal wages of about 6.0% - 7.1% is expected by the end of forecast horizon. In dependence on the development of consumer prices, real wages could grow by an average of 3.7% in the following years.

### *Inflation*

An expected transitory acceleration of consumer prices inflation resulting from the faster growth of world oil prices transmitted into the other commodity prices and subsequent increase of energy and regulated prices in the Slovak Republic was confirmed in 2006. However, due to inflation sensitivity on oil prices development a stronger impact was brought about than it was previously presumed. Compared with the expectations of the previous Convergence Programme, headline inflation (based on HICP) will accelerate approximately by 1 percentage point this year and thereby reach 4.4% (4.5% according to CPI).

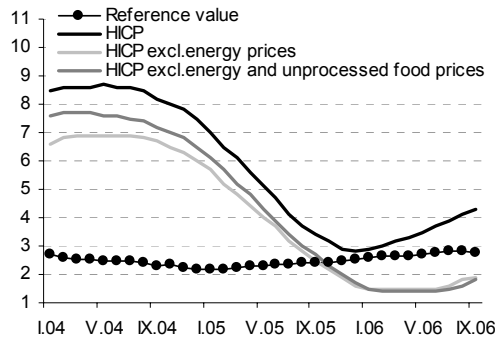
Recent development indicates that the external factors not influenced by the monetary policy and defined as the exemptions from the central bank inflation target fulfilment are the main reason of the inflation in the SR and thus shaping its cost-push backdrop. It is proved that the energy prices in 2006 explain as much as 2.4 percentage points of the 4.5% rate of headline CPI inflation. However, expected deceleration by the end of the year should turn out since the base effect attributed to administered energy price hike one year before entails decline of its impact by almost 1 percentage point. It is apparent even though the

<sup>16</sup> since 2006, the average wage within the national economy includes income of military forces, indices are calculated from comparable data



development in the oil markets has already forced another increase in gas and heating prices for the households that has been approved by Slovakia's regulatory body.<sup>17</sup>

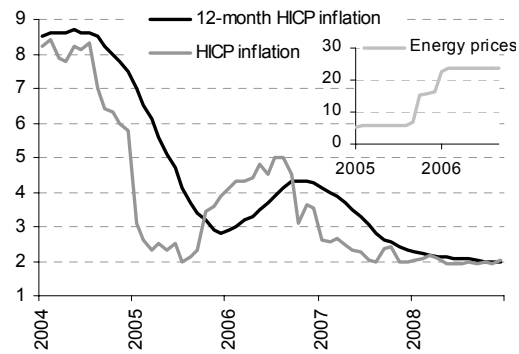
**Maastricht criterion on price stability**



Note: y-o-y in %, 12-month moving averages

Source: Statistical Office of the SR, Eurostat, Ministry of Finance of the SR

**Medium-term inflation expectation**



Note: Energy price changes with Dec. 2004 as a base period, otherwise y-o-y changes in %

Source: Ministry of Finance of the SR

Due to the cost inflation, the NBS will not manage to meet inflation target for 2006 directly (i.e. including the factors defined as the exception for assessing the inflation target fulfilment). Consequently headline HICP inflation would exceed the NBS' inflation target thanks to these exogenous factors by more than 1.5 percentage points at the end of the year. However, it will depend on fuel prices development indeed and perhaps also food prices would play an important role in the rest of the year. Currently, it cannot be excluded that headline inflation rate would be slowed down even more towards the end of the year influenced by fuel prices that, in fact, react quite promptly to the oil prices, based on suddenly favourable expectations of the crude oil and refinery product markets.

In spite of the decline in oil prices prevailing in recent months, this kind of exogenous cost-push factors can be further perceived as a significant global risk of medium-term inflation development, especially in a view of the countries with substantial import of energies, such as Slovakia. The effect of increasing regulated prices of gas and heating energy in Slovakia in the last quarter of 2006 will be particularly passed into the following year, whereby the average annual inflation will accelerate by approximately 0.4 percentage points (0.5 p.p. according to the HICP) This impact cannot be considered final if the oil prices upward trend would prevail in the international markets again.

**Ministry of Finance Forecasts**

	2004	2005	2006F	2007F	2008F	2009F	2006F
CPI (annual average)	7.5	2.7	4.5	3.1	2.0	2.4	2.6
HICP (annual average)	7.5	2.8	4.4	3.1	2.0	2.4	2.6
CPI (end-of-year)	5.9	3.7	4.1	2.6	2.0	2.2	2.5
HICP (end-of-year)	5.8	3.9	4.0	2.4	2.0	2.2	2.5

Source: Ministry of Finance of the SR

<sup>17</sup> Further price increasing is based on the overall development of oil prices during this year, also after considering the temporary drop of the oil prices towards the end of the third quarter



Thus regulated prices, especially the energy prices might induce additional inflationary pressures in 2007 higher than expected in the previous Programme. The cost inflation will reflect especially the electricity prices that could be increased by about 10% at the beginning of the following year. Moreover, depending on the forthcoming oil prices development gas and heating prices can also increase the headline inflation. Therefore the forecasts stated in the updated version of the Convergence Programme are based on the more conservative assumptions of regulated energy prices in January 2007 (increase by approximately 5.3%<sup>18</sup>) that correspond with the prudent assumption of slight increase in the oil prices in the following year since that risk is still viewed as significant. At the same time, there is also a positive risk that the oil prices will not be increased in the next year or they can even develop in a more favourable way than this year in the event of global economy growth slowing-down. It means that in such case the cost inflation could be diminished more significantly than forecasted.

At the same time, it is expected that services inflation<sup>19</sup> will not significantly accelerate and the secondary cost effects of energy prices will remain dampened onwards. The wage growth in services sector can be of certain risk, however we suppose that—the real Unit Labour Costs (ULC) will not threaten the inflation development seriously similarly as it has been so far.

Likewise the case of the oil prices, the inflation forecasts are based on more conservative food prices estimates as well. It is not expected that the consumer food prices will rise in a smaller pace in 2007 than this year. The food prices inflation should reach approximately 2.8%<sup>20</sup> as a result of the basis effect in particular.

On the other hand, it is expected that the prices of tradables will reflect the low imported inflation onwards. In parallel, real labour productivity<sup>21</sup> growth especially in the sector of tradables should remain significantly ahead of the real wages growth, what would also contribute to favourable price development of tradables and to slow-down the headline inflation in turn.

In 2008, the rate of inflation should be still influenced in particular by price development of tradables and market services, whereby the headline inflation would be decelerated and converged to core inflation and thus the Maastricht criterion on inflation should not be threatened towards the end of 2007 and in 2008.

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<sup>18</sup> The average monthly rate of change of regulated energy prices including gas, heating and electricity as the assumption the Ministry of Finance forecasts are based on used also as an macro-basis in general government budget

<sup>19</sup> Excluding administered or regulated prices of services

<sup>20</sup> The estimate of food prices inflation on year-on-year basis is the same for CPI and HICP inflation forecasts since the weights of these prices are almost equal in consumer basket of the both price indices

<sup>21</sup> Labour productivity is defined as a share of GDP in constant prices per employee



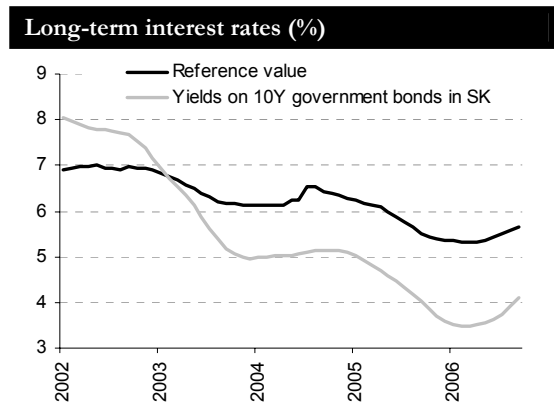


Since we expect further positive development of labour productivity compared to real wages in the following years, as well as strong competition in the foreign markets, any significant increase in inflation after adoption of Euro is assumed that happened in several other countries in this situation. In the line of that unit labour costs should have a more significant influence on the price level.

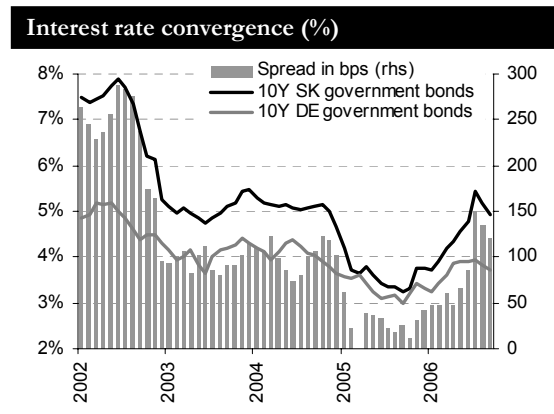
Higher inflation in the long run can be also driven by the process of real convergence through the pressures referred to as Balassa-Samuelson (B-S) effect. At present, this effect is estimated in the extent of approximately 1 percentage point. However, econometric analyses imply that the impact of the oil prices growth on some non-tradable goods and services, including the energy, can exceed the impact of wages shifted from the sectors exhibiting higher productivity. Therefore our estimates suggest no stronger B-S effect.

#### Interest rates

Development of inflation and its factors throughout the year and relating risks of possible stronger secondary cost effects has entailed gradual tightening of the monetary policy. This year the NBS increased its interest rates several times. Except of it yields on the 10-years state bonds increased by more than 100 basis points at the long end of the yield curve. It was caused by a rise in long-term interest rates especially in the Eurozone and the USA on one hand and an increase of the risk premium on Slovak bonds on the other one, that has been recently reflected by the economic uncertainty in financial markets as a result of parliamentary elections, as well as political events throughout the whole Central European region. In spite of that, Maastricht criterion on interest rates is being met by the SR while the fulfillment should not be endangered in a medium-term horizon. We expect that in the following period the long-term interest rates should remain on the current levels in accordance with the long-term yields within the Eurozone. Possible drop of yields on 10-year state bonds is limited to a certain extent by liquidity risk and also by the fact that no more significant turn (relaxing) in the monetary policy performance is expected in the near future.



Source: Eurostat, Reuters



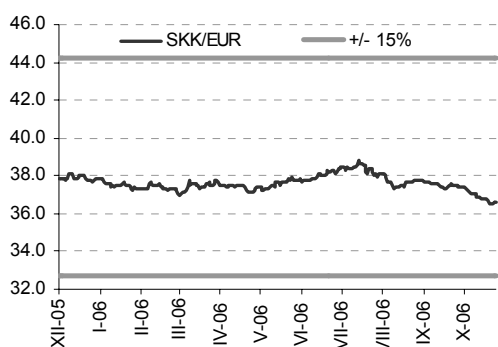
Source: Eurostat



### Exchange rate

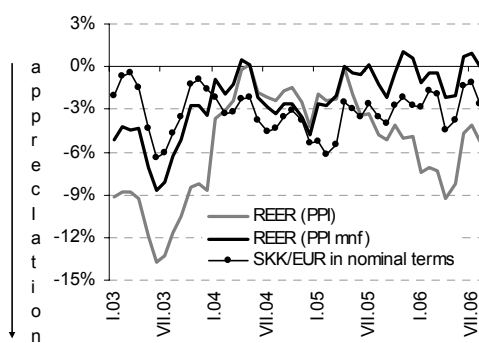
Since the accession of the SR to the foreign exchange rate regime ERM II, the exchange rate of the Slovak koruna has been hovering notably under the central parity level of 38.455 SKK/EUR, while at the beginning of the last quarter of 2006, the Slovak koruna reached its strongest levels. Although the development on the FX market in the middle of the year was influenced by depreciation due to political events and development of surrounding currencies in the region, the Slovak koruna has further appreciated mainly in real terms.

Development of the SKK/EUR Exchange rate in ERM II



Source: Reuters

Development of the SKK/EUR real exchange rate



Note: (%) Year-on-year changes

Source: Reuters  
Ministry of Finance of the SR

All circumstances regarding expectations of the Slovak economy, especially from the perspective of possibility to adopt Euro in 2009, will be crucial for the following development of the foreign exchange market. At present, there are expectations prevailing on the financial markets that this objective is achievable since the monetary and fiscal policy is disciplined and meeting of the Maastricht criteria is their top priority. It should be fostered by further foreign direct investment inflow and productivity growth even though the development of the surrounding FX markets might pose the general external risk onwards.

## II.4. External balance

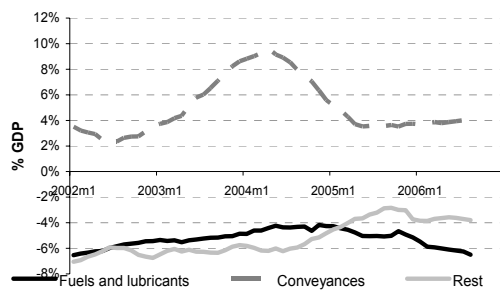
**Balance of foreign trade** forecast for the years 2006 to 2010 has been updated in line with its development during the 8 months of 2006 and with the updated domestic demand forecast and potential foreign demand on the side of the important trade partners of the SR. The update confirms the initial assumptions of significant improvement of the trade balance by 2010.

In line with the initially assumed trend, the foreign trade balance from the beginning of 2006 was worse than the balance in 2005, while the total turnover has surprisingly increased (growth of export and import). However, the decline in balance development slightly exceeded the initial expectations. Deficit of SKK 36.5 bn was reached in August 2005, while the deficit in August 2006 was as much as SKK 56.9 bn. Improvement of the foreign trade is expected in the remaining months of the year due to the influence of growth decline in



import of fuel and investment goods and, at the same time, due to automobile industry export revival. Thus, the foreign trade deficit for the whole year 2006 approached the previous year deficit; however it should not be exceeded much. In the following years we expect gradual increase of the export share at GDP formation, as well as a significant improvement in the balance that should gradually move towards a balanced position within a medium-term horizon. The trade balance deficit is expected to decrease to 1.3% of GDP by 2008, and to 0.7 of GDP in 2010. The expected positive trend should reflect the growing export in the automotive industry, as well as in other industries, especially the electrical and electronics industry and metal-processing. The current figures of foreign trade estimate have been slightly adjusted; however the main influential factors identified in the previous updated version of the Convergence Programme remain unchanged.

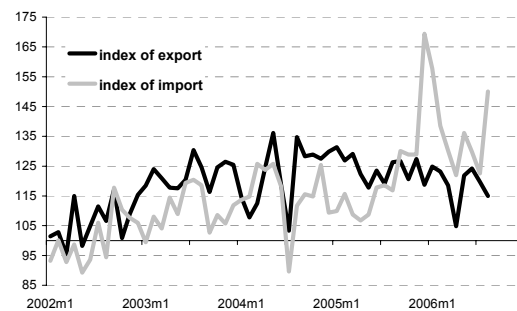
12M net cumulative exports of selected categories of goods (% of GDP)\*



\*) 12 month.

Source: Statistical Office of the SR, Ministry of Finance of the SR

Year-to-year index of export and import of investment goods except for automotive



Source: Statistical Office of the SR, Ministry of Finance of the SR

Positive expectations within **balance of services** development have reflected in slight increase of its surplus in the following years. The updated **balance of income** forecast for 2006 includes an increased outflow of funds caused by disbursement of dividends to direct foreign investors, and specification of effect of a methodological change implemented in 2005 (inclusion of reinvested earnings into payments and inclusion of the gross income of Slovak residents working abroad into revenues in balance of income). Change in the **current transfers** forecast takes into consideration more particular idea of contribution flows to the EU budget and receipts from it, as well as a slight change in expectations of the economic growth in the following years.

Development of the current account of payment balance and its components (% of GDP)

	2004	2005	2006F	2007F	2008F	2009F	2010F
Balance of Foreign trade	-3.7	-5.2	-4.6	-1.8	-1.3	-0.9	-0.7
Exports	65.7	67.5	75.2	79.5	81.1	82.1	83.1
Imports	69.4	72.7	79.8	81.3	82.3	83.0	83.7
Balance of Services	0.6	0.7	0.9	0.9	1.0	1.0	1.0
Balance of Income	-1.0	-4.2	-3.9	-3.7	-3.6	-3.4	-3.3
Current transfers	0.4	0.0	0.7	1.0	1.0	1.1	1.1
Current account	-3.6	-8.6	-6.9	-3.5	-2.8	-2.3	-1.9

Source: Ministry of Finance of the SR



Updated forecast of balance of the **current account of payment balance (CA)** was adjusted to 6.9% in 2006 and to 3.5% of GDP in 2007 especially as a consequence of development of the foreign trade deficit<sup>22</sup> and the balance of income deficit. However, it is expected that the deficit will be safely covered by the financial account surplus based especially on inflow of direct foreign investments (FDI). The inflow of FDI into the SR (equity and reinvested earnings) as the main impulse for the potential product growth should culminate in 2006 on the level of almost 6% of GDP, while in the next years it will probably not exceed 5% of GDP. After 2006, the balance should improve also due to a surplus in the balance of services and contributions from the EU via current transfers; in 2009 - 2010 the current account deficit may be on the level of about 2% of GDP.

The outlined development of the current account of payment balance of the SR may, however, be subject to a **possible risk** posed by e.g. the development of prices of oil, the development of household consumption, or the development of the SR automobile industry exports. Risk weight can be considered by sensitivity of deficit to relevant changes. It is expected that a theoretic increase in **household consumption** by 1 percentage point might cause a drop in the annual trade balance by 0.17% of GDP. Possible increase in the average **prices of oil** by USD 10 per barrel would result in the trade balance drop by approximately 0.23% of GDP. As far as forecasts of the **automobile industry exports** are concerned, conservative assumption of rather high import intensity (85%) based on the average added value in the car manufacturing industry is still applied. If involvement of Slovak firms in the production process would achieve a higher level and the import intensity would reduce for example to 75%, it would have a positive effect on the trade balance, totalling to improvement of approximately 1% of GDP.

According to the estimate of the International Monetary Fund, the **sustainable annual deficit** in the current account of payment balance of the SR is about 6% of GDP. After being temporarily exceeded in 2005 and 2006, the deficit should rapidly improve in 2007 and thus it should return deep into the sustainability zone that should be consequently maintained within a medium-term horizon at least. Starting with the year 2007, a sufficiently wide zone between the expected and marginal sustainable deficit of current account extending on an annual basis should be formed thanks to stable DFI inflow and EU contributions in particular.

**Balance of direct foreign investments** (equity and reinvested earnings) in the SR in the 1<sup>st</sup> half of 2006 reached SKK 55.5 bn. When compared with 2005, the year 2006 had a much better start in spite of some limitations (connected with the pre-election period) regarding sale of land to the foreign investors in particular. The above-mentioned sum included reinvested earnings of approximately SKK 17.5 bn. In the following years, stable inflow of so-called "green-field" FDI is expected, primarily related, whether directly or indirectly, to the production of important car manufacturing plants in Slovakia, as well as to the entry of international investors in other industries (electrical and electronics industry, metal-processing, wood-processing and paper producing industries). However, the amount of FDI will be also influenced by the successful completion of planned projects of those investors that have been operating in the SR for a longer period (production extension). From a

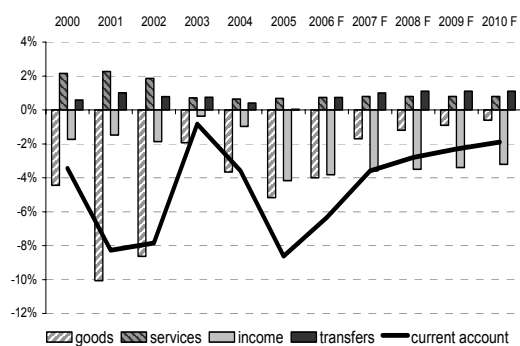
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<sup>22</sup> CA balance in the first and the second quarter 2006 reached a deficit of 7.4% and 8.7% of GDP respectively in respective quarters



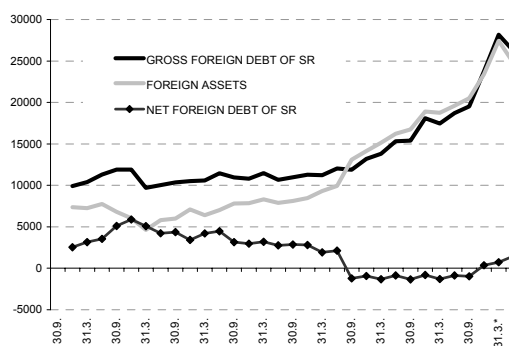
medium-term perspective, these investments will contribute to the growth in labour productivity and, as a result, to sustain high competitiveness of the Slovak economy.

Projection of medium-term development of components of the current account of SR's payment balance (% of GDP)



Source: Ministry of Finance of the SR

Development of the foreign indebtedness of the SR (mil. USD)



Source: NBS, Ministry of Finance of the SR

The **total gross foreign debt** amounted to USD 31.5 bn as of 30 June 2006 and thus it slightly increased to approximately 61% of GDP (on 30 June 2005 it was 57.5% of GDP). A short-term debt comprised 51.3% of the above-mentioned sum, i.e. very slightly exceeded the long-term liabilities. The year-to-year increase of the gross debt of USD 5.3 bn was caused by all sectors of Slovak economy. In particular: intercompany loans from abroad (increase by USD 2.2 bn), emission of government bonds (USD 1.0 bn), commercial banks (USD 0.74 bn) and other sectors (USD 1.15 bn). Thus the share of the overall gross foreign debt per one SR citizen reached the sum of USD 5,856 at the end of June. However, a better criterion for determination of the international position of a country is **net foreign debt**<sup>23</sup>. Since the assets amounted to USD 28.65 bn as of 30 June 2006, the net foreign debt amounted to USD 2.85 bn (5.5% of GDP); it has increased a little bit since the first quarter, however, it still does not pose a risk for the Slovak macroeconomic stability.

Similarly as in 2005, the **total exchange reserves of the NBS** were developing at a rather uneven rate in 2006. Their level has culminated in May 2006, when it reached as much as USD 17.44 bn, whereas by the middle of October it dropped to USD 13.1 bn. The significant drop was caused by a standard phenomenon - the development in the foreign exchange market before and after the parliamentary elections, when the NBS intervened several times in favour of the Slovak Koruna. As a result, the import coverage decreased, in October 2006 the foreign exchange reserves covered import of goods and services approximately up to 3.35 months.

## II.5. Forecast Risks

A conservative approach to economic forecast formation is usually taken by the SR. Therefore, our forecasts probably contain more positive risks than negative risks. **Positive risks** to forecasted economic growth can be expected mainly in the following three areas:

<sup>23</sup> It is calculated by deduction of foreign assets from the gross foreign indebtedness



labour market, foreign trade and EU funds, while the latest signals imply that the level of inflation in 2007 can also be lower due to lower regulated prices of energies (lower than assumed in the baseline scenario). Regarding the labour market, a slightly higher rise of employment and nominal wages may be experienced, leaving labour productivity and inflation unaffected. Better-than-expected effect of the automobile production can improve the GDP growth in 2006, while growth in the following years should not be weakened. Such development can be backed up by stronger than anticipated effect of launching the car production facilities on GDP, as well as by higher involvement of Slovak firms in the final production (lower import intensity of production). From the following year on, expectations accrue also for other sectors of industrial production. Improved balance of services can result from the fact that big foreign companies build their outsourcing centres in Slovakia. The third area where reality can come as a positive surprise is the one of EU funds that may bring more jobs to the sector of services and promote the growth of labour productivity.

Despite being minimized to greatest possible extent, the negative risks are, naturally, present in our forecast, too. Several potential negative risks are discussed in detail in Section IV, where their impacts on economy and public finance are simulated by means of a macro-economic model. The main risks include, in particular, the increasing price of oil and related primary and secondary impacts on the price level, as well as the subsequent need of faster growth of interest rates affecting public finance and economy dynamics negatively. In the baseline scenario, purely technical assumptions were used to model the development of interest rates and oil price ; their real development can thus be different. Since the Slovak economy is very open, possible worse development of the external environment could also affect the GDP growth to a certain extent. Although the above-mentioned negative risks are far from being neglected, their occurrence is not expected to threaten the internal or external balance of the Slovak economy in any serious way.

The main directions of the forecasted Slovak economy development are confirmed by the European Commission projections:

Comparison of forecasts of the MF SR and the European Commission			
	2006F	2007F	2008F
<b>Growth of GDP (%)</b>			
Ministry of Finance of the SR	6.6	7.1	5.5
EC	6.7	7.2	5.7
<b>Employment growth (ESA 95, %)</b>			
Ministry of Finance of the SR	2.0	1.1	0.8
EC	2.6	1.5	0.9
<b>Growth of HICP (average, %)</b>			
Ministry of Finance of the SR	4.4	3.1	2.0
EC	4.5	3.4	2.5
<b>Current account deficit (% of GDP)</b>			
Ministry of Finance of the SR	6.9	3.5	2.8
EC	7.8	4.8	3.4

Source: Ministry of Finance of the Slovak Republic, European Commission Autumn 2006 Forecast



### III. POSITION OF PUBLIC FINANCE

#### III.1. Policy Objectives and Strategy

This section defines medium-term and long-term fiscal objectives of the Government and political measures that should lead to their fulfilment. The main message is that the new Government does not change the main fiscal objectives in the field of the public finance consolidation that have been untouched basically since 2004. Meeting the medium-term objectives will require only small adjustments in tax legislation in 2006 and meeting the long-term objectives requires additional political measures outlined in this document. The consolidation efforts of the Government in the following period will be reasonable with regard to the set fiscal objectives, however, at the same time, there is a space for performance of the new Government's economic policy. As regards the policy philosophy, there is an effort to make the economic system more solidary and more socially fair. As regards the budget, the top priorities will include the field of education, health care and agriculture. However, all the economic policy priorities will be framed by medium-term and long-term fiscal objectives.

The fiscal policy strategy is framed by two of the Government's specific objectives. **The first basic fiscal objective is to decrease the general government deficit including the pension reform costs to below 3% of GDP in 2007 and thus to meet the criterion for joining the Eurozone. Another main objective is to reduce the cyclically adjusted general government deficit adjusted for one-off and temporary effects to the level of 0.9% of GDP until 2010.** This objective falls within the range recommended by the European Commission as the medium-term objective for Slovakia within the frame of the revised Stability and Growth Pact. According to the analyses by the Ministry of Finance of the Slovak Republic, if the necessary measures are taken, conditions for **achievement of the long-term sustainability of public finance** will be created.

Consolidation efforts of the Government in years 2005 to 2009 (ESA95, % of GDP)					
	2005	2006E	2007B	2008B	2009B
1. Net borrowing/lending	-3.1	-3.7	-2.9	-2.4	-1.9
2. One-offs	0.8	-0.1	0.0	0.0	0.0
3. Cyclical component	0.0	0.0	0.1	0.0	0.0
4. Cyclically adjusted balance excl. one-offs (MTO) (1+2-3)	-2.3	-3.8	-3.0	-2.5	-1.9
5. Effect of implementation of 2 <sup>nd</sup> pillar of the pension scheme	0.6	1.1	1.1	1.2	1.2
6. Balance adjusted by the 2 <sup>nd</sup> pillar (4+5)	-1.7	-2.6	-1.9	-1.3	-0.7
7. Interest payments	1.7	1.8	2.0	1.9	1.8
8. Adjusted primary balance (6+7)	0.1	-0.8	0.1	0.6	1.0
9. Consolidation efforts (year-to-year change in (6))	1.3	-1.0	0.7	0.6	0.6

(+) restriction, (-) expansion

Source: Ministry of Finance of the SR

The first objective is motivated by joint effort of the Government and the NBS to fulfil the Maastricht convergence criteria in 2007 and to adopt the single Euro currency in 2009. Medium-term objectives of the Government are defined in the three-year General Government Budget for 2007–2009, and thus they have a binding character. The budget for



2007 allows for the deficit of 2.9% of GDP, what makes a certain reserve against possible negative risks that could threaten the fulfilment of Maastricht deficit criterion. The budget is based exclusively on the effective legislative frameworks and future legislative changes already approved by the Government. When the future legislative changes are taken into consideration, these changes are described in the budget, and their impact on budget revenues and expenditures is explicitly quantified. The general government budget for 2007-2009 only allows for slight adjustments of the tax legislation that will be approved in 2006. Characteristics and impact of these changes on budget is specified in the section concerning the public finance quality.

Another basic objective is to reduce the cyclically adjusted general government deficit adjusted for one-off and temporary effects to 0.9% of GDP by 2010. The objective of ensuring a long-term sustainability of the public finance has been defined alike in the first Convergence Programme of Slovakia of May 2004.

This objective goes beyond the time horizon approved by the budget. The achievement of this objective is conditional on the adoption of measures beyond the current legislative framework after 2010. The Ministry of Finance of the SR counts upon three groups of measures. The necessary measures include parametric changes in the pension scheme, additional consolidation efforts in 2010 of 1.0% of GDP and such policy set-ups that will assure increase of the public expenditures in accordance with the growth of economy in the future.

The first group of measures includes specific **parametric adjustments in the pension scheme**, for instance a shift to an annual indexation of pensions (old-age, disability, survivor's pensions) by the inflation rate<sup>24</sup>. Although these measures are not yet effective, they have been explicitly cited during drawing up the pension scheme reform concept, and are generally counted upon for the future. These measures are explicitly indicated in the present and the previous Programmes. On the other hand, from the perspective of long-term sustainability of public finance, it is important that since 2007 Slovakia will report a surplus of cyclically adjusted general government balance adjusted for one-off and temporary effects and for the costs of the 2<sup>nd</sup> pillar of pension scheme.

The second group of measures concerns medium-term consolidation of the budget. The objective is to decrease the cyclically adjusted general government deficit adjusted for one-off and temporary effects to the level of 0.9% of GDP in 2010. It will require **consolidation efforts in 2010 of 1.0% of GDP**. This effort is higher by approximately one-half than the one planned (budgeted) by the Government for the following three years. In the following years, the Government can decide to spread the consolidation efforts more evenly or to prepare a structural reform that would alleviate the pressure on public finance in the specific year of implementation with a long-term effect. However, it is rather probable that the additional consolidation efforts will not be necessary in case the economic trend will continue to develop favourably. As shown in the table below, during the previous four years (including 2006) the actual general government deficit adjusted for unexpected one-off effects ended up significantly better than anticipated in the budget. Therefore, after all it may be sufficient to

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<sup>24</sup> for more details refer to the chapter concerning sustainability of the public finance





revaluate the budget objectives in the following years in order to include the latest general government trends in the objectives.

General government deficit (ESA95, % of GDP)				
	2003	2004	2005	2006
Budget	-5.0	-4.0	-3.8	-4.2
Reality *	-3.4	-3.0	-2.3	-3.8**

\* in 2003-2006 the actual figures are adjusted for one-off effects

Source: Ministry of Finance of the SR

\*\* current estimate is adjusted for one-off effects

The third group of measures relates to the necessary changes in the area of structural policies. It includes **setting-up of policies that will assure future increase of public expenditures in accordance with the economy growth provided that the tax burden would not increase**. It means such completion of structural reforms that would avoid the automatic future public expenditure growth above the growth level of the public revenues, except for the effects of the population ageing, after the year of 2010. Thus the preconditions for maintenance of the gross general government debt below 60% of GDP until 2080 should be met. It is necessary to emphasize that this group of measures has been managed to be fulfilled since 2003, including the whole period protracted by the current budget. It is proved in particular by the fact that strong fiscal consolidation is implemented in the environment of decreasing the overall general government revenues as a share of GDP.

General government revenues and expenditures in comparison with economic growth (ESA95% of GDP)								
	2003	2004	2005	2006E	2007B	2008B	2009B	2003 - 2009B
Adjusted total revenues***	35.8	35.0	36.6	35.3	34.5	33.9	33.9	-1.9
Taxes and social contributions as % of GDP	31.7	30.1	30.7	29.7	29.3	29.0	28.9	-2.8
Adjusted total expenditures	36.6	35.8	36.5	36.1	34.4	33.3	32.9	-3.7
Adjusted total expenditures – real growth in %**	-7.7	1.9	7.7	4.4	1.6	1.7	2.9	1.8*
<i>p.m. economic growth</i>	4.2	5.4	6.1	6.6	7.1	5.5	5.1	5.7*

\*\*\* adjusted total revenues are adjusted for one-off effects

Source: Ministry of Finance of the SR

\*\* adjusted total expenditures are adjusted for one-off effects and interest expenditures, real expenditures are deflated by the CPI index (consumer inflation)

\* it is not the overall change in 2003 - 2009, but an average for 2003 - 2009

Tax quota in 2003-2009 will drop almost by 3% of GDP. Adjusted expenditures (without interest expenditures and one-off effects) will drop in the same period by as much as 3.7% of GDP in spite of the fact that they include the rising EU funds. The most important fact is that the **average real growth of these expenditures is significantly lower than the economic growth in this period**.

The fiscal policy strategy will be determined by the Government consolidation objectives. Sound economic growth supported by the Government policy will continue to be the main source of consolidation. The new Government has set three basic expenditure priorities for the following period, that are health care, education and agriculture (for more information refer to the section concerning the public finance quality). However, at the same time, it has been decided that **all priorities must be in line with the fiscal framework of the Government consolidation objectives**. It means that the proposals and policies that will



bring growth of expenditures and drop of revenues must be finally compensated by adequate measures that will, vice versa, decrease the expenditures or increase the revenues.

The budget for 2007-2009 is based on realistic assumptions, positive and negative risks are balanced. The macroeconomic scenario on which the budget is based, as well as the budgeted tax revenue is subject to supervision by the professional public. Macroeconomic and tax forecasts are subject to assessment by committees whose members include generally acknowledged national economists. The budget explicitly contains statements of the committee members concerning forecasts of the Ministry of Finance of the SR in terms of whether they are optimistic, realistic, or conservative. Macroeconomic assumptions and tax forecasts in the budget for 2007-2009 were evaluated by the national experts in all cases as realistic ones (for more information refer to Annexes No. 2, 3 and the section concerning fiscal institutions).

### III.2. Current Development and Budget Implications for the Following Year

The Ministry of Finance of the SR thoroughly monitors the development of macroeconomic environment and public finance during a fiscal year. For this purpose, twice a year it prepares the document<sup>25</sup>, the objective of which is to analyse development and consider whether the budgeted objective is going to be achieved in the field of the general government deficit. If the risk of exceeding the deficit was identified, the material would contain a proposal of measures to restore the fiscal situation towards budgeted deficit.

The current development of the macroeconomic environment in 2006 confirms the original assumptions used during preparation of the budget for the current year. Majority of the most important indicators show that the development has improved, what constitutes advantageous conditions for fulfilment of the fiscal objectives. **The adopted general government budget for 2006-2008 set the general government deficit for 2006 to 2.9% of GDP, (exclusive of the pension reform costs). Current estimate of the deficit is 2.5% of GDP, i.e. the fiscal position has improved when compared with the budget.** Year 2006 is the last year when the general government deficit has been set by the Government excluding the pension reform costs. The reason for it is the uncertainty that accompanies launching of the pension scheme 2<sup>nd</sup> pillar, in particular the number of the people that have entered the 2<sup>nd</sup> pillar and related shortfall in the Social Insurance Agency revenues.<sup>26</sup>

During the preparation of the general government budget for 2006, it was assumed that the drop of the Social Insurance Agency revenues will amount to 1.3% of GDP. Therefore, the overall budgeted general government deficit for the purpose of notification achieved 4.2% of GDP in 2006. Current estimate of the 2<sup>nd</sup> pillar costs is 1.1% of GDP, i.e. less than estimated at the end of the year 2005, especially due to more accurate numbers and structure of the active savers that have entered the 2<sup>nd</sup> pillar. **After update of the 2<sup>nd</sup> pillar costs and update of the**

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<sup>25</sup> 'Report on Macroeconomic Development and Development of Public Finance for ..... and End of the Year Forecast' is prepared after the end of the first half (July) and after the end of three quarters of the calendar year (October)

<sup>26</sup> For more information refer to the chapter III.5 'Budget Consequences of Important Structural Reforms'



**balance of other general government subjects, the overall general government deficit dropped from the budgeted level of 4.2% of GDP to 3.7% of GDP<sup>27</sup>.**

The state budget is the only general government subject which contributes to the general government deficit reduction by SKK 8.8 bn. The better state budget result will be partially compensated by worse development of other general government components in the overall amount of SKK 5.3 bn. It is caused especially by the state financial assets and extra-budgetary accounts, where a negative impact of SKK 4.3 bn is expected. It will be partially compensated by one-off revenues of SKK 1.0 bn from anonymous deposits. Compared to the budget assumptions, the general government deficit will be negatively influenced also by municipalities and higher territorial units in the amount of SKK 1.2 bn.

The factors that have improved the general government balance include in particular the update of the general government tax revenues. Compared to the approved budget, the tax revenues are expected to be higher by SKK 9.3 bn. Despite of this, the net impact of taxes on general government balance is only SKK 5.8 bn. It is caused by the fact that according to law 93.8% of personal income tax belongs to municipalities that will use all the additional revenues for spending and their budgets are expected to be balanced. Except for the standard share of the personal income tax, SKK 2.1 bn will be available this year from settlement of tax arrears from the previous year.

**Impact of tax revenues update on the general government balance when compared with the budget for 2006 (ESA95, mil. SKK)**

(1) General government tax revenues	9,300
(2) Tax revenues of municipalities and higher territorial units (cash) – negative impact	-3,503
<b>(3) Impact of the tax revenues updates on the general government deficit</b>	<b>5,797</b>

(3)=(1)+(2)

Source:: Ministry of Finance of the SR

Better-than-budgeted development is expected also within non-tax revenues of the state budget (SKK +3.3 bn) that were influenced especially by returned unexhausted resources from the previous years and higher interest revenues of SKK 2.2 bn.

It is expected that the state budget expenditures in the ESA 95 methodology will increase by SKK 1.0 bn when compared to the approved budget. Positive impact of expenditure savings within the state debt servicing of SKK 1.0 bn is compensated by an increase within other current and capital expenditures. The Ministry of Finance of the SR assumes, for the sake of assurance of continuous financing of the Cohesion fund projects, to release approximately SKK 5.1 bn for pre-financing of the national projects of highway construction in spite of that Slovakia's receivable from the EU is not secured. Except for that, the Government has made use of the space provided by the single fiscal rule that exists within the state budget framework. Based on it, additional SKK 3.3 bn were released for expenditures, what corresponds with 1% limit of the possible increase of state budget expenditures, if such expenditures are covered by additional revenues. The above-mentioned increase of

<sup>27</sup> The difference was caused due to rounding (deficit without the effect is 2.52% of GDP, effect of the 2<sup>nd</sup> pillar is 1.14% of GDP, the overall deficit is 3.66% of GDP)



expenditures is financed from the additional revenues and therefore there is no impact on the overall state budget deficit. State budget expenditures in ESA 95 are influenced also by the expected delimitation of SKK 1.1 bn loan with the state guarantee from the Council of Europe Development Bank for Slovenský vodohospodársky podnik, š. p. Banská Štiavnica into the state debt. Except for these factors, the deficit is positively influenced by one-off revenue of SKK 1.0 bn from abolition of anonymous deposits.

After taking into consideration the transfers received from the State Financial Assets covering the loss of the Social Insurance Agency revenues stemming from the launching of the 2<sup>nd</sup> pillar and higher social contributions paid by the state in the amount of SKK 2.2 bn, the general government deficit is negatively influenced also by Social Insurance Agency in the amount of SKK 2.7 bn. The estimation of deficit is increased also by loan of SKK 0.4 bn drawn by the Prešov higher territorial unit for infrastructure, assurance of emergency deposits of oil and antiviral substances against bird flu in the amount of SKK 1.0 bn and investment in the share capital of ŽSR in the amount of SKK 1.0 bn (reclassified as a capital transfer).

<b>Current estimation of the general government balance in 2006 (ESA95, SKK mil., not consolidated)</b>	
	<b>Update</b>
<b>General government deficit after approval of individual budgets in SKK mil</b>	<b>44,408</b>
<b>General government deficit after approval of individual budgets in % of GDP</b>	<b>2.9</b>
A. Update of the estimate of general government tax revenues in ESA95 (including update of impact of transfer of 2% of income tax to the third sector in the amount of SKK 84 mil.)	-5,713
B. Update of the estimate of other than tax revenues of the state budget	-3,300
C. Update of the estimate of the state budget expenditures	1,030
D. Net effect of abolition of anonymous deposits (one-off revenue)	-1,000
E. Financial management of the Social Insurance Agency (including the received transfers from the State Financial Assets and the State Budget in the amount of SKK 2.2 bn)	513
F. Financial management of the State Financial Assets (SFA) and extra-budgetary accounts (excluding the one-off revenue from anonymous deposits of SKK 1.0 bn)	4,266
G. Other general government subjects	700
<b>Current estimation of the general government deficit in mil. SKK</b>	<b>40,904</b>
<b>Current estimation of the general government deficit in % of GDP</b>	<b>2.5</b>
of which: improvement of deficit by means of the GDP estimation update (in % of GDP)	0.2

(+) indicates increase and (-) indicates decrease of the GG deficit in the ESA 95 methodology

Source: Ministry of Finance of the SR

Change of the Government after election in the middle of the year was a specific feature of the year 2006. Even though it can be said that new Government and its declared priorities did not bring any significant changes within fiscal expectations for the current year. Most measures adopted by the Government are financed within the existing state budget limits that were achieved by across-the-board cut of expenditures in the amount of 10%. Resources gained in this way will be used in accordance with the new government objectives, what means a slight adjustment of the purpose of expenditures, however, without any impact on the general government deficit. The Government has paid a lot of attention especially to the budget framework for 2007 – 2009 that provides room for full-value incorporation of new priorities.

Current development in 2006 implies two possible risks for the following years. The first one is the development in the Social Insurance Agency that has contributed to the increase of deficit by SKK 2.7 bn in 2006. It was caused especially by higher budget expenditures for



pensions in the amount of SKK 3.8 bn. At the same time, the budgeted revenues from the social contributions were achieved only thanks to measures for improvement of collection of arrears, what will probably not repeat in the following years. Higher expenditures for pension benefits are a consequence of several factors. Except for the impact of the macroeconomic indicator updates (wages, inflation) on regular increasing of the pension benefits, higher expenditures are also influenced by the amount and number of early old-age retirements. The reform of the PAYG pillar has implemented a possibility of early old-age retirement that started to be utilized to a large extent. Amendment of the Act on Social Insurance in force since August 2006 made the pension-entitlement conditions stricter, what has brought a significant increase of interest in early old-age retirement in the first half of 2006. Besides, other adjustments were adopted by the amendment, especially the ones having long-term negative impact on the general government balance. The budget development of the Social Insurance Agency was negatively influenced also by the judgement of the Constitutional Court that decided on unconstitutionality of the disability pension revaluations in the period from the beginning of 2004 (withdrawal and decrease of pensions already granted). The Government respected the Court decision and so retrospective revaluation of the disability pensions will start in 2006 and continue in 2007. All the above mentioned risks have been already identified during the year 2006 and the general government budget for 2007-2009 takes this negative development into consideration.

The second risk is the transfer of unexhausted limits of capital expenditures and expenditures designed for co-financing of the joint SR and EU programmes into the following budget year. In 2005 individual line ministries did not draw resources of SKK 12.3 bn that were finally shifted to the year 2006. Based on the current development, the Ministry of Finance expects that budgetary chapters will save SKK 12.2 bn this year, what means that the limits transferred to the following year will be approximately the same as in the year 2005. In case of acceleration of drawings of the EU funds in 2007 and 2008, the chapters can draw the current budget limits, as well as the transferred expenditures. However, the above-mentioned risk can be solved also in an operative way during the year. The general government budget expects that the chapters will transfer the same amount of expenditures from 2007 to 2008 as the amount transferred to the year 2007, in particular due to slower drawing of resources from the new programme period 2007-2013, that will compensate the possible acceleration of drawing of the resources of the ending programme period 2004 -2006.

The current estimate of the general government deficit for 2006 (3.7% of GDP including costs of the second pillar) is higher than the one sent to Eurostat in the October notification of deficit and debt (3.4% of GDP)<sup>28</sup>. At the time of sending the notification tables to Eurostat, the last estimated deficit from July 2006 was at the level of 3.4% of GDP. The next update is prepared by the Ministry of Finance to take place after three quarters of the budgeted year on a regular basis. The new estimate of deficit is therefore available only in the second half of October, i.e. after the deadline for sending the notification tables.

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<sup>28</sup> The countries shall send the notification tables no later than on 1<sup>st</sup> October.



The deficit was increased by an update of the general government expenditures in particular when compared with July 2006. The most significant impact on general government deficit had the state budget's expenditures allocated to pre-financing of the Cohesion Fund projects without adequate increase in the receivable from the EU. Besides that, worse budgetary development of the Social Insurance Company had a negative impact on the deficit estimation, since the deficit of the Social Insurance Company will be covered by SKK 1.6 bn from the State Financial Assets. When compared with July 2006, the expected revenues from abolition of anonymous deposits were specified after a commitment of SKK 1.0 bn to the citizens was recorded. The general government expenditures were further increased by the investment in the share capital of ŽSR (SKK 1.0 bn) and by takeover of a loan with a state guarantee to the state debt (SKK 1.0 bn). All these negative effects were partially compensated by other savings in the state budget expenditures and in particular by increase in the tax revenue estimation that contributed to the deficit decrease by SKK 2.3 bn when compared to July.

### III.3. Structural Balance, Fiscal Position, Fiscal Impulse

This section informs about consolidation efforts of the Government that forms a significant part of the Revised Stability and Growth Pact. The consolidation efforts represent the path that is planned to be taken by the Government with the aim to meet the medium-term objective, which is the central tool of the new Pact. The main conclusion is that the Government committed to consolidate the public finance in the budget for 2007-2009 at the rate required by the Pact, i.e. at least 0.5% of GDP annually in case of economic 'good times'. In 2006 it is expected that the adjusted deficit will be 2.6% of GDP, the budget for 2007 allows for the adjusted deficit equal to 1.9% of GDP. Second section of this chapter deals with the fiscal impulse that shows the impact of the general government balance on aggregate demand and, as a result, public finance contribution to the macroeconomic stability. Positive conclusion is that fiscal policy will have the anticyclical restrictive character during the budgeted period and it will smooth out the economic cycle.

Consolidation efforts represent the path that is planned to be taken by the Government with the aim to meet the medium-term objective. Slovak consolidation efforts in this document are calculated according the European Commission methodology that takes into consideration the cyclical budget component, one-off and temporary effects and the costs of implementation of the 2<sup>nd</sup> pillar of pension system.



Consolidation efforts (ESA95, % of GDP)					
	2005	2006E	2007B	2008B	2009B
1. Net borrowing/lending	-3.1	-3.7	-2.9	-2.4	-1.9
2. Cyclical component	0.0	0.0	0.1	0.0	0.0
3. One-offs	0.8	-0.1	-	-	-
- remission of receivables from foreign countries	0.9	-	-	-	-
- fine paid by the company Slovnaft	-0.1	-	-	-	-
- abolition of anonymous deposits	-	-0.1	-	-	-
4. Effect of implementation of 2 <sup>nd</sup> pillar of pension scheme	0.6	1.1	1.1	1.2	1.2
5. Cyclically adjusted balance adjust. for one-offs and 2 <sup>nd</sup> pillar (1-2+3+4)	-1.7	-2.6	-1.9	-1.3	-0.7
<b>Consolidation efforts</b>	<b>1.3</b>	<b>-1.0</b>	<b>0.7</b>	<b>0.6</b>	<b>0.6</b>

Source: Ministry of Finance of the SR

For the purpose of analysis of the Government consolidation efforts it is necessary to divide the current (officially reported) general government balance to cyclical and structural components at first. Structural component shows the general government balance, in case the economy operates on its potential level. Cyclically adjusted balance is the general government balance adjusted for the changes in the cyclical component that represents the reaction of the general government revenue and expenditure on changes in business cycle. Size of the cyclical component depends on the size of the output gap and on elasticity of selected revenue and expenditure categories that react on economic activity fluctuations. Output gap within the time horizon covered by the Convergence Programme achieves values at about zero level. Sensitivity of the general government balance to changes in the output gap is taken in full extent from the OECD forecasts.

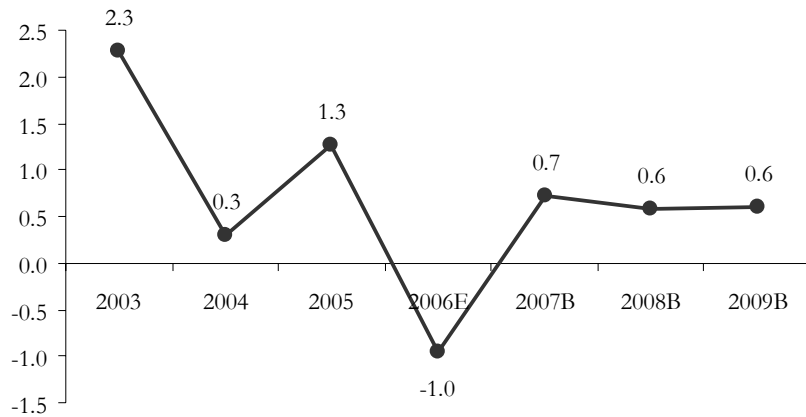
Costs related to the implementation of the 2<sup>nd</sup> pillar of pension system are the second component in the calculation of the Government consolidation efforts. According to the MF SR estimates, the pension reform costs should range from 0.6% of GDP in 2005 to 1.2% of GDP in 2009.

The third component includes one-off and temporary Government measures. The budget for 2007-2009 does not include any such measures. In 2003-2006 period, three one-off Government measures were identified:

1. Debt remission to foreign countries within the framework of international aid increased the general government deficit by 0.9% of GDP in 2005; if the remission did not take place, the deficit would be lower.
2. Fine paid by the company Slovnaft that influenced the general government balance in 2005 in a positive way (0.1% of GDP).
3. Expected revenues from abolition of anonymous deposits in 2006 will be SKK 1.0 bn (0.1% of GDP), and this one-off sum will improve the general government deficit.



Consolidation efforts of the Government in 2003 - 2009 (% of GDP)



Source: Ministry of Finance of the SR

The graph above clearly shows that the Government has committed to consolidate the public finance in the budget for 2007 - 2009 at a rate required by the revised Stability and Growth Pact, i.e. at least by 0.5% of GDP annually in case of economic 'good times'. The current development in 2006 is especially a result of the fact that the actual deficit in 2005 was substantially lower than the budgeted one and this favourable development could not be fully reflected in the budgeted objective for the following year.

The general government consolidation should provide room for sustainable economic growth with low inflation, low interest rates, stable exchange rate and positive expectations of subjects with regard to the future economic policy and, as a result, it should influence the supply side of economy in a positive way and thus compensate the decreased contribution to the aggregate demand.

Fiscal impulse is a simple analytical concept measuring the contribution of general government budget to a year-to-year change in the aggregate demand. It provides information on whether the Government's fiscal policy is expansive or restrictive. Combined with the output gap, it characterises the fiscal policy in terms of whether it contributes to stabilisation of economy or, on the contrary, whether it operates in pro-cyclical manner.

For the purpose of calculation of the fiscal impulse, the balance designed for calculation of the consolidation efforts was adjusted for two additional items, namely financial relations with the EU budget and interest paid by general government. EU flows are included since contributions to the EU budget do not affect domestic demand and, on the other side, the receipts from the EU have neutral effect on deficit (they appear on both revenue and expenditure side of budget), but they have in fact an expansionary effect on economy.

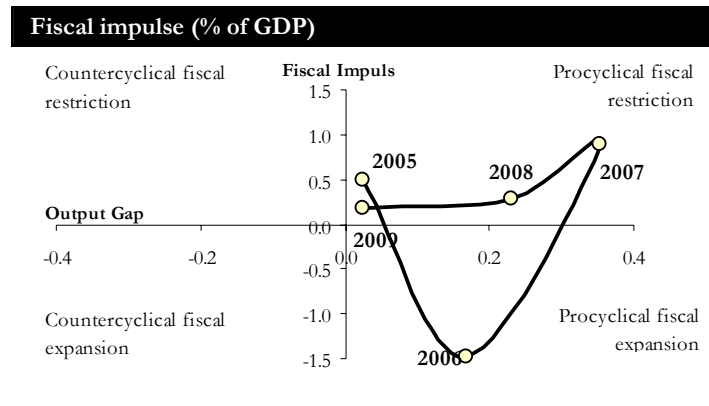




Fiscal impulse (ESA95, % of GDP)					
	2005	2006E	2007B	2008B	2009B
1. Net borrowing/lending	-3.1	-3.7	-2.9	-2.4	-1.9
2. Cyclical component	0.0	0.0	0.1	0.0	0.0
3. One-off effects	0.8	-0.1	0.0	0.0	0.0
4. Effect of implementation of the 2 <sup>nd</sup> pillar of pension scheme	0.6	1.1	1.1	1.2	1.2
5. Cyclically adjust. balance adjust. for one-offs and 2 <sup>nd</sup> pillar (1-2+3+4)	-1.7	-2.6	-1.9	-1.3	-0.7
6. Effect of relations with the EU	0.3	0.8	0.9	1.1	1.4
7. Interest payments	1.7	1.8	2.0	1.9	1.8
8. Cyclically adjust. primary balance excl. the EU effect (5-6+7)	-0.2	-1.7	-0.8	-0.5	-0.3
9. Fiscal impulse (+ restriction, - expansion)	0.5	-1.5	0.9	0.3	0.2
<i>p.m. output gap</i>	0.0	0.2	0.4	0.2	0.0

Source: Ministry of Finance of the SR

The following graph shows that in 2007 - 2009 the fiscal policy will have restrictive and stabilising effect on economy and thus it **will contribute to the smoothing of the economic cycle. In this period, the consolidation and stabilisation objectives of the Government are aligned.**



Source: Ministry of Finance of the SR

### III.4. General Government Debt Level and Development

The Government's consolidation efforts and the sound economic development are reflected in stabilisation of the gross general government debt and net general government debt over a medium-term horizon. **At the end of 2009, the gross general government debt will amount to 29.7% of GDP and the net general government debt will amount to 29.4% of GDP, which is far below the Maastricht criterion level.**



General government debt indicators					
	2005	2006F	2007F	2008F	2009F
<b>Gross debt (mil. SKK)</b>	<b>507,428</b>	<b>537,883</b>	<b>569,003</b>	<b>593,390</b>	<b>606,164</b>
of which: state guarantees	29,879	22,568	14,016	13,034	12,052
<b>Net debt (% of GDP)</b>	<b>(2-1) 29.4</b>	<b>28.1</b>	<b>29.2</b>	<b>29.7</b>	<b>29.4</b>
Liquid financial assets (% of GDP)	(1) 5.1	5.0	2.7	1.3	0.3
<b>Gross debt (% of GDP)</b>	<b>(2) 34.5</b>	<b>33.1</b>	<b>31.8</b>	<b>31.0</b>	<b>29.7</b>
Change in gross debt (p.p.)	-7.1	-1.4	-1.3	-0.8	-1.4
growth in nominal GDP	-3.3	-3.2	-3.0	-2.1	-2.0
primary balance	1.4	1.9	0.9	0.6	0.2
interest payments	1.7	1.8	2.0	1.9	1.8
stock-flow adjustment	-7.0	-1.8	-1.2	-1.2	-1.3
<i>p.m. Implicit interest rate (%)</i>	<i>*) 4.6</i>	<i>5.7</i>	<i>6.6</i>	<i>6.3</i>	<i>6.1</i>

\*) The growth of the implicit interest rate after 2005 results not only from the expected growth of interest rates but also from state loans from the Treasury (refer to the text) that have reduced the reported gross debt but not interest payments to the same extent. *Source: Ministry of Finance of the SR*

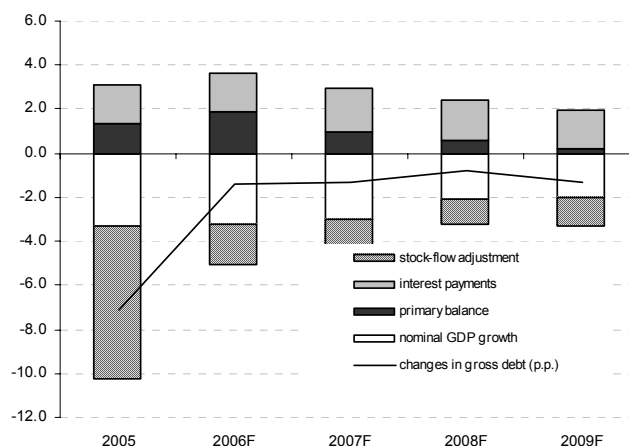
The development of gross debt will influence repayment of risk loans covered by the state guarantee in a positive way in particular in 2006 and 2007. State budget deficit will be influencing the debt in a negative way throughout the whole forecasted period. Other general government subjects, namely loans received by municipalities and higher territorial units, will contribute to growth of the gross debt especially in 2008.

In order to finance a budget deficit, the Debt and Liquidity Management Agency (ARDAL) borrowed SKK 77.1 bn from the Treasury until the end of 2005. This sum contributed to a significant decrease of the gross debt in 2005. The forecast for the years 2006 to 2009 expects that the amount of resources from the Treasury used to cover the state debt will not change, but it will remain on the level from the year 2005. These borrowings will not influence the debt development in 2006-2009 period. However, after this period expires, ARDAL will probably have to repay the money back to the Treasury. According to the forecast, the liquidity of the Treasury will significantly worsen due to transfer of state financial assets to the Social Insurance Agency with an intention to cover the loss of revenue from social contributions ensuing from the implementation of the 2<sup>nd</sup> pillar of the pension scheme. In fact, the balance of borrowings from the Treasury can increase or decrease depending on the actual development of liquidity of the Treasury and the varying needs of the state debt that cannot be forecasted accurately.

Change in the gross debt is influenced mostly by the nominal GDP growth that helps to decrease the debt. Interests paid will increase public debt in 2006 to 2009 by stable sums. As a result of the Government's consolidation efforts, contribution of the primary deficit to the debt growth will gradually decrease. Contribution of the stock-flow adjustment to public debt reduction will be stable in 2007-2009, varying from 1.2% of GDP to 1.8% of GDP.



Contributions of factors to the change in gross general government debt (pp)



Source: Ministry of Finance of the SR

High value of stock-flow adjustment in 2005 was influenced especially by already mentioned high borrowings of SKK 77.1 bn by ARDAL from the Treasury. In the following years, lower and stable level of this factor will be influenced especially by transfer of resources from the state financial assets to the Social Insurance Agency in order to cover the budget shortfall of the pension scheme 2<sup>nd</sup> pillar. According to the ESA 95 methodology, the loss will increase the accrual deficit, but it will not influence the gross debt growth since it will be financed by the financial assets (accumulated resources in particular from privatisation). As long as the resources from privatisation and the financial assets suffice to cover the shortfall, gross debt will not grow, however, the net debt will, since the net assets will decrease. The revenue from privatisation in the amount of SKK 1.9% of GDP is budgeted only in year 2006, after 2006 no revenue from further privatisation is expected, only negligible revenue from contracts that have been already signed. However, the expected privatisation revenue in 2006 will not contribute directly to the gross debt decrease, since the revenue will accumulate the financial assets. Other important elements of stock-flow adjustment include difference between cash and accrual tax revenues and debt interest payments.

Stock-flow adjustment (% of GDP)				
	2006F	2007F	2008F	2009F
Transfer of resources from State Financial Assets to Social Insurance Agency	-1.2	-1.1	-1.2	-1.2
Difference between cash and accrual tax revenues	-0.2	-0.2	0.0	0.1
Difference between cash and accrual interests	0.3	0.1	0.3	0.3
Other	-0.7	0.0	-0.2	-0.4
<b>Stock-flow adjustment</b>	<b>-1.8</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.3</b>

Source: Ministry of Finance of the SR



### III.5. Budget Consequences of Important Structural Reforms

Slovakia is a country under the Excessive Deficit Procedure (EDP procedure) and it heads towards meeting of its medium-term objective – to decrease the cyclically adjusted general government deficit adjusted for one-off and temporary effects to 0.9% of GDP in 2010. This chapter provides details about the influence of the second (fully-funded) pillar on the general government balance. Implementation of the fully-funded pillar into the pension scheme is the only type of structural reform currently applied by Slovakia in accordance with the revised Stability and Growth Pact in evaluation of the Government consolidation efforts. Implementation of the fully-funded pillar into the pension scheme has a provable negative impact on the general government balance within the medium-term horizon and positive impact within the long-term horizon<sup>29</sup>. It results from the above-mentioned reasons that it is necessary to take into consideration also costs of the pension scheme reform when evaluating the pace of deficit reduction.

Based on the decision by Eurostat from 2004<sup>30</sup>, the funded second pillar will be classified outside the general government sector, what means that the contributions re-directed to the private companies are not the general government revenue anymore and similarly, the pensions that will be paid in the future from the accumulated savings will not be the expenditures of the general government. Slovakia has fully implemented this Eurostat decision already in the October notification of deficit and debt in 2006<sup>31</sup>, where the notified general government deficit for the year 2005 included all costs of launching the fully-funded pillar. Due to the same reason, the general government budget objectives for 2007-2009 include all costs for the pension reform.

When compared with the original expectations presented in the Convergence Programme in May 2004, the number of persons that entered the second pillar increased. The first estimation of loss of the Social Insurance Agency revenues assumed that approximately 1.1 million of actively contributing savers will enter the second pillar. At present, the Social Insurance Agency registers more than 1.5 millions savers, of which almost 250 thousands are economically non-active. Some persons entered the 2<sup>nd</sup> pillar only because they wanted to manage it before the deadline for entering the second pillar, i.e. until 30<sup>th</sup> June 2006. These persons have been paying the contributions for 1 or 2 months only and after their applications were accepted, they stopped contributing to the system actively. Voluntarily unemployed people, i.e. people that are outside the labour market and citizens working abroad are the best example. At present, the number of such people can only be estimated since the financial flows are not stabilized yet. Due to the above-mentioned reasons, the number of actively paying savers is estimated to be almost 1.27 million of people, what means an increase by approximately 168 thousand people when compared with the estimation of 1.1 million of people from May 2004.

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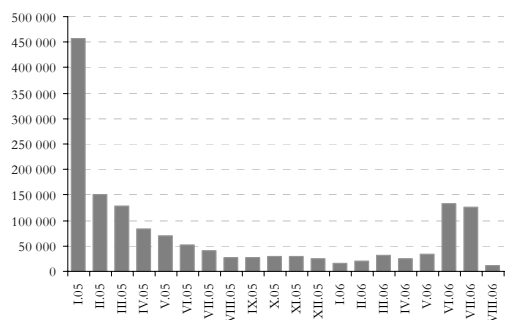
<sup>29</sup> Calculation of costs and benefits of the fully-funded pillar is included in the Convergence Programme of November 2005, chapter VI. Long-term Sustainability of the Public Finance

<sup>30</sup> Eurostat News Releases N° 30/2004 of 2 March 2004

<sup>31</sup> Eurostat provided transitory period for implementation of its decision until April 2007, Eurostat News Releases N° 117/2004 of 23 September 2004

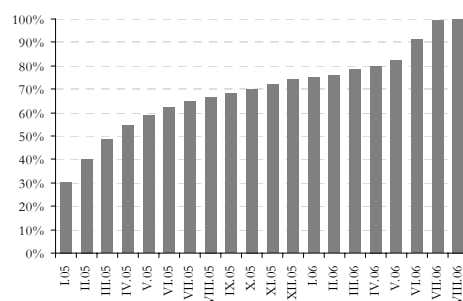


Monthly increase of the number of savers from 1 January 2005 to 30 August 2006



Source: Social Insurance Agency, Ministry of Finance of the SR

Cumulative development of the number of savers as of 31 August 2006 (expressed as % from the overall number of savers)



Source: Social Insurance Agency, Ministry of Finance of the SR

Change in the number of people engaged in the 2<sup>nd</sup> pillar has a direct impact on the general government costs. The general government deficit for 2007 is budgeted at the level of 2.9% of GDP and it includes also costs of launching the second (fully-funded) pillar in the amount of 1.1% of GDP. When compared with the Convergence Programme from May 2004, the costs were increased by 0.1% of GDP, what reflects a slightly higher number of actively engaged people. When compared with the previous Convergence Programme from November 2005, the impact of the second pillar was decreased by 0.3% of GDP in particular due to specification of the number of active savers.

Impact of the loss of revenues due to implementation of the 2<sup>nd</sup> pillar on general government balance (% of GDP)

	2004	2005E	2006B	2007B	2008B	2009F	2010F
Convergence Programme – May 2004	0.0	0.5	0.9	1.0	1.2	1.3	1.3
Convergence Programme – November 2005	0.0	0.8	1.3	1.4	1.4	1.5	1.5
<b>Current estimate</b>	<b>0.0</b>	<b>0.6</b>	<b>1.1</b>	<b>1.1</b>	<b>1.2</b>	<b>1.2</b>	<b>1.3</b>
Change against CP of November 2005	0.0	-0.2	-0.2	-0.3	-0.2	-0.3	-0.2

Source: Ministry of Finance of the SR



## IV. SENSITIVITY ANALYSES AND COMPARISON WITH THE PREVIOUS UPDATE

### IV.1. Alternative Scenarios and Risks

In general, forecast risks and impulses for alternative scenarios are the forecast assumptions themselves. With regard to the fact that some risk factors can develop in a very stochastic way or it is impossible to make a reasonable quantification of their impacts, this chapter deals exclusively with specification and consideration of the impact of the most probable and quantifiable risk factors of exclusively economic character.

As regards the technical aspect and as far as possible, the quarterly medium-term multi-equation economic model based on a combination of econometric relations and calibration was used for quantitative analysis of the probable impact of risk factors in comparison with the baseline scenario.

The latest economic development confirms the justification of simulations and discussions concerning risks indicated in the previous updated version of the Programme again, especially concerning the effect of lower-than-anticipated growth of foreign demand, higher growth of the overall labour productivity of production factors, and concerning the effect of potential threat of increase in oil prices. However, the latest signals in the economic development required adding another two types of alternative scenarios –simulating higher growth of employment and simulating lower inflation rate in 2007 when compared with the baseline scenario.

The presented results of model-based simulations of partial effects provide an idea of size, direction and timing of the effects and seriousness of each type of risk, if it had effected separately. The presented quantification of the impacts on public finance should however be perceived as a technical estimate since the macroeconomic model, that is used for simulations, models the public sector on a more aggregated level. Anyway, it is able to provide reasonable estimates indicating potential risks to the general government budget.

Similarly, while assessing the contrary effects of the fiscal measures (e.g. change in tax rates) on macroeconomic development, the aggregate macroeconomic model can simulate only framework indications on the aggregate level demonstrating the impact direction and the overall sensitivity to changes. Aggregates macroeconomic model does not enable quantification of effects of small partial changes in the economic policy. An actual example of such situation is the implemented decrease in the VAT rate of medicines and medical devices from 19% to 10%. Since the weight of medicines in the consumption basket is 1.42% and weight of the medical devices is approximately 0.25%, it is clear that the macroeconomic effect is small. Furthermore, the sensitivity of consumption of these products to tax rate changes, or to changes of their prices is certainly lower than in case of other types of products. If an aggregated macroeconomic model with aggregated effective VAT rate and excise tax rate and with aggregated elasticity to rate changes was used for simulation of the scope of such effect, it would provide an overrated quantification of the impacts.



The quantification of the effects of transfers from the EU on the economic development is another current issue that we dealt with. Based on the data concerning the size of transfers taken from the general government budget proposal, we calculated their effects on the GDP under certain simplified assumptions. Calculations are only rough, since the whole process of allocation is much aggregated and not easily traceable from the perspective of the necessary model quantifications. It resulted in an approximate estimate of effects of the transfers from the EU on the nominal GDP and its growth. The effect on the GDP growth is expressed in the following table as a difference between the nominal GDP with and without the resources from the EU.

Impact of the EU funds resources on GDP	2006	2007	2008	2009
Relative increase in GDP due to utilization of the EU funds (in % of GDP)	1.2	0.9	1.0	1.1
Change of growth rate of the nominal GDP due to EU funds (in p.p.)	0.2	-0.2	0.0	0.2

*Source: Ministry of Finance of the SR*

Another section deals with the detailed processing and calculation of effects on macroeconomic indicators by means of a medium-term economic model, resulting from several important risk factors: drop in the foreign demand, rise in oil prices (negative risks) and growth of the overall productivity, lower inflation and employment growth (positive risks).

### Scenario with lower foreign demand

The alternative scenario of economic development simulates negative risk in a form of lower-than-expected performance of trading partners of Slovakia that would be reflected in **slowed-down export** of the country. Simulation allows for a decrease in the level of real foreign demand (bn SKK) in comparison with the baseline scenario by 3% every year during the period from 2007 to 2010. Thus the scenario allows for permanent shock and ability of the National Bank to immediately identify its presence.

Simulated loss in export production would increase the current account deficit (when compared with the baseline scenario). At the same time, GDP, investments and consumption would be lower than anticipated in the baseline scenario, and, at the same time, labour market would perform worse. Lower domestic demand would be consequently reflected in a lower inflation rate. However, worse economic development would generate pressures on growth of the public finance deficit (lower revenues and higher obligatory expenditures). Since GDP would be decreased faster than the potential product when compared with the baseline scenario, there would be a room for interest rate decrease and, as a result, the negative effect (due to lower GDP and higher unemployment) of decreasing wages on the private consumption would not be manifested at a very dramatic rate. Much more significant drop in comparison with the baseline scenario would occur in the area of investments – their drop would be caused in particular by slow-down of the FDI dynamics induced by a lower overall foreign demand and resulting lower needs for construction of the new production capacities. The drop in consumption and investments would cause a decrease in imports, and this would gradually reach a level equal to that of the declined exports and, as a consequence, the current account deficit relative to GDP would gradually



reach the level of the baseline scenario. The negative effect of the permanent shock on GDP would probably culminate in the second year after the shock, with a 0.9% lower real GDP level than in the baseline scenario. A simulated risk would generate negative pressures on public finance. As a consequence of the overall economy slow-down, drop-out of revenues would occur (cumulatively by approximately 2.1%) and by the year 2010 there would be a pressure on general government deficit increase relative to GDP by 0.2 p.p. compared to the baseline scenario.

### **Scenario with higher growth of the overall productivity of production factors**

The following scenario simulates a positive risk of higher productivity growth that may be caused by launching the production in new and modern plants held by foreign owners. Forecasting productivity growth is very difficult and for a small transitive economy of the SR, this holds two-fold. One-shot shocks in the form of production restructuring of an important automobile industry exporter, increased inflow of FDI or important technology imports can significantly accelerate the productivity growth. Further successful performance of structural reforms, policies and applicable measures constitute a positive risk that should also be after all reflected in the simulated higher growth of productivity and higher growth of economy. It includes especially the four already mentioned priority fields of the National Reform Programme that follow the Lisbon Strategy objectives – education and employment, business environment, R&D, information society. The objectives of the economic policy supporting business, infrastructure, competitiveness of industry, job creation in weaker regions, regional mobility, investments in human resources and educational systems including their reforms, effective energy policy focused on wide ecological aspects (ecologically suitable innovations and technologies), utilisation of renewable energy resources, as well as safe and effective energy supply would unequivocally result in better competitiveness of the Slovak economy and its permanently sustainable growth. Since simulations of effects of individual above-mentioned objectives cannot be directly quantified in practice, they are included in the common effect expressed through higher growth of the overall productivity (of labour and capital).

The model simulations demonstrate that an increase in the growth of total productivity by 0.5 p.p. would improve the country's competitiveness, and proportionately also the total level of potential product. Since it is realistic to consider the productivity growth only in the tradable sector that represents approximately one half of the value added in Slovakia, the before-mentioned simulated increase would *de facto* bring annual increase in productivity of tradable sector by 1 p.p. Faster growth of the potential product would help to close output gap faster and that would result in a lower inflation rate. Lower inflation would support the growth of investments and private consumption. At the same time, higher productivity would bring higher corporation profits and possibilities of new investments, therefore the positive deviation from the baseline scenario in the area of growth of investments would be stronger than in the area of consumption. Though the increasing consumption would cause increase in imports, the overall effect on balance of payments would be positive – the ratio of current account deficit to GDP would decrease; increase in competitiveness would bring an increase in export and it would slightly weaken imports. The takeoff of the GDP would be accompanied by growth in demand for money, goods and services, as well as for labour force, what would be reflected in growth in employment and wages. Economic acceleration would gradually start boosting inflation pressures so by 2010 the consumer price index





would achieve the CPI level of the baseline scenario. Over the monitored horizon, the overall effect of the simulated risk would be reflected in stimulated private consumption, rise of GDP to 1.2% higher level than the one in the baseline scenario, and in improvement of the current account deficit relative to GDP by 0.1 p.p. Improvement of the GDP level would bring a drop in the public finance deficit relative to GDP by 0.4 p.p. as a result of combination of positive effects on both sides: revenues would rise by 0.8% and expenditures would drop by 0.3 % in comparison with the baseline scenario.

Impact of changes in certain forecast assumptions on development of relevant economic indicators								
Relative/absolute change in values of the variables in comparison to the basic scenario (relative change in %, absolute change in units indicated in the brackets)								
	Consumer expend- iture	Gross fixed invest- ment	GDP	Unem- ployment ( <sup>'000s</sup> )	CPI inflation (% p.a.)	Short-term interest rate (% p.a.)	Current account (% of GDP)	Pressure on government balance (% of GDP)
<b>Scenario : Drop in foreign demand by 3%</b>								
2006	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2007	-0.2	-1.4	-0.8	0.6	0.0	0.0	-0.1	-0.2
2008	-0.6	-1.9	-0.9	0.6	-0.3	-0.1	-0.0	-0.3
2009	-0.7	-1.9	-0.8	0.6	-0.3	-0.4	0.0	-0.2
2010	-0.8	-1.7	-0.7	0.5	-0.3	-0.5	0.0	-0.2
<b>Scenario : Overall productivity growth by 0.5%</b>								
2006	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2007	0.0	0.2	0.1	-0.1	0.0	0.0	0.0	0.0
2008	0.2	0.8	0.5	-0.4	-0.1	0.0	0.1	0.2
2009	0.4	1.5	0.8	-0.6	0.0	0.0	0.1	0.3
2010	0.7	2.3	1.2	-0.8	0.1	0.0	0.1	0.4

Source: Ministry of Finance of the SR

### Scenarios with higher oil prices

During the second half of 2005, oil prices started to be one of very serious potential sources of threats to the economic growth on the global level. Since the significant increase in oil prices has sharply influenced the development of price indicators in Slovakia, this effect cannot be underestimated while forecasting future economic development of Slovakia, not even in the period when the global oil prices show decreasing tendency (starting with September 2006). Furthermore, oil prices may affect the Slovak economy also indirectly, through weakening the growth in the EU countries.

The baseline scenario of the future development assumes oil prices at the level of 67 USD/bl in 2007 - 2010. Since the Common External Assumptions of the European Commission (by



September 2006) applied a little higher assumption of 69.1 USD/bl., our next scenario of alternative development reflects this difference and thus simulates a permanent increase in oil prices from 67 to 69.1 USD/bl. (by 3.1%) for the period of 2007 - 2010. In order to evaluate the seriousness of the risk resulting from the growth of oil prices, we have prepared also a significantly pessimistic scenario, which simulates the impact of increase in oil prices by 10 USD/bl. to a constant level of 77 USD/bl. (by 14.9%) in the period of 2007 - 2010.

The impact of the alternative scenarios of oil prices development on the Slovak economy is equal in both cases, however the size of the effects differs in dependence on the size of a shock. Model simulation signalises that increase in the assumption of oil prices development by approximately 2 USD/bl does not cause any significant deviation in development of the main macroeconomic indicators from the baseline scenario. Increase of prices of fuel, gas and, as a consequence, heat for households would be a direct consequence of increase in oil prices. Effect on inflation would be best visible in the second year after the shock (after the secondary effects become fully evident), the CPI growth would rise by additional 0.2% or 0.7 p.p. respectively. Of course, assuming that oil prices remain on the above-mentioned level, their effect on inflation would quickly expire and the negative impact on slowing down the economy of the SR and the EU in consequence of lower demand would become more dominant. Since oil prices represent a global problem, the above-mentioned results of simulation take into consideration the whole context of the Slovak economic development within global economic environment (making use of a multi-country model).

The rise of inflation due to the increasing oil prices and prices of oil products would force the central bank to increase short-term interest rate in both scenarios. The higher inflation would reduce real incomes and together with a higher interest rate it would thus contribute to a decline in household consumption. Higher interest rates would have similar negative impact on investments as well. In consequence of slow-down of the real economy, unemployment would rise. Economic slow-down based on the price shock would negatively influence the current account deficit and the public finance deficit as well. Government balance might be worsened as a consequence of lower revenues (by 0.1 or 0.4% in comparison with the baseline scenario) and higher expenditures (by 0.2 or 0.7%).



**Impact of changes in certain forecast assumptions  
on development of relevant economic indicators**

Relative/absolute change in values of the variables in comparison to the basic scenario  
(relative change in %, absolute change in units indicated in the brackets)

	Consumer expend- iture	Gross fixed invest- ment	GDP	Unem- ployment ( <sup>000s</sup> )	CPI inflation (% p.a.)	Short-term interest rate (% p.a.)	Current account (% of GDP)	Pressure on government balance (% of GDP)
<b>Scenario : Increase in oil prices by approx. 2\$ (from USD 67 to USD 69.1 per barrel)</b>								
2006	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2007	-0.1	-0.1	-0.1	0.0	0.1	0.2	-0.1	-0.1
2008	-0.4	-0.3	-0.1	0.1	0.2	0.2	-0.1	-0.1
2009	-0.4	-0.4	-0.1	0.1	0.0	0.1	-0.1	-0.1
2010	-0.4	-0.4	-0.1	0.1	0.0	0.0	-0.1	-0.1
<b>Scenario : Increase in oil prices by 10\$ (from USD 67 to USD 77 per barrel)</b>								
2006	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2007	-0.6	-0.5	-0.3	0.2	0.5	0.8	-0.4	-0.4
2008	-1.7	-1.5	-0.6	0.4	0.7	1.2	-0.3	-0.6
2009	-1.9	-1.8	-0.6	0.4	0.3	0.6	-0.3	-0.5
2010	-1.8	-1.9	-0.6	0.4	0.1	0.2	-0.3	-0.3

Source: Ministry of Finance of the SR

**Scenario with higher growth of employment**

With regard to the fact that the submitted baseline scenario concerning employment development is rather conservative, we also bring an alternative scenario of the economy development considering a 1.5% growth of the overall employment in 2008 - 2010. At the same time we assume that higher growth of employment would not threaten productivity and that there would be no pressure on profit of companies to decrease in consequence of increased wage costs. Higher growth of employment will immediately start to be reflected in a drop of the number of unemployed over the whole monitored period (the dynamics of the employment growth increases, it is not a one-shot effect). It can be expected that the growth of equilibrium employment and potential product will increase and that the increased demand from the side of households will not cause inflationary pressures. However, the demand for imports could increase whereby the current account deficit would slightly worsen. Towards the end of the period, the increased potential would be positively reflected in investments and in the overall growth of the economy. However, the impact is rather slight, only 0.1%. The positive side of this scenario is that the public finance balance will improve due to lower social expenditures.



**Impact of changes in certain forecast assumptions  
on development of relevant economic indicators**

Relative/absolute change in values of the variables in comparison to the baseline scenario

*(relative change in %, absolute change in units indicated in the brackets)*

	Consumer expend- iture	Gross fixed invest-ment	GDP	Unem- ployment	CPI inflation	Short-term interest rate	Current account	Pressure on government balance
			( '000s)	(% p.a.)	(% p.a.)	(% of GDP)	(% of GDP)	
<b>Scenario: 1.5% employment growth over 2008-2010 (instead of 0.8%)</b>								
2008	0.1	0.0	0.0	-0.5	0.0	0.0	0.0	0.1
2009	0.1	0.0	0.0	-1.1	0.0	0.0	-0.1	0.2
2010	0.1	0.1	0.1	-1.7	0.0	0.0	-0.1	0.3

*Source: Ministry of Finance of the SR*

### Scenarios with lower inflation rate in 2007

Decreasing prices of oil, seen lately and experienced also in present, indicate that the prices of oil could stabilise in the following year, and, as a result, prices of energies will probably not increase to such an extent as is reflected in the baseline inflation forecast of 3.1% for the year 2007. In connection to the current development of prices of oil, the prices of gas for households can actually decrease by approximately 3% at the beginning of the following year. At the same time, the drop of prices of fuels that can be observed from September 2006 on and that contributes significantly to lowering inflation, can continue during this year and the following year as well. These alternative assumptions result in two scenarios of inflation slow-down in 2007 when compared to the submitted baseline scenario; namely the scenario of inflation slow-down from the baseline forecasted level of 3.1% to 2.8% (the level of the current NBS forecast) and even more optimistic scenario of inflation slow-down by approximately 0.8 p.p., i.e. to the level of 2.3%. Besides the primary impact of the prices of oil, this scenario allows also for a slightly less conservative growth of prices of food.

The impact of the alternative scenarios of inflation development on the Slovak economy is again qualitatively the same in both cases; however, the size of the effects differs depending on the size of shock. Decreasing CPI inflation would create space for drop of interest rates without threatening the price development. Lower inflation would cause increase in real income and would contribute to increase in the household consumption. Decrease in the interest rate would support growth of investment and thus the production side of economy would be fostered. Thus, the real economy would be accelerated; however, this would become more pronounced in the following year. As a result, the unemployment rate could decrease, depending on the size of the shock. Higher demand caused by consumption and investments could influence the current account deficit negatively. Since the positive shock to inflation would be temporary (after 2007 the inflation would be on the same level as forecasted in the baseline scenario, prices would settle on levels lower by 0.2 or 0.5 percent), due to higher demand, the short-term interest rate would gradually return to the level of the baseline scenario. In consequence of the temporary drop in social expenditures of the



government, influenced by inflation and the number of unemployed, the public finance deficit would develop better compared to the baseline scenario.

Impact of changes in certain forecast assumptions on development of relevant economic indicators								
Relative/absolute change in values of the variables in comparison to the baseline scenario (relative change in %, absolute change in units indicated in the brackets)								
	Consumer expend- iture	Gross fixed invest-ment	GDP	Unem- ployment ( '000s)	CPI inflation (% p.a.)	Short-term interest rate (% p.a.)	Current account (% of GDP)	Pressure on government balance (% of GDP)
Scenario: 2.8% inflation in 2007 (on the level of the current NBS forecast)								
2007	0.2	0.1	0.0	0.0	-0.3	-0.2	0.0	0.1
2008	0.2	0.2	0.1	0.0	0.0	-0.1	-0.1	0.1
2009	0.2	0.2	0.1	0.0	0.0	0.0	-0.1	0.0
2010	0.2	0.2	0.1	0.0	0.0	0.0	-0.1	0.0
Scenario: 2.3% inflation in 2007								
2007	0.5	0.2	0.1	-0.1	-0.8	-0.4	-0.1	0.2
2008	0.6	0.5	0.2	-0.1	0.0	-0.2	-0.2	0.2
2009	0.5	0.5	0.2	-0.1	0.0	0.0	-0.2	0.1
2010	0.5	0.5	0.2	-0.1	0.0	0.0	-0.2	0.1

Source: Ministry of Finance of the SR

### Scenario of general government interest costs

From the perspective of **general government interest payments**, the risk factors include especially higher interest rates and weaker Slovak crown exchange rate, as compared to the baseline scenario. The results of testing of partial debt sensitivities (without making use of the overall model of the Slovak economy) to interest rates and exchange rate are shown in the table below. However, it should be emphasised that already the basic scenario is based on conservative assumptions. **The risk scenario** is specified (alike in previous Convergence Programmes) as technical simulation of 5% depreciation of Slovak currency in relation to Euro and, at the same time, of increase in interest rates by 1 percentage point above the baseline scenario levels in each forecasted year. The overall risk for public finance amounts to about 0.3% of GDP and should be sufficiently covered by the conservative approach applied in the baseline scenario quantifications.

General government interest payments (ESA 95%, GDP)				
	2006F	2007F	2008F	2009F
Baseline scenario	1.8	2.0	1.9	1.8
Risk scenario	1.9	2.3	2.2	2.1
<b>- difference</b>	<b>0.1</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>

Source: Ministry of Finance of the SR



#### IV.2. Comparison with the previous update

The current update (based on data available before the November revision of national accounts) confirms the future development trends of macroeconomic and fiscal parameters presented in the last-year Convergence Programme of the SR. The actual development of home economy and external environment over the previous period necessitated certain adjustments in figures, however these are usually not significant, or can have a rather positive effect on the further process of real and nominal convergence of the SR. Some corrections or, on the contrary, retention of former estimates reflected the conservative character of the submitted macroeconomic projections. We will endeavour to maintain this character of predictions in the future in order to avoid generation of excessive risks to the fulfilment of fiscal objectives caused by too optimistic estimates of the development of macroeconomic environment.

The 2006 update brought higher estimates of the economic growth, primarily due to effects of a more favourable development of foreign trade, as well as of domestic demand, the latter supported by a positive development on the labour market. Estimates for the following years indicate that the growth of Slovak economy will continue to attain high, though sustainable levels. It turns out that the higher growth of economy could slightly support the fulfilment of fiscal objectives, with a positive effect on the reduction in the public finance deficit and, with a certain time lag, also the reduction in the debt ratio.

Comparison between the previous forecast and the updated forecast						
	ESA code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>Real growth of GDP (%)</b>						
Previous update		5.1	5.4	6.1	5.6	
Reality and current update		6.1	6.6	7.1	5.5	5.1
Difference		1.0	1.2	1.0	-0.1	
<b>General government balance (% of GDP)</b>						
	EDP B.9					
Previous update		-4.9	-4.2	-3.0	-2.7	
Reality and current update		-3.1	-3.7	-2.9	-2.4	-1.9
Difference		1.8	0.5	0.1	0.3	
<b>Gross general government debt (% of GDP)</b>						
Previous update		33.7	35.5	35.2	36.2	
Reality and current update		34.5	33.1	31.8	31.0	29.7
Difference		0.8	-2.4	-3.4	-5.2	

Source: Ministry of Finance of the SR



## V. QUALITY OF PUBLIC FINANCE

### V.1. Policy Strategy

Consolidation of public finance is the Government's focal medium-term objective. Consolidation objectives are important from the perspective of financial stability, but the Government is also well aware of the key importance of the qualitative aspect of public finance. A successful continuation of the fulfilment of medium-term objectives enables the Government to focus on this issue in particular. Therefore, it is a political priority for the next period to improve efficiency and effectiveness of the use of public resources, and their orientation towards the promotion of the economy's potential growth.

This section describes the main development trends on the side of revenues and expenditures of the general government in the medium run. With regard to the fact that no reliable data are available in the COFOG functional classification, analysis describes especially the economic classification trends. The new Government has undertaken to perform economic policy according to its Programme Declaration that defines its efforts to make the economic system more solidary and more socially fair, however, not at the expense of sound economic growth. In accordance with these objectives, the Government prepared slight adjustment of the tax system since January 2007. The new Government has set three basic priorities for the following period on the side of expenditures, namely health care, education and agriculture. However, at the same time it has been decided that all priorities must be in accordance with the fiscal framework determined by the Government's consolidation objectives. It means that the proposals and policies that will bring increase in expenditures and decrease in revenues must be finally compensated by adequate measures that will decrease the expenditures and increase the revenues.

Sound and high economic growth enabling slight real growth of expenditures and concurrent decrease of expenditures as a share of the nominal GDP will be the main resource of the public finance consolidation in 2006-2009. The Government also prepares a decrease in the number of civil servants that can include up to 20% of its all employees. Such decrease should take place during the year 2007, savings in the budget should be more notable in 2008, since severance payments should be paid to the people made redundant.

### V.2. Revenue-Side Development

Priorities and objectives of the new Government are reflected in changes in the tax system that will enter into force since January 2007. The changes have only slight impact on the public finance, the overall tax burden remained practically unchanged. The overall impact on the general government revenues is slightly negative due to implementation of lower VAT on medicines and selected medical aid tools of 10% (originally, the VAT rate was unified at 19%). It is important to remark that the loss of revenues due to the VAT change (approximately SKK 3.0 bn every year) is not a loss of the general government in full extent. Contrary to that, more than 80% of this sum will remain in the public sector. In most cases the health insurance agencies settle the medicines to pharmacies and hospitals (private out-of-pocket payments for medicines are still relatively low). Health insurance agencies belong



to the general government sector since their main revenues are the revenues from mandatory health care contributions. Health insurance agencies will after all pay less for the medicines and thus the VAT decrease will be reflected especially in the increase of resources of health insurance agencies that are used for disbursement of medicines and health care. It is expected that the economy of health insurance agencies will be balanced. The overall impact of tax changes is therefore positive from the perspective of general government budget.

All other tax adjustments increase revenues of the general government. More significant changes relate to the personal income tax, where degressive tax allowances were implemented. The basic tax allowance of tax payers with higher revenues (approximately upper 6% of taxpayers according to the wage distribution) will start decreasing according to the set formula, whereby the progressivity of their taxation will increase when compared with the previous status. At the same time, the flat income tax of 19% will remain unchanged. The second significant change was the possibility to transfer 2% of corporate income tax to the third sector dropped to 0.5% in 2007 and 2008; then this possibility is about to be fully abolished since it has a non-system character.

Quantification of tax proposal effects on general government revenues (ESA95, mil. SKK)			
	2007	2008	2009
1. 10% VAT on medicines	-2,799	-2,968	-3,155
2. PIT – degressive tax allowance	160	1,125	1,199
3. PIT – decrease of lump expenditures for self-employed from 60% to 40%	13	13	14
4. CIT – abolition of the possibility to transfer 2% of income tax to the 3 <sup>rd</sup> sector	629	698	1,021
5. CIT – abolition of the exception of SKK 300, 000 for non-profit organizations	222	222	222
6. PIT – implementation of taxation of yields from mutual funds	215	205	158
<b>OVERALL IMPACT ON GG</b>	<b>-1,560</b>	<b>-705</b>	<b>-542</b>
of which municipalities and higher territorial units	0	1,064	1,133

Source:: Ministry of Finance of the Slovak Republic

Besides the above-mentioned changes that relate to the change of the Government, also other adjustments are assumed. An increase in excise tax on tobacco products in accordance with the approved schedule in order to achieve a minimum tax burden on cigarettes required in the EU by 2009 is the most important adjustment. An increase in excise tax rate is expected at the beginning of 2008 and 2009. Besides that, the budget expects a loss in excise tax revenues concerning mineral oil at the annual level of approximately SKK 1.0 bn due to tax allowance for the alternative resources of motor fuels (biofuels). It is a consequence of implementation of the directive 2003/30/EC on the promotion of the use of biofuels or other renewable fuels for transport.

Social contributions paid by the state on behalf of legally defined groups of persons into Health Insurance Companies are increased by 1 percentage point. However, the change covers only the first four months in the year 2007 so far. This measure provides room for examination of the possibilities of financing and increasing the effectiveness in the health care sector and consequently utilisation of this measure in the future will be reevaluated.

When evaluating the pace of consolidation, it should be taken into consideration that tax revenues to GDP will be relatively stable in the period 2006-2009 (drop by 0.2% of GDP), however social contributions will decrease more significantly, by 0.6% of GDP, and the biggest drop will be recorded in the field of non-tax revenues that will drop by as much as





1.1% of GDP. The drop of social contributions is higher than the drop of tax revenues due to conservative approach of the Social Insurance Agency to estimates of its revenues, that means a positive risk for the public finance from the point of view of the MF SR. Non-tax revenues decrease especially due to nominal drop of the expected income from dividends of the state-owned enterprises. The drop of capital revenues including income from the sale of the state property is another factor. More and more important role within the general government is played by the funds from the EU that will increase by 0.8% of GDP in the same period. However, it does not create space for deficit reduction since on expenditures side mostly capital transfers will increase by at least the same amount.

### V.3. Expenditure Development

The new Government has determined three basic priorities in the areas of expenditures for the following period, which include health care, education and agriculture.

Increasing the effectiveness remains the top priority in the field of health care, however, at present there is a predominant view saying that this area is financially starving. Therefore, the health care area is getting more resources in 2007 than under baseline scenario with no policy change by more than SKK 4.4 bn. The above-mentioned decrease in the VAT rate brought approximately SKK 2.3 bn to the resources and the increase in health care contributions on behalf of the group of persons defined by the law by 1 percentage point will bring another SKK 2.1 bn. So the priorities in the field of health care will be financed through changes in taxes and health care contributions.

The level of teachers' wages is the Government's priority in the field of education. The main objective within this field is to increase wages in the primary and secondary schools to the level close to the average wage in the Slovak economy. Higher wage expenditures are also assumed in the budget for universities (increase by 8%). These measures demonstrate the Government's efforts to make the work in the field of education more attractive and thus to attract young pedagogic employees to this sector.

Agriculture is one of the priorities of the new Government that was demonstrated by an increase in the expected subsidies in this sector. According to the general government budget for 2007 to 2009, the direct payments in 2007 will achieve 70% of the EU average (in 2006 it was 54%).

Expenditures for wages and goods that will both drop in the 2006-2009 by 0.6% GDP will significantly contribute to consolidation in the area of expenditures. The Government is preparing to decrease the number of civil servants by up to 20% from the overall number of employees. This decrease should happen especially during the year 2007, while savings in the budget should be more notable in 2008 since severance payments have to be paid to the people made redundant. The biggest consolidation of expenditures is expected to take place in the field of subsidies and transfers, where a drop of 1.3% of GDP is expected in the year 2009 when compared with the year 2006. Interest payments on public debt remain unchanged as a share of GDP in this period.



General government revenue and expenditure balance in years 2002-2009 (ESA 95, % GDP)							
	2002	2006B	2006E	2007B	2008B	2009B	2009B-2006E
<b>REVENUE TOTAL</b>	<b>38.0</b>	<b>36.9</b>	<b>35.4</b>	<b>34.5</b>	<b>33.9</b>	<b>33.9</b>	<b>-1.5</b>
<b>Tax revenues</b>	<b>18.8</b>	<b>17.6</b>	<b>17.1</b>	<b>17.0</b>	<b>16.9</b>	<b>16.9</b>	<b>-0.2</b>
Personal income tax	3.4	2.6	2.5	2.6	2.7	2.8	0.3
from dependent activity	2.9	2.3	2.2	2.3	2.4	2.5	0.3
from self-employment	0.5	0.3	0.4	0.4	0.4	0.4	0.0
Corporate income tax	2.6	2.5	2.7	2.8	2.8	2.9	0.2
Withholding income tax	0.8	0.3	0.3	0.2	0.2	0.2	0.0
Property taxes	0.5	0.4	0.4	0.4	0.3	0.3	-0.1
Value added tax	7.5	7.9	7.7	7.4	7.3	7.3	-0.5
Excise taxes	3.1	3.3	3.0	3.2	3.1	2.9	-0.1
Road tax	0.2	0.2	0.2	0.2	0.2	0.1	0.0
Taxes from international trade and transactions	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on specific services (municipalities)	0.3	0.3	0.2	0.2	0.2	0.2	0.0
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Social contributions</b>	<b>14.2</b>	<b>13.2</b>	<b>12.6</b>	<b>12.3</b>	<b>12.0</b>	<b>12.0</b>	<b>-0.6</b>
Social Insurance Agency	8.3	8.3	7.8	7.6	7.5	7.4	-0.4
Health Insurance companies	5.0	4.9	4.8	4.7	4.5	4.5	-0.2
National Labour Office	0.9	0.0	0.0	0.0	0.0	0.0	0.0
<b>Non-tax revenues</b>	<b>4.7</b>	<b>3.9</b>	<b>3.9</b>	<b>3.5</b>	<b>3.0</b>	<b>2.8</b>	<b>-1.1</b>
of which interests	0.7	0.3	0.4	0.4	0.4	0.3	-0.1
<b>Grants and transfers</b>	<b>0.2</b>	<b>2.3</b>	<b>1.7</b>	<b>1.8</b>	<b>2.0</b>	<b>2.2</b>	<b>0.5</b>
of which from the EU	0.0	2.2	1.7	1.8	1.9	2.2	0.5
<b>TOTAL EXPENDITURE</b>	<b>45.7</b>	<b>39.8</b>	<b>37.9</b>	<b>36.3</b>	<b>35.2</b>	<b>34.6</b>	<b>-3.3</b>
<b>Current expenditures</b>	<b>38.1</b>	<b>35.6</b>	<b>34.0</b>	<b>33.2</b>	<b>32.1</b>	<b>31.4</b>	<b>-2.5</b>
<b>Compensation of employees</b>	<b>7.4</b>	<b>7.2</b>	<b>6.9</b>	<b>6.6</b>	<b>6.4</b>	<b>6.3</b>	<b>-0.6</b>
-Wages and salaries	5.5	5.3	5.1	4.8	4.7	4.7	-0.4
-Employers' social contributions	1.9	1.8	1.7	1.7	1.6	1.6	-0.1
<b>Goods and other services</b>	<b>5.0</b>	<b>5.4</b>	<b>5.1</b>	<b>4.9</b>	<b>4.8</b>	<b>4.5</b>	<b>-0.6</b>
- Use of the EU funds	0.0	0.1	0.1	0.1	0.1	0.1	0.0
- Other	5.0	5.3	5.1	4.8	4.7	4.4	-0.6
<b>Grants and transfers</b>	<b>22.0</b>	<b>21.1</b>	<b>20.2</b>	<b>19.8</b>	<b>19.1</b>	<b>18.9</b>	<b>-1.4</b>
- Agricultural subsidies	0.7	1.0	0.9	1.0	1.0	1.1	0.2
- Transport subsidies	0.4	0.7	0.7	0.6	0.6	0.6	-0.1
- Support for housing	0.3	0.3	0.2	0.1	0.1	0.1	-0.1
- Active labour market policies	0.3	0.3	0.3	0.3	0.3	0.3	0.0
- Health care	4.8	4.7	4.5	4.4	4.3	4.3	-0.2
- Sickness benefits	0.8	0.3	0.3	0.3	0.3	0.3	0.0
- Old-age and disability pensions	7.2	7.3	7.1	7.0	6.8	6.7	-0.4
- Unemployment benefits	0.4	0.2	0.2	0.1	0.1	0.1	0.0
- State social benefits and aid	3.0	2.1	2.1	1.8	1.7	1.6	-0.5
- Social contributions on behalf of certain groups	2.2	1.8	1.8	1.9	1.7	1.7	-0.1
- Transfers to the EU budget	0.0	0.9	0.8	0.9	0.9	0.8	0.0
- Transfer of 2% of income tax to the third sector	0.0	0.1	0.1	0.0	0.0	0.0	0.0
- Other	1.9	1.4	1.3	1.2	1.1	1.1	-0.2
<b>Interest repayments</b>	<b>3.7</b>	<b>1.9</b>	<b>1.8</b>	<b>2.0</b>	<b>1.9</b>	<b>1.8</b>	<b>0.0</b>
<b>Capital expenditures</b>	<b>7.5</b>	<b>4.1</b>	<b>3.9</b>	<b>3.2</b>	<b>3.1</b>	<b>3.2</b>	<b>-0.7</b>
Capital asset acquisition	3.1	2.0	2.0	1.6	1.4	1.3	-0.7
Capital transfers*	4.4	2.2	1.9	1.6	1.7	1.9	0.0
<b>General government balance*</b>	<b>-7.7</b>	<b>-2.9</b>	<b>-2.5</b>	<b>-1.8</b>	<b>-1.3</b>	<b>-0.7</b>	<b>1.8</b>
Impact of the 2 <sup>nd</sup> pillar	0.0	-1.3	-1.1	-1.1	-1.2	-1.2	-0.1
<b>GG balance incl. of impact of the 2<sup>nd</sup> pillar</b>	<b>-7.7</b>	<b>-4.2</b>	<b>-3.7</b>	<b>-2.9</b>	<b>-2.4</b>	<b>-1.9</b>	<b>1.7</b>

\* inclusive of remitted receivables from foreign countries in the amount of 2.1% of GDP in 2002

Source:: Ministry of Finance of the SR

\*\* expenditure sub-items for the years 2008 and 2009 are only indicative since the individual budget chapters provide only the budgets of the main expenditure items



According to the general government budget for the years 2007 to 2009, the level of capital expenditures will slightly exceed 3% of GDP. Increased drawing of resources from structural funds and the Cohesion Fund of the EU for projects in the field of infrastructure and environment is expected. However, the actual amount of drawing can be very different because it depends on the ability of funds utilization. The expected reality of the year 2006 is an example of such development. Expenditures for capital assets will decrease, however construction of highways will not stagnate since its construction is provided by Národná diaľničná spoločnosť (NDS; National Highway Organization) that has been outside the general government sector since 2005. Direct state subsidies from the past will be replaced by loans of NDS and its own income from sale of highway stamps.

Improvement of the public finance quality is possible only under the assumption that individual objectives and strategies on the side of the revenues and expenditures of the general government budget will be mutually harmonized and consistent. Three strategic documents in particular should be interconnected within the institutional side of the public finance quality. This section includes interconnection of the Convergence Programme with the National Strategic Reference Framework, the following subchapter informs about interconnection with the National Reform Programme.

The National Strategic Reference Framework (NSRF) for the years 2007-2013 is a central integrating strategic document that defines and interconnects the relevant items of individual autonomous but coherent strategies of EU, country, sectors and regions through financing from the structural funds and from the Cohesion Fund including the co-financing resources with the aim to achieve the biggest possible synergy and effectiveness during fulfilment of the vision and achievement of the NSRF strategic objective by 2013.

The NSRF strategy is based on three strategic priorities and their three objectives that will be endeavoured to be met by the NSRF through financing the projects in the 2007 - 2013 programme period.

Strategic priority	Objective of strategic priority
1. Infrastructure and regional availability	Increase in the infrastructure density in regions and increase in effectiveness of the related public services
2. Innovations, informatization and knowledge economy	Development of resources of permanently sustainable economic growth and increase in competitiveness of industry and services
3. Human resources and education	Increase in employment, growth of labour force quality for the needs of knowledge economy and increase in social inclusion of risk groups

In 8 October 2006 the Government of the SR decided about allocation of EUR 11.3 bn according to the NSRF SR 2007 - 2013 (in current prices) among individual operation programmes:



Operation programme (OP)	Fund	EU contribution. (in EUR)	OP share of the overall allocation (in %)
OP of the Bratislava Region	ERDF	82,000,000	0.7
Transport OP	ERDF +CF	3,206,904,595	28.2
OP of competitiveness and economic growth	ERDF	772,000,000	6.8
OP of technical aid	ERDF	97,601,421	0.9
OP of research and development	ERDF	1,214,415,373	10.7
OP of education <sup>32</sup>	ESF	617,801,578	5.4
OP of employment and social inclusion <sup>33</sup>	ESF	881,801,578	7.8
OP of health care	ERDF	250,000,000	2.2
Environmental OP	ERDF +CF	1,800,000,000	15.8
OP of informatization of society	ERDF	993,095,405	8.7
Regional OP	ERDF	1,445,000,000	12.7
<b>Total all funds in NSRF 2007-2013</b>		<b>11,360,619,950</b>	<b>100</b>

#### V.4. Interconnection of the Convergence Programme with the National Reform Programme

Adequate interconnection between fiscal objectives and the Lisbon Strategy objectives is an important aspect of quality of the public finance. From the budget perspective, it is important that the structural policies and reforms would respect the fiscal objectives of the Government that determine the financial framework for these policies. On the level of political objectives and commitments of the Government it includes coordination and interconnection of the Convergence Programme and Implementation Strategy of the National Reform Programme. The objective of this section is to provide for the first time in the history of this document interconnection between the National Reform Programme of the SR and the Convergence Programme in connection with the revised Stability and Growth Pact and the Lisbon Strategy.

Priorities of the National Reform Programme of the SR are set in two key fields, the objective of which is to contribute to high and sustainable growth of economy in the long run:

1. Policies to promote employment
2. Microeconomic policies

Policies to promote employment endeavours to focus on the most important problems in the Slovak labour market, such as long-term unemployment, support of disadvantaged groups and regional disparities. Significant attention is paid to education, where the main objective constitutes transformation of the content of education and its harmonization with the labour market requirements.

Microeconomic policies are oriented around the field of science, research and innovations, improvement of the entrepreneurship environment and the formation of an information

<sup>32</sup> OP is common for both objectives Convergence and Regional competitiveness and employment

<sup>33</sup> OP is common for both objectives Convergence and Regional competitiveness and employment



society. The field of science, research and innovations is supported by the specialised state agency and state programmes. At the same time, innovations and support of the small and medium-sized entrepreneurship are interconnected through established technological incubators and through higher offer of the venture capital. Equally important task is played by the measures aimed at the increase in quality of the regulation environment that help developing the entrepreneurship environment. The formation of information society is aimed at the creation of e-government services, which would make the activities inside the general government as well as the activities towards the public more effective. The increase of Internet penetration among the citizens is another priority.

The implementation of the above-mentioned objectives will be based primarily on public resources and resources received from the EU, in addition to the private sector resources. The process of the general government budget drawing up is based on priorities and fiscal frameworks. The budget resources are allocated at first to the priorities, that logically cause a decrease in expenditures in other fields. An important prerequisite is that implementation of the National Reform Programme must be in accordance with the medium-term plan of the fiscal consolidation in order to achieve a long-term sustainability of public finance.

Preparation of the implementation table adjusted for the purposes of the Convergence Programme was based on the Report on Implementation Progress of the National Reform Programme of the SR of October 2006. For the sake of completion it should be said that in spite of the existing political will of the new Government it was not possible to include here the priorities concerning the whole programme period (2006-2008). The table includes only objectives set up and partially implemented by 31 August 2006. Furthermore, only the measures having the influence on the general government budget quantified in the given document were included. At present, an supplement to the original Report is being drawn up and this supplement should overcome the shortcomings of the first implementation report.

<b>Budgeted expenditures connected with priorities (% of GDP)</b>			
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Science, research and innovations	0.16		
Information society	0.04		
Education and employment	0.22	0.05	0.04
<b>Total</b>	<b>0.43</b>	<b>0.05</b>	<b>0.04</b>

*Source:: Ministry of Finance of the SR*

In absolute numbers, the priorities in the field of education and employment were allocated SKK 3.6 bn in 2006, the priorities in the field of science, research and innovations were allocated SKK 2.7 bn and formation of information society was allocated SKK 0.7 bn according to the available data. The fourth priority not mentioned in the table constitutes support of entrepreneurship environment, in which especially legislative changes and measures were implemented or are planned to be implemented and it is not possible to quantify their direct costs (for example performance of audit of barriers in entrepreneurship). The table 9 in the annex to the Programme includes more detailed classification of resources for individual Lisbon Strategy priorities.



## VI. SUSTAINABILITY OF PUBLIC FINANCE

*Slovakia is on its way to successful completion of medium-term consolidation objectives. Conditions for sound economic development and for accession to the Eurozone will be created in the forthcoming period, that was not a commonplace at the beginning of this millennium. However, these are not the only fiscal challenges. The previous sections implied that future focus of fiscal policy in Slovakia lies in qualitative aspect of the public finance. However, the need of fiscal consolidation will not vanish in the near future, it will only acquire a new dimension. Expected negative demographic development makes the responsible governments think far ahead in their fiscal policies. Present positive development of public finance does not necessarily mean a positive development in 30-50 years, when the expenditures of population ageing will culminate. However the Slovak Government is aware of these costs and long-term sustainability of public finance have become the main objective of the fiscal policy since the first Convergence Programme. This section describes the expected impact of the population ageing on the budgets until 2050, specific medium-term objective for 2010 assuring long-term sustainability of the public finance and fiscal policy strategy that should lead to fulfilment of this objective.*

Sustainability of the public finance was described for the first time in the Convergence Programme of May 2004. Since then, the aspect of long-term sustainability is also present in other important government documents, especially in the general government budget. Draft general government budget for the years 2005-2007 included a separate Annex defining the long-term sustainability of the general government as the basic fiscal policy objective. Discussion concerning sustainability of public finance and measures necessary to be taken in order to achieve it became known to the professional public and it has become a standard framework of political decision-making process.

### VI.1. Policy Strategy

Long-term sustainability of public finance has both, economic and moral aspect. From the economic perspective, sound public finance is a prerequisite of high and sustainable economic growth. Moral aspect is based on assurance of intergenerational fairness. Public resources are distributed by means of general government budget to individual groups of citizens (solidarity) as well as to individual generations. Policy of high deficits and debt automatically goes at the expense of the future generations, most often leads to necessary increase in taxes in the future.

**The main objective of fiscal policy in the field of public finance is to decrease the cyclically adjusted deficit of the general government adjusted for one-off effects to 0.9% of GDP by 2010.** This objective falls within the deficit range recommended by the European Commission as the medium-term objective for Slovakia within the frame of the revised Growth and Stability Pact. According to the analyses of the Ministry of Finance of the Slovak Republic, if the necessary measures are taken, conditions for achievement of the long-term sustainability of public finance will be created. The necessary measures include parametric changes within the pension scheme, additional consolidation effort in 2010 on the level of 1.0% of GDP and such policy set-ups that would assure increase in public expenditure in accordance with the growth of economy in the future. The strategy is described in detail in the section III.1.



Long-term sustainability of public finance can be defined in various ways, most often it is referred to as fulfilment of the condition of intertemporal budget constraint. From the perspective of political objectives it is more suitable to transfer this definition into a more specific and measurable form. Already in the first Convergence Programme, the Ministry of Finance of the SR has defined the long-term sustainability as an ability to maintain the deficit and debt levels within the basic rules of the Stability and Growth Pact. It means that the **deficit of general government should not exceed 3% of GDP and public debt should not exceed 60% of GDP by 2080.**

The defined objective brings several advantages for Slovakia. The year 2080 per se, has three advantages. Firstly, the time horizon is long enough and specific enough at the same time. Theoretic definition of the intertemporal constraint states an infinite time horizon, what is somewhat abstract term from the perspective of political graspability. Secondly, long-term fiscal analyses of the MF SR work with this time horizon and with relevant assumptions, especially demographic forecasts. Thirdly, this period is longer than the long-term horizon (year 2050), that is taken into consideration by the European Commission when evaluating sustainability of the public finance. Year 2050 is generally considered to be the year when the fiscal problem concerning the EU population ageing will culminate. However, according to the analyses of the MF SR, this critical period will come at about 2060 in Slovakia.

Deficit of 3% of GDP has also several advantages. Firstly, it is the basic rule of both, the 'old' and the revised Stability and Growth Pact, it is a convergence criterion for entry to the Eurozone. Slovakia plans to meet this limit in the following year and therefore this objective is very current at present. This objective respects the main medium-term objective of the Pact, i.e. status close to the balanced budget and, at the same time, it creates a space for absorption of possible negative shocks by the budget (economic stagnation, natural disasters).

Last but not least, the public debt of 60% of GDP has also its advantages. Firstly, similarly as in the case of deficit, this number plays an important role within the EU fiscal rules. Secondly, this objective reasonably distributes the costs of population ageing in Slovakia among the present and the future generation, what is an important step from the perspective of intergeneration fairness. The general government debt is expected at a level of approximately 30% of GDP in 2009. Present generation bears the costs of economic transformation, it is confronted with the requirement of strong fiscal consolidation and, at the same time, with requirement of higher investments that will assure prosperity of future generations in particular. Therefore it is natural and fair at the same time to distribute the future costs of population ageing to the present and the future generations. This is enabled by the possibility to increase the general government debt up to a level of 60% of GDP, while no obstacle to sound economic growth of all generations is created.

## VI.2. Long-term Budget Perspectives with regard to Population Ageing

Population ageing is a global phenomenon now affecting mostly developed industrial economies, Slovakia not being an exception. EU has paid exceptional attention to this issue during recent years. A special working group for population ageing was established (AWG –



Ageing Working Group) with the objective to analyse the expenditure sensitive to demographic development and its impact on development of the whole public finance. In 2003, the Group was invited to make new projections for all member countries that will be based on common assumptions and on the same calculation method. The aim was to gather comparable information, as complete as possible, about risks resulting from the expected demographic changes. In February 2006, the new round of projections for all EU countries were approved and published for the wide public<sup>34</sup>.

In previous Convergence Programmes, Slovakia presented mostly its own forecasts of long-term development, although the forecasts were based on the results of the AWG work. This Programme is the first to change the approach; henceforth, Slovakia will present only the forecasts produced within the AWG. There are two advantages: firstly, it is a logical consequence of the previous praxis, even though it incorporated the AWG outputs in the maximum possible level, but as mentioned above, new projections were approved and published to the wide public only in 2006. Secondly, these forecasts were approved by the Slovak experts within the framework of the AWG. Long-term forecasts are necessarily affected by a high level of uncertainty and therefore it makes sense to present approved outputs and underlying assumptions.

This subchapter comprises two sections. The first section describes size of the problem that will have to be faced by the public finance in Slovakia in the future. The second section shows the sustainability indicators, i.e. the measures in the field of fiscal policy that will have to be taken in order to promote fiscal sustainability. Both sections state only the data agreed and approved within the AWG. The Ministry of Finance only adds the interpretation to such data.

#### *Long-term projection of revenues and expenditures sensitive to population ageing*

General government expenditures identified by the AWG can be influenced by demographic changes in a positive or negative way. The expenditures include pension benefits, health care, long-term care, education and unemployment benefits. The first three types of expenditures will rise in the future, on the contrary, expenditures for education and for the unemployed will drop (less children, decreasing unemployment rate and less people in the labour market).

Besides this, changes in pension system of some countries including Slovakia were taken into consideration. As regards to Slovakia, it includes loss of revenues of the general government after launching the fully-funded pillar of the pension scheme.

General government debt interests are the last item sensitive to population ageing. The above-mentioned factors affect the deficit growth and thus also the debt growth. Higher debt means higher interest costs of debt servicing.

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<sup>34</sup> Economic Policy Committee and European Commission-DG ECFIN (2006) 'The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Reports No 1, 2006, ('Ageing Report')





Change in revenues and expenditures of general government caused by demographic changes (% GDP)							
	2004	2010	2020	2030	2040	2050	Change 2004-2050
<b>A. Revenues shortfall (loss due to 2<sup>nd</sup> pillar)</b>	<b>0.0</b>	<b>-1.3</b>	<b>-1.5</b>	<b>-1.7</b>	<b>-1.7</b>	<b>-1.9</b>	<b>-1.9</b>
<b>B. Expenditures sensitive to population ageing</b>	<b>16.2</b>	<b>15.4</b>	<b>15.3</b>	<b>16.5</b>	<b>17.7</b>	<b>19.1</b>	<b>2.9</b>
- pension benefits	7.2	6.7	7.0	7.7	8.2	9.0	1.8
- health care	4.4	4.7	5.2	5.7	6.0	6.3	1.9
- long-term care	0.7	0.8	0.7	0.9	1.1	1.3	0.6
- education system	3.7	3.0	2.2	2.2	2.3	2.4	-1.3
- unemployment benefits	0.3	0.2	0.1	0.1	0.1	0.1	-0.2
<b>C. Interest expenditures</b>	<b>2.2</b>	<b>1.5</b>	<b>1.4</b>	<b>2.0</b>	<b>3.7</b>	<b>6.7</b>	<b>4.5</b>
<b>Impact on general government balance</b>							<b>-9.3</b>
<i>p.m. gross debt</i>	<i>41.6</i>	<i>30.8</i>	<i>28.5</i>	<i>39.9</i>	<i>73.0</i>	<i>134.5</i>	<i>92.9</i>

\*Current legislation status: retirement age: 62 years of age, indexation: 50:50 (wages, inflation), 2<sup>nd</sup> pillar implemented

Source: Ageing report (February 2006), MF SR

**If no remedial measures are taken, the negative demographic development would increase the general government deficit by huge 9.3% of GDP by 2050 and public debt would increase to 134.5% of GDP.** These calculations are based on the initial situation in the year 2004. There are no newer calculations officially available. AWG produces update of long-term projections regularly, every three years, for all the EU countries. Meanwhile, a country can ask for more current estimations, however it must inform the AWG by means of its Convergence Programme about the adopted legislation changes or other adjustments that should change the estimates; otherwise it would not be reasonable to draw up the estimates. The above-mentioned calculations take into consideration all the important measures taken in Slovakia in this field: implementation of the fully-funded pillar, increase of the retirement age, valorisation of pensions by the Swiss method, etc. In this regard, the calculations are up-to-date.

Two basic implications result from these figures for the fiscal policy. The first one relates to the fact, although surprising at first sight, that the biggest negative impact would have the interest payments on public debt. This illustrates the importance of making use of every opportunity for reduction of the general government debt. In Slovakia, it includes mostly higher-than-anticipated tax revenues and privatisation revenues. The second implication relates to the fully-funded pillar of the pension scheme. Its implementation decreased the revenues (both, immediate and the future ones) however, it also decreased future old pension expenditures due to the reduction of pension entitlements. In other words, if the fully-funded pillar was not implemented, the public finance would have to face a deficit higher by 11.7% of GDP, not as shown by 9.3% of GDP in 2050.

#### *Evaluation of long-term sustainability*

The focus of evaluation of the public finance long-term sustainability is to prove mutual consistency of the short-term (or medium-term) fiscal objectives with the long-term objectives. The EU evaluation process is based on indicators of sustainability. The evaluation does not end by consideration whether the public finance is sustainable or not, but through specific indicators it quantifies the size of the measures that should be taken in the following period in order to ensure sustainability.



The European Commission uses the following quantitative indicators<sup>35</sup>:

1. *S1 indicator* - represents a value by which the primary balance should change (through increased taxes or decreased 'non-interest' expenditures) in order to ensure that the general government debt would be 60% of GDP in 2050.
2. *S2 indicator* - expresses the value, by which the primary balance should be changed (similarly as in case of S1) in order to make the current level of government's liabilities (current debt) and the discounted value of the future expenditures covered by discounted value of future revenues in an infinite time horizon. No specific year is determined and no specific debt level is set. However, the debt should be sustainable and it should not tend to 'explode' in the future. That is not assured within the S1 indicator, which only targets a certain debt value.
3. *RPB (Required Primary Balance)* - this indicator is a follow-up of S2 indicator since it just transforms the result into a different level. It describes what the average level of primary balance should be in the next five years in order to assure the long-term sustainability defined by the S2 indicator.
4. *Costs of delay (Costs of consolidation delay)* - express increase of S1 or S2 indicators in case the deficit reduction necessary to ensure long-term sustainability would be delayed by five years.

The starting point for calculation of indicators is the current situation of public finance. In this case, it is the latest known real figure of the deficit and the debt, which comes from the year 2005. Important parameters include the current levels of deficit and debt and future public expenditures sensitive to demographic development that develop in accordance with the above-mentioned AWG projection. It is important that the Commission takes into account only the current status of legislation (year 2005) that impacts the future growth of these expenditures. Planned changes and reforms are not taken into consideration in calculations. During the whole period, revenues and expenditures not relating to the demography are fixed at constant ratio to the GDP. It means that only the revenues and expenditures influenced by the population ageing affect the change of the deficit.

Quantitative indicators of long-term sustainability of public finance				
	Value	Initial fiscal position	Requirement for debt in 2050 (60% of GDP)	Change of the primary balance within a long-term horizon
<b>S1 indicator</b>	<b>1.3</b>	<b>0.7</b>	<b>-0.5</b>	<b>1.1</b>
Costs of delay	0.2			
RPB	-			
<b>S2 indicator S2</b>	<b>3.0</b>	<b>0.9</b>	<b>-</b>	<b>2.1</b>
Costs of delay	0.3			
RPB	2.9			

Source: Sustainability report, Ministry of Finance

Interpretation of indicators from the table will be as follows: If Slovakia wants to achieve the level of public debt of 60% of GDP in 2050, the Government should increase the taxes now

<sup>35</sup> European Commission-DG ECFIN (2006) 'Long-term sustainability of public finances in the European Union' European Economy, No 4, 2006, ('Sustainability Report')



(in 2006) or decrease the expenditures by 1.3% of GDP (S1 indicator). The required fiscal consolidation to the amount of 1.3% of GDP can be divided into three components. Consolidation in the amount of 0.7% of GDP is necessary due to the current high deficit. On the contrary, since the Slovak general government debt is relatively low at present, it should be possible to relax the fiscal policy (decrease taxes or increase expenditures) by 0.5% of GDP. The third factor constitutes demographic trends themselves, due to which it is necessary to make a consolidation by 1.1% of GDP already at present. If Slovakia hesitated with the required measures, in five years it would be necessary to increase the consolidation efforts by 0.2% of GDP to 1.5% of GDP in order to assure the same objective, i.e. the general government debt at a level of 60% of GDP in 2050. These are the fiscal costs of delay.

Interpretation of the S2 indicator is similar. Contrary to S1, the objective is not to achieve a specific value of debt in the respective year but to achieve overall sustainability. Under the given conditions it is not surprising that the need of consolidation is much bigger, and in 2005 it was at a level of 3.0% of GDP.

Contrary to long-term fiscal forecasts, these indicators are updated annually. Their principal message is that the main fiscal problem will arise in the relatively far future (in 40-50 years in Slovakia). However, politicians can importantly contribute to solving this problem nowadays. The need for consolidation would be much lower in the future, if Governments had already decreased the deficits and the debt at present. At the same time, the later the remedial measures will be taken, the more significant (fiscally expensive) they will have to be. The bigger the necessity of fiscal consolidation, the more negative impact on the living standard of people, since the consolidation in such case would especially mean repayment of old debts at the expense of the current development.



## VII. INSTITUTIONAL ASPECTS OF PUBLIC FINANCE

Effective fiscal rules, institutions and procedures on the national level can significantly influence the fiscal discipline and thus contribute to long-term sustainability of public finance. The last-year Convergence Programme of Slovakia included a separate chapter concerning national financial institutions for the first time. It described various institutional aspects of the budgetary process, such as fiscal rules, budget legislation, state guarantees, fiscal management of the subjects outside the general government but within the public finance and utilization of the privatisation revenues. No material changes occurred in these fields.

The existence of reliable and credible macroeconomic assumptions and tax forecasts is the basis of the high-quality budget process. The principles of objectivity and transparency are the key principles in this field. The objective of this chapter is to describe the process of drawing up the economic assumptions and tax forecasts for the needs of the budget.

The Committee on Macroeconomic Forecasts was established in 2004 and later, in 2005, the Tax Revenue Forecasts Committee was established under the patronage of the Institute of Financial Policy (IFP, analytical department of the MF SR responsible especially for economic and tax forecasts).

Operation of the Committees is governed by the formal Statute, members are appointed by the Minister. The Committees are not closed, professional credit and respecting of rules set by the Statute are the only conditions of accession of new members. The members include the IFP director for the MF SR, National Bank of Slovakia, Slovak Academy of Science, Infostat and analysts from the main commercial banks operating in the territory of Slovakia. Sessions usually take place three times a year following the basic procedures of the budget process. However, in case of unexpected events (for example macroeconomic shocks), extraordinary session can be called.

The first session in the year usually takes place before preparation of the first draft of general government budget (February), the following session takes place before finalizing the budget proposal (June) and the last session takes place before definite approval of the budget by the Government (October). The session of the Committee on Macroeconomic Forecasts is always followed by the session of the Tax Revenue Forecasts Committee after few days. This sequence results from the nature of tax forecasts which are based on macroeconomic data.

At the sessions, representatives of the Institute of Financial Policy present preliminary forecasts of obligatory and compulsory indicators set by the Statutes of individual Committees. At sessions of the Tax Revenue Forecasts Committee, tax revenues budgeted on the level of the state budget are presented. The Committee is not particularly interested in local taxes because these are budgeted on the level of municipalities and municipalities have the right to change tax rates.

Consequently, professional discussion among members of the Committees follows. With regard to the results of the discussions by the Committees, the macroeconomic and tax forecasts of the MF SR can be adjusted and finalized. The members of the Committees shall



then express their opinions about definite forecasts of the MF SR within a set number of days. Their opinions include the basic evaluation, whether the forecast is conservative, realistic or optimistic and concrete arguments supporting the opinion. The Statute sets an algorithm for evaluation of the tax forecasts deviation (deviation of 1% from the overall revenues) that directly determines the character of evaluation.

The creation of these Committees and the mechanism of forecasts evaluation contributed to the increase of transparency of the budgetary process. At the same time, possible doubts concerning intentional political overestimation or underestimation of taxes were eliminated. During the whole history of the Committees, no institution has ever evaluated the forecasts by the MF SR as optimistic.



## ANNEXES

### Annex 1 – Indicative Estimate up to 2010

Estimate up to 2010							
	Unit	2005	2006F	2007F	2008F	2009F	2010F
GDP, constant prices 2000	%	6.1	6.6	7.1	5.5	5.1	5.0
Final consumption of households	%	7.2	5.7	5.3	4.4	4.2	4.1
Final consumption of government	%	0.5	3.9	2.0	3.0	2.8	2.8
Gross fixed capital formation	%	13.8	8.2	6.0	5.0	5.0	5.5
Export of goods and services	%	13.5	17.6	14.2	8.5	7.3	6.9
Import of goods and services	%	15.5	15.2	11.2	7.3	6.4	6.3
Average annual inflation rate	%	2.7	4.5	3.1	2.0	2.4	2.4
Current account balance	% of GDP	-8.6	-6.9	-3.5	-2.8	-2.3	-1.9
Average number of employees (according to LFS methodology)	%	2.1	3.5	1.5	0.8	0.8	0.8
Average unemployment rate (according to LFS)	%	16.2	13.8	13.2	12.9	12.4	12.0
Average real monthly wage per employee	%	6.3	3.1	3.9	4.0	3.7	3.6
GG revenues (according to ESA 95)	% of GDP	36.0	34.2	33.4	32.7	32.7	32.7
GG expenditures (according to ESA 95)	% of GDP	39.2	37.9	36.3	35.2	34.6	33.6
GG balance (according to ESA 95)	% of GDP	-3.1	-3.7	-2.9	-2.4	-1.9	-0.9

Source: Ministry of Finance of the SR

### Annex 2 – Committee on Macroeconomic Forecasts

Aiming at enhancing the transparency and objectiveness of macroeconomic forecasts, the MF SR again addressed members of the Committee on Macroeconomic Forecasts. Committee updated the forecasts of individual member institutions and reviewed the MF SR forecasts in September 2006. The medium-term forecast of the MF SR was perceived by a majority of Committee members as realistic:

Evaluation of the MF SR forecast in the Committee on Macroeconomic Forecasts	
Member of the Committee on Macroeconomic Forecasts	Characteristic of forecast
NBS (National Bank of Slovakia)	realistic
VÚB Bank	realistic
Infostat	prevailingly realistic
ING Bank	realistic
Tatrabanka	realistic
SLSP	realistic
SAV	realistic 56%, conservative 24%, optimistic 20%

Source: Committee on Macroeconomic Forecasts



Average forecasts of selected indicators of the SR economy development prepared by members of the Committee on Macroeconomic Forecasts (ex MF SR) and forecasts of MF SR										
No.	Indicator	Unit	Current year		Forecast					
			2006		2007		2008		2009	
			Com mittee	MF SR	Com mittee	MF SR	Com mittee	MF SR	Com mittee	MF SR
1	GDP; in current prices	SKK billion	1,618.0	1,623.8	1,770.7	1,787.7	1,906.7	1,912.0	2,050.5	2,042.5
2	GDP; real growth	%	6.6	6.6	7.0	7.1	5.6	5.5	5.3	5.1
3	Final consumption of households; real growth	%	6.0	5.7	5.7	5.3	5.1	4.4	4.9	4.2
4	Final consumption of households; nominal growth	%	10.8	10.8	8.6	8.2	7.4	6.6	7.6	6.7
5	Average monthly wage (nominal growth)	%	8.0	7.8	7.2	7.1	6.2	6.0	6.4	6.2
6	Average monthly wage (real growth)	%	3.3	3.1	3.9	3.9	3.8	4.0	3.8	3.7
7	Average growth of employment, according to LFS	%	3.4	3.5	1.8	1.5	1.1	0.8	0.8	0.8
8	Average growth of employment, according to the number of registered	%	2.4	2.1	1.6	1.5	1.0	0.8	0.8	0.8
9	Average rate of unemployment, according to LFS	%	14.0	13.8	13.2	13.2	12.7	12.9	12.2	12.4
10	Consumer price index (average growth)	%	4.5	4.5	2.9	3.1	2.4	2.0	2.6	2.4
11	Producer price index (average growth)	%	8.0	8.8	3.4	3.2	2.6	2.4	2.6	2.0
12	Current account balance(share in GDP)	%	-6.8	-6.9	-4.5	-3.5	-2.9	-2.8	-1.9	-2.3
13	Final consumption of government (real growth)	%	4.5	3.9	3.3	2.0	2.5	3.0	2.4	2.8
14	Gross fixed capital formation (real growth)	%	9.2	8.2	7.1	6.0	6.9	5.0	5.5	5.0
15	Exports of goods and services (real growth)	%	16.7	17.6	14.7	14.2	10.5	8.5	8.4	7.3
16	Imports of goods and services (real growth)	%	15.2	15.2	12.6	11.2	9.6	7.3	7.5	6.4

\* year 2009 – Committee ex NBS

Source: Committee on Macroeconomic Forecasts

### Annex 3 - Tax Revenue Forecasts Committee

One year after the establishment of the Macroeconomic Forecasting Committee, also the Tax Revenue Forecasts Committee was founded. This step significantly contributed to enhancement of transparency in the compilation of general government revenue. During a Committee session in October 2006, Committee members expressed their opinions in respect of the medium-term tax revenue development forecast, and evaluated it as realistic.

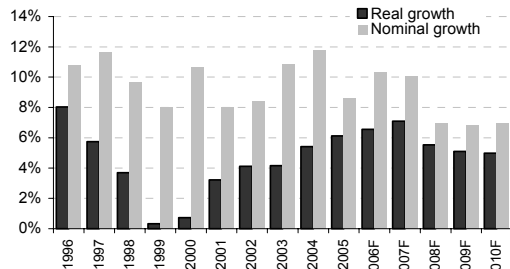
Evaluation of MF SR Forecast in Tax Revenue Forecasts Committee	
Member of the Tax Revenue Forecasts Committee	Characteristic of forecast
NBS (National Bank of Slovakia)	realistic
Infostat	realistic
ING Bank	realistic
Tatra banka	realistic
ČSOB	realistic
SLSP	realistic

Source: Tax Revenue Forecasts Committee



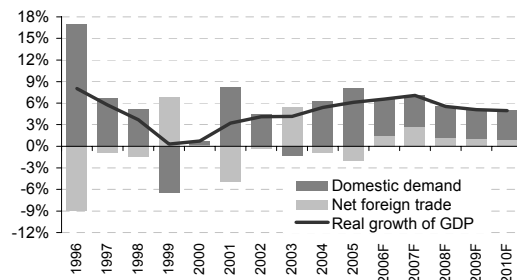
## Annex 4 - Graphs

### Growth of gross domestic product in %



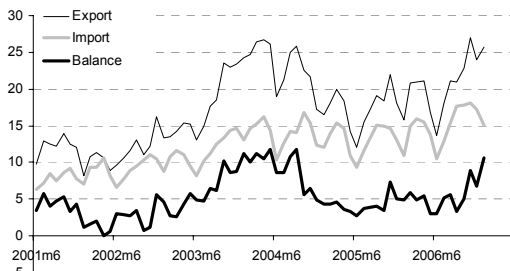
Source: Statistical Office of the SR, Ministry of Finance of the SR

### Contributions to growth of GDP in p.p.



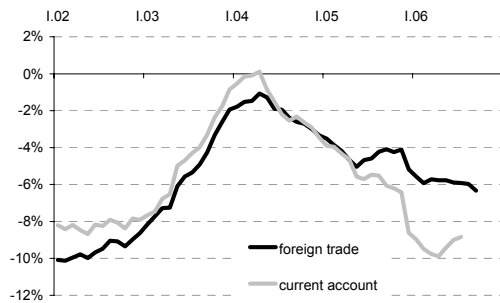
Source: Statistical Office of the SR, Ministry of Finance of the SR

### Export, import and balance of motor vehicles and their parts and accessories (billion SKK)



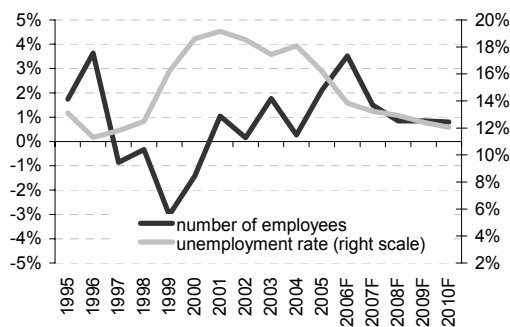
Source: Statistical Office of the SR, Ministry of Finance of the SR

### Trade balance and current account balance – 12-month cumulative balance (% of GDP)



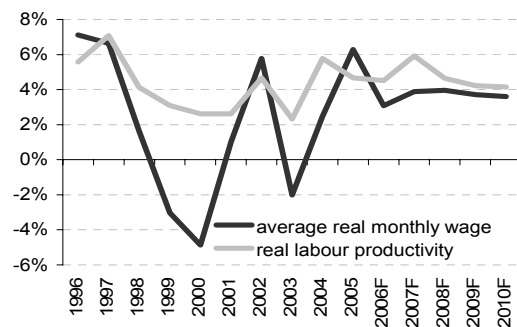
Source: Statistical Office of the SR, Ministry of Finance of the SR

### Economic activity according to LFS



Source: Statistical Office of the SR, Ministry of Finance of the SR

### Real wage and labour productivity



Source: Statistical Office of the SR, Ministry of Finance of the SR





## Annex 5 – Required Tables

Table 1a: Macroeconomic overview								
	ESA code	2005 Actual	2005 growth rate	2006 growth rate	2007 growth rate	2008 growth rate	2009 growth rate	2010 growth rate
1. Real GDP	B1*g	1,178.8	6.1	6.6	7.1	5.5	5.1	5.0
2. Nominal GDP	B1*g	1,472.1	8.6	10.3	10.1	7.0	6.8	6.9
Components of real GDP								
3. Private consumption expenditure	P.3	658.5	7.0	5.6	5.3	4.4	4.2	4.1
4. Government consumption expenditure	P.3	221.3	0.5	3.9	2.0	3.0	2.8	2.8
5. Gross fixed capital formation	P.51	320.2	13.8	8.2	6.0	5.0	5.0	5.5
6. Change in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	28.6	2.4	1.6	0.7	0.7	0.6	0.6
7. Exports of goods and services	P.6	1,049.8	13.5	17.6	14.2	8.5	7.3	6.9
8. Imports of goods and services	P.7	1,099.5	15.5	15.2	11.2	7.3	6.4	6.3
Contributions to real growth of GDP								
9. Final domestic demand		-	7.5	6.1	4.9	4.3	4.1	4.1
10. Change in inventories and net acquisition of valuables	P.52 + P.53	-	0.7	-0.8	-0.8	0.0	-0.1	0.0
11. External balance of goods and services	B.11	-	-2.0	1.5	2.7	1.2	1.1	0.8

Source: Statistical Office of the SR, Ministry of Finance of the SR

Table 1b: Price developments (ESA95)								
	ESA code	2005 Actual	2005 growth rate	2006 growth rate	2007 growth rate	2008 growth rate	2009 growth rate	2010 growth rate
1. GDP deflator		1.249	2.4	3.5	2.8	1.3	1.6	1.9
2. Private consumption deflator		1.282	2.6	4.9	2.8	2.0	2.4	2.4
3. HICP		-	2.8	4.4	3.1	2.0	2.4	2.4
4. Public consumption deflator		1.244	1.1	5.1	2.6	1.8	2.2	2.3
5. Investment deflator		1.195	2.8	2.1	1.9	1.6	1.8	1.9
6. Export price deflator (goods and services)		1.080	-1.9	3.2	1.1	0.2	0.4	1.0
7. Import price deflator (goods and services)		1.091	-1.6	3.9	0.5	0.6	0.9	1.3

Source: Ministry of Finance of the SR

Table 1c: Labour market developments (ESA95)								
	ESA code	2005 Actual	2005 growth rate	2006 growth rate	2007 growth rate	2008 growth rate	2009 growth rate	2010 growth rate
1. Employment, persons		2,084	1.4	2.0	1.5	0.8	0.8	0.8
2. Employment, hours worked (1000 hours)		3,623,800	1.6	0.3	3.3	1.4	1.4	1.8
3. Unemployment rate (%)		16.3	-1.8	-2.5	-0.6	-0.3	-0.5	-0.4
4. Labour productivity, persons		-	4.7	4.5	5.5	4.6	4.2	4.1
5. Labour productivity, hours worked		-	4.5	6.2	3.7	4.1	3.6	3.1
6. Compensation of employees (SKK million)	D.1	550,739	6.6	10.3	8.7	6.9	7.1	7.2

Source: Statistical Office of the SR, Ministry of Finance of the SR



**Table 1d: Sector balance (ESA95, % of GDP)**

	ESA code	Year	Year	Year	Year	Year	Year
		2005	2006	2007	2008	2009	2010
1. Net loans granted / received from the rest of the world	B.9	-8.6	-6.4	-3.1	-2.5	-2.0	-1.6
of which:							
- Goods and services		-4.5	-3.7	-0.8	-0.3	0.1	0.3
- Primary receipts and transfers		-4.1	-3.2	-2.7	-2.5	-2.4	-2.2
- Capital account		0.0	0.5	0.4	0.3	0.3	0.3
2. Net loans granted / received from the private sector	B.9	-5.5	-2.7	-0.2	-0.1	-0.1	
3. Net borrowing / net lending - general government	EDP B.9	-3.1	-3.7	-2.9	-2.4	-1.9	
4. Statistical difference							

Source: Statistical Office of the SR, Ministry of Finance of the SR

**Table 2: Development of general government budget**

	ESA code	2005	2005	2006	2007	2008	2009
		mil. SKK	GDP %	GDP %	GDP %	GDP %	GDP %
<b>Net loans (EDP B9) of general government sub-sectors</b>							
1. General government	S.13	-45,995	-3.1	-3.7	-2.9	-2.4	-1.9
2. Central government	S.1311	-34,188	-2.3	-3.6	-2.8	-2.3	-2.0
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-987	-0.1	-0.1	-0.1	0.0	0.0
5. Social security funds	S.1314	-10,820	-0.7	0.0	-0.1	-0.1	0.1
<b>General government (S13)</b>							
6. Revenue total	TR	499,271	33.9	32.6	31.7	31.2	31.1
7. Expenditure total	TE[1]	545,266	37.1	36.3	34.6	33.6	33.1
8. Net borrowing / net lending	EDP B.9	-45,995	-3.1	-3.7	-2.9	-2.4	-1.9
9. Interest (incl. of FISIM)	EDP D.41 incl. FISIM	25,678	1.7	1.8	2.0	1.9	1.8
<i>pm: 9a. FISIM</i>		261	0.0	0.0	0.0	0.0	0.0
10. Primary balance	[1]	-20,317	-1.4	-1.9	-0.9	-0.6	-0.2
<b>Selected revenue components</b>							
11. Tax revenue (11=11a+11b+11c)		276,774	18.8	17.6	17.4	17.4	17.3
11a. Tax on production and imports	D.2	187,141	12.7	11.8	11.7	11.5	11.4
11b. Current taxes on income, wealth, etc.	D.5	89,608	6.1	5.8	5.8	5.8	5.8
11c. Capital taxes	D.91	25	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	161,162	11.0	10.3	9.8	9.7	9.6
13. Property income	D.4	28,783	2.0	1.8	1.7	1.5	1.4
14. Others (14=15-(11+12+13))		32,552	2.2	3.0	2.8	2.6	2.8
15=6. Revenue total	TR	499,271	33.9	32.6	31.7	31.2	31.1
<i>p.m. Tax burden (D.2+D.5+D.61+D.91-D.995)[2]</i>		429,446	29.2	27.8	27.2	27.0	26.9
<b>Selected expenditure components</b>							
16. Collective consumption expenditure	P.32	160,339	10.9	10.8	10.2	10.0	9.9
17. Social benefits incl. social transfers in kind	D.62 + D.63	224,538	15.3	15.3	15.0	14.5	14.2
17a. Social transfers in kind	P.31 = D.63	65,975	4.5	4.5	4.4	4.3	4.3
17b. Social benefits other than soc. transfers in kind	D.62	158,563	10.8	10.8	10.5	10.2	9.9
18.=9. Interest (incl. of FISIM)	EDP D.41 incl. FISIM	25,678	1.7	1.8	2.0	1.9	1.8
19. Subsidies	D.3	19,487	1.3	1.3	1.3	1.3	1.3
20. Gross fixed capital formation	P.51	31,045	2.1	1.8	1.4	1.2	1.1
21. Others (21=22-(16+17+18+19+20))		84,179	5.7	5.3	4.8	4.8	4.8
22=7. Expenditure total	TE	545,266	37.1	36.3	34.6	33.6	33.1
<i>pm: compensation of employees</i>	D.1	107,629	7.3	7.3	7.0	6.8	6.7

[1] Primary balance is calculated as (EDP B.9, item 8) + (EDP D.41 + FISIM, item 9)

Source: Ministry of Finance of the SR

[2] Level of tax revenue is lower than in 2005 due to transition to the new method of accrual taxes. Year 2005 is reported by means of a coefficient method (tax liability and capital transfer with usage of D.995), budget is drawn up using the new method of time-adjusted cash payments.

[3] Inclusive of those collected by the EU and adjustments of taxes and social security contributions unlikely to be collected (D.995)



**Table 3: General government expenditure according to function classification (% of GDP)**

	COFOG code	2004	2009
1. General public services	1	4.9	
2. Defence	2	1.0	
3. Public order and safety	3	1.3	
4. Economic affairs	4	6.5	
5. Environmental protection	5	0.5	
6. Housing and community amenities	6	1.2	
7. Health	7	4.1	
8. Recreation, culture and religion	8	1.2	
9. Education	9	3.6	
10. Social protection	10	15.5	
<b>11. Expenditure total [1]</b>	<b>TE</b>	<b>39.7</b>	

[1] With regard to the fact that data are updated with a delay of T+12, revised data for the year 2004 and the reality for the year 2005 are not available at present.

Source: Eurostat  
Ministry of Finance of the SR

**Table 4: Development of general government debt (% of GDP)**

	2005	2006	2007	2008	2009
1. Gross debt	34.5	33.1	31.8	31.0	29.7
2. Change in gross debt	-7.1	-1.4	-1.3	-0.8	-1.4
<b>Contributions to change in gross debt</b>					
3. Primary balance	1.4	1.9	0.9	0.6	0.2
4. Interests	1.7	1.8	2.0	1.9	1.8
<b>5. Stock-flow adjustment</b>	<b>-7.0</b>	<b>-1.8</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.3</b>
of which:					
- Differences between cash and accrual	0.9	0.1	-0.1	0.2	0.3
- Net increase in financial assets	-7.4	-1.2	-1.1	-1.2	-1.2
- Valuation effects and others*	-0.6	-0.7	0.0	-0.2	-0.4
p.m. implicit interest rate	4.6	5.7	6.6	6.3	6.1
<b>Other relevant factors</b>					
6. Liquid financial assets	5.1	5.0	2.7	1.3	0.3
7. Net financial debt (7=1-6)	29.4	28.1	29.2	29.7	29.4

\* Differences between the cash and accrual tax revenue and interests, and impact of transition of resources of the state financial assets to the Social Insurance Agency are the only individual factors of stock-flow adjustment quantified explicitly. Other factors have been aggregated in 'Valuation effects and others.'

Source: Ministry of Finance of the SR

**Table 5: Cyclical developments (% of GDP)**

	ESA code	2005	2006	2007	2008	2009
1. Real GDP growth (%)		6.1	6.6	7.1	5.5	5.1
2. Net lending of general government *	EDP B.9	-2,3	-3,8	-2,9	-2,4	-1,9
3. Interest expenditure	EDPD.41+ FISIM	-1.7	-1.8	-2.0	-1.9	-1.8
4. Potential GDP growth (%) (1)		5.8	6.5	6.9	5.6	5.4
contributions:						
- labour		0.4	0.5	0.5	0.4	0.4
- capital		1.5	1.6	1.6	1.7	1.7
- total factor productivity		3.9	4.4	4.8	3.5	3.2
5. Output gap		0.0	0.2	0.4	0.2	0.0
6. Cyclical budget component		0.0	0.0	0.1	0.0	0.0
7. Cyclically adjusted balance (2-6)		-2,3	-3,8	-3,0	-2,5	-1,9
8. Cyclically adjusted balance (7-3)		-0,5	-2,1	-1,0	-0,6	-0,2

\* ex one-off government measures

Source: Ministry of Finance of the SR

(1) Until an agreement on the Production Function Method is reached, MS can use own figures.



**Table 6: Divergence from previous update**

	ESA code	Year	Year	Year	Year	Year
		2005	2006	2007	2008	2009
<b>Real GDP growth (%)</b>						
Previous update		5.1	5.4	6.1	5.6	
Current update		6.1	6.6	7.1	5.5	5.1
Difference		1.0	1.2	1.0	-0.1	
<b>General government net lending (% of GDP)</b>						
	EDP B.9					
Previous update		-4.9	-4.2	-3.0	-2.7	
Current update		-3.1	-3.7	-2.9	-2.4	-1.9
Difference		1.8	0.5	0.1	0.3	
<b>General government gross debt (% of GDP)</b>						
Previous update		33.7	35.5	35.2	36.2	
Current update		34.5	33.1	31.8	31.0	29.7
Difference		0.8	-2.4	-3.4	-5.2	

Source: Ministry of Finance of the SR

**Table No 7: Long-term sustainability of public finance – AWG scenario (% of GDP)**

	2004	2010	2020	2030	2040	2050
<b>Total expenditure</b>	<b>38.0</b>	<b>36.4</b>	<b>36.2</b>	<b>38.0</b>	<b>40.9</b>	<b>45.3</b>
thereof: expenditure affected by population ageing	16.2	15.4	15.3	16.5	17.7	19.1
A. Expenditure on old-age pensions*	7.2	6.7	7.0	7.7	8.2	9.0
1. Pensions from social insurance system	7.2	6.7	7.0	7.7	8.2	9.0
a) Old-age and early old-age pensions	5.4	4.8	4.6	5.0	5.5	6.3
b) Other pensions (disability, survivor's)	1.8	1.9	2.3	2.7	2.7	2.7
2. Employee pensions (within GG sector)	-	-	-	-	-	-
B. Health care	4.4	4.7	5.2	5.7	6.0	6.3
C. Long-term care	0.7	0.8	0.7	0.9	1.1	1.3
D. Education	3.7	3.0	2.2	2.2	2.3	2.4
E. Other expenditure affected by population ageing	0.3	0.2	0.1	0.1	0.1	0.1
Interests	2.2	1.5	1.4	2.0	3.7	6.7
<b>Revenue total</b>	<b>35.0</b>	<b>33.0</b>	<b>32.8</b>	<b>32.7</b>	<b>32.7</b>	<b>32.6</b>
of which: Property income (D.4)	1.7	1.3	1.3	1.3	1.3	1.3
of which: from social contributions	12.8	11.2	11.0	10.9	10.9	10.8
Reserves of pension funds	0.0	7.0	18.9	31.5	45.7	58.0
of which: consolidated reserves of GG pension funds	0.0	0.0	0.0	0.0	0.0	0.0
<b>Assumptions</b>						
Growth of labour productivity**	5.2	4.2	3.3	2.7	1.9	1.7
Real growth of GDP	5.5	5.3	3.3	2.0	0.4	0.3
Participation rate in men (age of 15 to 64)	77.3	79.6	82.1	82.3	79.4	78.7
Participation rate in women (age of 15 to 64)	64.1	67.1	73.5	73.8	70.0	69.1
Total participation rate (age of 15 to 64)	70.7	73.3	77.8	78.0	74.7	73.9
Unemployment rate	18.1	15.2	9.7	7.0	7.0	7.0
Population aged 65+ in total population	11.5	12.3	16.3	20.8	24.1	29.3

Source: Ministry of Finance of the SR



**Table 8: Basic assumptions**

	2004	2005	2006	2007	2008	2009	2010
<b>Short-term interest rate in the Eurozone (annual average)</b>	2.1	2.1	3.1	3.7	3.6	4.2	4.2
<b>Long-term interest rate in the Eurozone (annual average)</b>	4.1	3.3	3.3	4.1	4.2	4.8	4.9
<b>USD/EUR exchange rate (annual average) (Eurozone and ERM II countries)</b>	1.2	1.3	1.25	1.28	1.28	1.28	1.28
<b>World ex EU, GDP growth</b>	6.0	5.6	5.7	5.2	5.2	5.2	5.2
<b>-EU GDP growth</b>	2.4	1.5	2.8	2.4	2.4	2.1	2.1
<b>Growth of relevant foreign markets</b>	2.4	2.5	3.0	2.8	2.6	2.5	2.4
<b>World import volumes, ex EU</b>	14.0	8.8	9.1	8.2	7.9	7.9	7.9
<b>Oil prices (Brent, USD/barrel)</b>	37.8	57.3	65.0	67.0	67.0	67.0	67.0

*Source: Ministry of Finance of the SR*



**Table 9: Implementation table**

Key challenges	Integrated guidelines	Provision	Implementation status		Direct budgetary costs (% of GDP)		
			Status	Schedule	2006	2007	2008
Science, research and innovations	7	Formation of central state agency supporting research and development	accomplished	2006	0.04		
Science, research and innovations	7	Support of mobilities, human resources, science and technical cooperation and state programmes in the field of research and development	accomplished, state programmes are in the process of accomplishment	2006	0.01		
Science, research and innovations	8	Support of technological incubators and enhancement of the risk capital supply	assumed accomplishment in the second half of 2006	2006; in case of risk capital, effective since 1 January 2007	0.11		
Information society	9	Measures for establishment and support of the e-government	in the process of accomplishment	2006, 2007	0.02		
Information society	9	Enhancement of Internet availability in households and at schools	accomplished	2006	0.02		
Education and employment	17, 19	Enhance effectiveness of active labour market measures	in the process of accomplishment	2006-2008	0.07*		
Education and employment	18	Enhance quality and targeting of education programmes for the unemployed	accomplished	2006	0.01		
Education and employment	19	Enhance the support of services for employees threatened by collective redundancies or made redundant	accomplished	2006	0.02		
Education and employment	19	Implementation of new forms of support for disadvantaged groups of population	in the process of accomplishment	2006-2008	0.05	0.05	0.04
Education and employment	20	Transformation of education content, methods of teaching foreign languages and modification of university programmes for the future teachers	in the process of accomplishment	2006-2008	0.02*		
Education and employment	20, 23	Formation of a network of 'studying regions' and support of business skills of the secondary school students	in the process of accomplishment	2006-2008	0.01*		
Education and employment	23	Reform of university education - system and social scholarships	accomplished	2006	0.04		
<b>Total</b>					<b>0.43</b>	<b>0.05</b>	<b>0.04</b>

\* in such cases resources for the whole programme period are entered (2006-2008)

Note: Integrated guidelines constitute the framework of measures required to be taken in order to achieve sustainable growth in employment, they were prepared pursuant to the Lisbon Strategy

Source: Ministry of Finance of the SR