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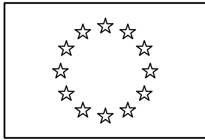

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.5.2008
SEC(2008) 572 final

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/182/EC on the existence of an excessive deficit in Slovakia

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. BACKGROUND

Article 104 of the Treaty establishes that Member States should avoid excessive deficits and lays down a procedure for their identification and correction. The excessive deficit procedure (EDP) is further specified in Council Regulation (EC) No 1467/97 on "speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the planned or actual government deficit exceeds the reference value of 3% of GDP (unless either the deficit ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether government debt exceeds the reference value of 60% of GDP (unless the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the EDP. As part of the application of this Protocol, Member States have to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93[2,3,4].

On 12 May 2004, the Commission initiated the EDP for Slovakia with the adoption of a report under Article 104(3), based on a general government deficit of 3.6% of GDP in 2003[5]. On 5 July 2004, the Council decided, on a recommendation from the Commission, that Slovakia was in excessive deficit according to Article 104(6)[6]. At the same time, and also based on a Commission recommendation, the Council addressed recommendations under Article 104(7) to Slovakia with a view to bringing the situation of an excessive government deficit to an end, by 2007 at the latest[7].

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1 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

2 OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

3 The most recent notification of Slovakia can be found at: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal.

4 Slovakia benefited from a transition period for implementing the Eurostat decision of 2 March 2004 on the classification of funded pension schemes and as a result notified deficit and debt figures without the net cost of its 2005 pension reform until April 2006 (Eurostat News Release No 117/2004 of 23 September 2004 on the transition period to implement the decision in Eurostat News Release No 30/2004 of 2 March 2004). As the different documents under the EDP, including in particular the Council recommendation under Article 104(7), took the implications of the March 2004 Eurostat decisions fully into account, all deficit and debt figures quoted in this document include the pension reform cost and are thus fully comparable.

5 SEC(2002) 131.

6 OJ L 62, 9.3.2005, p. 16.

7 All EDP-related documents for Slovakia can be found at the following website: http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

In its recommendation under Article 104(7), the Council recommended the Slovak authorities to "take action in a medium-term framework in order to achieve their objective of bringing the deficit below 3% of GDP in a credible and sustainable manner by 2007 at the latest, in accordance with the path for deficit reduction as specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004"; to "implement with vigour the measures envisaged in the May 2004 convergence programme, in particular those related to the proposed further health care reforms and further public sector rationalisation"; to "accelerate the fiscal adjustment if the implemented structural reforms result in higher growth than expected in the convergence programme of May 2004, in particular by dedicating any higher-than-budgeted revenues primarily to faster deficit reduction"; and to "take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target".

In addition, the Council invited the Slovak authorities to "strengthen the binding character of the three-year budgetary framework by introducing detailed medium-term expenditure ceilings to be adopted by parliament".

Table 1: Adjustment endorsed by the Council on 5 July 2004

% of GDP, unless indicated otherwise	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	-3.6	-4.0	-3.9	-3.9	-3.0
p.m.: Real GDP growth (%)	4.2	4.1	4.3	5.0	4.7

Source: Council recommendation under Article 104(7) and Council opinion on the May 2004 convergence programme, both adopted on 5 July 2004

On 22 December 2004, i.e. after the expiry of the deadline for taking action set in the Council recommendation, the Commission adopted a communication to the Council, which concluded that action taken until then by Slovakia was consistent with the Council recommendation and that no further steps under the EDP were necessary at that stage[8]. In its meeting of 18 January 2005, the Council concurred with this assessment.

According to Article 104(12), a Council decision on the existence of an excessive deficit is to be abrogated, on the basis of a Commission recommendation, when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

2. RECENT DEFICIT DEVELOPMENTS

The data available in May 2004, when the Commission initiated the EDP for Slovakia, indicated that the 2003 deficit was at 3.6% of GDP and the deficit was expected to remain above the reference value in subsequent years. According to the data provided by the Commission (Eurostat) following the reporting by Slovakia before April 2008[9] the general government deficit remained below 3% of GDP in the years 2003-2005 due to a subsequent data revision (in the April 2007 notification) mainly resulting from a change in the accrualization method for tax revenue. The headline deficit increased to 3.6% of GDP in 2006 (mostly due to a substantial increase in government consumption of 1% of GDP, the 2005

8 SEC(2004) 1630.

9 Eurostat News Release No 54 of 18 April 2008.

pre-stocking with cigarettes in view of an imminent excise tax hike and increased pension reform costs) before falling to 2.2% of GDP in 2007[10].

A pension reform was launched in 2005, affecting social contributions by redirecting 9% of gross wages to a funded (second) pension pillar. Due to widespread public interest in this pillar and a gradual transition, these revenue transfers are estimated to have increased from 0.8% of GDP in 2005 to 1.2% and 1.3% of GDP in 2006 and 2007 respectively.

Slovakia committed itself to gradually increase taxes on cigarettes up to the minimum levels required by the EU. As a result, taxes were increased in May 2004, January 2006 and January 2008 and are planned to be raised again in December 2008. All increases so far were preceded by a sizeable pre-stocking with cigarettes at various stages of the distribution chain. This has led to shifts in tax revenue resulting in extra tax revenue of some 0.1%, 0.3% and 0.5% of GDP in 2003, 2005 and 2007 respectively followed by equivalent revenue shortfalls in the subsequent years. Moreover, Slovakia has claims on several foreign countries. In 2003, 2005 and 2007 cancellations of some of these claims had a deficit-increasing effect of 0.4%, 0.9% and 0.1% of GDP respectively.

Given the better-than-originally-estimated 2003 deficit, headline deficit developments were consistent with the deadline for correction of the excessive deficit set by the Council in its 104(7) recommendation although the consolidation path was quite different. In particular, in 2007 the headline deficit fell by almost 1½% of GDP to 2.2% of GDP. The fiscal consolidation has benefited from buoyant GDP, employment and revenue growth, allowing the expenditure-to-GDP ratio to fall faster than the revenue-to-GDP ratio. The fall in the expenditure-to-GDP ratio from 40.2% of GDP in 2003 to 36.9% of GDP in 2007 was also induced by expenditure restraint and expenditure reforms. These included restrictions on social and unemployment benefits, tightening of conditions for early retirement and a gradual increase in the pension retirement age. The creation of the National Motorway Company in 2005 has enabled the government to partly finance motorway construction through private sector borrowing. On the revenue side, a comprehensive tax reform was introduced in 2004, shifting the weight from income to consumption taxation. Together with the 2005 pension reform it has contributed to a fall in the revenue-to-GDP ratio from 37.4% of GDP in 2003 to 34.7% of GDP in 2007.

[10] Deficit ratios are usually revised - upwards or downwards - after the publication of the first outcome in the spring notification. For the EU Member States as a whole, the revisions are usually relatively small and on average insignificantly different from zero. For Slovakia, in view of the distance between the currently reported deficit for 2007 and the deficit reference value, there is a low probability that potential future revisions in government accounts would raise the 2007 deficit ratio in excess of 3% of GDP. The fact that there are pending issues on the sectoral delimitation of general government in Slovakia (notably on the appropriate sectoral classification of health-care related units, such as hospitals and health-insurance companies in general government or the corporate sector) has not a significant impact on the upward and downard risks of deficit revisions in future. Though detailed data are not available, there are indications that the financial balance of the units that need to be re-classified inside government or outside government, to be in line with ESA95 rules, is very small. (See Eurostat findings of the dialogue visit to Slovakia on 10 and 11 March 2008: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,47631456&_dad=portal&_schema=PORTAL, available soon.)

The 2007 deficit outcome was below the official target of 2.9% of GDP set in the December 2006 update of the convergence programme. The over-performance was mainly induced by higher-than-foreseen GDP and employment growth, lower-than-budgeted co-financing for the EU funds and a larger-than-expected pre-stocking with cigarettes at the end of 2007, triggered by a hike in the excise tax on tobacco in January 2008 and resulting in additional revenue of ½% of GDP compared to ¼% of GDP expected by the programme.

Nevertheless, the cyclical upswing and growth dividends from structural reforms were not fully exploited for fiscal consolidation. As a result, the structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) deteriorated from some 1½% of GDP in 2003 to around 3% of GDP in 2006 before improving to around 2½% of GDP by 2007. However, the creation of the second funded pension pillar in 2005 has contributed to the structural deterioration[11].

3. DEFICIT PROJECTIONS FOR 2008 AND BEYOND

According to the Commission services' spring 2008 forecast the headline deficit is expected to narrow further to 2.0% of GDP in 2008 before increasing to 2.3% of GDP in 2009 (under the customary "no-policy-change" assumption) against the background of markedly slowing but still robust GDP and decelerating employment growth. Revenue-increasing measures included in the 2008 budget such as a broadening of the corporate and personal income tax base and an increase in the maximum ceiling on social contributions are foreseen to generate additional revenue of around ¼% of GDP in 2008. The revenue shortfall induced by the 2007 pre-stocking with cigarettes is likely to be broadly offset by a further hoarding of cigarettes motivated by a lower excise tax hike planned for the end of 2008. Moreover, a temporary opening up of the second pension pillar in the first half of 2008, allowing all current participants to leave and new participants to join, should result in an one-off revenue of around 0.1% of GDP as savings accumulated in previous years in the second pillar will be transferred to the pay-as-you-go pillar if participants decide to leave. On the expenditure side, farming subsidies are set to continue increasing substantially. The main reason for the 2009 deterioration projected in the spring forecast is a likely revenue shortfall of some ½% of GDP due to aforementioned expected further substantial pre-stocking with cigarettes in 2008.

While the forecast for 2008 is in line with the latest official target of 2% of GDP (set by the Ministry of Finance in February 2008 as a reaction to the February 2008 Council opinion on the November 2007 update of the convergence programme) the forecast for 2009 is significantly above the latest national target of 1.7% of GDP (set in April 2008 in the outline for the new budget proposal), which is not yet underpinned by explicit measures.

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[11] In accordance with Article 2(7) of Regulation (EC) No 1467/97, a decision to abrogate a decision on the existence of an excessive deficit should take into account the net cost of a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar if the deficit has declined substantially and continuously and has reached a level that comes close to the reference value. Since the 2007 general government deficit was below the 3%-reference value there is no need to consider the application of this Article.

The structural deficit is expected to deteriorate from around 2½% to some 2¾% of GDP between 2007 and 2008 which is not in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times. In 2009, under the customary no-policy-change assumption the structural deficit is foreseen to deteriorate further to some 3% of GDP mainly due to the cigarette pre-stocking related revenue shortfall.

According to the February 2008 Council opinion[12] on the November 2007 update of the convergence programme the budgetary stance in the programme seems insufficient to ensure that the medium-term objective (MTO) for Slovakia, set as a structural deficit of just below 1% of GDP, is achieved by the end of the programme period (2010), as envisaged in the programme. Moreover, the Council concluded that the envisaged change in the structural balance for 2008 is not in line with the Pact and should be more ambitious.

4. DEBT DEVELOPMENTS AND PROJECTIONS

The debt ratio decreased gradually from 42.4% of GDP in 2003 to 29.4% of GDP in 2007, i.e. well below the 60% of GDP reference value, mainly thanks to privatisation revenue. According to the Commission services' spring 2008 forecast, gross public debt is expected to remain broadly stable over the forecast horizon (on a no-policy change basis).

5. CONCLUSIONS

The data available in May 2004 indicated that the 2003 deficit was at 3.6% of GDP and the deficit was expected to remain above the reference value in subsequent years. According to the latest data, the general government deficit remained below 3% of GDP in the years 2003-2005 before increasing to 3.6% of GDP in 2006 mainly due to a substantial increase in government consumption. The headline deficit then fell to 2.2% of GDP in 2007. The structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, deteriorated in 2006 by some 2% of GDP but improved again by around ½% of GDP in 2007. According to the Commission services' spring 2008 forecast, the headline deficit is expected to narrow to 2.0% of GDP in 2008 and, on a no-policy change basis, to increase to 2.3% in 2009. This indicates that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner.

General government gross debt declined from 42.4% of GDP in 2003 to 29.4% in 2007, well below the 60% of GDP reference value. According to the Commission services' spring 2008 forecast, the debt ratio is expected to remain broadly stable over the forecast horizon (on a no-policy change basis).

From an overall assessment, it follows that the excessive deficit situation in Slovakia has been corrected. Accordingly, the Commission recommends to the Council to abrogate its decision on the existence of an excessive deficit in Slovakia.

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12 OJ C 49, 22.2.2008, p. 44.

Table 2: Budgetary developments, 2003-2009

	2003	2004	2005	2006	2007	2008		2009	
% of GDP, unless indicated otherwise						COM	CP[2]	COM[3]	CP[2]
General government balance	-2.7	-2.4	-2.8	-3.6	-2.2	-2.0	-2.3 (-2.0)	-2.3	-1.8 (-1.7)
- Total revenues	37.4	35.4	35.3	33.5	34.7	34.3	33.0	33.8	31.8
- Total expenditure	40.2	37.8	38.1	37.2	36.9	36.3	35.3	36.1	33.7
Of which : - interest expenditure	2.5	2.2	1.7	1.5	1.4	1.4	1.4	1.4	1.5
- gross fixed capital formation	2.6	2.4	2.1	2.2	1.9	1.9	1.8	1.9	1.4
Pension reform costs	0.0	0.0	0.8	1.2	1.3	1.3	1.3	1.3	1.3
Pre-stocking with cigarettes (net impact)	0.1	-0.1	0.3	-0.3	0.5	-0.1	n.a.	-0.4	n.a.
Primary balance	-0.2	-0.2	-1.1	-2.2	-0.8	-0.6	-0.9	-1.0	-0.3
One-off and temporary measures	-0.4	0.0	-0.9	0.0	-0.1	0.1	0.1	0.0	0.0
Structural balance[1]	-1.4	-1.4	-1.0	-3.1	-2.6	-2.8	-3.1	-3.1	-2.4
Structural primary balance[1]	1.1	0.8	0.8	-1.7	-1.2	-1.5	-1.7	-1.7	-0.9
Government gross debt	42.4	41.4	34.2	30.4	29.4	29.2	30.8	29.7	30.5
Pm Real GDP growth (%)	4.8	5.2	6.6	8.5	10.4	7.0	6.8	6.2	5.8
Pm Output gap	-3.2	-3.4	-3.2	-1.6	1.9	2.7	2.3	2.5	2.1

[1] Cyclically-adjusted (primary) balance excluding one-off and temporary measures.

[2] Cyclically-adjusted and structural balances and output gaps according to the programme as calculated by Commission services on the basis of the information in the programme.

[3] No-policy change assumption.

Sources: Commission services' spring 2008 forecast (COM) and November 2007 update of the convergence programme (CP) (In brackets the latest national targets set in February and April 2008)

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/182/EC on the existence of an excessive deficit in Slovakia

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(12) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) By Council Decision 2005/182/EC[13], following a recommendation from the Commission in accordance with Article 104(6) of the Treaty, it was decided that an excessive deficit existed in Slovakia. The Council noted that the general government deficit was 3.6% of GDP in 2003, above the 3% of GDP Treaty reference value.

(2) On 5 July 2004, in accordance with Article 104(7) of the Treaty and Article 3(4) of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[14], the Council made, based on a recommendation from the Commission, a recommendation addressed to Slovakia with a view to bringing the excessive deficit situation to an end by 2007 at the latest. The recommendation was made public.

(3) In accordance with Article 104(12) of the Treaty, a Council Decision on the existence of an excessive deficit is to be abrogated when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

(4) In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the procedure. As part of the application of this Protocol, Member States are to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community[15].

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[13] OJ L 62, 9.3.2005, p. 16.

[14] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

[15] OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

(5) Based on data provided by the Commission (Eurostat) in accordance with Article 8g(1) of Regulation (EC) No 3605/93 following the notification by Slovakia before 1 April 2008 and on the Commission services' spring 2008 forecast, the following conclusions are warranted:

– due to data revisions after the 2004 Council decision on the existence of an excessive deficit, the general government deficit remained below 3% of GDP in the years 2003-2005. After increasing to 3.6% of GDP in 2006 it was reduced to 2.2% of GDP in 2007, which is below the 3% of GDP deficit reference value. This compares with a target of 2.9% of GDP set in the December 2006 update of the convergence programme,

– the fiscal consolidation has benefited from buoyant GDP, employment and revenue growth, allowing the expenditure-to-GDP ratio to fall faster than the revenue-to-GDP ratio. The falling expenditure-to-GDP ratio was also induced by expenditure restraint and expenditure reforms such as substantial restrictions on social benefits. Nevertheless, the cyclical upswing and growth dividends from structural reforms were not fully exploited for fiscal consolidation. As a result, the structural deficit (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is estimated to have deteriorated from some 1½% of GDP in 2003 to around 3% of GDP in 2006 before improving to around 2½% of GDP by 2007. However, part of the structural deterioration can be attributed to the introduction of the second funded pension pillar in 2005 with transfers to this pillar estimated to have increased from 0.8% of GDP in 2005 to 1.2% and 1.3% of GDP in 2006 and 2007 respectively. In addition, increases in taxes on cigarettes preceded by sizeable pre-stocking with cigarettes at various stages of the distribution chain led to sizeable shifts in tax revenue resulting in extra tax revenue in 2003, 2005 and 2007 followed by equivalent revenue shortfalls in the subsequent years,

– for 2008, the Commission services' spring 2008 forecast projects the headline deficit to be reduced further, to 2.0% of GDP, driven mainly by continued strong growth prospects and some revenue-increasing measures such as a broadening of the corporate and personal income tax base and an increase in the maximum ceiling on social contributions. This is in line with the official deficit target of 2.0% of GDP set in February 2008. For 2009, the spring forecast projects, on a no-policy change basis, an increase in the deficit to 2.3% of GDP. This indicates that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner. The structural balance is projected to deteriorate by some ¼ percentage point of GDP in 2008 and, on a no-policy change basis, by around ¼ percentage points in 2009. This has to be seen against the need to make progress towards the medium-term objective (MTO) for the budgetary position, which for Slovakia is a structural deficit of just below 1% of GDP,

– government debt remains well below the 60% of GDP reference value. It declined from 42.4% of GDP in 2003 to 29.4% in 2007. According to the spring 2008 forecast, the debt ratio is projected to remain broadly stable over the forecast horizon (on a no-policy change basis).

(6) In the view of the Council, the excessive deficit in Slovakia has been corrected and Decision 2005/182/EC should therefore be abrogated.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that the excessive deficit situation in Slovakia has been corrected.

Article 2

Decision 2005/182/EC is hereby abrogated.

Article 3

This Decision is addressed to the Slovak Republic.

Done at Brussels,

For the Council
The President