THE REPUBLIC OF SLOVENIA

CONVERGENCE PROGRAM

2005 - UPDATE

Ljubljana, December 2005

CONTENTS

INTRODUCTION

This is the first fully–fledged convergence program of the new government. The key policy objectives of the Government are twofold:

- the adoption of the Euro at the beginning of 2007, and
- the implementation of an ambitious policy agenda whose economic development objective is to exceed the average level of EU's economic development (GDP per capita on PPP basis) and increase employment in line with Lisbon strategic goals.

To these ends in addition to carrying out the Program for ERM II Entry and Adoption of the euro (November 2003), [1] the government adopted a new Slovenia's Development Strategy (SDS) in June 2005. [2] The Strategy provides the developmental vision for Slovenia in the years ahead and contains the objectives and priority areas for development. In addition, the government adopted the National Reform Program for Achieving the Lisbon Strategy Goals (October 27th, 2005)[3] which is consistent with the SDS, and endorsed a comprehensive reform package put forward by the Committee for Reforms (November 3rd, 2005)[4], a task force set out by the government to propose concrete policy measures for implementing the SDS. The implementation of these policy measures should, among other objectives, lead to an accelerated GDP growth and an increase in employment.

The macroeconomic forecasts, including the fiscal projections, presented in this convergence program do not take into account the positive impact of the envisaged reform package. This is because at the time of elaboration of the budgets for 2006 and 2007 and preparation of fiscal projections for 2008 the package of policy measures although endorsed by the government, had not been implemented yet. Thus according to the Code of Conduct[5] the fiscal projections were elaborated based on a conservative macroeconomic forecast (IMAD 2005 Autumn Report), which was also used for the preparation of the budgets for 2006 and 2007. Furthermore, the underlying forecasts for 2008 and beyond do not envisage a change in the current potential GDP growth (around 3.8%). Future updates of the Convergence Program will incorporate the impact of the adopted policy measures.

Compared with the previous program, the current update broadly confirms the previously planned fiscal adjustment against a similar macroeconomic scenario and enhances the measures towards improving the quality of public finances. Maintaining budget discipline in particular is instrumental for a successful monetary integration, preserving competitiveness and facilitating the achievement of broad development goals. Higher potential growth and more efficient state administration will in turn contribute towards improved public finances.

1 See http://www.bsi.si/html/eng/publications/europe/ERM2_BS_Vlada_200311.pdf.
2 See http://www.sigov.si/zmar/projekti/srs/StrategijarazvojaSlovenije.pdf
3 See http://www.sigov.si/zmar/aprojekt/alizb-strategija/alizb-strategija.pdf
4 See http://www.vlada.si/?lng=slo&vie=ctl&gr1=vbmOgl&id=2005100623424037
5 Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes.

1. POLICY FRAMEWORK AND OBJECTIVES

The objective of economic policy remains the creation of conditions for a faster and sustainable welfare increase in Slovenia above the average level of the enlarged EU. According to the Slovenia's Development Strategy (SDS), Slovenia should exceed the average level of the EU's economic development and increase employment in line with the Lisbon strategy goals by 2013. Firstly, this requires stable and broadly balanced macroeconomic environment, including sustainable fiscal policy, price stability and sustainable wage developments. Thus, in the period up to 2007 the continued coherent implementation of macroeconomic policies will be vital for Slovenia's successful entry to the EMU at the beginning of 2007. Furthermore, the macroeconomic policy mix for the fulfillment of the Maastricht criteria should not only ensure nominal convergence but should also be sustainable, i.e. sufficiently restrictive as to guarantee that the main macroeconomic equilibria are preserved after Slovenia's entry to the EMU. Secondly, the economic growth potential will increase as a result of the implementation of the National Reform Program's specific policy measures in the areas of competition, economic growth and employment.

The overarching policy objective in the period ahead is to fulfill the Maastricht criteria and adopt the Euro in 2007. Slovenia already meets the fiscal criteria while inflation has reduced in a sustainable manner. The price stability criterion, despite increases in the international price of oil, is targeted to be met in early 2006. Since joining the ERM II in June 2004 the exchange rate has only marginally fluctuated around the central parity. Provided that the current policy mix is maintained, the exchange rate should remain stable, thus enabling Slovenia to meet all Maastricht criteria in 2006 and introduce the Euro in January 2007.[6] The preparatory work for Euro introduction is progressing according to the Masterplan for the Euro Change Over (January 2005)[7] and the Communication Strategy on the Introduction of the Euro (June 2005)[8] both documents jointly adopted by the government and in Bank of Slovenia.

Fiscal policy during the program period is set to contribute to long-term sustainability of public finances by gradually reducing the structural deficit towards the range consistent with the current potential growth of the economy, while implementation of the proposed reform package would enhance the achievement of the latter. In addition, the policy objective of restraining the growth of the debt-to-GDP ratio will continue to be met. Pursuing such a policy target allows not only for better preparation to cope with long-term costs related to ageing population, but also contributes to price stability in the process leading to monetary integration and enhances the responsiveness of fiscal policy to asymmetric shocks. The implementation of the proposed reform package, however, shall enhance the fulfillment of this target.

During the program period tax reform will continue to be pursued accompanied by expenditure rationalization (reduction and restructuring). The aim is to promote

6 When joining the ERM II the Slovenian government committed itself in the communiqué of the ERM II committee to continue to take measures to reduce inflation in a sustainable way. This involves maintaining prudent fiscal policy, establishing effective competition and improving regulation in sectors where there are monopolies. Supported by credible coordination between the government and Bank of Slovenia, the policy commitment is being fulfilled.
7 See http://www.bsi.si/html/eng/publications/europe/Evro-masterplan_jan05-ang.pdf
8 http://www.bsi.si/html/eng/publications/europe/Euro%20campaign.pdf

economic growth while maintaining economic stability. Such an approach will preserve the sustainability of public finance and ensure compliance with medium term fiscal objective. The tax reform package recently approved by the parliament (November 24/24 - 2005) whose impact is incorporated in the fiscal projections presented in this convergence program aims at reducing the tax burden on labor, increasing employment, promoting savings throughout the economy and enhancing economic growth by rewarding R&D activities. Complementary expenditure policy will redirect expenditure composition towards growth-enhancing components while at the same time increase Slovenia's absorption capacity of EU funds.

During the program period the general government deficit will be reduced while at the same time a sufficient margin will be observed to respect the 3% reference value under normal cyclical fluctuations. The medium term objective (MTO) for the cyclically adjusted balance is set at 1% BDP. The deficit will be reduced gradually and reach the MTO in the final year of the program period. Such a level allows Slovenia to maintain a public investment-to-GDP ratio of about 3% in the years ahead. It also lies within the suggested range for the specific MTO for a country with a potential growth and debt levels similar to Slovenia's. The overall fiscal stance will result in keeping the debt-to-gdp ratio constant at current level (below 30%).

Throughout our participation in the ERM II, monetary policy will continue to be focused on the stability of the nominal exchange rate around the central parity. The joint assessment at the ERM II entry was that the market exchange rate for the Slovenian tolar reflected an appropriate balance between real and nominal convergence.[9] After ERM II entry the Bank of Slovenia successfully stabilised the daily market exchange rate close to the central parity of SIT 239.640 for EUR. The deviations of the market rate from the central rate after ERM II entry have been negligible. The highest deviation of the market exchange rate from the central parity was 0.1%. Solid fundamentals provide credible and sustainable support to the exchange rate stability and the fulfillment of the respective Maastricht criterion.

The setting of nominal interest rates in the ERM II environment depends on factors that are relatively independent from Bank of Slovenia decisions, above all: i) interest rates in the eurozone, which reflect the ECB's monetary policy stance and; ii) foreign investors' perception of the country and currency risk premiums. These factors allowed the Bank of Slovenia to maintain interest rates at unchanged levels since ERM II entry.

The risk of the excessive aggregate demand stemming from strong credit growth (see Box 1) has not materialised. Considering the latest data on domestic demand and the outlook for 2006 and 2007 its probability remains fairly low. However, in the event of excess of aggregate demand would take place, given that monetary policy has limited ability to adjust interest rates, the appropriate response will be given within the policy framework of the Joint Program for ERM II entry and adoption of the euro.[10]

Income policy in the program period will continue to be consistent with price stability and competitiveness of the economy. The policy of wage increases lagging behind

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9 In setting the central rate a consensus was required among the Slovenian government, the Bank of Slovenia, the European Commission, the ECB and the governments and central banks of the eurozone and Denmark as a participant in the ERM II.

10 See http://www.bsi.si/html/eng/publications/europe/ERM2_BS_Vlada_200311.pdf.

the productivity growth by 1 percentage point as agreed by the social partners for the period 2003-2005 is envisaged to remain in place in the run to the euro adoption. The government has already adopted the framework for its negotiating position of the new social agreement. This framework was taken into account in the preparation of the two year budgets for 2006 and 2007 and envisages that for the period after adoption of the euro the provisions of the Agreement will be amended in line with the policies ensuring a long-term macroeconomic equilibrium. In the medium term (the period over one economic cycle), this would entail wage growth equaling productivity growth or lagging behind it by a certain amount proportional to new employment. Such wage growth does not increase unit labour costs and does not create cost pressures on inflation.[11]

The Slovenian response to the revised EU Lisbon Strategy and to the broad developmental challenges facing Slovenia is addressed in the SDS adopted in June 2005 and the NRP adopted in October 2005. The main objectives of the strategy are the following: (i) exceed the average level of the EU's economic development (measured as GDP per capita in PPP) and increase employment in line with the Lisbon Strategy goals in the next ten years; (ii) improve the quality of living and the welfare of each individual, measured by the indicators of human development, health, social risks and social cohesion; (iii) enforce the sustainability principle as the fundamental quality criterion in all areas of development, including the goal of sustained population growth; and (iv) to develop into a globally recognisable and renowned country through a distinct development pattern, cultural identity and active engagement in the international community.

Five priority areas for development identified in the SDS are:

i) a competitive economy and faster economic growth;
ii) effective generation, two-way flow and application of the knowledge needed for economic development and quality jobs;
iii) an efficient and less costly state;
iv) a modern social state and higher employment; and
v) integration of measures to achieve sustainable development.

The NRP spells out the policy measures in the priority areas identified in the SDS. It includes measures aimed at stimulating the economy's restructuring, its further liberalization and fostering growth and employment. The NRP measures have been complemented and enhanced by a comprehensive reform package put forward by the Reform Committee and endorsed by the government in November 2005. While the entire reform package will have a profound influence on the Slovene economy, the details of individual measure remain to be finalised. In doing so, they will be subject to extensive discussion among social partners, and their impact will be presented in future updates of the Convergence Program.

11 See Reform Programme for Achieving the Lisbon Strategy Goals.

2. ECONOMIC OUTLOOK

2.1. External assumptions

In September 2005 when the IMAD was preparing its autumn forecasts, which are used as the basis for macroeconomic projections in the Convergence Programme (CP), the assumptions about international economic developments were taken from forecasts that were available up until mid-September 2005. These include the Consensus September forecasts, the September OECD interim report on the economic prospects in this organisation's member states, the expected revisions of the European Commission's forecasts from its summer estimate of the economic situation in the EU, and the forecasts of the WIIW for Southern European countries. The IMF's September forecasts and the October Consensus, which were released later, do not diverge from the figures that were used as assumptions, nor do the European Commission's common external assumptions. In comparison with these, the biggest deviation was observed in the price of oil, which is higher in the CP assumptions. Since the IMAD's autumn forecasts were prepared in the first half of September 2005 when oil prices were at a high level, it was reasonable to expect that they will also persist at a relatively high level in 2006 and 2007. This is also the main difference between the IMAD's forecasts and the EC's common external assumptions (especially for 2007), which particularly affects the relatively worsened terms of trade.

Table 2.1.: Basic external assumptions

	2004	2005	2006	2007
EUR/USD exchange rate*	1,242	1,264	1,256	1,256
Nominal effective exchange rate (% change)	-0,7	0,0	-0,1	0,0
EUR exchange rate (average level)	238,9	239,6	239,6	239,6
World GDP growth (% change)	5,1	4,3	4,3	-
EU GDP growth (% change)	2,4	1,5	1,9	2,2
Growth in relevant export markets (% change)**	9,2	7,3	8,5	8,4
World imports volumes – advanced economies*, growth in %**	8,8	5,4	5,8	-
Oil prices (Brent, USD/barrel)	38,3	58,0	68,0	66,0

Source: IMAD Autumn report 2005.

Notes: *A technical assumption based on the average of the last 6-month period (March – August 2005).
** Germany, Italy, France, UK, Austria, Switzerland, USA, Japan, Czech R., Slovakia, Hungary, Poland;
***The assumption differs from the Code of Conduct as it also includes the EU countries.

The autumn economic growth forecast for 2005-2008 assumes a slight slackening of economic growth in most of Slovenia's main trading partners in 2005 over 2004 and a rebound in 2006. The euro area economic growth forecasts for 2005 have seen slight downward revisions since spring. The forecast for 2006 still projects that GDP growth will accelerate in 2005 over 2006, although the spring figures have been scaled down. The strong economic growth recorded by the new EU members in 2004, fed by the cyclical recovery of domestic demand, the improved economic situation in the international environment and the positive effects of EU accession, has generally moderated this year, while a slight rebound is still projected for 2006 and 2007. Similarly, the countries of former Yugoslavia, to which Slovenia exported almost 17%

of its merchandise exports in the first half of 2005, are also expected to record lower economic growth in 2005 over 2004, while their outlook for 2006 is more upbeat and projects that GDP growth will recover.

2.2. Cyclical developments and short-term prospects

The forecast of GDP growth for 2005 totals 3.9%. The economy's growth will be driven mainly by foreign demand. Given the projected 8.6% real rise in exports of goods and services and the 6% rise in their imports, the external trade balance will contribute around 1.4 p.p. to economic growth. In the regional structure of exports, the share of EU countries is rising due to the 'trade creation effect' induced by Slovenia's membership in the EU, and partly due to the strongly accelerated exports of vehicles to France and Austria this year. Exports to Croatia and Serbia & Montenegro have also continued to grow at robust rates in 2005. On the other hand, exports to Russia have slowed down, and the volume of exports to BiH, Macedonia and the USA are even projected to be lower than in 2004. This year's real growth of private consumption (3.6%) will be higher than last year but will nevertheless not exceed the aggregate GDP growth, thus remaining within sustainable macroeconomic limits. Due to the comparatively weak growth of gross fixed capital investment in the first half of 2005, this year's projected increase in investment consumption (4.0% in real terms) will be lower than in 2004. Specifically, residential construction should remain vigorous in the second half of the year whereas investment in non-residential construction should remain at the high level recorded in the past two years.

The autumn forecast of real GDP growth for 2006 stands at 4.0%. Against the improved economic outlook in the international environment, the growth of exports to most trading partners is expected to strengthen although total export growth (7.8%) will be slightly lower than in 2005 due to the effect of this year's booming exports to France (representing a high comparative basis). Domestic consumption is projected to accelerate in 2006, largely due to the slightly higher increase in gross fixed capital formation (4.5%) fed by the sustained robust growth of housing construction and the smaller negative contribution of the change in inventories to economic growth. The growth of private consumption (3.1%) will cool off somewhat compared to 2005. Given the expected dynamics of total domestic consumption and exports, the growth of imports (6.5%) will also be slightly higher than this year, while the contribution of international trade balance will consequently shrink to 0.8 p.p.

In 2007 and 2008, real GDP growth will total 4.0% and 3.8%, respectively. Assuming favourable conditions in the international environment, exports of goods and services will record stronger growth (8.1% and 7%), as will gross fixed capital formation (5.0% in both years), whereas private consumption growth is projected to come in at around 3.1%. Given the projected trends in exports and domestic consumption, the real growth of goods and services imports in 2007 is forecast at 7.3% (6.6% in 2008).

Table 2.2.: Macroeconomic prospects

Percentage change unless otherwise indicated	**ESA Code**	**2004 Level**	**2004**	**2005**	**2006**	**2007**	**2008**
		Level in mio SIT*	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	**B 1 g**		**4.2**	**3.9**	**4.0**	**4.0**	**3.8**
2. Nominal GDP	**B 1 g**	6,251,244	7.5	6.4	6.4	6.3	6.4
Components of real GDP							
3. Private consumption expenditure	P3	3,461,491	3.1	3.6	3.1	3.1	3.1
4. Government consumption expenditure	P3	1,219,092	2.9	2.5	2.4	2.6	2.4
5. Gross fixed capital formation	P51	1,506,015	5.9	4.0	4.5	5.0	5.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+ P53		2.2	1.2	1.1	1.0	1.0
7. Exports of goods and services	P6	3,761,522	12.5	8.6	7.8	8.1	7.0
8. Imports of goods and services	P7	3,837,032	13.2	6.0	6.5	7.3	6.6
Contributions to real GDP growth (percentage points)							
9. Final domestic demand		-	3.7	3.5	3.3	3.4	3.3
10. Changes in inventories and net acquisition of valuables	P52+ P53	-	0.9	-1.0	-0.1	0.0	0.1
11. External balance of goods and services	B11	-	-0.4	1.4	0.8	0.6	0.4
* Revised national accounts data with FISIM being allocated							

Source: SORS; Autumn Report 2005, IMAD

Table 2.3.: Sectoral balances

in % GDP	**ESA Code**	**2004**	**2005**	**2006**	**2007**	**2008**
Net lending / borrowing	B.9	-2.0				
of which:						
Balance on goods and services		-1.2	-0.5	-0.1	0.2	0.5
Balance of primary incomes and transfers		-0.8	-1.1	-0.6	-0.1	-0.4
Capital account		0.1				
Net lending / borrowing of the private sector	B.9					
Net lending / borrowing of general government	B.9	-2.1	-1.7	-1.7	-1.4	-1.0
Statistical discrepancy						

Source: IMAD.

Box 1: Size and factors of crediting

Bank lending has been gradually strengthening since the beginning of 2003. The year-on-year rate of growth in lending to the private sector was below 10% at the beginning of 2003, but rose to almost 25% in 2005. The depth of financial intermediation is increasing in line with this, with lending to the private sector having been equivalent to approximately 40% of GDP at the end of 2002 but passing 50% in the middle of 2005. The high growth in lending can be to a high degree attributed to the process of deepening financial intermediation in order to catch up with more developed economies in the EU, and to interest rate convergence. Private sector lending as a proportion of GDP is higher in Slovenia than in Lithuania, Poland, Slovakia and the Czech Republic, lower than in Malta, Cyprus and Estonia, and similar to the levels in Hungary and Latvia.

Beside the process of financial intermediation deepening and interest rate convergence additional factors affected increasing crediting to corporate sector and households.[1] The need for financing corporate sector increased because of high economic growth. At the same time corporate sector replaced foreign sources of finance with domestic sources, which is partly the result of interest rate convergence. Beside relatively strong growth in consumption several factors affected increasing lending to households: disbursement of housing loans on the basis of the National Housing Saving Scheme, the relatively low level of indebtedness, increasing competition on the lending market, removing restrictions on foreign currency lending and simplified loan procedures.

Taking into account forecasts of relatively strong economic activity and other macroeconomic aggregates[2] we estimate that crediting will remain relatively high, although the current rate of growth in borrowing will begin to gradually decline. The recent elimination of the withholding tax on interbank lending (November 2005) will eliminate the discriminatory bias towards domestic banks and reduce costs of accessing long term loans resulting from the 2004 tax reform. On account of the rise in banks' borrowing abroad and in foreign currency lending to corporate sector, the proportion of corporate financing accounted for by foreign loans will decrease from approximately one-third of total lending in 2004 to less than one-fifth this year and in the next two years. Relatively strong consumption will also bring about strong household borrowing. Dynamics of lending to households will gradually decrease because the released funds from National Housing Saving Scheme will be lower as last year.

[1] More about the factors of increase of lending in Monetary Policy Report (November 2005), page 25http://www.bsi.si/html/eng/publications/mon_policy/MP_ang_y5q4.pdf
[2] See chapter 4 in Monetary Policy Report (November 2005)

Supported by favourable economic growth, the labour market's performance is expected to improve gradually in 2006-2008. The rise in employment, which started in 2004 following a two-year decline, will continue; as a result, unemployment should also drop at a somewhat faster pace. The projected real growth of gross wages per employee in 2005 (3.2%) is based on the SORS' year-on-year figure of the increase in gross wages per employee in the first seven months of 2005 (6.5% in nominal terms and 4.0% in real terms) and the assumed slowdown in the year-on-year wage growth in the remainder of the year. In line with wages policy for 2006 and 2007, the real gross wage per employee is forecast to be up 2.6% and 2.8%, respectively, in these two years.

Table 2.4.: Labour market

	2004 Level (in 000)	2004	2005	2006	2007	2008
Employment, according to SNA (growth in %)	914,3	0.4	0.7	0.5	0.5	0.3
Registered unemployment rate, in %		10.3	10.0	9.6	9.2	8.9
ILO unemployment rate, in %		6.3	6.1	5.8	5.6	5.5
Gross wage per employee (real growth, in %)		2.0	3.2	2.6	2.8	2.9
Compensation of employees (growth in %)		4.5	4.0	3.2	3.4	3.4

Source: SORS; Autumn Report 2005, IMAD

The deficit in the current account of the balance of payments will exceed the spring forecast slightly but should nevertheless remain within sustainable limits. According to the revised balance of payments data for 2002-2004, the current account deficit exceeded the originally released figures by EUR 305 m and totalled EUR 544 m or 2.1% of GDP[12]. In line with these changes and bearing in mind the current dynamics in the first half of the year (a smaller trade deficit and a bigger services surplus relative to the same period last year), forecasts of export-import flows and estimates of flows in factor incomes and transfers up until the end of the year, the current account deficit should total 1.6% of GDP in 2005. Next year the deficit is projected to contract to below 1% of GDP, while a roughly balanced current account is expected thereafter, primarily as a result of the larger positive balance in transfers and the slightly higher surplus in services (which has been rising steadily every year).

Table 2.5.: Current account of the balance of payments

	2004	2005	2006	2007	2008
Current account of the balance of payments, EUR mn	-544	-436	-195	48	-17
Current account of the balance of payments, % of GDP	-2.1	-1.6	-0.7	0.2	-0.1

Source: BoS; Autumn Report 2005, IMAD

2.3. Inflation

Inflation has continued to slow down gradually in 2005. After the decline of 1.4 p.p. to 3.2% in 2004 and following its downswing in the summer months, the year-on-year price growth (CPI) climbed slightly again in September to total 3.1% at the end of October, while average inflation fell by 0.9 p.p. since December 2004, coming in at 2.7% at the end of October. As a result, the gap between inflation in Slovenia and the Maastricht inflation criterion has been narrowing (see Figure 2.1.). Average inflation, measured by the harmonised index of consumer prices (HICP), which is used to determine the Maastricht criterion, totalled 2.7% in October. It thus lagged behind the

12 The biggest change was seen in the CIF/FOB ratio, which raised the values of imports, and the inclusion of actual reinvested earnings which were higher than their estimated values. http://www.bsi.si/html/eng/financial_data/hit/placilne_bilance_EUR_1994_naprej.html

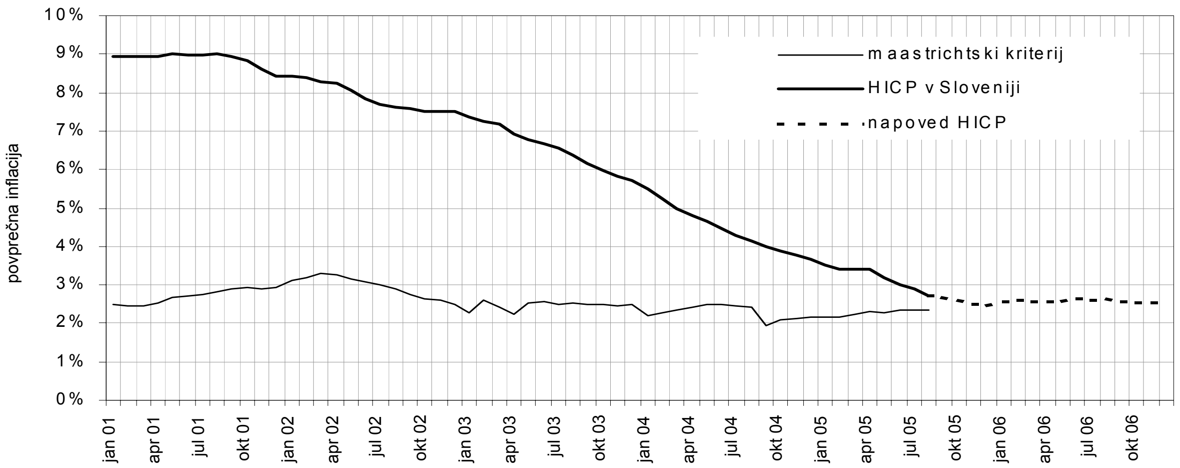
Maastricht criterion, estimated on the basis of the available methodological explanations from EU institutions, by a mere 0.3 p.p.

Table 2.6.: Price Developments

Rate of change	**2004**	**2005**	**2006**	**2007**	**2008**
1. GDP deflator	3.2	2.4	2.3	2.2	2.5
2. Private consumption deflator	3.5	2.5	2.5	2.4	2.4
3. HICP[12]	3.6	2.5	2.5	2.4	2.4
4. Public consumption deflator	4.0	3.9	3.3	3.2	3.5
5. Investment deflator	5.1	4.1	2.3	2.3	2.2
6. Export price deflator (goods and services)	3.0	3.3	2.2	2.1	1.5
7. Import price deflator (goods and services)	4.2	4.5	2.8	2.4	1.5

Source: SORS; Autumn Report 2005, IMAD

Figure 2.1.: Average inflation (HICP) in Slovenia and the Maastricht criterion



Source of data: Eurostat; forecast by IMAD.

The slower growth of consumer prices was the result of measures adopted by the government and the Bank of Slovenia. Monetary policy supported the decline in price growth by maintaining a consistent interest rate and exchange rate policies until entering the exchange rate mechanism ERM II in June 2004, while economic policy's other supportive measures included the prudent application of the restrictive Administered Price Adjustment Plan for 2004-2005, the counter-cyclical adjustment of excise duties, and the application of guidelines adopted in the social agreement[13].

13 The contribution of administered prices (excluding energy) to inflation has thus decreased by 0.2 p.p. this year, while the raising of excise duties on tobacco and tobacco products contributed 0.3 p.p. to inflation as the government continued to harmonise them with the rates agreed in the EU (they should be fully harmonised at the beginning of 2008). In the past ten months, the growth of market-determined prices fell to 1%, administered prices (excluding liquid fuels and gas) were up 2.4%, while the prices of liquid fuels and gas climbed by 20.4%. At the same time, the gradual decline of inflation was also supported by other changes related to Slovenia's EU membership. These were reflected particularly in the lower prices in the food and beverages market, which fell by 3.4% due to the abolition of customs

Any faster lowering of inflation was prevented by the soaring oil prices, which ballooned by about 60% in the nine months to September (Brent crude, USD/barrel). Therefore, the higher prices of liquid fuels for transport and heating made a direct contribution of 1.6 p.p. to the 2.8% price increase in the first ten months. Core inflation (excluding food and energy) thus dipped to below 1.0% this year.

At the end of 2005, year-on-year inflation is expected to total 2.7% while average inflation should come in at 2.5%. Due to Slovenia's entry to the EU and the exchange rate mechanism ERM II, price growth softened appreciably in the second half of 2004, totalling just 0.4%, compared to the 2.8% rise in consumer prices in the first half of 2004. Supported by the further application of macroeconomic instruments and the still perceivable impact of EU accession, inflation halved in the first half of 2005 over the same period last year, coming in at 1.5%. As a result, year-on-year inflation declined relatively fast and totalled 1.9% in June. In the third quarter of the year, price growth rose comparatively to total 1.1% (-0.2% in Q3 of 2004) due to the higher prices of liquid fuels, which pushed year-on-year inflation up to 3.2%. The final quarter of the year is again expected to experience lower price rises than last year, and year-on-year inflation should therefore dip to 2.7% until the end of the year.

Inflation is expected to decline further in 2006 and to stabilise at the achieved level in 2007. Upholding the key economic policies that helped bring inflation down to a level which has come close to the EU average in the past few months will enable price rises to remain at the achieved level in the next two years. Given that the Bank of Slovenia will keep the tolar's exchange rate stable in the remaining period of Slovenia's participation in the exchange rate mechanism ERM II and the government will support these efforts with its policies (counter-cyclical adjustment of excise duties and application of the guidelines adopted in the social agreement), core inflation is expected to remain at a level around 0.1% also in 2006. At the same time, the government is supposed to sustain its key guidelines in the area of administered prices policy; the rises of these prices should therefore not diverge substantially from the rises of market-determined prices. Together with the expected lower inflationary impact of external factors (deceleration of oil price rises), this should result in a further decline in inflation in 2006: year-on-year inflation is projected to dip to 2.3% while average inflation should total 2.5%.

The same year-on-year price growth as in 2006 is also projected for 2007 (2.3%) whereas the forecast of average inflation for next year totals 2.4%. In 2007, following Slovenia's planned entry to the European Monetary Union (EMU), the government will continue to pursue its counter-inflationary macroeconomic policies since higher price rises than in Slovenia's key trading partners would lead to the reduced competitiveness of Slovenia' tradable sector. Drawing on other EMU members' experience with the euro changeover, the government has decided to carry out the measure of dual pricing prior to adoption of the euro in order to reduce the risk of the euro changeover exerting a significant impact on price rises.

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duties, the boosted competition resulting from Slovenia's membership in the EU and the impact of more favourable weather conditions.

Table 2.7.: Inflation

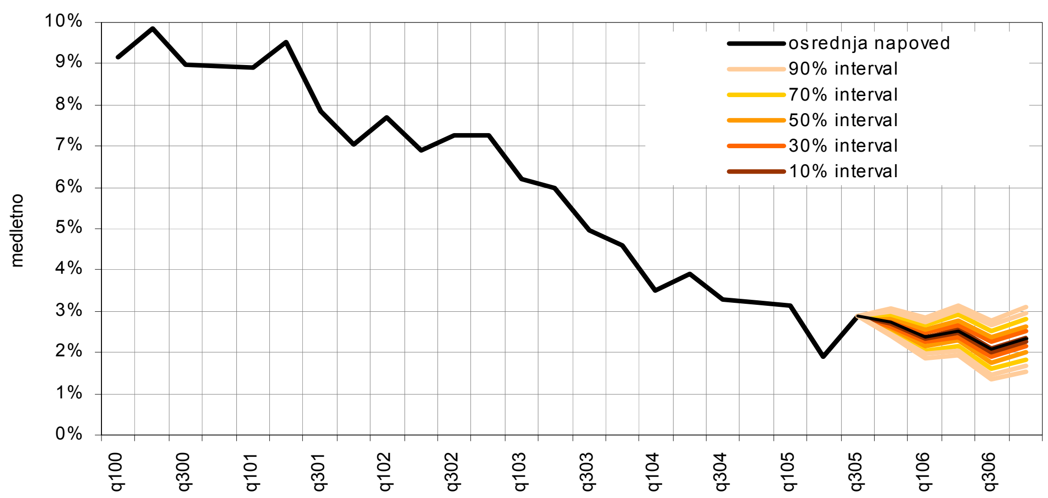
in %	2004	2005	2006	2007	2008
Inflation (annual average, %)	3.6	2.5	2.5	2.4	2.4
Inflation (Dec./Dec.)	3.2	2.7	2.3	2.3	2.5

Source: SORS; Autumn Report 2005, IMAD

If Slovenia's inflation rate were to remain higher than that of its main trading partners after the euro is adopted, the competitiveness of Slovenia's economy would continue slipping. Prices in Slovenia may rise at a faster pace than in its main trading partners due to the faster productivity growth in the Slovenian economy (Balassa-Samuelson effect) and the structural imbalances that still persist in it. Therefore, in order to achieve further sustainable lowering of inflation and hence prevent the deterioration of the economy's competitiveness Slovenia should carry through structural reforms, notably liberalise and ensure competitive conditions within those sectors where prices are still state-regulated or where monopoly suppliers still exist, as well as enhance labour market flexibility.

In line with the Programme for Entering the ERM II and Introducing the Euro, Slovenia will fulfill the Maastricht inflation criterion by mid-2006 at the latest. The persistent rises in oil prices and consequently prices in Slovenia and other EU countries are increasing the uncertainty as to whether Slovenia can achieve this criterion because their impact on inflation across individual member states has been uneven. Nonetheless, the current decline in inflation and particularly in prices that do not significantly depend on external factors is estimated to have been achieved in a sustainable way. The gap between inflation in Slovenia and the Maastricht criterion, which totalled 0.3 p.p. in August, should therefore be eliminated by mid-2006. The risks of inflation diverging from the central forecast in 2006 are still evenly distributed. Compared with the previous update, these risks have not changed and remain evenly spread (see Figure 2.2.). If the adopted economic policies continue to be consistently applied, price rises different than those projected may, in our estimate, occur mainly due to shocks from the international environment, notably further oil price fluctuations.

Figure 2.2.: Central forecast and the probability of expected deviations



Source of data: SORS; forecast by IMAD.

2.4. Growth implications of envisaged structural reforms

The implementation of the structural reform agenda envisaged in the Reform Program for Achieving the Lisbon Strategy Goals and the recommendations of the Reform Committee should result in the increase in potential output and growth and in fulfilling the objectives of the SDS. In turn, a more favourable economic performance should have a positive impact on the government budget and debt dynamics. Thus Slovenia will be also better prepared to cope with the demographic challenge ahead.

The implementation of the reform agenda should render a more competitive and flexible economy that, within the EU policy framework, will be better prepared to cope with the challenges of integration and globalization. With the implementation of the reform measures the government will pursue the following:

- stimulate the economy's competitiveness and raise economic growth rates and promote faster development of entrepreneurship and small and medium-sized enterprises
- create a more business-friendly environment
- improve the efficiency of network industries and public utilities
- increase the inflows of development-supporting domestic and foreign investment
- speed up the state's withdrawal from enterprise ownership (privatisation)
- build and improve the infrastructure to enable growth and development and support the development of Trans-European Networks (TEN-T)
- increase the efficiency of the state by raising professional standards and transparency in the public administration, improving the quality of its services and strengthening its consulting function.
- increase the influence of R&D in the domestic environment, particularly by encouraging greater R&D and innovation cooperation between enterprises and the public research sphere and mediators for the transfer of research results to enterprises
- increase investment in R&D in accordance with the Barcelona objective to 3% of GDP
- strengthen the use of information and communications technology by building up R&D and development in the ICT sector through the instruments envisaged for public educational and research institutions and as a support to the private sector and foreign investment
- create an environment in which citizens will be able to find employment more rapidly and more easily and at the same time enjoy the necessary level of social protection

The optimal implementation of the SDS in the areas of entrepreneurship and business environment, research and development and innovation, employment and education should result in the increase of the exports' growth rate and as a consequence the increase in market share in the most important trading partners. Higher productivity and new working places should thus increase employment. In the context of an improved business environment, real growth in gross fixed capital formation is expected, not only from increases in domestic private investments but through higher FDI.

According to the implementation of the SDS scenario the macroeconomic performance ahead could be broadly separated in three periods. In the first period until 2007 the policy mix should consolidate the nominal convergence achieved and facilitate meeting Maastricht criteria. In this period structural reforms will begin to be implemented and the economic growth should kept current dynamics. The shift to a higher level of development will take place after 2007, when reforms should start to provide first results and be reflected in faster productivity growth and improvement in competitiveness. The GDP growth rate should increase to 5.5 % (about 3 percentage points above the most developed EU country) on average in the period 2008-2010. After that period of fast economic growth should follow a period of relatively slower growth to a level of about 5%. This should be the new level of potential GDP growth. Under this scenario inflation would continue to converge to the EU average.

Table 2.8.: Key macroeconomic variables under SDS scenario until 2013

Real growth in % unless indicated otherwise	**2008–2010**	**2011–2013**
GDP	5,5	5,0
Value added	5,7	5,1
Exports of goods and services	9,7	8,5
Imports of goods and services	9,0	7,7
Private consumption	5,1	4,7
Government consumption	3,5	3,3
Gross fixed capital formation	5,5	4,8
Employment (growth in %)	1,3	1,0
Unemployment rate (ILO, in %)	4,4	3,4
Productivity (growth in %)	4,2	3,9
Inflation (in %)	2,5	2,4

Source: IMAD.

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1. Policy strategy

The government is committed to a fiscal policy that will facilitate the process of monetary integration and improve the quality of public finance. At the same time, fiscal policy will contribute to fasten the process of income catching up to the level of more advanced EU members.

The fiscal strategy is underpinned by the government's commitment to further fiscal consolidation that is consistent with the revised version of the Stability and Growth Pact. Within this framework improvements in the quality of fiscal policy (both in revenue and expenditure) will be pursued. This approach is reflected in the envisaged gradual reduction of the headline deficit and in preserving the quality of the adjustment. The share of public investment in GDP will remain at about 3% GDP during the program period.

The size of the general government deficit will be halved gradually from 2% of GDP in 2004 to 1% of GDP in 2008. The gradual pace of deficit reduction is explained by the additional effort required to cope with the envisaged impact of the tax reform package, primarily by the gradual elimination of payroll tax, which should reduce the share of tax revenues in GDP by about 1% during the program period. Such a development was not foreseen in the previous update of the convergence program. On the other hand, the fiscal effort on the expenditure size will be significant. Total government expenditure in GDP will be reduced by about 2.5% in the period 2005-2008. At the same time the expenditure composition will be geared towards development priorities and towards increasing the absorption capacity of EU funds. It is important to note that in absence of the predicted decline in tax revenue the headline deficit would be eliminated by 2008.

The tax reform package recently approved by the parliament (November 23/24 - 2005) aiming at enhancing competitiveness and growth potential in the economy will be implemented starting January 1st, 2006. Policy measures aim also at simplifying tax procedures. The tax reform has been designed without prejudice to the fiscal consolidation objective. The reform measures concern payroll tax, personal income tax, corporate income tax, value added tax and tax procedure. Tax policy will be accompanied by specific measures to increase the efficiency in the tax administration area.

Expenditure policy besides reducing the share of expenditures in GDP will redirect its composition towards financing development priorities, especially expenditure on R&D and education and increasing the absorption capacity for the use of EU funds and provision of funds for co-financing.

For the next financial perspective (2007 – 2013) Slovenia aims at maintaining a budgetary position of net recipient of EU funds. The estimates of receipts from the EU budget and payments to the EU budget over the period of the next financial perspective are based on the Luxembourg compromise proposal from June 2005. These estimates were used when elaborating the budget for 2006 and 2007 and incorporated in the fiscal projections for 2008.

The Luxembourg compromise proposal suggested that Slovenia would be entitled to EUR 5.2 bn in appropriations for commitments from the EU budget over the 2007 – 2013 period. Out of those EUR 5.2 bn, EUR 3.4 bn would come from the Structural and Cohesion Funds. The Slovene contribution to the EU budget over the period covered by the next financial perspective would amount to EUR 2.5 bn.

Estimates based on the compromise proposal imply that central government's receipts from the EU budget over the next financial perspective would amount to 1.65% GDP per annum, while total outflows to the EU budget would amount to 1.10% GDP annually. The net budget position in the period 2007 – 2013 would amount to 0.55% GDP. This does not take into account the flows from EU budget that do not appear as revenue of the central government budget and would amount to 0.11% GDP. These entail revenues from Heading 1a – Competitiveness and Heading 3 – Internal Policies which are disbursed to final users in member states directly.

3.2. Medium-term policy objective (MTO)

Slovenia is participating in the ERM II mechanism and aims at adopting the euro at the beginning of 2007. Maintaining a cyclically adjusted deficit (CAB) with sufficient margin against breaching the 3% benchmark is instrumental to comply with the Stability and Growth Pact and guarantee that the target date for euro adoption is met. Pursuing the reduction of the CAB towards a position close to balance will also provide the economy with more resiliency to offset adverse business cycle fluctuations and prepare public finance to cope with the challenge of population aging.

The revision of the Pact has included the need to take into account country-specific features when addressing the issue of the medium-term objective (MTO). In particular the debt-to-GDP ratio and potential growth are the two key variables to determine the MTO. The Pact also provides room for accommodating structural reforms and investment requirements.

In setting the MTO for the period 2005-2008 various factors were considered. Slovenia has a relatively low debt-to-gdp ratio (29.5% of GDP at the end of 2004). According to the EU Commission it was the fifth lowest ratio among EU members in 2004. Slovenia is a medium developed EU country with a potential growth rate that also broadly reflects its relative degree of development (3.7%). The recent EPC estimates of potential growth rates for the period 2004-2010 place Slovenia's potential growth tenth highest among EU members[14]. Slovenia as a medium developed country with specific institutional features has important policy priorities to address in the medium term to enhance its prospective development potential (see NRP). Thus, gross fixed capital formation as percentage of GDP will remain above the EU-average (2.6%) during the program period.[15] The ageing of population represents a key challenge for the long-term sustainability of public finances. According to the EPC projections, the expected old age dependency ratio (population

14 http://europa.eu.int/comm/economy_finance/epc_en.htm

15http://europa.eu.int/comm/economy_finance/publications/european_economy/2005/statannex0205_en.pdf aged 65 and over as a percentage of the population aged 15-64) of Slovenia for the 2050 ranks 5th among the highest of EU members.[16]

Taking into account the policy commitments and key factors the MTO for the cyclical adjusted balance was set at **–1% of GDP.** The MTO is to be met by 2008. With this target Slovenia will assure that the Maastricht deficit criteria will be fulfilled and the 3% benchmark observed. It will keep the debt-to-GDP ratio constant at current levels which will restrain long-term fiscal pressures. The target will also be met with existing level of investment.

The MTO will be reached gradually by the end of the program period. The consolidation pace will be lower than the recommended benchmark of 0.5% annually. However, government expenditure as percentage of GDP will be reduced on average at about 0.7% per year during the program period. The target and the pace of reaching it respond to the additional fiscal effort needed to cope with the envisaged reduction of tax revenues of about 1% of GDP resulting from the phasing out of the payroll tax. Such a policy change was not envisaged in the 2004 update of the convergence program, and must be seen as a major structural effort of the new government on the side of the public finance revenues. Another issue to consider is that the output gap will be closed only gradually by the end of the programme period and that the fiscal projections were done under a cautious growth forecast not including the effect of the envisaged structural reforms on potential growth. Furthermore, the undergoing restructuring of the high share of mandatory expenditures can only be carried out at a gradual pace due to the existing legal framework.

3.3. Actual balances and implications

According to revised data the general government deficit in 2004 was 2.0% of GDP slightly lower than presented in previous update (2.1% of GDP). The envisaged deficit for 2005 is 1.7% of GDP (Table 2) and is lower than the deficit presented in the previous update (2.1%). Budget execution for the first 10 months suggests that the targeted deficit will be reached. In May 2005, the supplementary central government budget for 2005 was approved. The 2005 central government budget was adopted in 2003 in accordance to the Public Finance Law which prescribes the adoption of budgets for 2 years on a rolling basis (see section 7). The 2005 budget was not reviewed in 2004 due to the closeness of the general election (October 2004). Since the year of its adoption in 2003 important developments took place that warranted a revision of the 2005 adopted central government budget, among others:

i) Slovenia's membership in the EU and the need to include the budgetary position vis-à-vis the EU budget;
ii) macroeconomic projections that were used for the elaboration of the budget were outdated;
iii) personal income and corporate income taxes were reformed in 2004 and,
iv) non-tax revenues needed to be adjusted according to new plan realization.

[16] See footnote 14

With respect to policy developments not foreseen in the elaboration of the 2005 central government budget, the Personal Income Tax Act and Corporate Income Tax Act were reformed in 2004 and their implementation started on January 1st, 2005 after some important amendments made by the newly elected government already in December 2004. The key changes concern the 60% reduction in the tax base of capital gains for substantial holdings and the exclusion of past interbank loans from withholding tax which has just been eliminated in November 2005.

The 2004 changes to Personal Income Tax Act reduced primarily the burden for lower income taxpayers. The new regime reduced the number of tax brackets from 6 to 5. In addition, the minimum threshold for payroll taxes was raised to lower the tax burden of the lowest income group.

Changes to the Corporate Income Tax Act expanded the tax base through a more precise definition of taxpayers and a stricter stipulation of detailed conditions for exemptions for those engaged in nonprofit activities. Tax incentives were streamlined. Particularly, the general relief for investment in fixed assets and a relief for R&D equipment was introduced. The tax rate was retained (25%) while the effective tax rate is expected to increase from 12% to about 17%. The envisaged widening of the scope of the R&D allowance resulting from the November 2005 adopted legislation on this field will contribute to stabilize the effective tax rate on this level. The increase revenues from corporate income tax is and will make up for the reduced revenues from changes income tax.

The central government budgets for the years 2006 and 2007 were submitted for their adoption in October with amendments in November 2005. The general government's deficit figures as percentage of GDP in the next two years will be 1.7% and 1.4% respectively. Their formulation is underscored by the envisaged restrictive wage policy. The key policy change in their formulation is the implementation of the new tax package. Payroll tax revenues as percentage of GDP will decline from 1.9% in 2005 to 1.5% and 1.2% in 2006 and 2007 respectively. The revenue shortfall will be financed partially by the effect of the tax reduction in higher wages and corporate profits and offset by general government expenditure reduction. Given that the payroll tax will be completely abolished in 2009 the 2007 budget foresees, among alternatives, the possibility of increase in the VAT's standard and reduced rates from 20% to 21% and from 8.5% to 9% respectively. The final decision with respect to the financing of the payroll tax reduction will be taken in 2006 when the government's reform agenda in the public finance field will have a more definite form.

The projected general government deficit for 2008 is 1% of GDP. This projection is based on the same policy scenario as the budgets presented to the parliament for 2006 and 2007. The envisaged fiscal effort in 2008 with respect to expenditure reduction is consistent with the trend decrease foreseen in 2006-2007. The projection includes the policy scenario for the next financial perspective and foresees for Slovenia a positive net recipient position of EU funds.

As a result of the tax reform the share of tax burden in the economy will decline by about 1% of GDP in the period 2005-2008. This is the result of the elimination of the payroll tax which will reduce indirect taxes by 1% of GDP (Table 2). The overall share of total revenue in GDP will decline by 1.8% of GDP also explained by the reduction of non tax revenue. The later will be the consequence of improving the efficiency of public services while maintaining the real value of structure of fees.

The share of total general government expenditure in GDP will be reduced by 2.5% of GDP during the program period on average at about 0.7% of GDP per year. The fiscal effort is anchored in the restrictive wage and employment policy in the government sector affecting collective and individual consumption which will decrease as percentage of GDP by about 1.2% of GDP during the program period. Enhancing efficiency of public administration and rationalizing and not creating additional social transfers will also contribute to decrease the share of expenditure in GDP in the period 2005-2008.

Table 3.1.: General government budgetary prospects

	ESA Code	2004 Level	2004	2005	2006	2007	2008
		mio SIT	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	**-127.746**	-2.0	-1.7	-1.7	-1.4	-1.0
2. Central government	S.1311	**-121.617**	-1.9	-2.4	-1.7	-1.4	-1.1
3. State government	S.1312	**...**					
4. Local government	S.1313	**-3.670**	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	**-2.458**	0.0	0.7	0.0	0.0	0.0
General government (S.13)							
6. Total revenue	TR	**2.825.300**	45.2	44.9	44.4	44.0	43.1
7. Total expenditure	TE	**2.953.046**	47.2	46.7	46.1	45.4	44.2
8. Net lending / borrowing	EDP B.9	**-127.746**	-2.0	-1.7	-1.7	-1.4	-1.0
9. Interest expenditure	EDP D.41	**119.326**	1.9	1.8	1.6	1.5	1.4
10. Primary balance		**-30.833**	-0.5	-0.2	-0.3	-0.1	0.2
Selected components of revenue							
11. Indirect Taxes	D.2	**1.005.895**	16.1	16.1	15.6	15.7	15.0
12. Direct Taxes	D.5	**553.698**	8.9	8.9	8.9	9.3	9.3
13. Capital Taxes	D.91	**941**	0.02	0.02	0.01	0.01	0.01
14. Social contributions	D.61	**920.307**	14.7	14.6	14.5	14.5	14.4
15. Property Income	D.4	**55.446**	0.9	1.3	1.3	1.1	1.0
16. Other revenues		**289.012**	4.6	4.0	4.0	3.5	3.4
17.=6. Total Revenue	TR	**2.825.300**	45.2	44.9	44.4	44.0	43.1
p.m. Tax Burden (D.2+D.5+D.61+D.91)		**2.480.842**	39.7	39.6	39.1	39.4	38.7
Selected components of expenditure							
18. Collective Consumption	P.32	**468.776**	7.5	7.5	7.5	7.5	7.2
19. Social transfers in kind	P.31 = D.63	**901.856**	14.4	14.7	14.3	14.1	13.8
19a. Social benefits in kind	D.631	439.788	7.0	7.0	6.9	6.8	6.7
19b. Transfers of individual non-market goods and services	D.632	462.068	7.4	7.6	7.5	7.3	7.1
20. Social transfers other than social benefits in kind	D.62	**1.018.157**	16.3	16.1	15.9	15.7	15.6

21. Interest expenditure	D.41	**119.326**	1.9	1.8	1.6	1.5	1.4
22. Subsidies	D.3	**99.270**	1.6	1.4	1.3	1.2	1.2
23. Gross fixed capital formation	P.51	**193.211**	3.1	3.1	3.4	3.2	3.1
24. Other expenditure		**152.450**	2.4	2.2	2.2	2.1	2.0
25.=7. Total expenditure	TE	**2.953.046**	47.2	46.7	46.1	45.4	44.2

Source: MF RS.

3.4. Balance by sub-sectors of general government

The central government deficit (state budget, extrabudgetary funds, agencies and other entities at the level of central government) in 2004 was 1.9% of GDP (Table 2). The central government's deficit in 2005 will be 2.4% of GDP and it will gradually decline to 1.1% of GDP in 2008 (see section 5 for the detail of underlying policies). The increase in the central government deficit in 2005 is due to the central government's debt assumption (0.7% of GDP) of the Pension and Health funds' debt. The debt assumed by the central government budget was SIT 28 billions and SIT 17 billions respectively. The debt of the Pension Fund was incurred in 2000 while the debt of the Health Fund was gradually accumulated from the year 2000 onwards. The debt assumption does not impact the overall general government balance in 2005 as it was included in the general government deficits in the years in which the Pension and Health funds registered deficits.

The two compulsory social security funds, the Pension and Disability Insurance Fund (Pension Fund) and Health Insurance Fund (Health Fund) will operate without deficits during the program period as required by Pension Fund Law in the case of the former and by the budget memorandum in the case of the latter. The two funds will register slight surpluses in 2005 in the amount of debt assumed by the State budget. In the years 2006-2008 the funds will present balance budgets (Table 2).

The Pensions Fund's balance, including central government transfers to cover the difference between original revenues of the Pension Fund and total expenditure for pension and disability insurance exhibited a slight surplus of 0.07% of GDP in 2004. The size of the State budget's transfers to the Fund during the program period will remain constant as percentage of GDP at current levels of about 3.8% and overall pension expenditure will stabilize at about 13.2% of GDP. The projection includes the recent change in the pension indexation formula. The Fund's expenditure dynamics will be governed primarily by the ongoing implementation of the pension reform in the years ahead.

In 2004 the Health Fund recorded a slight deficit amounting to 0.2% of GDP. Over the next program period the share of health-related expenditure in GDP will remain broadly stable and will amount to 6.2% in 2008. Among the reasons explaining the performance of the Health Fund during the program period are the implementation of measures that have contained the growth of expenditure in medicines such as the use of generic rather than original medicines, and the introduction of a reference price list for medicines which resulted in significant savings. The Government has the intention to enhance the reform measures in the health care system. The line ministry has elaborated a first draft of a new system law which should contribute to further rationalization of public sector expenditure on health.

The overall consolidated budgets of 193 local governments registered a slight deficit in 2004 (0.1% of GDP). In the period 2005-2008 local communities combined budget will be balanced. During 2005-2006 local communities will receive transfers from the State budget in order to cover the loss of revenue due to the 2004 reform in personal income tax.

3.5. Structural Balance

Potential growth and budgetary estimates were done without considering the positive effect of structural reforms on growth. The average potential growth of GDP during the program period is about 3.9% (production function method). Potential growth is explained primarily by total factor productivity and capital. Their contributions on average are 2.1% and 1.5% respectively during 2005-2008. While the contribution of total factor productivity is relatively stable during the program period, the contribution of capital exhibits a growing trend. Labour contribution is small but positive. The output gap will be fairly closed by 2008.

Table 3.2.: Cyclical developments

% of GDP	**ESA Code**	**2004**	**2005**	**2006**	**2007**	**2008**
1. Real GDP growth (%)		4.2	3.9	4.0	4.0	3.8
2. Net lending of general government	EDP B.9	-2.0	-1.7	-1.7	-1.4	-1.0
3. Interest expenditure (incl. FISIM recorded as consumption)	EDP D.41+FISIM	1.6	1.4	1.2	1.2	1.1
4. Potential GDP growth (%)		3.4	3.8	4.0	3.9	3.7
Contributions:						
- labour		-0.2	0.3	0.7	0.1	0.2
- capital		1.4	1.4	1.4	1.5	1.5
- total factor productivity		2.2	2.1	2.0	2.3	2.0
5. Output gap		-0.2	-0.1	-0.2	-0.1	-0.0
6. Cyclical budgetary component		-0.1	-0.1	-0.1	0.0	0.0
7. Cyclically adjusted balance (2-6)		-1.9	-1.7	-1.6	-1.4	-1.0
8. Cyclically adjusted primary balance (7-3)		-0.04	-0.03	-0.03	-0.03	-0.02

Source: MF RS.

In cyclically adjusted terms the deficit as percentage of GDP will continue its gradual but sustained declining path. Such a trend began in 2002. Fiscal consolidation process reflects the goals of the government and compliance with the Pact. The pace of fiscal consolidation is underpinned by the overall macroeconomic performance and the impact of the phasing out of payroll tax during the program period. At the end of the program period the cyclical adjusted deficit will be within the agreed range for a country with low debt and high potential growth. Throughout the period Slovenia will observe the minimum threshold for not exceeding the 3% deficit ceiling.

3.6. Debt levels and developments

The outstanding amount of general government debt was SIT 1.842 Bn (29.5% of GDP at the end of 2004). The largest share (96%) of the total represents the central government debt. The shares of social insurance funds' debt and local communities' debt were 2.4% and 1.6% respectively. In 2005 the state budget assumed the debt from social insurance funds and in the future they will not exhibit debt, as their budget position including transfers from the state budget will remain balanced. Local communities' budget on the other hand have their indebtedness capacity constrained by the Law on Municipalities financing which limits the total amount of borrowing in a given year to a maximum of 20% of realized revenues in previous year. The debt service (interest and principal) is also subject to a maximum of 5% of realized revenues in the previous year. Local communities' budgets will not show exhibit in the program period.

The general government debt as percentage of GDP will remain stable during 2005-2008 at the same level as in 2004. Gross debt as percentage of GDP will be on average 29.5%. In June 2005 the government repaid debt in the amount of SIT 80.9 billions (1.2% of GDP) using privatization receipts from the selling of a share in Nova Ljubljanska Banka in 2002. This transaction which is reflected in the negative stock adjustment figure in 2005 and active debt management operation will contribute to maintain the debt level below the figures stated in the previous update. Among the other components explaining the debt dynamics the contribution of the primary balance will be positive until 2007. The stock and flow (SFA) component will also contribute to the growth of debt in 2006-2008 but their size on average over this period will be lower than EU-15 weighted SFA average over the last decade (0.4%). The effect of the interaction between the cost of debt and economic growth as captured by the "snowball effect" will contribute to reduce the debt-to-gdp ratio. This highlights the importance of the relatively low general government debt.

Table 3.3.: General government debt developments

% of GDP	**2004**	**2005**	**2006**	**2007**	**2008**
1. Gross debt	29.5	29.0	29.6	29.8	29.4
2. Change in gross debt ratio	0.4	-0.5	0.6	0.2	-0.4
Contributions to change in gross debt ratio					
3. Primary balance	0.5	0.2	0.3	0.1	-0.2
4. "Snowball effect"	-0.1	0.0	-0.1	-0.3	-0.4
5. Stock-flow adjustment	0.1	-0.7	0.4	0.4	0.2
of which: **difference between cash and accruals**	0.02	0.01	0	0.04	0
p.m. implicit interest rate on debt	6.2	6.1	5.3	5.1	4.8

Source: MF RS.

Due to the undeveloped and small financial market and high inflation, until 2000 the central government borrowed on the domestic market primarily through index-linked instruments (mainly inflation index-linked, while instruments were to a lesser extent indexed to the exchange rate first of the Deutschmark and later the Euro). In 2000, the Government took the first step in the gradual transition towards the use of long-term nominal financing instruments by starting to issue long-term instruments and borrowing, both with variable interest rates. The variable part of interest rates was still linked to inflation. Through the process of gradual transition from the use of inflation-indexed instruments to the use of nominal instruments of financing, the state began to reduce the sensitivity of its debt to inflation trends. In 2002, the central government for the first time on the domestic market issued long-term nominal three-year tolar bonds with a fixed interest rate. In 2003, the gradual transition towards the use of nominal instruments was completed with the issuing of the first five- and ten-year tolar bonds with nominal, fixed interest rates. The issuing of the first ten-year tolar nominal bonds with fixed interest rates enabled verification of compliance with the Maastricht long-term interest rate criterion. During 2004 and 2005 – the central government continued borrowing in the domestic market by issuing tolar securities with nominal, fixed interest rates. Until the euro adoption, borrowing will be done in the domestic market under similar terms than in 2005.

3.7. Budgetary implications of "major structural reforms"

The government adopted the Reform Programme for Achieving Lisbon Strategy Goals in October 2005 and submitted the two year budgets for 2006 and 2007 for adoption to the parliament in September. The measures identified in the Program will be financed within the budget envelope.

In addition, the government endorsed in November additional reform measures proposed by the Reform Committee. In the implementation of some of the proposed measures which can have broad budgetary consequences (revenue and expenditure) the government will consult social partners and assess their full implications including budgetary ones. Thus, the budgetary impact of the additional measures is not yet included. Their implementation should be made without prejudice of the fiscal targets identified in this convergence program and the commitments to the Pact. Fiscal projections will be amended in future updates when the proposed measures will have a final and legal form.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

4.1. Sensitivity analysis to changes in economic activity

A possible downturn in the international environment represents a risk to the baseline forecast. An alternative scenario foresees a 0.5 percentage point lower growth rate in our main trading partners in the EU. The risk stems from a possible adverse impact of higher oil prices on economic activity in these countries, and from a possible further worsening of global imbalances which would slow down the rates of growth in the US and in EU. Such a development would slow down the rate of Slovene export growth in 2006 by 0.7 percentage point. It would also negatively influence investment consumption (lowering by 0.6 percentage points mainly due to lower private sector investment). Weaker demand would have a negative impact on value added growth in manufacturing, which in turn would slow down the import of intermediate consumption, thus slowing down the real growth rates of imports (estimated at 0.5 percentage points). The overall effect of these factors would result in around 0.3 of a percentage point lower economic growth compared to the baseline scenario. Under this scenario, the general government deficit worsens by 0.2% of GDP.

4.2. Sensitivity of budgetary projections to different scenarios

The sensitivity of budget projections to changes in variables adversely affecting tax revenue is presented in Tables 4.1 and 4.2. The idea is to highlight the downward risk of macroeconomic performance in budget projections. The effect of the change in average wage, employment and household consumption in government balance was assessed. Three scenarios were made: i) a lower average growth wage by 1 percentage point; ii) non increase in employment (keeping employment in the economy at the same level as in the previous year and; iii) decrease in household's consumption by 1 percentage point.

Table 4.1. shows the impact on the budget balance of the changes in the mentioned macroeconomic variables channeled though different taxes considered independently. As expected in all cases the impact is negative and particularly in the case of social security contributions and indirect taxes. In the case of the former the impact of not increasing employment is substantial due the relative high share of social security contributions in total tax revenue (around 37 percent).

Table 4.1.: Sensitivity of general government balance to changes in macroeconomic variables

	Tax category	Macroeconomic base	Change in macroeconomic base	Change in general government balance (% BDP)
1	Personal Income Tax	Average gross wage	Lower by 1 percentage point	**-0.06%**
		Employment	Same as in year t–1	**-0.03%**
2	Corporate Income Tax	Gross income	Lower by 1 percentage point	**-0.03%**
3	Social security contributions	Average gross wage	Lower by 1 percentage point	**-0.12%**
		Employment	Same as in year t–1	**-0.16%**
4	Indirect Taxes	Final domestic demand	Lower by 1 percentage point	**-0.14%**

Source: MF RS.

Table 4.2. shows the combined effect of changes in the three macroeconomic variables in the budget balance channeled though various taxes. The impact is relatively large in the cases where employment does not increase and average wage growth decline (about 0.2% of GDP). This in the case of employment behaviour highlights the importance of policies towards increase employment also on the grounds of improving public finances and its long-term sustainability. In the case of wage dynamics the simulation underscores the tension between the positive impact of wages on tax revenues and the fiscal consolidation which is anchored in a restrictive wage policy.

Table 4.2.: Cumulative sensitivity of general government balance to changes in macroeconomic variables

	Macroeconomic base	Change in macroeconomic base	Tax category	Change in general government balance (% BDP)
1	Average gross wage	Lower by 1 percentage point	Personal Income Tax, Social Security Contributions	**-0.18%**
2	Employment	Same as in year t–1	Personal Income Tax, Social Security Contributions	**-0.19%**
3	Gross income	Lower by 1 percentage point	Corporate Income Tax	**-0.03%**
4	Final domestic demand	Lower by 1 percentage point	Indirect Taxes	**-0.14%**

Source: MF RS.

4.3. Sensitivity analysis on the debt service

The cost of servicing existing debt in 2005 is relatively insensitive to changes in key variables affecting it. Were the EUR/SIT exchange rate (abandonment of ERMII) and the USD/SIT exchange rate to increase in 2006 by 15%, this would increase interest payments in the year 2006 by 0.07% of GDP, and debt level by 0.08% of GDP. If inflation would increase by 3.9 percentage points above the planned level in 2006, this would increase interest costs by 0.02% of GDP in the year 2007 and by 0.015% of GDP in the year 2008 and would have negligible impact on the debt level. The combined effects of the exchange rates depreciation and higher inflation would be 0.069% of GDP on interest and 0.078% of GDP on debt level in year 2006.

Table 4.3.: Sensitivity of interest payments and debt repayments of the general government to changes in certain macroeconomic aggregates for two standard estimation errors

% GDP	2006		2007		2008	
	Interest	Debt	Interest	Debt	Interest	Debt
Change in exchange rates (EUR/SIT and USD/SIT)	0.067	0.078	0.002	0.000	0.002	0.000
Change in inflation	0.002	0.000	0.021	0.001	0.015	0.000
Change in exchange rates and inflation	0.069	0.078	0.023	0.001	0.018	0.000

Source: MF RS.

It is clear from above that the existing central government debt is a relatively stable macroeconomic aggregate that is not strongly influenced by changes in exchange rate and inflation. This is primarily a consequence of the currency structure and the structure of debt instruments. The bulk of central government debt is denominated in tolars and euros, with other currencies representing only about 1.4% of the total debt. In terms of the debt structure by type of instruments, fixed-rate debt already represents around 80% of the total debt, while the proportion of index-linked debt (to inflation and/or exchange rates) is around 17% of the total debt.

4.4. Comparison with the previous update

The forecast of economic growth in 2005-2008 differs marginally from the previous forecast released in the Convergence Programme 2004 update. Primarily due to the slightly changed forecasts of real export growth, which were largely prompted by developments in 2004 and the first half of 2005, the forecast of economic growth is 0.1 p.p. higher for 2006-2007 and 0.2 p.p. lower for 2008.

Table 4.4.: Divergence from previous update (January 2005)

% of GDP	**2004**	**2005**	**2006**	**2007**	**2008**
1. Real GDP growth					
Previous update	4.0	3.8	3.9	4.0	4.0
Latest update	4.2	3.9	4.0	4.0	3.8
Difference	0.2	0.1	0.1	0.0	-0.2
2. General government net lending					
Previous update	-2.1	-2.1	-1.8	-1.1	na
Latest update	-2.0	-1.7	-1.7	-1.4	-1.0
Difference	0.1	0.4	0.1	-0.3	na
3. General government gross debt					
Previous update	30.2	30.7	30.9	29.7	na
Latest update	29.5	29.0	29.6	29.8	29.4
Difference	-0.7	-1.7	-1.3	0.1	na

Source: IMAD, SORS, MF RS.

The projection of net lending of the government is relatively more favorable in the current update for the 2004-2006. This is particularly the case in 2005. The difference is explained by the fact that the projections for 2005 presented in the previous update corresponded to the 2005 budget adopted in 2003 and were only changed when the supplementary budget was approved in June 2005. The main reason for the difference pertains to central government budget projected deficit which was about 0.4% of GDP higher than in the current update (see section 3.3). In 2007 the net lending is higher in the current update partly explained by the elimination of the payroll tax and partly (about 0.2%) due to reestimates of the still uncertain budgetary effect of New Financial Perspectives which brings revenues but demand higher share of expenditures. Projections for 2005-2006 do not include the marginal deficit generated by the Housing Fund (0.01% of GDP) which according to Eurostat decision is not part of the general government sector. Such deficit was included in the previous update.

The general government debt is lower in the current update in the years 2004-2007. The difference is particularly sizable in 2005 and 2006 due to the debt repayment operations made by using privatization proceeds and debt management operations.

5. QUALITY OF PUBLIC FINANCES

Fiscal policy will contribute to meet the Slovenia's Lisbon strategic goals. Public finances will contribute to future potential growth by maintaining fiscal discipline through adherence to the medium term objective (section 3) and by enhancing the quality of public finances. The policy agenda includes the adjustment of tax structure to strengthen growth potential, rationalization and reallocation of expenditure structure towards growth enhancing components including increasing the absorption capacity of EU funds and improving the efficiency of public expenditure by tightening the relation between the utilization of resources used and the objectives pursued.

The tax reform package recently approved by the parliament and including in the budgetary projections will contribute to rise growth potential by: i) enhancing competitiveness and employment creation through reducing the labor cost by means of a gradual elimination of the payroll tax; ii) savings and investment will be encourage by introducing a single lower tax rate on interest, dividends and capital gains (20%) and; iii) private expenditure in R&D will be encouraged by a new tax allowance which goes beyond existing expenditures and includes finance contracts.

In addition the approved package of reform includes the simplification of tax procedure and reform of the operation of the tax administration towards a more efficient and friendlier tax administration is envisaged.

Within the context of the foreseen reduction of public expenditure the resource allocation will be oriented to growth-enhancing categories. Among the measures considered are: i) increase and improvement of the quality of expenditure in education and on R&D; ii) transfer of the provision of some public services to the private sector and co-financing; iii) developing a legal and operating framework for executing public private partnership projects; iv) increase employment of young and older workers (tax expenditure) and; v) enhancing the information system on social transfers that will ensure better monitoring and transparency.

Expenditure policy will improve the administrative and absorption capacity for EU funds to enhance economic growth. The measures considered include: i) centralization and rationalization of the procedures relating to the acquisition of resources from structural funds; ii) preparation of a selection of quality projects of national importance to be financed in the next financial perspective

Performance budgeting should be enhanced and effectively used in the preparation and implementation of the budget. Currently program objectives, targets and indicators are part of the budget document but are not yet used for determining budget allocations during the budget preparation. Similarly budget priorities are not yet determined based on performance as the system of verification of indicators and compliance is still under development. During the program period the capacity for effective monitoring budget implementation based on indicators will be developed and effectively used for budget preparation.

5.1. General government revenues policy

The government has adopted an ambitious tax reform package. This is particularly the case of the payroll tax and personal income tax where significant systemic changes are foreseen.

The most important tax reform measure concerns the abolition of the payroll tax. The elimination of the payroll tax should reduce labor cost, increase competitiveness and contribute favorably to employment creation and growth. The payroll tax will be eliminated gradually over a period of 4 years. This cautious approach corresponds to a realistic assessment of the speed of expenditure rationalization necessary to ensure fiscal consolidation and to ensure the compliance with all the conditions necessary to adopt the euro in the foreseen timeframe. The tax revenue currently generated from this tax is about 2% of GDP. The rate of payroll tax will be decreased gradually: 20% in 2006, 40% in 2007, 70% in 2008 and it will be abolished completely in 2009.

The other key systemic change concerns personal income tax. The idea is to unburden families on their savings or investments. Higher savings in turn will have positive impact on gross fixed capital formation leading to higher productivity growth. The current system taxes all types of incomes at progressive tax rates. The new system will impose a low rate on interest, dividends and capital gains. The proportionate tax rate will be 20%. The income taxed from other sources while be still taxed at the current progressive tax rates.

The tax reform proposal also pursues further rewarding of investment of enterprises willing to enhance their technological capability by broadening the tax allowance on R&D investment. The scope of the tax allowance on R&D activities will be widened to include not only purchase of equipment but also services related to research. With such a change, on the top of the relatively low corporate tax rate, investment in research should increase. With the envisaged change in the tax allowance the effective corporate tax rate would remain around the current level.

The combined effect of the reforms in personal, corporate income taxes of 2004-2005 and the elimination of payroll tax should result in a slightly higher increase in direct taxes in the program period (0.4% of GDP). The factors explaining this development is primarily the increase in corporate income tax and the financing of the payroll tax elimination (Table 2).

Other important changes concern the simplification of the tax system as well as tax procedures. Among the measures put forward is the possibility for small and medium size enterprises to pay VAT after they receive their payments and not only on accrued receipts. Measures aiming at simplifying the tax procedure include the possibility of tax liability disclosure once a final legal decision has been made and the possibility of self declaration or subsequent full disclosure of data important for the correct tax liability ascertainment.

The proposed tax changes will render a tax system that is more competitive while at the same time became more stable and predictable as they address the most critical aspects of the tax system. In addition, the government has also endorsed the

Committee of Reform proposal in the area of taxation which includes the following measures:

- Introduction of a flat tax rate on personal income;
- Single VAT rate;
- Modifications to the corporate income tax (some of them already adopted on November 2005)
- Introduction of a tax on wealth;
- Modifications to the tax on transfers of immovable property;
- Modifications to inheritance tax;
- Further administrative measures in setting up the real estate registry and enhancing the Tax and Customs Administrations and:
- Further simplifications of tax procedures;

The realization of some of the tax reform measures will depend upon social dialogue and impact assessment of the proposed changes.

5.2. Expenditure policy

The government policy will continue reducing the share of government expenditure in GDP and reorient its composition towards financing growth–oriented categories (e.g. infrastructure, R&D, higher education). This also concerns the increase of the absorption capacity of EU funds which includes improving administrative capacity and increasing the number and quality of EU projects.

The policy measures aiming at rationalizing expenditure include the reduction of cost of public administration, enhancing its effectiveness and rationalizing social transfers. The policy measures concern primarily labor cost, social transfers and purchase of goods and services. The measures affecting these categories are captured in the behaviour of collective and individual consumption and social transfers (Table 3.1.).

The key policy underlying expenditure reduction and the cost of public administration is the reduction of labor cost. The overall wage policy will contribute to this end. The average wage growth in the economy will lag the productivity growth by at least 1 percentage point and wage growth in public sector will be lower than in the private sector on average by 1.3% during 2005-2008.

The wage bill in the public sector will decline by 0.8% of GDP over the program period. This is a more ambitious target than in the previous update. Two measures underpin the envisaged wage bill behavior: i) The wage policy that ties wage increase in the general government sector only to expected inflation and within this scope earmarks savings in the wage bill to finance wage disproportions between different segments of the public sector and; ii) the policy of reducing employment in the general government sector by 1% annually and which has been already incorporated in the 2005-2007 budgets. The restrictive employment policy foresees additional employment in the public sector only in the judiciary system and in activities related to international commitments on security (army (Nato) and police (Schengen border)) and health care sectors (doctors).

The implementation of the new Public Sector Salaries Act (2004) will be gradual and selective among and within subsectors of general government when applied in the period 2006-2009 and will be fully implemented in 2009. The law should be implemented in a fiscally neutral manner. The public sector wage agreement allows the government to save half of the yearly increase in the wage bill due to inflation to finance the implementation of the Act.

The other key policy area concerns the rationalization of government operating costs (purchase of goods and services) and improvement of public administration efficiency. Policy measure will contain the growth of expenditures on goods and services. The share of this category will remain constant as percentage of GDP during the program period (around 7% of GDP). There was a significant reduction of in this type of expenditure in 2004 (1% of GDP). The budget formulation process will be instrumental in enforcing agreed cost saving measures. Other measures considered are: i) reallocation of expenditures from programs that are less effective and successful to more effective programs; ii) changing the criteria for eligibility for funds; iii) obtaining additional resources for infrastructure projects from non-public sources; iv) establishing the legal and operating framework for instituting public private partnerships (PPP); and v) simplification of the budget preparation process enabling greater control over efficiency and effectiveness of expenditure.

The degree of restrictiveness of the policy affecting public sector administration, particularly wage and employment policies is only partially captured by the relative stability of the share of collective consumption in GDP (Table 3.1.) but more visible in expenditure in individual consumption. The stability of expenditure in public administration cost and not its reduction is due to increasing expenditure commitment of NATO membership which demands reaching a 2% of GDP target of expenditure in defense until the end of the program period and the building of the Schengen border which should be finalized in 2007. In 2008 such a development is captured by the reduction in collective consumption.

The new government is committed to deepen the process of rationalization of social transfers. No additional changes in laws defining additional transfers to individuals are foreseen during the program period. This was not the case in the past. The system of social transfers has been gradually oriented towards low-income groups of the population and to effectively target poverty reduction. The objectives in the area of social transfers are: reducing the dependency of the population on social transfers, ensuring social security through working activities, greater flexibility of the system of social transfers, and improving protection for the most socially vulnerable.

Concrete measures which will generate some results during the program period and will contribute to achieve the objectives include: i) encourage the beneficiaries of social transfers and unemployment benefits to pursue employment by means of subsidies and active employment policy; ii) elimination of unjustified accumulation of benefits; iii) upgrading information systems to enable greater transparency and oversight of the systems of social transfers.

The growth rates of expenditure for social transfers will slow down. As a consequence, their share in GDP will be reduced by 0.5 percentage points over the program period. The foreseen development will result from the interaction of policy measures, which prevent the creation of additional rights; but rather rely one effective active labor market policy and improved macroeconomic performance.

Implementation of labor market policy will contribute to decrease in unemployment by 3 to 4% every year in the period 2005-2008. The share of transfers to unemployed in GDP will slightly decrease in percentage of GDP from 0.33 in 2005 to 0.25 in 2008. Where relatively significant expenditure reduction is foreseen are on child and social care allowances where increases in their amount have been further tightened in 2005. The demographic profile has also a bearing on the expected dynamics as the number of recipients is decreasing. The relative size of these allowances will be reduced by 0.3% of GDP during the program period.

The share of interest expenditure in GDP will decline from 1.8% in 2005 to 1.4% in 2008. This development results from the debt repayment of about 1.2% of GDP in 2005 and active debt management operations of about 1.6% of GDP in 2005 that will result in significant savings. As a result of debt management operations the central government debt service is estimated to decline from 1.6% of GDP in 2004 to 1.4% in 2005. Active debt management will continue contributing to reduce debt service. Additional privatization proceeds will be used for debt reduction.

The share of subsidies in GDP will continue declining and will stabilize at 1.2% of GDP. The share of subsidies to agricultural sector financed with domestic sources has been increasing and will stabilize at the end of the program period. Subsidies will be primarily disbursed in the agricultural sector with the aim of contributing to leveling out the conditions for Slovene farmers with those from other EU Members States. The share of other subsidies (e.g. restructuring/closing enterprises and mines) in total subsidies will decline and the freed resources will be oriented to finance the increasing amount of subsidies devoted to meet horizontal objectives. The increasing funding for research, the creation of technological centers and parks is included within collective consumption in Table 3.1.

The effect of the recent change in pension indexation formula linking the minimum pension to average gross wage developments will stabilize the share of expenditure in pensions at about 13.1% of GDP during the program period. This is partly explained by the fact that average pension will still lag behind the average wage growth by 0.5 due to changes in the accrual rate of pension benefits and to the gradual prolongation of retirement age. Both changes result from the pension reform approved in 1999.

In the field of health, further measures will be introduced to contain expenditure. The ministry of health has already prepared a draft of a new law on Health Care Insurance System which is currently under consideration by social partners. The draft law foresees changes in sick leave benefit and shifting costs to the private sector which can render significant savings. Measures already adopted relate to the use of generic rather than original medicines, and the introduction of a reference price list for medicines will contribute to stabilize expenditure in medicines during the program period. Total expenditure on health will remain broadly stable over the program period and will amount to 6.2% GDP in 2008.

Slovenia needs to continue closing the development gap with respect to the EU average and the infrastructure still needs to be improved. The policy is to keep the relative share of investment (acquisition of capital assets and transfers) at its current level of around 3% of GDP.

In terms of investment, the state budget will primarily finance primary and secondary education, scientific research and tertiary education, roads and other transport infrastructure, environmental investment, hospitals, the new Schengen border and programs related to boosting competitiveness.

In the field of primary and secondary education, the Ministry of Education and Sports will continue upgrading the schooling infrastructure. The annual average increase in investments during 2006 and 2007 will be about 23.8%. In 2006, the biggest increases are budgeted for investment maintenance of secondary schools, and 62 different primary schools. More funds will be made available for minority schools. New investment will be undertaken in tertiary education, an important part of which will be the new University Library in Ljubljana.

With respect to infrastructure, further investment in state roads and motorways is envisaged. In the case of motorways, priority will be given to the 10th Transeuropean Network and the final section of the motorway towards Hungary (Pomurje).

In the field of environment, the majority of investment is devoted to co-financing communal infrastructure (wastewater treatment, supply of fresh water, sewage treatment systems). The 2006 central government budget foresees an increase in investment of about 23.6%.

Additional funds will be devoted to increase competitiveness. In particular, significant budget has been allocated to promoting foreign investment, based on the Program for foreign investment promotion 2005 – 2009. The budgets for 2006-2007 envisage an increase of funds of about 50.9% per year.

The change in expenditure composition, partly explained by the reductions in the shares of interest payments and subsidies in the GDP, will facilitate financing Slovenia’s Lisbon Agenda expenditure priorities.

Priority areas include research and development, education and training, employment, entrepreneurship and competition. The financing of the priorities listed in the National Reform Program for Achieving the Lisbon Strategy Goals will be done within the budget envelope and by enhancing the absorption capacity of EU funds.

Slovenia currently invests 1.6% GDP for R&D, 60% of which is financed by the private sector and 40% by the public sector. Slovenia has signed up to the Lisbon target of 3% for R&D by 2010, and within this level greater emphasis will be given to the private sector financing. The public sector R&D-related expenditure will increase over the program period: 0.77% GDP is budgeted for 2006, 0.85% for 2007 and 0.92% is programmed for 2008. On top of increased R&D spending and the additional tax reliefs introduced with the latest tax reform, greater co-operation between the research sphere and the economy will be promoted.

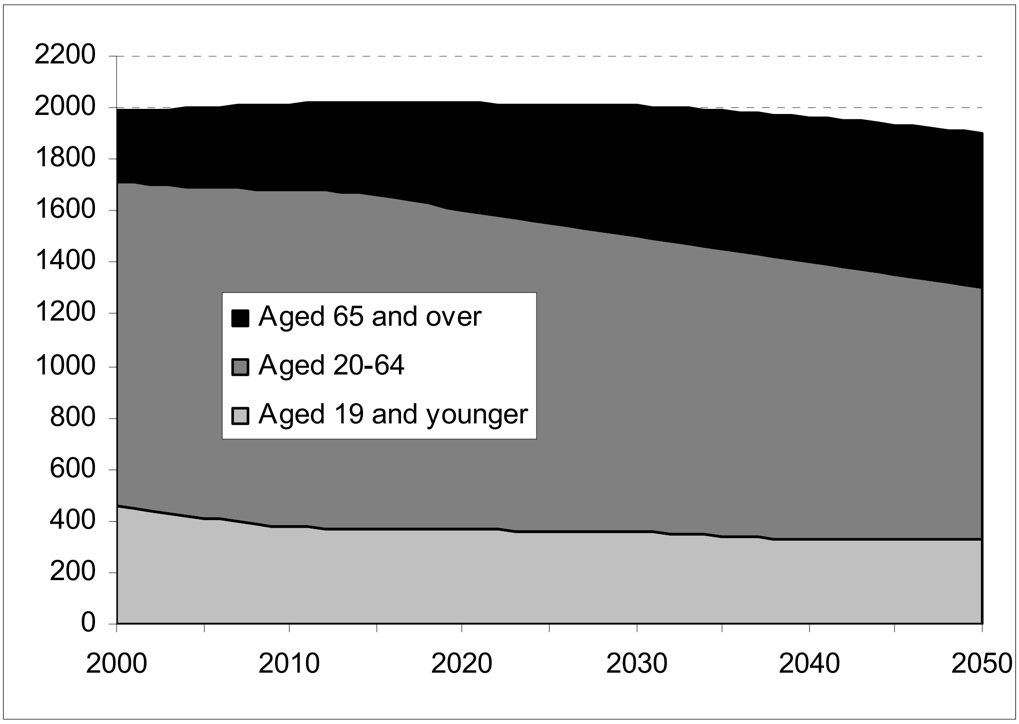
6. SUSTAINABILITY OF PUBLIC FINANCES

In future decades there will be major economic policy challenges related to the ageing of the Slovenian population where the situation could be extremely severe. The life expectancy is currently lower than in most developed countries, so the prolongation of the life span is expected. At the same time fertility is on the lowest level in Europe. It stabilized at about 1.2 children per woman.

In the period till 2050, Slovenia's population is projected to increase for about 20 thousand people and then it will start to decrease. In the year 2050 the population is projected to be for about 100 thousand smaller than it is now. In comparison to the projections that we used in the previous update this is a much smaller drop (then a decrease of almost 270 thousand people was estimated). Eurostat assumes higher net migrations, higher life expectancy and faster increase of total fertility rate – although the final level of fertility is now slightly lower than in projections prepared by working group of Slovenian demographers in the spring of 2004. Despite only a moderate drop in the number of inhabitants the demographic structure will change drastically.

The number of people aged 65 and more is projected to increase for about 300 thousands (15.0% of population) from year 2004 to 2050 (31.3% of population) (see figure 6.1). The number of people in the age 20-64 years will decline from about 64% in 2004 to 51.4% in the year 2050. This change will have strong negative effect on fiscal situation.

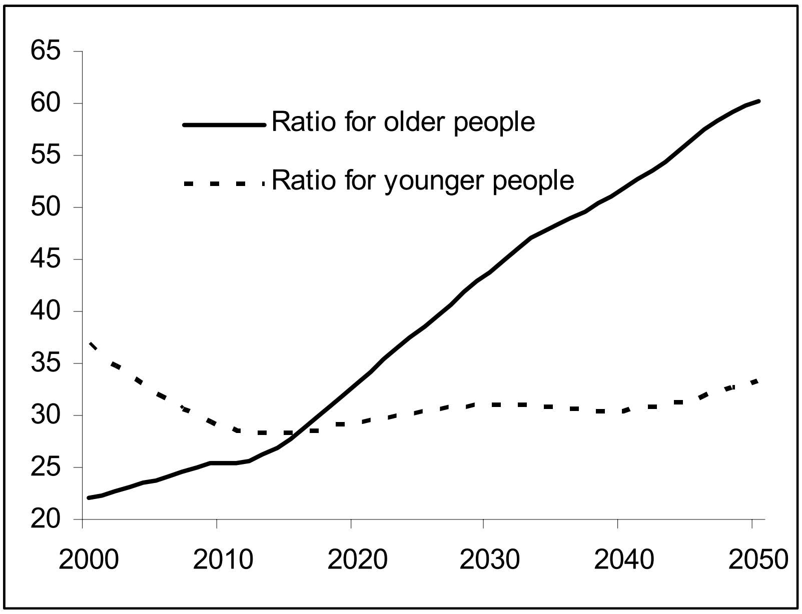
Figure 6.1.: Eurostat's demographic projections for Slovenia up to the year 2050 – number of inhabitants (in thousands); by age groups



Source: Eurostat.

A standard rough measure of the dependency burden is calculated as the ratio between the number of persons of non-working age and the number of persons of working age. The dependency ratio for young people, measured as the number of persons under the age of 20 per hundred persons in the 20-64 age group, will fall from the current 33 persons to about 28 persons at the beginning of the next decade and with growing fertility it will growth again and in 2050 it will reach the current level (see diagram 2). But the dependency ratio for older people (aged 65 years and more) per hundred people between the ages of 20 to 64 is estimated to rise continuously from around 24 in year 2004 to over 60 in 2050.

Diagram 6.2.: Demographic dependency ratios



Source: Eurostat; own calculations.

To analyse the effects of demographic changes on public finances a model of generational accounting was used. The intergenerational account methodology tries to assign as much fiscal categories as possible to representatives of specific age groups and gender. In the first step the relative tax and transfer position of individual age cohorts was estimated (mainly from micro-data surveys) and benchmarked against the corresponding base-year government budget aggregate in the second step. We were also trying to incorporate the effects of legal amendments which have been passed into law and other estimations of future changes. Age and sex specific projections of revenues and expenditures were applied on projected population number (by age and sex groups).

The fiscal effects of the stated demographic changes are on the expenditure side (increase of pensions, health and long-term expenditures) as well on the revenue side (decline of the revenue base resulting from the dwindling labour supply). Without the pension reform of 1999 which is currently under implementation the situation would have become unbearable soon. Key measures of the 1999 pension reform are the following:

- Rising the age at retirement. In the transitional period from 2000 to 2013, the minimum age limit for women will be gradually increased. It will be raised from 53 in the year 1999 to 58 in the year 2014 and will thus equal the minimum age limit for men. The required pensionable service for women (to retire at this minimum age of 58 percent) will be gradually raised from 35 to 38 years. At the same time, the possibility of early retirement will practically disappear (for both sexes).

- Gradual reduction of the pension amount through the reduction of yearly accrual rate from 2% to1.5% and total accumulated accrual rates from 85% to 72.5% (for full qualifying (service) period). This reduction of total accumulated accrual rates in applied to the newly retired insured persons; however, due to the equalization of old and new pension benefit (for the same period service), pensions will be gradually reduced to the existing pensioners as well[17].
- Gradual extension (from the year 2001 to the year 2008) of the period for calculating pensionable base from 10 to 18 most favourable consecutive years of service.

However according to the new legislation approved in 2005 the minimum pension growth will be again aligned to wage growth starting the year 2006 onwards. The new indexation of pensions is similar to that existing before the pension reform in 1999. This will increase long-term pension expenditures. In the program period (2005-2008) the effect will be shown by slowing down and stabilizing the share of Pension Fund's expenditure in GDP at the level of 13.2% of GDP[18] while expenditure on pensions as percentage of GDP will remain constant at the level of 11.2% during the period 2005-2010 (Table 3.1.).

Long-term sustainability in public finances depends essentially on activity rates, employment rates and unemployment rates. The latest assumptions from European Commission were used for the estimates. According to those assumptions the employment rate for the age group 15-64 years will increase from current 63.7% in the year 2004 to 69.3% in the year 2050; activity rate for the stated age group will increase in this period from 68.0% to 73.4% and the unemployment rate is projected to drop from 6.2% in year 2004 to 5.4% in the year 2012 and remain on this level till the year 2050.

There are estimates of increasing age at retirement based on the new pension legislation which entered into force in the year 2000. But it is difficult to predict the additional prolongation of working period i.e. postponement of retirement because of bonuses regarding later retirement, because of active employment policy, because of voluntary permanency in the employment etc. Instead of estimating only legally enforced changes activity projections (scenarios) of the Institute of Macroeconomic Analysis and Development for the future projections of retirement rates (which implies substantially postponed retirement) were used. They are based upon European Commission assumptions of future activity rates, employment rates and unemployment rates.

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[17] It is an effect of Article 151 of the Pension and Disability Insurance Act whose intention is to give equal rights to pensioners retired in different periods. To this end, an alignment of pensions paid in the current year and those from the previous periods is made each year.

[18] This share includes all expenditures of Pension fund (pensions, supplements and allowances regardless of their nature (earning and non earning related benefits. Only (earning related benefits expenditures currently amounts till 11,2% of GDP).

Table 6.1.: Long-term sustainability of public finances, % of GDP[19]

	2005	2010	2020	2030	2040	2050
Total expenditures	46.7					
Of which: age-related expenditure	18.8	18.9	20.9	24.2	27.7	30.1
Pension expenditures	11.2	11.2	12.5	14.6	17.0	18.5
Healthcare	6.7	6.7	7.3	8.2	9.0	9.6
Long-term care	0.9	1.0	1.1	1.4	1.7	2.0
Total revenues	44.9					
of which: from pensions contributions	9.9	10.3	10.9	11.0	10.9	10.9
Assumptions (in %)						
Labour productivity growth	3.5	3.1	3.0	2.7	1.9	1.7
Real GDP growth	3.4	3.7	2.4	2.0	1.0	1.1
Participation rates males (aged 15-64)	73.5	76.4	77.9	77.0	75.4	76.4
Participation rates females (aged 15-64)	63.9	66.3	69.0	69.8	69.0	70.5
Total participation rates (aged 15-64)	68.8	71.5	73.6	73.5	72.3	73.5
Unemployment rate	6.0	5.5	5.4	5.4	5.4	5.4
Share of population aged 65 years and over (%)	15.3	16.5	20.4	25.1	28.4	31.1

Source: Institute for Economic research, IMAD, MF RS.

In the projection it was assumed that wage growth will be the same as productivity growth. As mentioned earlier, according to the legislation from the year 2005 pension growth will be indexed to the growth of wages (but the growth of pensions will be in the transition period smaller than the growth of wages because of gradual reducing pension benefits which is the consequence of the pension reform from the year 2000). For health and long-term care expenditures it was assumed that on per capita basis they will grow with the same growth rate as labour productivity.

All those three types of expenditures are expressed as share of GDP. Growth rate of GDP is calculated as sum of labour input growth rate and labour productivity growth rate. This means that it is calculated in the same way as in the calculations from European Commission.

According to the projections the effect of the pension reform and optimistic assumptions about future movements of employment and unemployment rates, fiscal situation will not face serious problems in the next decade. The main reason for this is the impact of the adopted pension reform (gradual increase of retirement age for women and decreasing level of benefits) and only moderate changes in demographic structure. But then the baby-boom generation will come into retirement, prolongation of life expectancy will continue and as a consequence demographic ratio of older people will become very unfavourable. Additional adjustments of the parameters in pension legislation or a new pension reform will be necessary.

19 The version of the table included in the Convergence program differs slightly from the table forwarded to the AWG. The main reason for the difference is the change in data fot 2004 and 2005, which in the case of Convergence program already includes the actual valorization of pensions in these two years, while the AWG table still contained the baseline figures. The final difference in year 2050 amounts to 0,3 percentage points (18,8% GDP in the AWG scenario).

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. Budget formulation and deficit targeting

According to the Public Finance Act budgets for two consecutive years have to be prepared and adopted on a rolling basis since 2002. The budget formulation framework, a two-stage process, provides the government with the possibility to target precisely the budget approved figure. In the first stage the government's cabinet sets out the overall expenditure framework for two years and in the second it confirms the budget appropriations within the expenditure limits.

The existing budgetary procedure does not maintain expenditure ceiling regardless of macroeconomic circumstances, but provides for the option to adjust the first and second year budgets in light of changing macro-economic circumstances.

The budgetary framework allows for precise deficit targeting by means of budget execution procedure without the need to recourse to supplementary budget legislation. Under the scenario of changes in macroeconomic circumstances or occurrence of new commitments the government can determine the suspension of adoption of new commitments within the agreed limits of the Budget Execution Law. Furthermore, in the case of changing economic circumstances reflected in lower revenues than approved by parliament the government can reduce expenditures, and if the revenue short-fall is higher than a given threshold it can only increase expenditure up to a limit set by the Budget Execution Law (e.g. 2005).