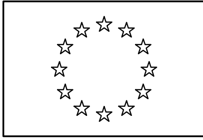

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DIRECTORATE GENERAL
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DECEMBER 2005 UPDATE OF THE CONVERGENCE PROGRAMME OF SLOVENIA (2005-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The second update of the Slovene convergence programme, covering the period 2005-2008, was submitted on 8 December 2005. The updated programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.[2]

In its opinion of 8 March 2005 on the previous update of the convergence programme, covering the period 2004-2007, the Council invited Slovenia to (i) seize all opportunities to accelerate the reduction of the general government deficit and (ii) undertake further measures to improve the long-term sustainability of the public finances, including the reforms of the pension and health-care systems.

Following a transition recession in the early nineties, the Slovene economy fully restored robust GDP growth averaging nearly 4% over the last decade. Inflationary pressures have been successfully curbed and consumer price growth approached the EU average by the end of 2005. The general government balance slipped in 1997 and stayed negative since then, with deficits averaging 3% of GDP on an ESA95 basis in the period 2000-2004.

The macroeconomic scenario, where GDP growth is projected to remain at around 4% throughout the programme period against buoyant domestic demand, appears plausible. Cyclical conditions are likely to improve gradually; the negative output gap, estimated to have stood at 1% of GDP in 2005, is forecast to close by the end of the period. The growth assumptions do not include the impact of a reform plan approved in October 2005, which is expected to accelerate growth to over 5% on average after 2008. This seems somewhat optimistic, especially as the programme fails to provide details on how the structural reforms would affect (potential) growth.

In 2005, inflation became volatile but continued to decline on average, dropping to 2.5% by the end of the year (3.7% in 2004). The government remained committed to prudence in regulating administered price increases and indirect tax changes. Moreover, regular adjustments of excise duties to counteract the adverse effects of high oil prices helped in reining inflation. Furthermore, disinflation has been fostered by ERM II membership. The tolar has stayed very close to the central parity of 239.64 SIT/EUR ever since

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[1] This technical analysis, which is based on information available up to 24 January 2006, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 1 February 2006. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Mateja Peternelj (Mateja.Peternelj@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

[2] The programme has gaps in the compulsory and optional data prescribed by the new code of conduct. In particular, compulsory data on labour productivity growth are not available. Also missing are certain optional data concerning labour market developments, sectoral balances and general government debt developments. The table on general government expenditure by function is not included.

Slovenia joined ERM II on 28 June 2004. The long-term interest rate spread has been fluctuating within, and occasionally even much below, 100 basis points since April 2004, closely mirroring the development of bond yields in the euro area. The monetary authorities recognise constraints in adjusting the policy interest rates to keep inflation under control in the run-up to EMU entry. Over the programme horizon, inflation is expected to settle at around 2.5%, which seems realistic but further removal of the remaining structural rigidities needs to be pursued. With a view to introducing the euro in the beginning of 2007, the programme sees as crucial wage moderation and sound public finances.

As regards budgetary implementation in 2005, the general government deficit for 2005 is estimated at 1.7% of GDP in the Commission services' autumn 2005 forecast, against a target of 2.1% of GDP set in the previous update of the convergence programme. The preliminary outcome is better than expected as revenues had been underestimated based on the new direct tax regime, in force since January 2005.

The updated programme aims at creating conditions for a successful EMU integration while catching-up with average EU income levels. The budgetary strategy is geared to keeping the general government deficit well below 3% of GDP and targets to achieve the medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact by 2008. To that end, the programme announces tax reform measures, leading to a drop in the share of revenue as a percentage of GDP by 1.8%, and measures on the expenditure side, resulting in a decline in the expenditure ratio by 2.5% of GDP. The programme envisages a back-loaded consolidation path. In the beginning of the programme period, the general government deficit is expected to linger at 1.7% of GDP and then slowly decrease, to 1.4% in 2007 and further to 1.0% of GDP in 2008. Compared with the previous programme, the new update postpones the target of achieving a deficit of 1% of GDP by one year against a broadly unchanged macroeconomic scenario.

Based on Commission services' calculations according to the commonly agreed methodology and consistent with the information in the programme, the structural balance, i.e. in cyclically-adjusted terms and net of one-off and other temporary measures, is envisaged to improve by 0.2 percentage point of GDP over the programme horizon. The structural deficit stood at 1¼% of GDP in 2005. Following a slight deterioration, to reach 1½% of GDP in 2006, the deficit is expected to improve gradually thereafter. The new programme sets the medium-term objective (MTO) for the budgetary position in the meaning of the Stability and Growth Pact at a structural deficit of 1.0% of GDP, to be reached by 2008. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of almost 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct, adequately reflecting the debt ratio and average potential output growth in the long term.

The risks attached to the budgetary targets are broadly balanced. Slovenia has established a track record of better-than-projected budgetary outcomes in the recent years, also supported by an effective budgetary mechanism of containing general government expenditures in response to an unexpected revenue shortfall. Furthermore, the assumptions on growth may turn out better than projected, should the structural reforms be implemented timely. However, the absence of clear schedules for cutting government

spending to offset the revenue loss due to the tax reform and, especially, in light of the recent decision to re-introduce indexation of pensions to wages, may make the realisation of the targets difficult. In particular, the high share of mandatory expenditure (more than 80% of the overall outlays) is rooted in the rigid regulatory framework, which still awaits political consensus to be restructured in a more flexible way.

In view of this risk assessment, the budgetary stance, as outlined in the updated programme, seems to provide a sufficient safety margin against breaching the 3% of GDP threshold for the deficit with normal macroeconomic fluctuations throughout the programme period. The strategy also seems sufficient to ensure that the programme's MTO will be reached in 2008, as planned. However, the pace of adjustment towards the programme's MTO is not fully in line with the Pact, which sets a "benchmark" in the annual improvement in the structural balance at 0.5% of GDP for euro-area and ERM-II Member States and specifies that the adjustment should be higher in good economic times. While cyclical conditions improve steadily over the programme horizon the structural balance is planned to improve by only ¼% of GDP.

The programme invokes a temporary deviation on the basis of "major structural reforms", as meant in the revised Stability and Growth Pact and the new code of conduct. The departure from the Pact's benchmark for the speed of structural adjustment is requested by the additional fiscal effort to cope with the revenue shortfall due to the tax reform and against the negative output gap, expected to close only by the end of the programme period. However, the structural reforms on which the temporary deviation is based are insufficiently detailed. Furthermore, the programme does not provide a cost-benefit analysis nor evidence of a significant beneficial impact on the long-term sustainability of public finances. Therefore, the temporary deviation from the adjustment path towards the programme's MTO is not in line with the revised Stability and Growth Pact.

Gross government debt is relatively low and will remain so over the programme period. In 2005, the debt is estimated to have fallen to 29% of GDP. The programme foresees a slight increase in the debt ratio in the next two years, peaking at 29.8% of GDP in 2007. By 2008, the debt is forecast to fall to 29.4%, as a favourable stock-flow adjustment is anticipated.

With regard to the sustainability of public finances, Slovenia appears to be at high risk on grounds of the projected budgetary costs of ageing populations. The relatively low debt ratio will contribute to limit the budgetary impact of ageing. However, Slovenia will still face a very large increase in government expenditure. Even though the 1999 pension reform has significantly alleviated future increase in expenditure, its effects have been partly offset by a new indexation rule, i.e. moving from partial to full indexation to wages. Further changes in the pension schemes, as recognised by the programme, will prove necessary at some point to contain future increase in government expenditure and reduce the risk to long-term sustainability. If no further measures are taken to relieve the pressures of age-related expenditure, the long-term sustainability of public finances will be undermined. A careful planning and timely adoption of measures are key in this regard.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. However, long-term sustainability of public finances is not explicitly

identified as the policy priority. Measures remain vague and do not allow an assessment of the feasibility of the strategy in the longer term.

The national reform programme of Slovenia, submitted on 28 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies adoption of the euro in 2007 as the key priority. Geared to create conditions for a successful EMU integration, including by improving the quality of the public finances, the updated convergence programme bears a close link with the NRP's comprehensive list of policy measures. However, as a number of measures remain largely unspecified, the budgetary implications of the actions outlined in the national reform programme have not been included in the budgetary projections of the convergence programme.

The updated programme aims at containing inflation close to the EU average while projecting a gradual fiscal adjustment path. In view of the above assessment, it would be appropriate for Slovenia to: i) make a more rapid progress towards achieving the programme's MTO, especially by specifying and implementing the measures underlying the planned reduction of the expenditure ratio as well as by frontloading the adjustment effort; ii) undertake further measures to improve the long-term sustainability of the public finances, particularly in relation to the pension system.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Dec 2005**	**4.2**	**3.9**	**4.0**	**4.0**	**3.8**
	COM Nov 2005	4.2	3.8	4.0	4.2	n.a.
	CP Jan 2005	*4.0*	*3.8*	*3.9*	*4.0*	*n.a.*
HICP inflation (%)	**CP Dec 2005**	**3.6**	**2.5**	**2.5**	**2.4**	**2.4**
	COM Nov 2005	3.6	2.6	2.5	2.5	n.a.
	CP Jan 2005	*3.6*	*3.0*	*2.7*	*2.6*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2005[1]**	**-1.4**	**-1.2**	**-0.7**	**-0.3**	**0.0**
	COM Nov 2005[5]	-1.2	-0.9	-0.5	0.2	n.a.
	CP Jan 2005[1]	*-1.2*	*-1.2*	*-1.3*	*-1.3*	*n.a.*
General government balance (% of GDP)	**CP Dec 2005**	**-2.1**	**-1.7**	**-1.7**	**-1.4**	**-1.0**
	COM Nov 2005	-2.1	-1.7	-1.9	-1.6	n.a.
	CP Jan 2005	*-2.1*	*-2.1*	*-1.8*	*-1.1*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2005**	**-0.5**	**-0.2**	**-0.3**	**-0.1**	**0.2**
	COM Nov 2005	-0.2	-0.1	-0.4	-0.2	n.a.
	CP Jan 2005	*-0.3*	*-0.4*	*-0.2*	*0.4*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2005[1]**	**-1.4**	**-1.2**	**-1.4**	**-1.3**	**-1.0**
	COM Nov 2005	-1.5	-1.5	-1.7	-1.7	n.a.
	CP Jan 2005[1]	*n.a*	*n.a*	*n.a*	*n.a*	*n.a.*
Structural balance[2] (% of GDP)	**CP Dec 2005[3]**	**-1.4**	**-1.2**	**-1.4**	**-1.3**	**-1.0**
	COM Nov 2005[4]	-1.5	-1.5	-1.7	-1.7	n.a.
	CP Jan 2005	*n.a*	*n.a*	*n.a*	*n.a*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2005**	**29.5**	**29.0**	**29.6**	**29.8**	**29.4**
	COM Nov 2005	29.8	29.3	29.5	29.2	n.a.
	CP Jan 2005	*30.2*	*30.7*	*30.9*	*29.7*	*n.a.*

Notes:
[1]Commission services calculations on the basis of the information in the programme
[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures
[3]There are no one-off and other temporary measures in the programme
[4]There are no one-off and other temporary measures in the Commission services' forecast
[5]Based on estimated potential growth of 3.7%, 3.5%, 3.5% and 3.5% respectively in the period 2004-2007.

Source:
Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The second update of the Slovene convergence programme was submitted on 8 December 2005, following the adoption by government.[3] It sets out a fiscal policy framework for the 2005-2008 period based on the 2006 and 2007 budget bills which were adopted by parliament on 12 December.

Slovenia's convergence programme adheres to the model structure for stability and convergence programmes specified in the new code of conduct. The data requirements[4] have been broadly met, with minor gaps in compulsory[5] and optional[6] data. For a detailed overview of all aspects of compliance with the new code of conduct, see Annex 2.

2. ECONOMIC OUTLOOK

Strained by a transition recession in the early nineties, the Slovene economy fully restored healthy growth. Over the last decade, real GDP has been remarkably stable and robust, growing at nearly 4% per annum on average. In 2004, GDP per capita in purchasing power standards reached around 80% of the average EU-25 level. Inflationary pressures spurred by the introduction of VAT in 1999 have been successfully contained. Helped by a concerted policy action of the government and the Bank of Slovenia – in effect since 2003 – consumer price growth has decreased rapidly and by the end of 2005 approached the average EU inflation rate. At the same time, labour market developments have been favourable. By 2004, the employment rate had increased steadily to 65.3%, slightly above the EU average, while the unemployment rate at 6.0% was one of the lowest in the EU. Still, challenges remain, reflected particularly in low employment of older workers and high youth unemployment. Moreover, structural rigidities in the labour market impede a faster catching-up with the EU productivity levels; labour productivity per person employed stood at only 75% of the EU-25 average in 2004 despite the above-average growth rates.

The macroeconomic scenario underlying the programme anticipates real GDP growth to stay robust at around 4%, driven mainly by buoyant domestic demand and further strengthened by a sustained export expansion. Over the programme period, cyclical

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[3] On 1 December, the ultimate deadline for submission of the convergence programmes set out by the code of conduct, a draft was made available to the Commission services.

[4] Following the invitation in the assessment of the previous programme, the update includes an improved delimitation of the general government expenditure, explicitly distinguishing between social benefits in kind and transfers of individual non-market goods and services.

[5] The programme does not provide labour productivity growth over the programme period while the table on sectoral balances is incomplete, with net external balance for 2005-2006 and statistical discrepancy in 2004 missing. Interest rates, though unavailable, are presumably based on the common assumptions for the Commission services' autumn 2005 forecast.

[6] The assessment is not hampered by the unavailability of optional data regarding labour market developments (based on hours worked), sectoral balances and general government debt. In the table on the long-term sustainability of public finances there is no pension sub-classification and nothing on education and interest expenditure. The optional table on general government expenditure by function is not included.

conditions (as measured by the output gap calculated by the Commission services with the commonly agreed methodology and consistent with the information provided in the programme) are improving steadily. The negative output gap, standing at around 1% of GDP in 2005, is expected to close by 2008.[7]

Based on a comparable set of external assumptions[8], the Commission services' autumn 2005 forecast foresaw real GDP growth to accelerate slowly until 2007, (slightly) exceeding potential output growth (estimated at 3½%) but without the risk of overheating. Economic activity is set to be fuelled following the recovery of investment expenditure. As imports are likely to rise accordingly, the positive contribution of net exports to GDP growth is projected to gradually wane. Furthermore, with the extension of the restrictive wage agreement[9] to the period 2006-2009 still pending, the Commission services forecast the compensation of employees to increase more rapidly.

Overall, the programme's growth projections closely correspond to the Commission services' autumn 2005 real GDP forecast for the period 2006-2007 and are broadly in line with the Commission services' estimate of potential GDP growth thereafter. The growth path underlying the macroeconomic scenario (see Table 1) can thus be considered as plausible. It is, however, noteworthy that in autumn the Commission services foresaw that the output gap would already turn positive in 2007, while the programme envisages the output gap (as recalculated by the Commission services using the commonly agreed methodology) to be closed only in 2008.

Against the background of solid economic activity, the labour market situation is set to improve further. In line with the programme's projection of favourable cyclical conditions, employment continues to increase moderately and the unemployment rate resumes its trend decline to below 6%. However, the labour content of GDP growth falls below the historical average over the programme horizon. Presumably, this is the consequence of structural rigidities in the labour market.

The commitments to improve labour market flexibility and further increase competition in the network industry, especially in the utilities, are seen as key to help achieve the programme's inflation projections. Inflation is projected to settle at around 2.5% in the programme period, broadly in line with the Commission services' autumn 2005 forecast until 2007. The assumed continuation of anti-inflationary policies is based on prudence in administering regulated prices and indirect taxes, and a renewed commitment to wage moderation beyond 2005 in the negotiations between social partners due this year. With exchange rate stability now credibly anchoring expectations, risks to the inflation

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[7] The calculations of potential growth (and hence the output gap) must be treated cautiously as they are exposed to potentially considerable uncertainty particularly for countries experiencing a catching-up process.

[8] The programme, however, duly notes that the oil price assumptions for 2006 and 2007, set at USD68 and 66, respectively, are on the high side of the projection range due to the forecasts having to be finalised by end September, in time for the government to lawfully launch the budgetary procedure.

[9] The Social Agreement for the period 2003-2005, concluded by the social partners in April 2003, introduced a rule of wage rises lagging behind productivity growth by at least one percentage point.

forecast are mainly external by way of oil price hikes. However, insofar important structural rigidities persist in the economy disinflation is unlikely to progress further.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	3.8	3.9	4.0	4.0	4.2	4.0	3.8
Contributions:							
- Final domestic demand	3.3	3.5	3.6	3.3	3.8	3.4	3.3
- Change in inventories	-1.1	-1.0	0.0	-0.1	0.6	0.0	0.1
- External balance on g&s	1.6	1.4	0.4	0.8	-0.1	0.6	0.4
Output gap[1]	-0.9	-1.2	-0.5	-0.7	0.2	-0.3	0.0
Employment (% change)	0.3	0.7	0.2	0.5	0.3	0.5	0.3
Unemployment rate (%)	5.8	6.1	5.7	5.8	5.6	5.6	5.5
Labour productivity growth (%)							
HICP inflation (%)	2.6	2.5	2.5	2.5	2.5	2.4	2.4
GDP deflator (% change)	2.5	2.4	2.5	2.3	2.5	2.2	2.5
Compensation of employees (% change)	6.1	4.0	5.6	3.2	5.9	3.4	3.4
External balance (% of GDP)	-1.5	n.a.	-1.8	n.a.	-1.9	n.a.	n.a.

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.

Source:
Commission services' autumn 2005 economic forecasts (COM); convergence programme update (CP)

Potential output growth as calculated by the Commission services according to the commonly agreed methodology, based on the information provided in the programme is fully in line with the estimates presented in the Commission services' autumn 2005 forecasts. Potential output growth is estimated at around 3.5%, whereby the largest contribution comes from capital accumulation.

Table 2: Sources of potential output growth

	2005		2006		2007		2008
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Potential GDP growth[1]	3.5	3.6	3.5	3.6	3.5	3.6	3.5
Contributions:							
- Labour	0.1	0.2	0.1	0.1	0.1	0.1	0.1
- Capital accumulation	2.1	2.1	2.0	2.0	2.0	2.0	2.0
- TFP	1.4	1.4	1.4	1.4	1.4	1.4	1.4

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

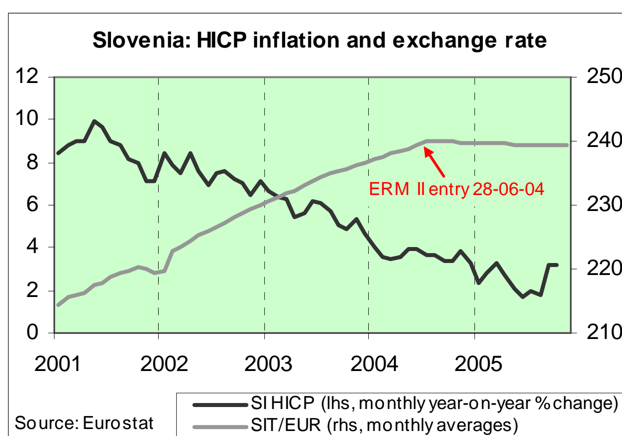
The programme announces important structural reforms (as per the National Reform Programme) to be carried out throughout the programme period, which are expected to considerably enhance the economy's growth potential. The authorities argue that they constitute "major structural reforms" in the meaning of the Stability and Growth Pact (p.19 of the December 2005 update of the convergence programme). A comprehensive list of measures has been proposed, stretching from the tax system, business environment, research and innovation, active labour policies to sustainable development. Although the reform plan was adopted by government in October 2005, the

implementation timetable remains uncertain as a number of measures await the agreement with social partners. Therefore, the programme does not assume any impact on growth within the programme period.

The reform plan aiming to deal with the structural imperfections in the economy is projected to produce positive economic effects beyond 2008. Real GDP growth is projected to accelerate to 5.5% on average between 2008-2010, and moderate to around 5% per annum from 2011-2013. While invoking "major structural reforms" to justify a temporary deviation from the adjustment path towards the medium-term objective (see section 4.2.3), the programme fails to provide a detailed evaluation of the impact of the reforms on (potential) growth, as required by the code of conduct.

3. Medium-term monetary policy objectives and their relationship to price and exchange rate stability

The convergence programme notes the constraints in adjusting the policy interest rates to control inflation and stresses the importance of income and other policies for achieving a low inflationary environment in a sustainable manner. This is seen as part of a strategy that would allow Slovenia to move ahead with the euro adoption, planned for 2007.



Since entering ERM II on 28 June 2004, monetary policy has focused on the maintenance of exchange rate stability. The tolar has stayed very close to the ERM II central parity of 239.64 SIT/EUR, with maximum deviations of 0.16 percent on the weaker side and of 0.1 percent on the stronger side.

Exchange rate stability has anchored inflationary expectations. In 2005, consumer price inflation continued its decreasing trend. The March and September spikes, largely fuelled by seasonal increases in clothing and food prices and an oil price hike, have been neutralised and by December, a 12-month moving average inflation rate reached 2.5%. The government exercised its discretion to partly counteract the adverse effects of high oil prices by regular adjustments of excise duties on energy products, but by July 2005, the lowest level of excise taxes allowed by EU legislation was reached. Furthermore, the government regulated administered price rises in such a way as not to exert inflationary pressures. Moreover, market prices have clearly been driven down by increased competition owing to EU accession.

The main policy interest rate – the 60-day tolar bill rate – has remained unchanged at 4% since ERM II entry. Three-month money market interest rates have constantly hovered just above this level, putting the interest rate differential against the euro area at somewhat below 200 basis points. This is judged by the Bank of Slovenia to be the highest possible level that still maintains exchange rate stability, while helping to contain possible inflationary pressures. As the recent increase in policy rates in the euro area has not been followed by the Bank of Slovenia, the spread on money market interest rates narrowed somewhat at the beginning of December. Exchange rate stability in the

presence of this positive interest rate differential continued to be underpinned by the standing agreement between the central bank and commercial banks on co-operation in the interventions on the foreign exchange market. In this framework, the central bank could withdraw the excess supply of foreign exchange though renewable foreign exchange swaps at its preferred exchange rate and thereby help to limit possible fluctuations of the tolar/euro exchange rate.

Since 2004, long-term interest rates in Slovenia have closely mirrored the development of bond yields in the euro area. The spread constantly fluctuated within 100 basis points since April 2004, occasionally narrowing to much lower levels.

4. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous convergence programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

4.1. Targets in successive programmes and implementation in 2005

The updated programme confirms the goal of gradually bringing down the general government deficit towards 1% of GDP through a relatively back-loaded adjustment. However, the achievement of this target has been postponed despite a broadly unchanged macroeconomic scenario. Between 2005-2008, the general government deficit is expected to decrease from 1.7% to 1.0% of GDP.

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008
General government balance (% of GDP)	**CP Dec 2005**	**-2.0**	**-1.7**	**-1.7**	**-1.4**	**-1.0**
	CP Jan 2005	-2.1	-2.1	-1.8	-1.1	n.a
	CP May 2004	*-1.7*	*-1.8*	*-1.5*	*-0.9*	*n.a*
	COM Nov 2005	-2.1	-1.7	-1.9	-1.6	n.a.
General government expenditure (% of GDP)	**CP Dec 2005**	**47.2**	**46.7**	**46.1**	**45.4**	**44.2**
	CP Jan 2005	48.2	48.0	47.4	47.4	n.a
	CP May 2004	*47.0*	*45.7*	*45.1*	*43.6*	*n.a.*
	COM Nov 2005	47.9	47.2	47.0	46.3	n.a.
General government revenues (% of GDP)	**CP Dec 2005**	**45.2**	**44.9**	**44.4**	**44.0**	**43.1**
	CP Jan 2005	46.1	46.0	45.6	46.3	n.a
	CP May 2004	*45.1*	*44.0*	*43.6*	*42.7*	*n.a.*
	COM Nov 2005	45.8	45.4	45.1	44.7	n.a.
Real GDP (% change)	**CP Dec 2005**	**4.2**	**3.9**	**4.0**	**4.0**	**3.8**
	CP Jan 2005	4.0	3.8	3.9	4.0	n.a
	CP May 2004	*3.6*	*3.7*	*3.8*	*3.9*	*n.a.*
	COM Nov 2005	4.2	3.8	4.0	4.2	n.a.

Source:
Convergence programmes (CP) and Commission services' autumn 2005 economic forecasts (COM)

In 2005, the general government deficit is estimated to have declined to 1.7% of GDP. This preliminary outcome is well below the anticipated deficit of 2.1% as forecast in the January 2005 update of the programme and is in line with the initial target of 1.8% of GDP, set in the May 2004 convergence programme.

In June 2005, a supplementary budget for 2005 was adopted by parliament after the new government revised the revenue projections as well as reviewed the composition of expenditures in line with the new priorities. Following the re-estimation of the effects of the direct tax regime reform, in force since 1 January 2005, it was established that the negative consequences for government revenue had been grossly overestimated. While the new personal and corporate income tax legislation was estimated to have a neutral impact on revenues[10], the latest estimations showed the effect to have been positive. Furthermore, the inflow of indirect taxes was also revised upwards. The new projections foresaw higher revenues in the amount of 0.9% of GDP. With the revisions to the original 2005 budget, the general government expenditure increased by 0.6% of GDP. Overall, the revised budget featured a 20 billion tolar (approximately 0.3% of GDP) lower deficit compared to the initial target.

On the basis of developments until September, the Commission services' autumn 2005 forecast saw a deficit of 1.7% of GDP to be realised as most likely (see Box 1).

Box 1: The revision of government accounts in 2005

It is noteworthy that in 2005 a further alignment of government accounts to ESA95 rules has been assured, which brought about an additional substantial upward revision of the 2001 and 2003 deficit.[11] During its regular visit in May 2005, Eurostat requested further modifications be made in the general government accounts for the September 2005 notification. The revision had important consequences for the 2000-2004 deficits in relation to the following issues:

– Recognition of war claims to be paid by **the Restitution Fund**, established for restitution of nationalised and confiscated properties to the original owners before the second world war and for compensation of damages to war and post-war victims. Government expenditure for 2001 was revised upwards by 0.8% of GDP for 2001 to include the recognition of war claims by the Restitution Fund following court rulings. According to ESA rules, the recognition of liabilities by a court ruling should be recorded as expenditure (in the form of a capital transfer) at the time of the legal decision, irrespective of the timing for effective cash payments.

– Exceptional dividend paid to government by **the Agency for Payments**, in charge of managing payments among legal entities and collecting revenues on behalf of the government until its liquidation in September 2003. Government revenue for 2003 was revised downwards by 0.3% of GDP, as the exceptional dividend based on the agency's accumulated surplus until its closure is not eligible to be recorded as deficit reducing. According to ESA95 rules, payments due to liquidation of government-owned units are financial transaction booked below the line (as privatisations) even if they are legally recognised as dividends.

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[10] The new personal income tax regime was estimated to reduce government revenues by 0.2% of GDP, which was expected to be fully compensated for by higher inflows following the modified corporate income tax law.

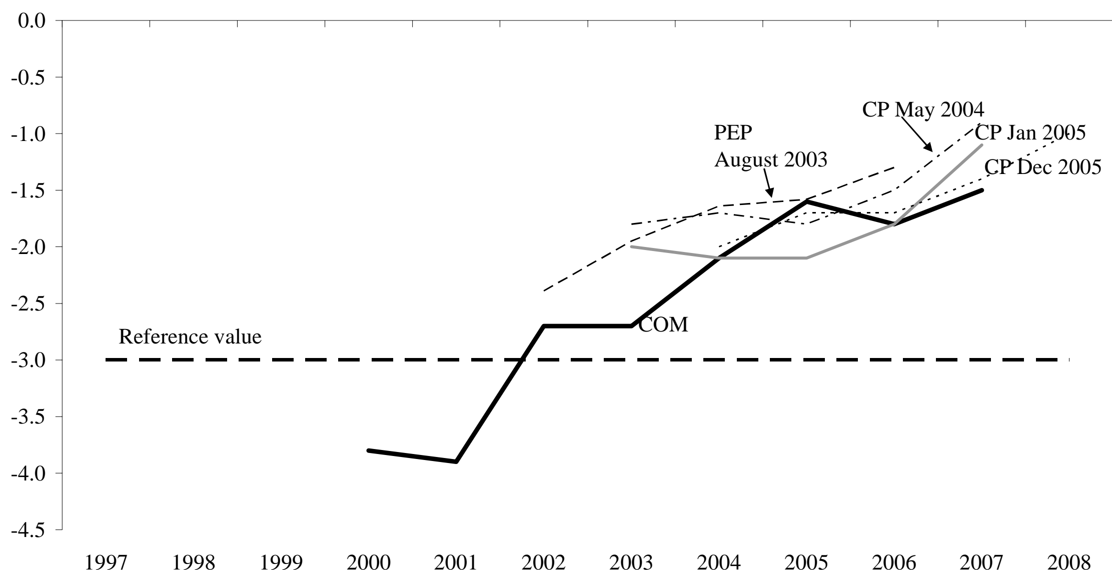
[11] Recall that already in 2004 a comprehensive ex-post revision of the government accounts to include the two extra-budgetary funds – the Capital Fund and the Restitution Fund – in the general government sector, has been made, which increased the general government deficit for the period 2000-2003 by 0.2-0.5% of GDP.

– Sectoral classification of **the Slovene Dwelling Fund**. The Fund has been reclassified as a private enterprise, given its mainly market-oriented activities related to purchasing and selling flats. By removing from the government accounts the deficit this unit incurred in 2003 (by purchase of dwellings for later resale in the framework of the national housing saving schemes, designed by government to support new home ownership), the general government deficit decreased by 0.2% of GDP.

– Other adjustments concerned the revision of expenditures in relation to booking subsidies and investment as imputed expenditure when it is incurred, i.e. on an accrual basis rather than according to cash outflows, as well as regarding guarantees on loans granted to private and public firms, which have been called or are likely to be effectively called. Furthermore, following a court decision, a liability of the Pension Fund for Craftsmen to the government was imputed as expenditure. On the revenue side, the adjustments were made for taxes and social contributions which accrued but are unlikely to be collected. Overall, the changes raised the general government deficit by 0.2-0.3% of GDP over the period.

After revision, the general government deficit increased substantially for 2001, from 2.8% to 3.9% of GDP. In 2003, the deficit increased by 0.7 percentage points, to 2.7% of GDP. For other years, the impact on deficits was rather small; in 2000 and 2002, the general government deficit was revised upwards by 0.3 percentage points, to 3.5% and 2.7% of GDP, respectively, while the deficit for 2004 is 0.2% percentage points above the previous figure.

Figure 1: General government balance projections in successive convergence programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive convergence programmes

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

Fiscal policy is predicated on a successful EMU integration as the key policy priority, while pursuing simultaneously development goals such as catching-up with average EU income levels based on, *inter alia*, the improvement in the quality of public finances. Implicitly, the main goal is to keep public finances sound with the general government deficit well below 3% of GDP. The programme aims at a steady and smooth fiscal consolidation, geared to achieving a deficit of 1% of GDP by the end of the programme period (2008).

In the update, the consolidation path is kept gradual and its time profile remains back-loaded while the pace of adjustment has been slowed somewhat despite a broadly unchanged macroeconomic scenario compared with the previous programme. In the beginning of the programme period, the general government deficit is expected to linger at 1.7% of GDP and then slowly decrease, to 1.4% in 2007 and further to 1.0% of GDP in 2008. The primary balance, on the other hand, is expected to initially slightly deteriorate, turning marginally negative (-0.1% of GDP) in 2006, followed by an improvement to 0.1% in 2007. By 2008, the primary balance is expected to rise to 0.4% of GDP. The improvement, however, is largely attributable to the closing of the output gap while discretionary measures only account for 0.2% of GDP of the adjustment effort.

Table 4: Composition of the budgetary adjustment

(% of GDP)	**2004**	**2005**	**2006**	**2007**	**2008**	**Change: 2008-2005**
Revenues	45.2	44.9	44.4	44.0	43.1	**-1.8**
of which:						
- Taxes & social contributions	39.7	39.6	39.0	39.5	38.7	**-0.9**
- Other (residual)	5.5	5.3	5.4	4.5	4.4	**-0.9**
Expenditure	47.2	46.7	46.1	45.4	44.2	**-2.5**
of which:						
- Primary expenditure	45.3	44.9	44.5	43.9	42.8	**-2.1**
of which:						
Consumption	21.9	22.2	21.8	21.6	21.0	**-1.2**
Transfers other than in kind & subsidies	17.9	17.5	17.2	16.9	16.8	**-0.7**
Gross fixed capital formation	3.1	3.1	3.4	3.2	3.1	**0.0**
Other (residual)	2.4	2.1	2.1	2.2	1.9	**0.0**
- Interest expenditure	1.9	1.8	1.6	1.5	1.4	
General government balance (GGB)	**-2.0**	**-1.7**	**-1.7**	**-1.4**	**-1.0**	**0.7**
- excluding second-pillar pension scheme						
Primary balance[1]	**-0.1**	**0.1**	**-0.1**	**0.1**	**0.4**	**0.3**
One-off and other temporary measures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
GGB excl. one-off & other temporary measures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Note:
[1] The primary balance differs from the numbers supplied in the convergence programme following the recalculation according to the formula suggested in the code of conduct, where the primary balance is a difference between net lending/borrowing and interest expenditure.

Source:
Convergence programme update; Commission services' calculations

4.2.2. *The composition of the budgetary adjustment in the programme*

The programme announces tax reform measures, leading to a drop in the share of revenue as a percentage of GDP by 1.8 percentage points, and measures on the expenditure side, resulting in a decline in the expenditure ratio by 2.5 percentage points of GDP. Although adjustment is expenditure-driven, the programme does not specify in sufficient detail the measures taken so as to curb public spending. Furthermore, the authorities consider it essential to keep the share of public investment at 3% of GDP.

The decline in the revenue ratio is substantial over the programme period and is due to a comprehensive tax reform, planned to be implemented starting in 2005. In November 2005, the parliament approved a number of modifications in the tax legislation, effective as of 1 January 2006 (see also Box 2). The most costly measure (2% of GDP) is the gradual abolition of the payroll tax by 2009. The payroll tax rate will be reduced gradually, by 20% in 2006, 40% in 2007, 70% in 2008, and should disappear by 2009. The changes in personal and corporate income tax concern additional simplification of the direct tax regime. While total revenues in 2007 are projected to fall, it is noteworthy that taxes and social contributions as a percentage of GDP increase. This is presumably due to a rise in the VAT rate that has been considered as a possibility to compensate for the loss linked to the phasing-out of the payroll tax.[12]

Although these measures improve the quality of public finances (see also Section 6 below), the consolidation effort remains rather limited. Fiscal adjustment in the period 2005-2008, when the general government deficit is expected to decrease from 1.7% to 1% of GDP, is mainly a consequence of the closing of the output gap.

Box 2: The budget for 2006

Although the 2006 budget should have already been adopted in 2004 according to the existing budgetary procedure of simultaneously adopting budgets for two consecutive years, the regularity of presenting budgets on a rolling basis was interrupted due to the October 2004 parliamentary elections. The new government, in office since 3 December 2004, has re-initiated the lawful budgetary process by presenting the 2006 and 2007 budgets to parliament in October 2005. Subjected to a two month scrutiny by parliament in line with a standard budgetary procedure and following a number of amendments, the 2006 Budget Bill and the accompanying Budget Implementation Act were passed together with a 2007 budget on 12 December 2005.

The 2006 budget targets a general government deficit of 1.7% of GDP. On the revenue side, further adjustments to the personal income tax and corporate income tax, as adopted at the end of November 2005 and in force from 1 January 2006, have been duly included. Although only effective since 1 January 2005, the new direct tax regime has been widely perceived as insufficient to serve the aim of enhancing the competitiveness and growth potential of the Slovene economy. To recall, changes in corporate income tax included a broadening of the tax base and the elimination of loopholes in the legislation while the personal income tax was designed so as to provide tax relief to the lowest income classes. The latest modifications mainly concerned further simplification of the direct tax regime. Moreover, in the framework of a gradual elimination of the payroll tax by 2009 its rate is lowered by 20%. On the expenditure

[12] The government has also declared itself in favour of introducing a flat tax rate in 2007 but it is difficult to speculate about the probability of the proposal being effectively enacted as it faces fierce opposition by social partners.

side, the measures enhancing cost effectiveness and flexibility will be largely offset by the decision to index pensions to wages. Furthermore, spending commitments related to EU and NATO membership (e.g. Schengen border, top-up payments related to the farming sector, defence) weigh on the budget.

The 2006 budget, however, does not include the effects of the anticipated structural reforms and the relevant features of the new EU financial perspective. Revisions to both the 2006 and the 2007 budget seem inevitable.

According to the programme, the high share of mandatory expenditure leaves little space to assume any new "financial obligations"[13]. However, savings could still be made on other expenditures in the budget.

4.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

According to the new programme, the MTO is set at a structural deficit of 1.0% of GDP and planned to be achieved by 2008. Based on Commission services' calculations according to the commonly agreed methodology and consistent with the information in the programme, the structural balance stood at -1.2% of GDP in 2005. Following a slight deterioration, to reach -1.4% of GDP in 2006, the situation is expected to improve gradually until 2008, when a deficit of 1% of GDP is planned to be reached.

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[13] The authorities argue that public finances will incur additional pressures due to the financial implications of EU and NATO membership.

Table 5: Output gaps, cyclically-adjusted and structural balances

% of GDP	2004		2005		2006		2007		2008	Change: 2008-2005
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Gen. gov't balance	-2.1	-2.1	-1.7	-1.7	-1.9	-1.7	-1.6	-1.4	-1.0	0.7
One-offs[2]	0	0	0	0	0	0	0	0	0	0
Output gap[3]	-1.2	-1.4	-0.9	-1.2	-0.5	-0.7	0.2	-0.3	0.0	-
CAB[4]	-1.5	-1.4	-1.5	-1.2	-1.7	-1.4	-1.7	-1.3	-1.0	0.2
change in CAB	0.5	0.5	0.0	0.2	-0.2	-0.2	0.0	0.1	0.3	-
CAPB[4]	0.4	0.5	0.2	0.6	-0.2	0.2	-0.3	0.2	0.4	-0.2
Structural balance[5]	-1.5	-1.4	-1.5	-1.2	-1.7	-1.4	-1.7	-1.3	-1.0	0.2
change in struct. bal.	0.5	0.5	0.0	0.2	-0.2	-0.2	0.0	0.1	0.3	-
Struct. prim. bal.[6]	0.4	0.5	0.2	0.6	-0.2	0.2	-0.3	0.2	0.4	-0.2

Notes:
[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme
[2]One-off and other temporary measures
[3]In percent of potential GDP; see Table 1 above
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.
[5] CAB excluding one-off and other temporary measures
[6] Structural primary balance = CAPB excluding one-off and other temporary measures
Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

The structural balance[14] is envisaged to improve by 0.2 percentage point of GDP over the programme horizon whereby the adjustment is relatively back-loaded. A high growth environment, in which revenues increase in line with economic activity, facilitates the achievement of budgetary targets despite the negative consequences of the modifications in the tax system. The expected relatively favourable macro-economic growth conditions in 2005 and 2006, with the economy growing above potential, thus offer the opportunity to speedily proceed with reforms.

According to the revised Stability and Growth Pact and the new code of conduct, Member States that have not yet reached their MTO can temporarily depart from the required adjustment path, while Member States that have already reached their MTO can temporarily deviate from it, in case of major structural reforms that have a verifiable positive impact on the long-term sustainability of the public finances. In both cases the budgetary position has to return to the MTO within the period covered by the programme. The claim to such a temporary deviation should be supported in the programme by a detailed quantitative cost-benefit-analysis (of the short-term costs and of the long-term benefits) from the budgetary point of view.

The programme states that the plan of comprehensive socio-economic reforms endorsed by government in October 2005 (see also Section 2 above), can qualify as "major structural reforms" in the meaning of the revised Stability and Growth Pact. According to the programme, a temporary deviation from the adjustment path towards the programme's MTO is warranted (p.19 of the December 2005 update of the convergence programme).

In particular, a tax reform planned to be carried out over the programme period is expected to produce beneficial economic effects by reducing the tax burden of the economy and thereby considerably increasing its competitiveness. Furthermore, micro-

[14] As mentioned, cyclically-adjusted and structural balances need to be interpreted with caution.

economic policy measures concerning *inter alia* the improvements of the business environment, R&D and innovation activities as well as the knowledge-based society promise to strengthen the economy's growth potential. With regard to these measures, the programme invokes a departure from the annual structural adjustment of at least 0.5% of GDP, set out as a benchmark by the code of conduct for ERM II countries like Slovenia, but envisages that the MTO level, set at -1% of GDP, will be achieved by the end of the programme period. The programme fails to support the claim to a temporary deviation with a detailed presentation of budgetary costs and benefits in the short and long term, as requested by the code of conduct.

4.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

4.3.1. Appropriateness of the programme's medium-term objective

As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of almost 2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

4.3.2. Risks attached to the budgetary targets

The updated programme features realistic budgetary projections whereby the risks to the targets are broadly balanced.[15]

On the one hand, Slovenia has established a track record of better-than-projected budgetary outcomes in the recent years. A careful fiscal targeting is supported by an effective mechanism of containing general government expenditures in response to an unexpected revenue shortfall. Since 2000, the legal framework allows the government to safeguard the deficit target in case economic conditions impinge on the public finances. Committed to fiscal discipline, the previous government successfully applied this mechanism in 2004 to contain the slippage after the budget had incurred a substantial liquidity loss in VAT resources, following the dismantling of border controls after EU accession.[16] Furthermore, the budgetary projections may seem cautious in view of the

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[15] The programme's deficit targets for 2006 and 2007 are more optimistic in comparison with the Commission services' autumn 2005 forecasts even though the latter were finalised before the enactment of the tax reform package in late November. Against the uncertainties surrounding the amendments to the tax legislation, the Commission services projected that the deficit would increase to -1.9% of GDP in 2006 and fall to -1.6% of GDP in 2007.

[16] In October 2004, when the shortfall approached the limit set in the Implementation Bill to the 2004 budget, the government refused claims for any further expenditure. As stipulated in the Implementation Bill to the 2004 supplementary budget, it was within the government's discretion to reduce expenditure proportionally – up to 15 billion tolars (0.25% of GDP) – to a revenue shortfall in the course of the year, without having to propose the budget to be amended.

planned structural reforms as their positive impact on growth is largely absent from the macroeconomic scenario.

On the other hand, the lack of firm commitments regarding the announced reform plan (timetable, budgetary impact) leaves targets exposed to implementation risk.[17] The absence of clear schedules for cutting government spending to offset the revenue loss due to the tax reform and, especially, in light of the recent decision to re-introduce indexation of pensions to wages[18], may well impede the realisation of targets. In particular, the high share of mandatory expenditure (more than 80% of the overall outlays) is rooted in the rigid regulatory framework, which still awaits political consensus to be restructured in a more flexible way.

4.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

Taking into account the risk assessment above, the budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO will be reached in 2008, as targeted. Risk of breaching the 3% of GDP threshold for the deficit in any of the years is not imminent as a safety margin with respect to the reference value within normal cyclical fluctuations is assured (the minimum benchmark for Slovenia is a cyclically-adjusted deficit of almost 2% of GDP).

The adjustment path towards the programme's MTO, however, should be more demanding. The annual improvement in the structural balance – planned to be 0.2% of GDP between 2005 and 2008 – does not meet the "benchmark" of 0.5% of GDP, specified in the Stability and Growth Pact for the euro area and ERM-II Member States. More effort would be expected given the assumption that the cyclical position gradually improves over the programme horizon.

The programme motivates a temporary deviation from the adjustment path towards the programme's MTO on the basis of "major structural reforms". It invokes a departure from the "benchmark" speed of structural adjustment based on the considerable fiscal effort needed to cope with the revenue implications of the tax reform and in the face of the negative output gap, expected to close only by the end of the programme period (p.19 of the December 2005 update of the convergence programme).

However, the conditions to allow for a temporary deviation set out in the code of conduct are not fully satisfied. Admittedly, Slovenia is broadly on track to assure that the MTO is achieved within the programme horizon while a safety margin is provided in each year of the period. But details about the structural reforms, particularly related to the planned expenditure cuts, remain unspecified. Furthermore, the programme falls short of providing substantial evidence on how the structural reforms will have a verifiable positive effect on the long-term sustainability of public finances. In particular, a comprehensive cost-benefit analysis is missing. Therefore, the requested temporary deviation from the adjustment path towards the MTO is not in line with the revised Stability and Growth Pact.

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[17] Social partners have been fiercely opposing the socio-economic reform agenda with an argument that certain measures would considerably undermine the social conditions of a large part of the population. In particular, the proposal to introduce the flat tax rate has been heavily criticised.

[18] In June 2005, a decision was adopted to fully index the increase of pensions to wage growth.

This assessment implies that budgetary strategy regarding the general government balance outlined in the programme is only partly consistent with the broad economic policy guidelines in the area of public finances, specifically with the integrated guideline No 1. The adjustment path towards the MTO could be expected to be more demanding (see Annex 3).

4.4. Sensitivity analysis

Sensitivity of fiscal projections to several negative shocks is analysed in the programme, as requested by the code of conduct. Shocks to three key economic variables have been tested for the budgetary impact: i) poor conditions on the labour market (resulting in no employment growth), ii) wage moderation (modelled by average wage growth which is by 1 percentage point lower) and iii) withering investors' and consumers' confidence (channelled through a decrease in domestic consumption by 1 percentage point). With a negative effect of at most 0.2% of GDP the government deficit did not prove very responsive to downside risks. However, the programme does not dwell on the underlying assumptions about how revenue and expenditure are projected to react to variations in economic variables. Furthermore, the programme does not provide sufficient information about how changes in the key aspects of the announced structural reform would affect potential output and the general government balance thereof – as required in the code of conduct when invoking a temporary deviation from the adjustment path toward the MTO.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2008 period; (ii) trend output based on the HP-filter[19] and (iii) no policy response (notably, the expenditure level is as in the central scenario[20]), reveal that, by 2008, the cyclically-adjusted balance is 0.6 percentage point of GDP below the central scenario. Hence, in the case of persistently lower real growth, additional measures of more than 0.5 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.[21] Although risks to the macroeconomic scenario are broadly balanced a strong commitment to meet the budgetary targets in the programme will be essential.

5. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

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[19] In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[20] The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

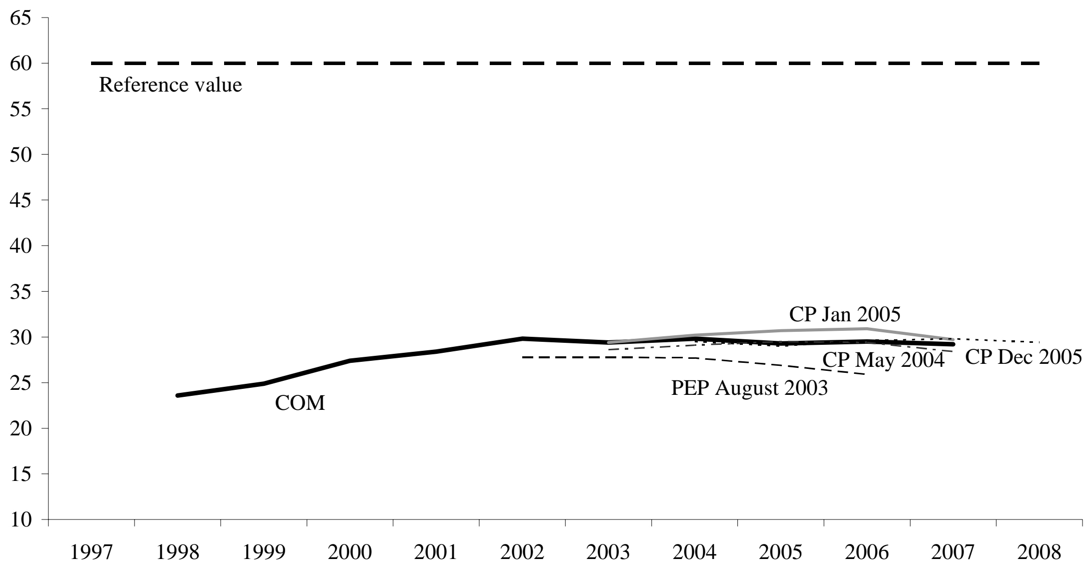
[21] Unexpected changes in inflation are assumed not to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

5.1. Debt developments in the programme

Compared to the January 2005 convergence programme, when gross government debt was estimated to increase to 30.7% of GDP by the end of 2005, the updated programme estimates the debt ratio to have reached 29.0% of GDP, down from 29.5% in 2004.[22] The preliminary outcome is broadly in line with the Commission services' autumn 2005 forecast of 29.3% of GDP. In June 2005, the government repaid debt in the amount of 80.9 billion tolars (1.2% of GDP) by using the remaining privatisation proceeds from the sale of a 30% share in the biggest Slovene bank, the Nova Ljubljanska Banka in 2002.[23]

Over the programme horizon, the debt ratio is set to remain relatively low, although the government anticipates a rise in the next two years. Gross government debt is expected to peak at 29.8% of GDP in 2007 but decline to 29.4% of GDP by 2008. The developments in the debt ratio are mainly influenced by the stock-flow adjustment since the contribution of the primary balance is broadly offset by the debt-decreasing snow-ball effect (as the implicit interest rate has been smaller than the GDP growth rate) throughout the programme period.

Figure 2: Debt projections in successive convergence programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive convergence

Table 6: Debt dynamics

	average 2000-2004	2005		2006		2007		2008
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio	29.0	29.3	29.0	29.5	29.6	29.2	29.8	29.4

[22] Recall that in 2004 the re-classification of the two extra-budgetary funds (Capital Fund and Restitution Fund) into the general government sector led to the upward revision of the debt ratios by 0.7-2.4% of GDP in the period 2000-2003.

[23] Debt incurred by the pension fund and the health fund – two compulsory social insurance funds, classified within the general government – in the total amount of 45 billion tolars was transferred to the state budget in 2005. Given the intra-government nature of the transaction the general government debt was not affected.

Change in debt ratio (1 = 2+3+4)	0.8	-0.5	-0.8	0.2	0.6	-0.2	0.2	-0.4
Contributions[1]*:*								
- **Primary balance** (2)	0.7	0.1	-0.1	0.4	0.1	0.2	-0.1	-0.4
- **"Snow-ball" effect** (3)	-0.2	-0.4	-0.3	-0.3	-0.1	-0.4	-0.3	-0.4
- Interest expenditure	2.3	1.7	1.8	1.5	1.6	1.4	1.5	1.4
- Real GDP growth	-0.9	-1.1	-1.1	-1.1	-1.1	-1.2	-1.1	-1.1
- Inflation (GDP deflator)	-1.6	-1.0	-1.0	-0.7	-0.7	-0.7	-0.6	-0.7
- **Stock-flow adjustment** (4)	0.3	-0.2	-0.4	0.6	0.6	0.0	0.6	0.4
- Cash/accruals	-0.1							
- Accumulation of financial assets	-0.2							
of which: Privatisation proceeds	-1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects & residual adj.	0.6							

Notes:
[1]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.
Source:
Convergence programme update (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

5.2. Assessment

The programme's projections for the general government debt are close to the Commission services' autumn 2005 forecast, which predicts the debt ratio to hover around 29.5% of GDP (under a no-policy change assumption). The updated programme remains silent on the government's intentions concerning the sale of state-owned equity and the subsequent use of revenues to retire public debt. The effect of privatisation proceeds on the level of debt can therefore not be inferred.

The risk of negative shocks to the debt can be considered as limited. The debt portfolio is deemed appropriate by the authorities since a long-term repayment profile spreads evenly over time, while the currency structure shows a growing share of tolar-denominated debt and a predominantly euro-denominated external debt. For the medium-term, the government plans to enforce a more active policy of debt management and expects to lower interest expenditure from 1.8 percentage points of GDP in 2005 to 1.4 percentage points of GDP by 2008.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

Geared to create conditions for a successful EMU integration, including by improving the quality of the public finances, the updated convergence programme bears a close link with the national reform programme (NRP), submitted on 28 October 2005 in the context of the renewed Lisbon strategy for growth and jobs. The convergence programme briefly reviews the government's structural reform agenda as presented in the NRP. An extensive list of largely appropriate measures is based on a comprehensive approach to

respond to the key challenge of a successful euro introduction. The proposed measures focus on enhancing competitiveness of the economy by improving the business environment, encouraging R&D activities, promoting job-creation-oriented investment as well as removing structural rigidities in the labour market.

The convergence programme outlines the fiscal measures in support of creating a competitive and efficient knowledge-based society. The tax reform has been designed with the aim to boost economic growth through the promotion of innovation and technological development. Investments in research and employment creation, in particular, are now entitled to tax relief, which should encourage entrepreneurship, one of the key challenges identified by the NRP. Furthermore, increasing the share of R&D-related expenditure in the budget has been identified a policy priority. Currently accounting for 1.5% of GDP, the highest among the ten new member states, R&D spending is to move closer to the target, set at 3% of GDP by 2010. In this context, policy action must focus especially on improving the interaction between research activities and industry.

The envisaged measures are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. Nevertheless, the quantification of the fiscal effects is largely missing. Although the NRP announced that the budgetary consequences of the planned reforms would be scrutinised in the convergence programme the measures have not been evaluated in detail. While none of the strategic documents elaborates on the budgetary implications of the measures, it is difficult to assess the general level of ambition and feasibility of the reform plan. Furthermore, the long-term sustainability of public finances has not been explicitly recognised as the policy priority.

7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Slovenia's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance[24] remains unchanged at the 2005 level throughout the programme period.

On the basis of information in the programme, age-related expenditure is foreseen to increase by 11.2 percentage points of GDP between 2008 and 2050, to which pension expenditure contributes most by 7.3 percentage points of GDP (see table A2 in the Annex). The Commission's analysis is based on the common projections for certain expenditure items[25] carried out by the Economic Policy Committee (EPC). The Slovene

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[24] The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out.

[25] Namely, government expenditure on pension, health-care, long-term care. Unemployment benefits and education expenditure are not available in the programme. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period.

programme includes a projected rise in the revenue/GDP ratio over the long run due to an increase in social contributions as a share of GDP.

The gross debt-to-GDP ratio would be on an explosive path and would breach the Treaty threshold around 2025 in both scenarios[26] (see Table A4 in the Annex).

According to both sustainability indicators (S1 and S2), a high sustainability gap arises in Slovenia, regardless of whether the ‘2005’ scenario or the ‘programme’ scenario is considered. The initial level of debt is currently well under 60% of GDP and the initial *structural* primary balance is positive. However, the large projected increase in expenditure over the next fifty years, to which the rise in expenditure on pensions as a share of GDP contributes significantly, has a very large adverse impact on long-term sustainability. Indeed, the sustainability gap according to the S2 indicator is significant at around 8% of GDP.

The S2 indicator gap translates into a required primary balance (RPB) of about 8% of GDP, much higher than the structural primary balance, which was marginally positive in 2005 and in the last year of the programme period. This substantial required strengthening of the budgetary position, as suggested by the RPB, appears therefore very difficult to achieve.

Moreover, the sustainability gap, as measured by the S2 indicator, would increase by around 0.5% GDP if the (budgetary or structural) adjustment was to be postponed by 5 years (see table A3 in the Annex), highlighting the importance of taking action sooner rather than later.

	Sustainability indicators and RPB					
	2005 Scenario			**Programme scenario**		
	S1	S2	RPB	S1	S2	RPB
Value (of which)	**4.0**	**7.9**	**8.1**	**4.3**	**8.1**	**8.1**
initial budgetary position	*-0.3*	*-0.2*		*-0.1*	*0.1*	
debt requirement in 2050	*-0.6*	*:*		*-0.5*	*:*	
future changes in budgetary position	*4.9*	*8.0*		*4.9*	*8.0*	

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualised flow of revenues and expenses over an infinite horizon, and the current revenue ratio[27]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See the European Commission (2005), European Economy, ‘Public finances in EMU – 2005, Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

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[26] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast.

[27] The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

Macroeconomic assumptions are in line with EPC commonly agreed assumptions. No projection on education expenditure and unemployment expenditure were available in the programme. Furthermore, the programme provides estimates of the increase in social contributions which, if it were to materialise, would reduce by around 1 percentage point of GDP both indicators of sustainability gaps.

The government has recently adopted a tax reform (including, among others, simplification of the direct tax regime and the progressive reduction of the payroll tax). Other reforms in the tax system are envisaged or under discussion. Therefore the overall impact of tax reforms on long term sustainability is still uncertain.

The parametric pension reform in Slovenia has already produced a positive budgetary impact since entry into force in 2000: the average retirement age has increased and pension expenditure as a percentage of GDP has declined. However, the favourable effects of the reform in containing the pension outlays were partially offset by the government decision to fully index pension to wages (previously indexed partly to wage growth and partly to inflation), adopted in May 2005. Further changes in the pension schemes, as recognised by the programme, will prove necessary at some point to contain future increase in public expenditure and reduce the risk to long-term sustainability.

Further to the measures adopted in 2004 to rationalise health-care expenditure, moving forward with the reform of the health-care system, which is currently under consideration by social partners (changes in sick leave benefit and shifting costs to the private sector), should contribute to strengthening the long-term sustainability of the public finances.

Overall assessment

With regard to the sustainability of public finances, Slovenia appears to be at high risk on grounds of the projected budgetary costs of ageing populations. Even though the 1999 pension reform has significantly alleviated future increase in expenditure, its effects has been partly offset by a new indexation rule, i.e. moving from partial to full indexation to wages. Further changes in the pension schemes, as recognised by the programme, will prove necessary at some point to contain future increases in government expenditure and reduce the risk to long-term sustainability. If no further measures are taken to relieve the pressures of age-related expenditure, the long-term sustainability of public finances will be undermined. A careful planning and timely adoption of measures are key in this regard.

* * *

Annex 1: Summary tables from the convergence programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g		4.2	3.9	4.0	4.0	3.8
2. Nominal GDP	B1*g	6251244	7.5	6.4	6.4	6.3	6.4
Components of real GDP							
3. Private consumption expenditure	P.3	3461491	3.1	3.6	3.1	3.1	3.1
4. Government consumption expenditure	P.3	1219092	2.9	2.5	2.4	2.6	2.4
5. Gross fixed capital formation	P.51	1506015	5.9	4.0	4.5	5.0	5.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53		2.2	1.2	1.1	1.0	1.0
7. Exports of goods and services	P.6	3761522	12.5	8.6	7.8	8.1	7.0
8. Imports of goods and services	P.7	3837032	13.2	6.0	6.5	7.3	6.6
Contributions to real GDP growth							
9. Final domestic demand		-	3.7	3.5	3.3	3.4	3.3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.9	-1	-0.1	0	0.1
11. External balance of goods and services	B.11	-	-0.4	1.4	0.8	0.6	0.4

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008
		level	rate of change	rate of change	rate of change	rate of change	rate of change
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		-	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

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[28]		914.3	0.4	0.7	0.5	0.5	0.3
2. Employment, hours worked[29]							
3. Unemployment rate (%)[30]			6.3	6.1	5.8	5.6	5.5
4. Labour productivity, persons [31]							
5. Labour productivity, hours worked[32]							
6. Compensation of employees	D.1		4.5	4.0	3.2	3.4	3.4

Table 1d. Sectoral balances

% of GDP	ESA Code	**2004**	**2005**	**2006**	**2007**	**2008**
1. Net lending/borrowing vis-à-vis the rest of the world	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				
2. Net lending/borrowing of the private sector	B.9					
3. Net lending/borrowing of general government	B.9/ EDP B.9	-2.1	-1.7	-1.7	-1.4	-1.0
4. Statistical discrepancy						

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[28] Occupied population, domestic concept national accounts definition.

[29] National accounts definition.

[30] Harmonised definition, Eurostat; levels.

[31] Real GDP per person employed.

[32] Real GDP per hour worked.

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-127746	-2.0	-1.7	-1.7	-1.4	-1.0
2. Central government	S.1311	-121617	-1.9	-2.4	-1.7	-1.4	-1.1
3. State government	S.1312						
4. Local government	S.1313	-3670	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	-2458	0.0	0.7	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	2825300	45.2	44.9	44.4	44.0	43.1
7. Total expenditure	TE[33]	2953046	47.2	46.7	46.1	45.4	44.2
8. Net lending/borrowing	EDP B.9	-127746	-2.0	-1.7	-1.7	-1.4	-1.0
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	119326	1.9	1.8	1.6	1.5	1.4
pm: 9a. FISIM							
10. Primary balance [34]		-30833	-0.5	-0.2	-0.3	-0.1	0.2
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		1560534	25.0	25.0	24.5	25.0	24.3
11a. Taxes on production and imports	D.2	1005895	16.1	16.1	15.6	15.7	15.0
11b. Current taxes on income, wealth, etc	D.5	553698	8.9	8.9	8.9	9.3	9.3
11c. Capital taxes	D.91	941	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	920307	14.7	14.6	14.5	14.5	14.4
13. Property income	D.4	55446	0.9	1.3	1.3	1.1	1.0
14. Other (14=15-(11+12+13))		289012	4.6	4.0	4.0	3.5	3.4
15=6. Total revenue	TR	2825300	45.2	44.9	44.4	44.0	43.1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[35]		2480842	39.7	39.6	39.1	39.4	38.7
Selected components of expenditure							
16. Collective consumption	P.32	468776	7.5	7.5	7.5	7.5	7.2
17. Total social transfers	D.62 + D.63		30.7	30.8	30.2	29.8	29.4
17a. Social transfers in kind	P.31 = D.63	901856	14.4	14.7	14.3	14.1	13.8
17b. Social transfers other than in kind	D.62	1018157	16.3	16.1	15.9	15.7	15.6
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	119326	1.9	1.8	1.6	1.5	1.4
19. Subsidies	D.3	99270	1.6	1.4	1.3	1.2	1.2
20. Gross fixed capital formation	P.51	193211	3.1	3.1	3.4	3.2	3.1
21. Other (21=22-(16+17+18+19+20))		152450	2.4	2.2	2.2	2.1	2
22=7. Total expenditure	TE[36]	2953046	47.2	46.7	46.1	45.4	44.2
Pm: compensation of employees	D.1						

[33] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[34] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[35] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[36] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2003	2008
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure (= item 7=26 in Table 2)	TE[37]		

Table 4. General government debt developments

% of GDP		2004	2005	2006	2007	2008
1. Gross debt[38]		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 changes in gross debt						
3. Primary balance[39]		0.5	0.2	0.3	0.1	-0.2
4. Interest expenditure (incl. FISIM) [40]		-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: - Differences between cash and accruals[41]		0.02	0.01	0.00	0.04	0.00
- Net accumulation of financial assets[42] *of which:* *- privatisation proceeds*						
- Valuation effects and other[43]						
p.m. implicit interest rate on debt[44]		6.2	6.1	5.3	5.1	4.8
Other relevant variables						
6. Liquid financial assets[45]						
7. Net financial debt (7=1-6)						

37 Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

38 As defined in Regulation 3605/93 (not an ESA concept).

39 Cf. item 10 in Table 2.

40 Cf. item 9 in Table 2.

41 The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

42 Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

43 Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

44 Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

45 AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. 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)	EDPD.41 + FISIM	1.6	1.4	1.2	1.2	1.1
4. Potential GDP growth (%) (1)		3.4	3.8	4.0	3.9	3.7
contributions: - labour - capital - total factor productivity		 -0.2 1.4 2.2	 0.3 1.4 2.1	 0.7 1.4 2.0	 0.1 1.5 2.3	 0.2 1.5 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)		0.0	0.0	0.0	0.0	0.0

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (CP)

Table 6. Divergence from previous update

	ESA Code	**2004**	**2005**	**2006**	**2007**	**2008**
Real GDP growth (%)						
Previous update		4.0	3.8	3.9	4.0	4.0
Current update		4.2	3.9	4.0	4.0	3.8
Difference		0.2	0.1	0.1	0.0	-0.2
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.1	-2.1	-1.8	-1.1	na
Current update		-2.0	-1.7	-1.7	-1.4	-1.0
Difference		0.1	0.4	0.1	-0.3	na
General government gross debt (% of GDP)						
Previous update		30.2	30.7	30.9	29.7	na
Current update		29.5	29	29.6	29.8	29.4
Difference		-0.7	-1.7	-1.3	0.1	na

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	-	**46.7**				
Of which: age-related expenditures	-	**18.8**	**18.9**	**20.9**	**24.2**	**30.1**
Pension expenditure	-	11.2	11.2	12.5	14.6	18.5
Social security pension	-	6.7	6.7	7.3	8.2	9.6
Old-age and early pensions	-	0.9	1.0	1.1	1.4	2.0
Other pensions (disability, survivors)	-					
Occupational pensions (if in general government)	-					
Health care	-					
Long-term care *(this was earlier included in the health care)*	-					
Education expenditure	-					
Other age-related expenditures	-					
Interest expenditure	-					
Total revenue	-	**44.9**				
Of which: property income	-					
of which: from pensions contributions (or social contributions if appropriate)	-	9.9	10.3	10.9	11.0	10.9
Pension reserve fund assets	-					
Of which: consolidated public pension fund assets (assets other than government liabilities)	-					
Assumptions						
Labour productivity growth	-	**3.5**	**3.1**	**3.0**	**2.7**	**1.7**
Real GDP growth	-	**3.4**	**3.7**	**2.4**	**2.0**	**1.1**
Participation rate males (aged 20-64)	-	**73.5**	**76.4**	**77.9**	**77.0**	**76.4**
Participation rates females (aged 20-64)	-	**63.9**	**66.3**	**69.0**	**69.8**	**70.5**
Total participation rates (aged 20-64)	-	**68.8**	**71.5**	**73.6**	**73.5**	**73.5**
Unemployment rate	-	**6.0**	**5.5**	**5.4**	**5.4**	**5.4**
Population aged 65+ over total population	-	**15.3**	**16.5**	**20.4**	**25.1**	**31.1**

Table 8. Basic assumptions

This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	2004	2005	2006	2007	2008
Short-term interest rate[46] (annual average)					
Long-term interest rate (annual average)					
USD/€exchange rate (annual average) (euro area and ERM II countries)	1.242	1.264	1.256	1.256	
Nominal effective exchange rate	-0.7	0.0	-0.1	0.0	
(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)	238.9	239.6	239.6	239.6	
World excluding EU, GDP growth	5.1	4.3	4.3	-	
EU GDP growth	2.4	1.5	1.9	2.2	
Growth of relevant foreign markets	9.2	7.3	8.5	8.4	
World import volumes, excluding EU	8.8	5.4	5.8	-	
Oil prices, (Brent, USD/barrel)	38.3	58.0	68.0	66.0	

[46] If necessary, purely technical assumptions.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].		X	Submitted on 8 December 2005, after the approval by government, following prior submission of a draft on 1 December.
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.		X	
The programme provides all optional information in these tables.		X	Certain optional data missing in Tables 1c, 1d and 4. Table 3 is not included.
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		X	
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.	X		However, oil price assumptions for 2006 and 2007, set at 68 and 66US$, respectively, are on the high side of the projection range.
Significant divergences between the national and the Commission services' economic forecasts are explained[2].	X		
The possible upside and downside risks to the economic	X		

Guidelines in the new code of conduct	Yes	No	Comments
outlook are brought out.			
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	External accounts appear sound.
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	
Information is provided on one-off and other temporary measures.		X	
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		However, details on the implementation timetable are missing.
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.		X	
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.		X	
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.		 X X	 Not applicable Not applicable
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.		X	
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		

Guidelines in the new code of conduct	Yes	No	Comments
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		However, budgetary impact of the measures is not quantified.
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		However, measures remain largely unspecified.
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].		X	
– Member States should avoid pro-cyclical fiscal policies[2].			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].			X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.			X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.			X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)		X	
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X		

Notes:

[1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.

[2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".

[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Annex 4: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	3.1	3.1	3.0	3.0	2.7	2.7	1.7	1.7
Real GDP growth	3.6	3.7	2.4	2.4	2.0	2.0	1.1	1.1
Participation rate males (aged 20-64)	76.5	76.4	77.9	77.9	77.1	77.0	76.3	76.4
Participation rates females (aged 20-64)	66.5	66.3	69.1	69.0	69.8	69.8	70.4	70.5
Total participation rates (aged 20-64)	71.6	71.5	73.6	73.6	73.6	73.5	73.4	73.5
Unemployment rate	5.5	5.5	5.5	5.4	5.5	5.4	5.5	5.4
Population aged 65+ over total population	16.5	16.5	20.4	20.4	25.1	25.1	31.1	31.1

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes	Impact on S2
Total age-related spending	18.9	18.9	20.9	24.2	27.7	30.1	11.2	8.0
Pensions	11.2	11.2	12.5	14.6	17.0	18.5	7.3	5.2
Health care	6.7	6.7	7.3	8.2	9.0	9.6	2.9	2.1
Care of the elderly	1.0	1.0	1.1	1.4	1.7	2.0	1.0	0.7
Education	:	:	:	:	:	:	:	:
Unemployment benefits	:	:	:	:	:	:	:	:
Total primary non age-related spending	23.9	23.9	23.9	23.9	23.9	23.9	0.0	0.0
Total revenues	43.1	43.1	43.1	43.1	43.1	43.1	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

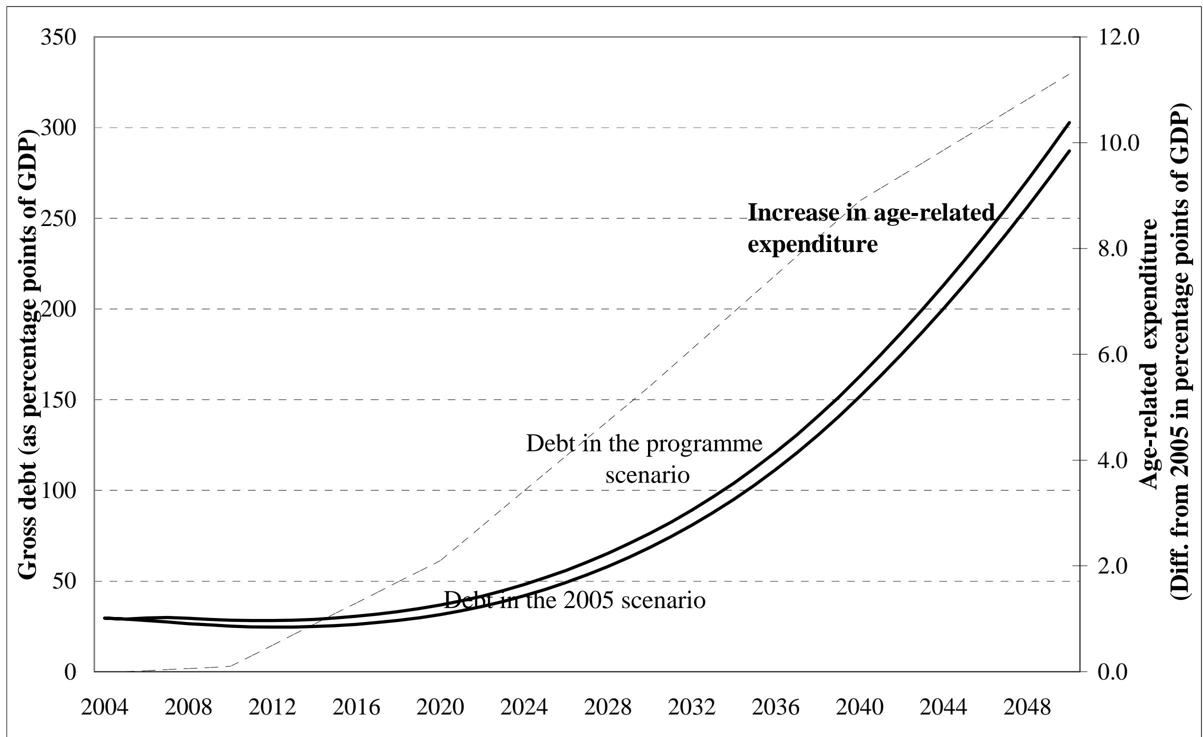
	S1	S2
2005 scenario	**0.6**	**0.6**
Programme scenario	**0.7**	**0.6**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	29.4	28.4	36.8	76.3	162.8	302.7	273.3
*Gross debt, i + 1**	*29.4*	*29.0*	*40.4*	*85.9*	*186.9*	*358.7*	*329.3*
*Gross debt, i - 1**	*29.4*	*27.9*	*33.5*	*68.2*	*143.3*	*259.1*	*229.7*
Adjusted gross debt	29.4	28.4	36.8	76.3	162.8	302.7	273.3
2005 Scenario							
Gross debt	26.5	25.1	31.5	68.5	151.7	287.2	260.7
*Gross debt, i + 1**	*26.5*	*25.6*	*34.6*	*76.9*	*173.2*	*338.3*	*311.8*
*Gross debt, i - 1**	*26.5*	*24.6*	*28.6*	*61.4*	*134.2*	*247.0*	*220.6*
Adjusted gross debt	26.5	25.1	31.5	68.5	151.7	287.2	260.7

* $i + 1$ and $i + 1$ represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.



350
300
250
200
150
100
50
0
Gross debt (as percentage points of GDP)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
Age-related expenditure
(Diff. from 2005 in percentage points of GDP)
Increase in age-related expenditure
Debt in the programme scenario
Debt in the 2005 scenario
2004
2008
2012
2016
2020
2024
2028
2032
2036
2040
2044
2048