THE REPUBLIC OF SLOVENIA

STABILITY PROGRAMME

2007 Update

Ljubljana, December 2007

CONTENTS

FOREWORD

This is the first update of Stability Programme of Slovenia and the first as a member of the Euro area. The document has been prepared in accordance with Council Regulation (EC) No. 1055/2005 amending Regulation 1466/97, which sets out the rules covering the content of Stability Programmes. The update of the Stability program conforms to the revised Opinion on the content and format of Stability and Convergence Programmes agreed by the Economic and Financial Committee of the EU in September 2005 and October 2007.

In conformity with the guidelines of the revised Stability and Growth Pact, that enhance national ownership, the Stability Program and its updates are discussed in the working bodies of the Parliament of the Republic of Slovenia. These bodies also consider the opinion of the Council of the European Union on the Stability Program of the Republic of Slovenia.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

According to the Slovenia's Development Strategy (SDS) the overriding economic policy objective is fostering conditions for a faster and sustainable welfare increase in Slovenia above the average level of the enlarged EU. The SDS is comprehensive and pursues improvement of welfare and quality of living based on the principles of sustainability.

Achieving the goals set in the SDS once Slovenia became member of the euroarea requires preserving macroeconomic stability by continuing with the ongoing medium term fiscal consolidation process based on sustainable policies and improving the quality of public finances. The envisaged elimination of the headline deficit during the program period and maintenance of the structural deficit within the target level of 1% of GDP besides ensuring macroeconomic stability will allow a substantial reduction in the level of debt in anticipation of the challenge of population aging. The pace of fiscal consolidation reflects the loss of tax revenue resulting from the ambitious tax reform aiming at improving the quality of revenue and its sustainability and of financing infrastructure deficit. In particular the government is addressing infrastructure projects that were neglected in the past.

Slovenia became January 2007 the first new EU member after the 2004 EU enlargement in joining the Monetary Union. The overall policy framework agreed by the Government of Slovenia and Bank of Slovenia allowed meeting nominal convergence criteria in particular lowering inflation. The process was underpinned by a gradual process of fiscal consolidation oriented in the medium term framework and a macroeconomic consistent wage policy. The challenge ahead is to maintain the policy orientation to overcome recent supply side shocks on prices and ensure that the effect of the shocks is short lasting.

The fiscal consolidation process that gained momentum in 2007 is consistent and underpins the stable macroeconomic scenario without major imbalances in which private demand pressures remain restrained and growth outlook is driven by exports and investment. In particular, at the time when the economy has performed very well fiscal policy has acted restrictively and in a countercyclical manner as reflected in a significant reduction of government expenditure in GDP, in low real government consumption growth and in the reduction of the structural deficit by 0.6 basis points. The restrictive stance will be maintained over the program period when the recent high economic growth dynamics is envisaged to slow down in the next years.

Wage policy should continue contributing to economic stability by evolving in line with the long run productivity growth trend and not reflecting cyclical gains. Similarly, under the current circumstances, where the economy has undergone large supply side shocks on prices, wage restrain should contribute to avoid second round effects on inflation in order to preserve the relative competitiveness of the economy. Adherence to the restrictive fiscal stance and to wage restrain in a period of gradual economic slow down should ensure that the effect of the supply side price shock is only temporary and that macroeconomic stability is preserved over the medium term.

Besides preserving macroeconomic stability the government is committed to enhance the response capacity of the economy to change in economic circumstances and improve framework conditions including the quality of public finances to enhance growth potential. Important measures in this regard include: screening competition in the food market; reducing tax wedge and tightening of benefit system to enhance labor utilization; improving conditions for increasing labor productivity (R&D); gradual increase in R&D expenditure; and improving infrastructure.

Growth potential has increased recently and should be preserved by continuing implementing the National Reform Program's (NRP) specific policy measures in the areas of competition, knowledge-based economy, economic growth and employment. The recent implementation report of the Reform Programme for achieving the Lisbon Strategy goals submitted to EU Commission in October 2007 provides a comprehensive review of the Slovenian approach, policy objectives, measures and the policy progress made in advancing the reform agenda.[1] Key areas where substantial progress has been made include: better regulation, improving business environment, increase in employment, tax reform and changes in the benefit system; knowledge-based economy; SMEs financing and; government efficiency.

Another important aspect of the fiscal policy during the program period is the improvement of the quality of public finances. In this regard the share of government investment in GDP will be maintained while the overall share of government expenditure and tax burden is being reduced significantly. Similarly, room is being created in favor of financing growth enhancing categories. Progress in implementing performance budgeting will contribute to improve the quality of public finances.

The policy response to the fiscal challenge of population aging is currently being addressed by implementing the 1999 pension reform measures and by reducing the government debt level. Additional measures aiming at increasing labor participation of old age individuals and additional incentives for participation in individual pension insurance are being prepared.

2. ECONOMIC TRENDS AND FORECASTS OF MACROECONOMIC AGGREGATES

2.1. External assumptions

The Autumn Forecast of Economic Trends (IMAD, September 2007), which serves as the basis for the macroeconomic forecasts in the Stability Programme, assumes that economic growth in most Slovenia's main trading partners will remain relatively strong in 2007 and moderate gradually in 2008 and 2009. The assumption regarding

[1] Slovenia: Implementation report on the National Reform Programme.

the average oil price is USD 67/barrel in 2007 and USD 68.5/barrel in 2008 and 2009.[2] The Autumn Forecast also uses a technical assumption that the euro/dollar exchange rate will remain at the average level recorded in the period March–August 2007. The assumption regarding the level of interest rates equals that from the common external assumptions, which were harmonised within the Economic and Financial Committee.

Table 2.1.: External assumptions

	2006	2007	2008	2009
USD/€ exchange rate (annual average) (euro area and ERM II countries) [1]	1.254	1.343	1.350	1.350
Nominal effective exchange rate [2]	0.2	0.7	0.1	
EU GDP growth	3.0	2.8	2.5	2.2
Growth of relevant foreign markets [3]	13.9	11.3	10.7	10.5
Oil prices (Brent, USD/barrel)	65.4	67.0	68.5	68.5

Source: IMAD - Autumn Forecast 2007.

Notes: [1] Technical assumption based on developments in period March-August 2007.

[2] In 2006 tolar, since 2007 euro.

[3] Germany, France, Italy, Austria, Hungary, Poland, Czech Republic, Slovakia, United Kingdom, Switzerland, USA, Japan.

The assumed international economic trends underlying the IMAD's Autumn Forecast were based on forecasts of international institutions available until mid-September 2007. These include the September Consensus release, the European Commission's (EC) September interim report on the EU economic outlook, and the summer forecasts of the WIIW institute for Southeast European countries. Thus, the macroeconomic forecast in the Stability Programme could not take into account the new estimates and figures that were released in the second half of September and October, which were used as the basis for the European Commission's autumn forecast published in November and for the common external assumptions. As a result, some divergence occurred between the two sets of assumptions, notably in oil prices due to their significant increases in October and November. Based on the common assumptions, the inflation forecast would probably be somewhat higher; there would also be a considerable deterioration in the terms of trade in 2007, which would continue in 2008.

2.2. Cyclical developments and short-term prospects

Economic growth in Slovenia has remained at a high level for the second consecutive year. The autumn forecast for 2007 totals 5.8%, 0.1 p.p. more than in 2006 and 1.5 p.p. more than projected in the Stability Programme 2006. The two main factors that contributed to the continued strong GDP growth and the upward

[2] The Autumn Forecast of Economic Trends, which was prepared in September 2007, assumed that oil prices will remain at the achieved level close to USD 70/barrel until the end of the year, and thus could not take into account the oil price hikes witnessed in October and the beginning of November.

revisions to forecasts are better external economic conditions and significantly stronger investment activity. In addition to cyclical developments, GDP growth has been supported by the effects of the adopted reforms, particularly in the field of taxation, along with the positive effects of EU membership, which has especially benefited external trade. Propelled by the continued vigorous growth of foreign demand, which has not moderated as expected, export growth (12.3% in 2006) has sped up further this year in comparison with 2006. Since May, exports have been additionally boosted by the increased volume of vehicle production and exports. In addition to the accelerated motorway construction, the higher increase in gross fixed capital formation was also partly underpinned by a greater volume of other construction and stronger investment in machinery and equipment (real growth rates of 9.1% in 2006). The high capacity utilization in manufacturing, underpinned by high domestic and foreign orders, was the main engine of private investment growth, which received an additional boost from the higher purchases of transport equipment in May. According to preliminary estimates, the real growth of private consumption has remained moderate this year; current indicators suggest a slight acceleration in comparison with 2006, mainly underpinned by the favourable trends in the labour market and partly by the effect of the smaller tax burden on the growth of net wages based on the new tax legislation. The growth of government consumption has significantly decreased in 2007. The structure of growth on the supply side shows that the production of manufacturing industries, particularly the chemical, machinery, and electro industries, and construction have been the main contributors to the increase in value added this year; apart from these, market services have also preserved strong growth of value added.

Lending activity has remained strong this year. Fairly high growth rates of the volume of loans were also recorded in 1998 and 1999 in Slovenia, mainly as a result of the increased consumption and investment ahead of VAT introduction. Subsequently, growth rates declined somewhat. They rebounded again under the influence of interest rates reduction that started in the second half of 2002 and continued until Slovenia's entry to the EMU. The growth of consumer loans has been recording rates around 25% since 2005, while the growth of corporate loans has picked up somewhat this year to a year-on-year rate around 30%, largely due to the redirection from borrowing abroad to borrowing in domestic banks. The latter may be related to the tightening of credit conditions abroad. Given that credit conditions are gradually also tightening in domestic banks, the high growth rates of lending activity could ease off next year.

Table 2.2.: Economic growth and related indicators

	ESA Coda	Year 2006	2006	2007	2008	2009	2010
		Level in SIT mio*	Rate of change	Rate of change	Rate of change	Rate of change	Rate of change
1. Real GDP	B 1 g		5.7	5.8	4.6	4.1	4.5
2. Nominal GDP	B 1 g	7,296,627	7.8	9.0	8.4	7.0	7.4
Components of real GDP							
3. Private consumption expenditure	P3	3,896,317	4.0	4.2	4.0	3.4	4.0
4. Government consumption expenditure	P3	1,403,543	4.4	2.6	3.2	2.6	2.5
5. Gross fixed capital formation	P51	1,907,462	8.4	14.5	6.2	2.6	4.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+ P53		2.2	2.0	2.0	2.0	1.9
7. Exports of goods and services	P6	4,916,115	12.3	13.4	10.3	9.7	8.8
8. Imports of goods and services	P7	4,988,328	12.2	14.2	10.1	8.2	8.0
Contributions to real GDP growth							
9. Final domestic demand		-	5.1	6.6	4.5	3.1	3.8
10. Change in inventories and net acquisition of valuables	P52+ P53	-	0.6	-0.1	0.1	0.1	0.1
11. External balance of goods and services	B11	-	0.0	-0.7	0.0	0.9	0.6

Source: SORS, IMAD - Autumn Forecast 2007..

Note: * Current prices and nominal exchange rare. A comparison of nominal values is possible under the technical assumption of the SIT/EUR exchange rate=239,64, which is used from 2007 onwards.

In 2008 **economic growth** will moderate but it will remain above the long-term average. The relatively lower real GDP growth (4.6%) in comparison with 2007 will partly reflect the expected easing in the growth of export demand and partly the more subdued growth rate of gross fixed capital formation. The volume of infrastructural investment will continue to increase, chiefly in motorway construction, as will the volume of investment in residential construction and in machinery and equipment. The robust investment activity will thus expand further and add sizeably to GDP growth. However, given the already achieved high levels we cannot expect an increase on a par with this year's in 2008. The growth of private consumption will remain at a similar level as in 2007. While this year private consumption has been mainly driven by employment growth and the positive effects of tax legislation changes, its expansion in 2008 will be mainly underpinned by higher wage increases.

In 2009 foreign demand will ease off further. Based on the forecasts of external economic developments, export growth is expected to slow down to below 10%. Meanwhile, particularly the lower growth of investment and private consumption will result in a cyclical moderation of GDP growth to long-term average around 4.1%. As in 2007 and 2008, the growth of gross fixed capital formation will be under a strong influence of the planned realisation of infrastructural projects, where investment in railway infrastructure will gain relatively greater weight, while the volume of motorway construction will gradually begin to ease off. Given the projected trends in employment and the moderation in the real growth of the gross wage per employee, the growth of private consumption will also be smaller (3.4%). In 2010 the growth of domestic consumption is expected to rebound somewhat, which will cause economic growth to increase again to total 4.5%. The growth of private consumption will accelerate in line with the projected growth of disposable income, which will increase due to the faster growth of wages. The growth of gross fixed capital formation will rebound to a level above 4% in 2010 after the cyclical slowdown in 2009, linked to the planned completion of the motorway network construction. The contribution of external trade will be somewhat smaller than in 2009 as a result of the accelerated growth of exports, but it will remain positive.

The forecasts for the years ahead do not indicate that the growth of aggregate demand will exceed potential growth, which could create additional inflationary pressures. Moderate growth of the government consumption and decreasing share of public expenditure will additionally contribute to sustainable growth of aggregate expenditure as well as expected continued restrictive orientation of the euro area's monetary policy.

Table 2.3.: Sectoral balances

% of GDP	ESA code	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-2,8	-3,5	-3,1	-2,0	-1,6
of which:						
- Balance on goods and services		-1.0	-1.7	-1.6	-0.5	0.0
-Balance of primary incomes and transfers		-1.8	-1.8	-1.5	-1.5	-1.5
- Capital account		0.1				
2. Net lending/borrowing of the private sector	B.9					
3. Net lending/borrowing of general government	B.9	-1.2	-0.6	-0.9	-0.6	0.0
4. Statistical discrepancy						

Source: SORS, IMAD - Autumn Forecast 2007.

The **current account deficit**, which increased in 2007 mostly due to strong investment activity and stronger growth of imports of intermediate goods for manufacturing and exports, will narrow gradually by 2010. This narrowing will be largely influenced by the expected developments in the trade in goods and services, where the deficit is projected to gradually narrow and finally be eliminated towards the end of the period.

This year's economic boom has had a favourable effect on **developments on the labour market**, where **employment** has risen strongly (forecast for 2007: 2.3%), while unemployment has declined. This has been evidenced by the lowering of the survey and registered unemployment rates, which are projected at 5.0% and 7.7% in 2007. Roughly a quarter of this year's surge in formal employment is attributable to the vigorous construction activity, where increased demand for labour has been partly met by hiring foreign workers. Employment has also increased appreciably in business services, where a significant share of workers found employment through job agencies and were also hired by other industries, and in manufacturing, particularly the metal and car industries, where the increase is linked to high orders and favourable business expectations regarding sales abroad as well as on the domestic market. The stronger demand for labour is also indicated by the results of surveys conducted in companies this year. Shortages of skilled labour have been the most frequently reported limiting factor to production, while insufficient demand for goods and services has become a relatively less prominent limiting factor. The high demand and the imbalances on the labour market have also been reflected in the high rate of available vacancies. In 2008 employment growth is expected to moderate to below 1%. In the next few years, it will total between 0.5% and 1%, following the dynamics of the projected economic growth. Positive employment growth will be underpinned by the new Labour Relations Act adopted this year (see also Section 2.4.).

Wage growth will accelerate to in 2008 (to 3.7% in real terms; this year 2.4%), which will be underpinned relatively more than in recent years by wage increases in the public sector due to the elimination of wage disparities in the public sector agreed in the Collective Agreement for the Public Sector, initialed in July 2007. It should be mentioned that since 2002 lagging of wage growth in public sector behind productivity growth has been stronger compared to lagging of growth of wages in the private sector, with the proportion of the adjustment percentage for the public sector wages intended for elimination of wage disparities. Nevertheless, the total wage growth will not exceed productivity growth in 2008. In 2009 the nominal growth of the gross wage per employee in the private and public sectors will be almost even, while the overall wage increase will total 2.8% in real terms. With the conclusion of the elimination of wage disparities in the public sector, wage growth will reaccelerate to 3.5% in 2010. The Agreement on the Base Wage Adjustment Mechanism and the Level of Expenditure Earmarked for the Elimination of Wage Disparities in the Public Sector incorporates a double safeguard clause, which allows the adjustments to be phased over a shorter period if macroeconomic trends are favourable, while the fourth adjustment may be postponed to September 2010 if the macroeconomic balance were to seriously deteriorate.

Table 2.4.:Difference between total productivity and real wage growth in %

	2004	2005	2006	2007	2008	2009
Difference between productivity and real growth of gross wage in private sector	1.0	1.2	1.7	0.4	0.9	0.8
Difference between productivity and real growth of gross wage in public sector	4.9	3.1	3.5	2.1	-1.6	0.6

Source: SORS, IMAD.

Table 2.5.: Labour market developments

	Year 2006 level in 000	2006	2007	2008	2009	2010
1. Employment, persons [1]	934.5	1.2	2.3	0.9	0.6	0.9
2. Unemployment rate (%) by ILO definition	61.0	6.0	5.0	4.9	4.8	4.6
3. Labour productivity, persons [2]	32.6*	4.5	3.4	3.7	3.5	3.6
4. Compensation of employees		4.4	5.3	4.6	3.4	4.4
5. Compensation per employee [3]		2.9	2.4	3.7	2.8	3.4

Source: SORS, IMAD - Autumn Forecast 2007.
Notes: [1] Occupied population, domestic concept national accounts definition. [2] Real GDP per person employed. [3] Empoyee - wage earners. * Level in 1000 EUR.

The introduction of the euro was successful and did not cause any major increase in **overall price levels**, primarily thanks to the co-ordinated macroeconomic policy mix and the adopted measures regarding dual pricing, the informal price watch and consumer information about possible risks in the currency changeover process. The total effect of the euro changeover on prices in Slovenia is estimated to have totalled 0.23 p.p. (IMAD), while the Eurostat estimated it at no more than 0.3 p.p. during the euro changeover period[3]. These estimates show that the euro-related price increase in Slovenia was one of the lowest compared with the corresponding increases in other euro area countries. Price increases attributable to the euro changeover were mainly observed in services, especially hotels and restaurants, which was expected based on the experience of other countries.

The inflation rate including the effect of euro introduction at the beginning of the year was among the highest in the euro area (year-on-year HICP inflation in December 2006: 3.0% in Slovenia, 1.9% in the euro area on average). The reasons for a high price growth is higher economic growth than the euro area average (in 2006 the GDP growth rate was 5.7% while in the euro area was on average 2.8%) as part of income catching up process. Nevertheless, in the last seven months inflation accelerated in Slovenia, leading to a consumer price increase in the first ten months of 4.2%, 2.2 p.p. more than in the same period last year. The key reasons for the price increase are supply side shocks caused by higher prices of oil and food. With these two shocks it is possible to explain the whole difference between the inflation rates in 2007 and 2006. Higher food prices contributed 1.6 p.p., while higher prices of liquid fuels for transport and heating added a further 0.6 p.p.

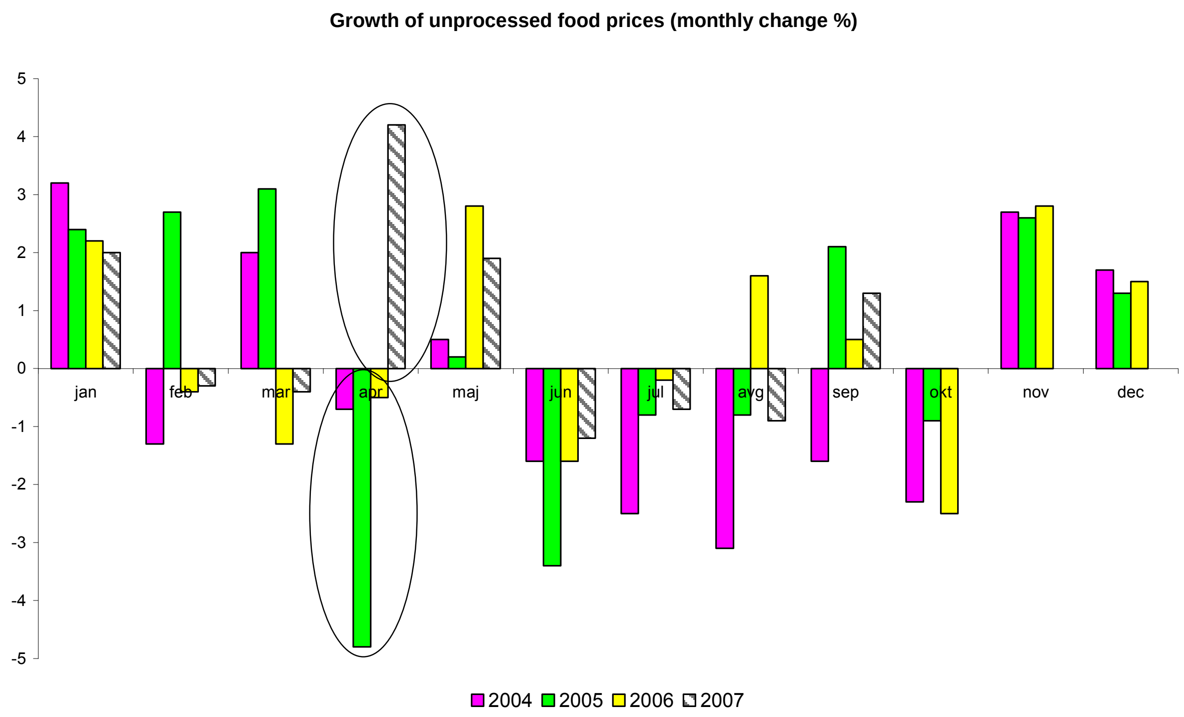
Food prices stand out notably in this regard. On the one hand, they reflect the rising prices of agricultural products on global markets. On the other hand, they reflect the specific conditions in Slovenia, particularly the impact of the market structure (concentration in the retail food sector, which has been increasing in recent years). In addition, food prices this year have been additionally influenced by two events that have largely affected the dynamics of price increases, thus the increase has not been evenly distributed – it was more pronounced from April onwards (see Figure 2.1): (i)

[3] Both estimates were made using the data until end-February 2007.

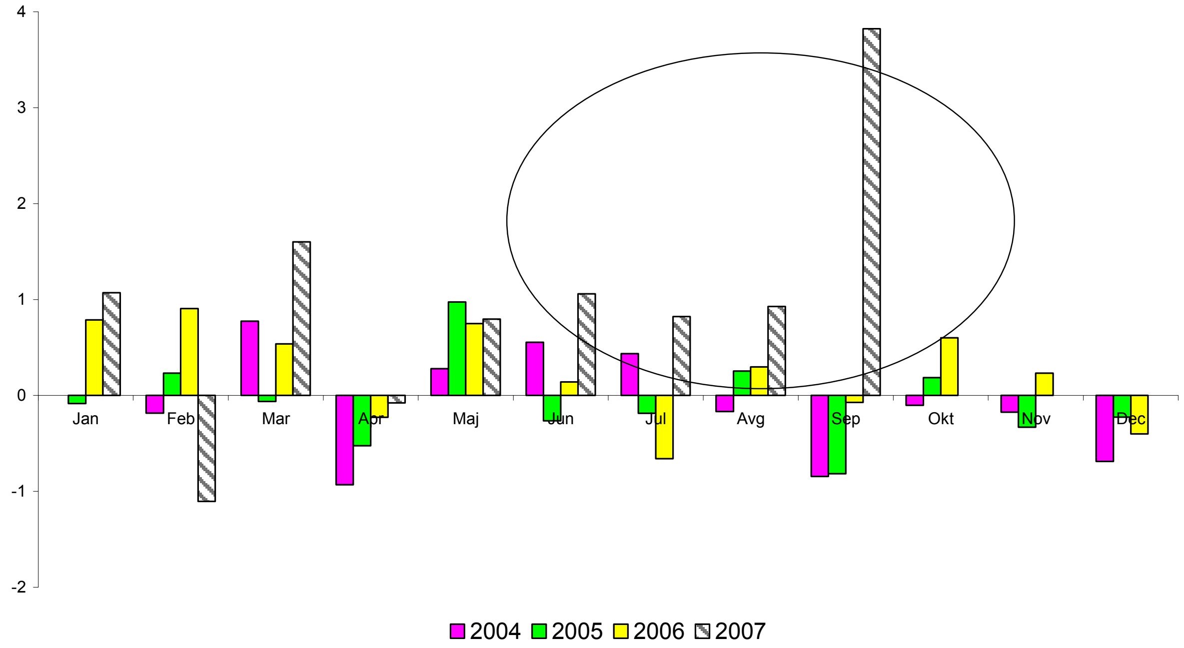
the price leap in seasonal products (notably fruit and vegetables) in the month of April, when these products first appeared on the market in euros, and (ii) the price increase in the second half of the year, when retailers' price commitments regarding the non-raising of prices due to euro introduction and double pricing expired. As a result, food prices increased by 11.1% since December 2006 and contributed 1.9 p.p. to inflation, i.e. approximately 40% of the total price increase in 2007. In the comparable period of 2006, their contribution to inflation totalled 0.3 p.p.

The price of oil, which exceeded USD 95/barrel in November, having surged by approximately 35 dollars since the beginning of the year, has meanwhile resulted in a high contribution of the prices of liquid fuels for transport and heating to inflation. In the ten months to October, these prices contributed 0.7 p.p. to inflation, while the expected contribution estimated at the beginning of the year was half smaller. Therefore, data indicate that the price increase has been relatively limited and largely determined by supply side shocks, caused by external factors, with some specific internal factors also playing a role. The rising food prices are a phenomenon that has been driven by global changes (higher demand for food in developing Asian countries, higher consumption of primary commodities for energy purposes in developed countries) and therefore also present in other European countries. Specific internal factors are related to the relatively high concentration in the retail food sector, and also the effect of the termination of price commitments on the dynamics of the inflation in the second half of the year.

Figure 2.1.: The effect of food price growth between 2004 and 2005



Growth rate proceseed food prices (monthly change %)



The governmental economic policies have remained restrictive also after the adoption of the euro. The autumn forecast of average inflation in 2007 is projected to be 3.4%, slightly more than the IMAD's revised inflation forecast from July 2007 (3.0%). In order to prevent the impact of supply side shocks that is currently observed only in some price groups from spilling over to other prices and to avert further inflationary pressures, it is vital that co-ordinated macroeconomic policy mix provides a stable macroeconomic framework, namely further fiscal consolidation, restrictive wages policy, and restrictive yet sustainable increase of administered prices. In the area of the fiscal policy, the share of expenditure relative to GDP is decreasing in 2007, as well as structural budget deficit, manifesting counter-cyclical orientation. Similarly the draft budgets for 2008 and 2009 and budgetary projections for 2010 are retaining a restrictive fiscal stance. Particularly the further reduction of the share of government consumption in the structure of GDP as well as of general government expenditure as a share of GDP reduces the possible pressures of aggregate demand on prices. That the budgetary stance is restrictive is also indicated by the preliminary estimates of the public sector's structural deficit, which on average will be below medium term objective throughout the programme period and will come to a balance by the end of the programme period. The wage policy also plays important role in containing inflationary pressures. In 2007 its restrictive stance has been preserved, ensuring that wage increases follow the economic situation in the country while lagging behind the achieved growth of productivity and thus preventing any upward pressures on prices. In line with the adopted agreements, earnings in the public sector will increase at a faster pace in 2008, due to impact of elimination of wage disparities. Nevertheless, the total wage growth will not exceed productivity growth in 2008. In the area of administered prices, which is most directly related to inflation, the current guideline according to which prices directly determined by the government increase at a slower pace than market-determined prices should be preserved, so that growth of administered price does not exceed the equilibrium level of inflation. The preservation of the restrictive stance of the economic policies will allow inflation to return to its long run equilibrium level of around 3% already next year, which will also be crucial to maintaining the price and cost competitiveness of the Slovenian economy in the medium term.

Table 2.6.: Price developments

Rate of change in %	2006	2007	2008	2009	2010
1. GDP deflator	2.0	3.0	3.6	2.9	2.7
2. Private consumption deflator	2.5	3.4	3.5	2.8	2.6
3. CPI	2.5	3.4	3.5	2.8	2.6
4. Public consumption deflator	2.5	3.7	5.8	4.0	4.8
5. Investment deflator	2.0	2.4	2.0	1.9	1.9
6. Export price deflator (goods and services)	2.7	3.3	2.8	2.2	2.0
7. Import price deflator (goods and services)	3.3	3.6	2.6	2.1	2.0

Source: SORS, IMAD - Autumn Forecast 2007.

2.3. Medium-term scenario

The medium-term scenario of economic trends, which serves as the basis for the projections provided in the Stability Programme, is based on the autumn forecasts of economic trends and takes into account the draft budgets for 2008 and 2009, as well as economic policy measures that are already being implemented, pursuant to the Guidelines on the format and content of Stability and Convergence Programmes. The structural reform measures and their expected positive effects on growth, which are still under preparation (e.g. in the areas of network industries and privatisation; see also section 2.4), are not included in the baseline scenario.

Table 2.6.: Key macroeconomic indicators for the period until 2013

Real growth in % (unless indicated otherwise	Medium-term scenario 2010–2013
GDP	**4.4**
Exports of goods and services	8.2
Imports of goods and services	7.7
Private consumption	3.8
Government consumption	2.5
Gross fixed capital formation	4.8
Employment, growth in %	**0.8**
Unemployment rate ILO, in %	**4.2**
Productivity, growth in %	**3.6**
Inflation, in %	**2.4**

Source: IMAD projections.

Based on the adopted economic policy measures, economic growth is projected to stabilise at a level around 4.3% after 2010. This shows that the Slovenian economy's long-term growth potential, which has been estimated at below 4% in previous years, has increased. Business and financial services will continue to grow briskly. The rapid expansion of telecommunications is also set to continue on the back of the growing competition between suppliers, supported by active government policy in this area. Investment in infrastructural projects will remain a major factor of economic expansion. In addition to the intensive construction of motorways, investment in the modernisation of the railway network will also be prominent. The contribution of factors based on investment in knowledge to economic growth will increase gradually. This increase will be partly underpinned by the projected higher investment in research and development, stimulated by the already adopted tax relief and the expected changes in the organisation of the research and education sectors.

2.4. Effect of structural reforms on growth

Structural reforms, which are also foreseen in the Reform Programme for Achieving the Lisbon Strategy Goals in Slovenia, are part of a comprehensive strategic development framework based on Slovenia's Development Strategy (adopted in 2005). The implementation of specific reform measures has been subject to a broad debate, which has also actively involved employers and employees through negotiations in the Economic and Social Council.

A comprehensive tax reform, which reduced the tax burden on labour and savings, was adopted already in the first year of implementing reforms. Regarding the taxation of corporate profits, the reform broadened the taxable base, increased the tax relief for research and development, and is gradually reducing the tax rate. In co-operation with the corporate sector, the government is carrying out a comprehensive programme of reducing the administrative burden and simplifying the business environment, including by reducing court backlogs. In order to carry out a project aimed at reducing administrative costs, a uniform methodology for measuring administrative costs (SCM) was adopted, following the examples of most European countries. In addition to the programme of measures for reducing the administrative burden, which will be adopted for the third consecutive year in 2007, the government has this year also adopted an action programme for systematic reduction of administrative costs in priority areas (by 25%).

Following the successful launching of the 'one-stop-shop' system for sole proprietors, a similar system will also be introduced for companies this year, which will shorten the time needed for setting up a business to four days. The proposed law on venture capital investment, which also provides for appropriate tax incentives, will significantly boost the activity and growth of small, especially growing and innovative, enterprises. The gradual withdrawal of the state from company ownership and the gradual liberalisation of network industries are contributing to stronger competition in the market. The government has adopted a number of measures to stimulate the co-operation between the research sphere and the business sector in the areas of R&D

and innovation. It doubled the share of funding for technology projects in budgetary research expenditure. In co-operation with local communities, the supply of sites for foreign investment has been increasing, while the procedures for hiring foreign workers have been simplified, and financial incentives for foreign investors have been provided.

The available data confirm that the set of measures aimed at increasing economic competitiveness is appropriate. Amid the overall strong growth of the economy, the growth rates of employment and corporate investment rose as well, partly due to the reduced tax burden. Claims for the R&D relief rose substantially, reflecting the increase in the business sector's expenditure on this purpose (in 2005 a total of 222 companies filed claims for an R&D relief totalling 2.5 mio EUR, while in 2006 the figure rose to 548 companies totalling 59.7 mio EUR of claims). The number of patent applications and the hiring of researchers in the private sector have been on the increase as well. Entrepreneurial activity is expanding and its structure is improving. In network industries, the strengthening of competition has been particularly evident in the area of telecommunications, while the liberalisation of the electricity market caused no major price leap in the initial period.

In the first year of implementing the reforms, the government adopted measures that provide better incentives for people's activity. The entitlement to unemployment benefits was made more conditional on claimants' willingness to accept offered employment, while the indexation of social transfers and minimum wages is now tied solely to consumer price rises rather than to both inflation and average wage growth. The social partners have reached an agreement regarding the amendments to the Employment Relationships Act, which represent a step towards introducing the flexicurity system. The main changes include increasing the internal flexibility of employment, broadening the legal bases for the use of flexible forms of employment and improving the efficiency of giving notice, including by shortening periods of notice. At the same time, active employment policy programmes have been modernised and the functioning of the national employment service, which also increasingly co-operates with private agencies, improved. Further, the government improved the legal bases for the prevention of undeclared work and provided for the performance of so-called small work. The regulation of the system of vocational qualifications and scholarships has enhanced the links between the labour market and the education system. This year has also seen the signing of a new social agreement for the period 2006-2009, which strikes a satisfactory balance between the necessary reform measures and the interests of the social partners. These measures have led to a higher employment rate, which has remained above the European average for several years, and to the lowering of the unemployment rate to its historically lowest level. The structural problems in the labour market have also started to be resolved. The long-term and youth unemployment rates are declining, while the employment rate of the elderly has started to rise.

In implementing the reforms, the government also considers the recommendations put forward by the Council of the EU in response to the submitted national reform programmes. This year, the government has already enhanced the functioning of and co-operation between the labour market institutions responsible for setting up the flexicurity system, evidenced by the entry of young people into the labour market and the links established between the education sphere and the labour market. Efforts aimed at reducing structural problems, especially long-term unemployment and employment of the elderly and highly educated young people must continue. Moreover, it will be necessary to additionally increase the transparency and activating role of the social transfers system. Public spending on R&D is increasing, but not as quickly as expected, and the targets in this area will therefore be achieved with some delay. The functioning of the Slovenian Technology Agency has been strengthened. The goal of reducing the time needed to set up a business will be reached at the beginning of 2008 with the launching of the 'one-stop-shop system' for all companies. On the other hand, progress regarding the improvement of the available staff and legal possibilities for the operation of the national Competition Protection Office has been less satisfactory. In addition, the work of regulatory bodies will have to be further improved, particularly in areas of network industries and liberal professions. The implementation of measures in the area of energy efficiency and climate change should also be reinforced. Finally, the government has not adopted additional measures to enhance the long-term financial sustainability of the pension insurance system this year, mainly due to the difficulty of reaching political and social consensus on this issue.

3. GENERAL GOVERNMENT BALANCE AND DEBT

3.1. Policy strategy

The ongoing medium term fiscal consolidation based on sustained fiscal policies and conservative fiscal planning has gotten momentum in 2007 and delivered a countercyclical policy at a time when economic growth has picked up and the economy has undergone large supply side price shocks. The structural deficit was reduced by 0.6% in 2007 and the share of government expenditures in GDP by 1.7 percent.

Slovenia is reaching and surpassing its medium-term objective in 2007. With its accomplishment, the policy objective is to maintain the structural deficit within the MTO targeted level of 1% of GDP throughout the program period. Furthermore, building on the good policy track record of the last two years, and particularly the policy momentum of having halved the structural balance from an estimated 2007 deficit of 1.7% of GDP in the Stability Program in 2006 to 0.8% of GDP, in the present updated the aim is to further reducing it to close to zero towards the end of the program period.

The pace of fiscal consolidation is consistent with the economic outlook that foresees a decline of GDP growth in the next year (1.2 percentage points) and in 2009 (additional 0.5 percentage points) and in particular with the reduction in aggregate demand over the next two years (2.1 percentage points in 2008 and an additional 1.4 percentage points in 2009).

The medium term fiscal policy is underpinning the overall macroeconomic stability and is reducing the headline deficit at the same time. Fiscal policy is taking place while the government finances three key priorities: i) the ambitious tax reform without rising VAT rates, which had been previously envisaged in the Stability Programme; ii) the previously neglected infrastructure projects; and iii) the implementation of the law on wages for public sector employees.

The impact of the full implementation of the comprehensive reform was estimated in the SP 2006 in a reduction of tax revenue about 2% of GDP. The reform demands a considerable effort on expenditure reduction. Total tax revenue-to-GDP ratio declined by 0.7% of GDP in 2007 and the ratio is estimated to decline from 24.6 % of GDP in 2006 to 23.2 % in 2010. Total government revenue declined by 1.1 % of GDP in 2007 and it is estimated to decline by 1.7% of GDP in the period 2007-2010. Gradual phasing out of payroll tax and its complete abolition by 1 January 2009 and the gradual reduction of corporate income tax rate from 25% in 2006 to 20% in 2010 will conclude the comprehensive tax reform. The aim of the reform is to contribute to the competitiveness of the economy and promote economic growth while at the same time maintaining macroeconomic stability. The reform in particular aims at: i) enhancing labor activity incentives (both demand and supply) by reducing the tax burden on labor; ii) promoting savings and investments in the economy by reducing the tax rate on capital income; iii) fostering investment by eliminating double taxation and; iv) enhancing economic growth by rewarding R&D activities. The reform measures concern payroll tax, personal income tax, corporate income tax, value added tax and tax procedure.

The second key priority issue whose budgetary effect was not considered in the SP 2006 is the implementation of the new Public Sector Salaries Act approved in 2002 whose aim is to correct the wage disparities among public sector employees. After long preparation process the law will be implemented gradually during the next three years starting in 2008. Public sector basic wage evolution since 2004 to 2009 is based on a policy that created room for financing wage disparities. In particular, part of the agreed yearly adjustment in basic wage is devoted to increase wages while a proportion is saved for correcting wage disparities. The implementation of the law should be gradual over the next three years in order to prevent large swings in expenditure associate with a one-off discrete increase. From the fiscal point of view the law will be implemented in a fairly neutral manner as share of compensation of employees in GDP will continue gradually declining.

The third important priority with significant bearing on the budget is the temporary financing of railway infrastructure during 2007-2009 as a first step of a broad financing strategy that contemplates EU funds and future engagement of private or third parties investors. The amount devoted to this project is particularly sizable in 2008 amounting to 0.4% of GDP. The railway projects aim at the modernizing and upgrading existing railway infrastructure and building new railway tracks (Divača-Koper) that are part of the 5th and 10th corridors identified also by the EU as investment priorities.

To accommodate the reduction of revenue and the mentioned budgetary sizable expenditure priorities other expenditure items will be rationalized while preserving the quality of expenditure. Consequently the share of fixed capital formation will remain above 3% of GDP over the program period while at the same time effort is being placed to reorient the expenditure composition towards growth enhancing priorities and improving the absorption capacity of EU funds will be increased. Within this framework, expenditures devoted to R&D, tertiary education, active labor market policy and life-long learning will gradually increase. The overall effect of expenditure policy will be reflected in a reduction of expenditure-to-GDP ratio of 2.3% in the period 2007-2010 2010. In 2007 the reduction is estimated in 1.7% of GDP.

The expenditure consolidation strategy lays on three key policies and conservative planning during the economic upswing. The policies under implementation and discussed in detailed in section 5 include the following: i) unification of indexation of all social transfers, other than pensions, to the growth of consumer price index only; ii) gradual reduction of intermediate consumption and; iii) restrictive employment and implementation of agreed wage policy in the public sector.

Another important element influencing the budgetary outcome is the two-year budget framework that when planning conservatively it binds significantly the outcome of the year following the next year budget. This is particularly the case because the budget items are planned on nominal basis in a very detail manner. Table 3.1 shows the GDP budget assumptions used in planning the budget outcome which are particularly relevant when considering the budget outcome for the year following the next year's budget. Due to conservative planning during upswing the budget for the year following the next is restrictive.

Table 3.1.: GDP growth assumptions used in budget formulation

% GDP	**2006**	**2007**	**2008**	**2009**	**2010**
1. Real GDP growth					
Stability program (previous update)	4.7	4.3	4.2	4.1	4.1
Stability program (latest update)	5.7	5.8	4.6	4.1	4.5
Difference	1.0	1.5	0.4	0.0	0.4

The headline deficit will be reduced from the current low level below 1% of GDP to close to zero in the next three year period. Now that the MTO is reached in 2007, the overall strategic goal is to observe it over the program period. As a result of this policy the debt-to-GDP ratio will continue declining in a sustained manner as percentage of GDP from 27.1% in 2006 to 22.5% in 2010. This policy has an important bearing in the long-term sustainability of public finances.

3.2. Medium term policy objective

The medium-term objective (MTO) for the cyclically-adjusted balance was set in 2005 at **–1% GDP**. The MTO set was more demanding than the minimum benchmark identified by the Commission for Slovenia (1.9% of GDP). The MTO will have been reached in 2007 (0.8% of GDP), two years earlier than planned. These developments are clearly in line with the Berlin ECOFIN conclusions of April this year. Furthermore the reduction of the MTO was of 0.6% of GDP in line with Stability Growth Pact that stipulates that Member states that have not yet reached their MTO should reduce it by 0.5%. This policy also clearly reflects the countercyclical stance of the government. The policy aim is to observe the target during the program period. This is consistent with overall macroeconomic framework and will allow further reduction in the debt-to-GDP ratio.

The Slovenian economy has exhibited strong performance during 2006 and 2007 and various forecasts indicate that the highest GDP growth rate was achieved in 2007. It is difficult to disentangle cyclical from structural increase in productivity but growth dynamics have been influenced significantly by investment. Nevertheless, the growth decomposition based on production function indicates a growing importance of total factor productivity which also reflects the positive contribution of government economic policy.

Estimate of potential growth and output gap with two methodologies allowed for new member states (HP-100 filter and PF method) provided alternative information as to the sign of the output gap in 2006 and as to the date where the peak of the cycle is reached. Estimates with HP filter indicate a negative output gap while with PF method a positive output gap in 2006. In 2007 both methods indicate a positive output gap. However, the PF methodology places the peak of the cycle in 2008 while HP filter in 2007. This influences importantly the structural deficit estimates.

Estimates of structural balance using PF method shows that in 2007 the MTO was met and comparing with 2006 a significant reduction of structural deficit of 0.6 percentage points was recorded. In the program period the MTO target of 1% of GDP will be respected and a further reduction is envisaged. It is important to highlight that the overall budget dynamics of headline deficit and structural deficit in the program period and particularly in 2008 (0.4% of GDP) are heavily influenced by railway financing (Table 3.3). Structural deficit estimates include one-off expenditure associated with international committements (expenditure related to EU Presidency totalling 0.2% GDP over 2 years).

Table 3.3.: Cyclical developments

% GDP	**ESA code**	**2006**	**2007**	**2008**	**2009**	**2010**
1. Real GDP growth (%)		5.7	5.8	4.6	4.1	4.5
2. Net lending of general government	EDP B.9	-1.2	-0.6	-0.9	-0.6	0.0
3. Interest expenditure	EDP D.41	1.4	1.2	1.1	1.1	1.1
4. One-off and other temporary measures1		0.0	-0.1	-0.1	0.0	0.0
5. Potential GDP growth (%)		4.4	5.8	4.3	4.2	4.7
contributions:						
- labour		0.3	1.5	-0.3	-0.1	0.3
- capital		1.6	2.0	2.1	1.9	1.9
- total factor productivity		2.6	2.3	2.5	2.4	2.4
6. Output gap		0.4	0.4	0.7	0.6	0.4
7. Cyclical budgetary component		0.2	0.3	0.2	0.2	0.2
8. Cyclically-adjusted balance (2 - 7)		-1.4	-0.9	-1.1	-0.8	-0.2
9. Cyclically-adjusted primary balance (8 + 3)		0.0	0.3	0.0	0.3	0.9
10. Structural balance (8 - 4)		-1.4	-0.8	-1.0	-0.8	-0.2

Source: MF RS.

Table 3.2.: The impact of railway investment on CABB

% of GDP	**2006**	**2007**	**2008**	**2009**	**2010**
Cyclically adjusted balance	-1.4	-0.8	-1.0	-0.8	-0.2
Cyclically adjusted balance excluding railway's investment	-1.2	-0.6	-0.6	-0.6	-0.2

Source: MF RS.

3.3. Actual balances and implications

According to the revised data the general government deficit in 2006 was 1.2% of GDP. It is lower than the deficit figure presented in SP 2006 (1.6% of GDP). The main reasons for the deficit outcome in 2006 are conservative planning and favourable economic performance. This conforms to the good track record of the past years. The envisaged deficit for 2007 is 0.6% of GDP and it is substantially lower than the deficit figure presented in the previous update (1.5%).

It is particularly important to highlight the budget outcome in 2007 because is the year in which the economy suffered supply side price shocks which push temporarily the annual inflation rate well above the equilibrium level. In 2007 the fiscal stance acted countercyclical as indicated by: i) the reduction of the share of expenditures in GDP by 1.7%; ii) the reduction in the government consumption real growth rate by 1.8 percentage points; iii) the general government deficit has been halved from 1.2% in 2006 to 0.6% in 2007 and; iv) the structural deficit was reduced by 0.6%.

Fiscal projections for the period 2008-2010 include two year budgets for adoption in the parliament for the periods 2008 and 2009 and projections for 2010. A restrictive fiscal policy orientation is envisaged over the program period. In a framework of economic slowdown, the expenditure share in GDP will be further reduced by 0.4 P.P. in 2008, 1.1 P.P. in 2009 and 0.8 P.P in 2010.

Government revenue will also continue declining. The ratio total revenues-to-GDP will decrease by 0.8 P.P. in 2008 by a similar magnitude as in 2007. In 2009 and 2010 the ratio will further decrease by 0.7 P.P and 0.2 P.P. respectively. In 2008 the general government deficit (0.9%) will be temporarily higher than in 2007 primarily due higher expenditure in railways and first face of adjusting wage disparity in the public sector. The deficits in 2009 (0.6%) and 2010 (0%) will be lower primarily due to lower expenditure in railways and the full implementation of the tax reform by 2010.

Table 3.5 shows that the deficit in absence of the railway financing as percentage of GDP in the period 2007 to 2010 will be 0.4%, 0.5%, 0.3% and 0% respectively.

Table 3.4.: General government budgetary prospects

	ESA code	2006 Level	2006	2007	2008	2009	2010
		mio EUR	% BDP	% BDP	% BDP	% BDP	% BDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	**-366.2**	**-1.2**	**-0.6**	**-0.9**	**-0.6**	**0.0**
2. Central government	S.1311	**-365.8**	-1.2	-0.7	-0.9	-0.5	0.0
3. State government	S.1312						
4. Local government	S.1313	**-25.4**	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	**25.0**	0.1	0.1	0.0	0.0	0.0
General government (S.13)							
6. Total revenue	TR	**13,413.4**	**44.1**	**43.0**	**42.2**	**41.5**	**41.3**
7. Total expenditure	TE	**13,779.6**	**45.3**	**43.6**	**43.2**	**42.1**	**41.3**
8. Net lending / borrowing	EDP B.9	**-366.2**	-1.2	-0.6	-0.9	-0.6	0.0
9. Interest expenditure	EDP D.41	**432.6**	1.4	1.2	1.1	1.1	1.1
10. Primary balance		**66.4**	0.2	0.7	0.2	0.6	1.1
11. One off expenditures			0.0	0.1	0.1	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		**7,476.4**	24.6	24.3	23.6	23.2	23.2
12a. Taxes on production and imports	D.2	**4,634.8**	15.2	15.2	14.6	13.9	13.7
12b. Current taxes on income, wealth, etc	D.5	**2,835.9**	9.3	9.1	9.0	9.3	9.5
12c. Capital taxes	D.91	**5.7**	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	**4,417.0**	14.5	14.4	14.4	14.3	14.2
14. Property income	D.4	**193.3**	0.6	0.6	0.7	0.6	0.6
15. Other 4		**1,326.6**	4.4	3.7	3.6	3.4	3.3
16. Total revenue	TR	**13,413.4**	**44.1**	**43.0**	**42.2**	**41.5**	**41.3**
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		**11,893.5**	**39.1**	**38.6**	**38.0**	**37.5**	**37.4**
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	**5,426.3**	17.8	17.2	17.2	16.8	16.6
17a. Compensation of employees	D.1	**3,479.9**	11.4	11.0	10.9	10.7	10.6
17b. Intermediate consumption	P.2	**1,946.4**	6.4	6.3	6.3	6.1	6.0
18. Social payments (18=18a+18b)		**5,363.3**	17.6	17.1	17.0	16.7	16.4
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D. 63131	**634.5**	2.1	2.1	2.1	2.0	1.9
18b. Social transfers other than in kind	D.62	**4,728.8**	15.5	15.0	14.9	14.7	14.5
19. Interest expenditure	D.41	**432.6**	1.4	1.2	1.1	1.1	1.1
20. Subsidies	D.3	**517.6**	1.7	1.7	1.6	1.6	1.6
21. Gross fixed capital formation	P.51	**1,114.5**	3.7	3.6	3.6	3.5	3.3
22. Other		**925.3**	3.0	2.7	2.6	2.4	2.3
23. Total expenditure	TE	**13,779.6**	**45.3**	**43.6**	**43.2**	**42.1**	**41.3**

Source: MF RS.

Table 3.5.: The impact of railway investment on net borrowing

% of GDP	2006	2007	2008	2009
Net Borrowing	**-1.2**	**-0.6**	**-0.9**	**-0.6**
Net borrowing without railway financing	-1.2	-0.4	-0.5	-0.4

Source: MF RS.

The central government deficit (state budget, extrabudgetary funds, agencies and other entities at the level of central government) in 2006 was 1.2% of GDP (Table 3.4). It was lower than the figure reported in last year's Stability Programme (1.5%). The central government's deficit in 2007 is estimated to be lower (0.7% of GDP). It is also expected to increase temporarily in 2008 as a result also of the reasons mentioned above and then it should gradually balance.

The two compulsory social security funds, the Pension and Disability Insurance Fund (Pension Fund) and Health Insurance Fund (Health Fund) registered slight surplus in 2006 and 2007 reflecting better labor market performance. During 2008-2010 they will operate without deficits as required by Pension Fund Law in the case of the former and by the budget memorandum in the case of the latter (Table 3.4.).

The overall consolidated budgets of local governments registered a slight deficit in 2006 (0.05% of GDP). In this year and in the period 2007-2009 local communities combined consolidated budget will be balanced.

3.4. Debt levels and developments

The outstanding amount of general government consolidated debt was Euro 8.245 million (27.1% of GDP at the end of 2006). The largest share (98.7) of the total represents the central government debt. After the state budget assumed the debt from two social insurance funds in 2005, the social insurance funds (health and pension fund) do not exhibit debt, while the share of local government debt is low and will remain constant during the program period. The indebtedness capacity of local government is constrained by the Law on Municipalities financing which limits the total amount of borrowing in a given year to a maximum of 20% of realized revenues in previous year. The debt service (interest and principal) is also subject to a maximum of 5% of realized revenues in the previous year[4].

The general government debt-to-GDP ratio will be reduced significantly during the program period. The debt trajectory is different to that presented in the SP 2006. In particular the ongoing decreasing trend in the debt ratio has taken momentum in 2007 (-1.5 P.P.) and the overall trajectory indicates a strong decline. The debt ratio is estimated to decrease by additional 3.1 P.P. from 25.6 % of GDP in 2007 to 22.5% in

[4] The debt service (interest and principal) ceiling may be increased to a maximum of 8% of realized revenues in the previous year in the case of financing infrastructure investments in the field of schooling, housing, waste and water supply or projects co financed from EU budget. In such case the overall debt stock ceiling of maximum 20% does not apply.

2010. Significant reductions are underpinned by the use of part of privatization receipts for debt repayment (2005 in the amount of SIT 80.9 bn (337 millions EUR) form selling a share in Nova Ljubljanska Banka in 2002, 2007 EUR 60 millions and 2008 EUR 178 millions including decrease of cash balances). The budget exhibits a relatively sizable primary surplus in 2007 and they will remain throughout the program period. The favorable cost and term structure [5] of the debt has also influenced positively on debt dynamics. This positive effect will persist but will be lower in 2009-2010. The size of the stock adjustment which increases the debt in the program period will remain lower than the average EU-15 weighted SFA average over the last decade (0.4%).

Table 3.6.: General government debt developments

% of GDP	**2006**	**2007**	**2008**	**2009**	**2010**
1. Gross debt	27.1	25.6	24.7	23.8	22.5
2. Change in gross debt ratio	-0.3	-1.5	-0.8	-0.9	-1.4
Contributions to change in gross debt ratio					
3. Primary balance	0.2	0.7	0.2	0.6	1.1
4. "Snowball effect"	-0.6	-1.0	-0.9	-0.5	-0.5
5. Stock-flow adjustment	0.5	0.2	0.2	0.2	0.3
p.m. implicit interest rate on debt	5.6%	5.0%	4.6%	4.9%	4.9%

Source: MF RS.

Due to the undeveloped and small financial market and high inflation until 2000 the central government borrowed on the domestic market primarily through index-linked instruments (mainly inflation index-linked while instruments were to a lesser extent indexed to the exchange rate first of the Deutschmark and later the Euro). In 2000 the Government took the first step in the gradual transition towards the use of long-term nominal financing instruments and in 2003 the gradual process was completed with the issuing of the first five- and ten-year tolar bonds with nominal fixed interest rates. Throughout the process of gradual transition from the use of inflation-indexed instruments to the use of nominal instruments of financing the state began to reduce the sensitivity of its debt to inflation trends. From 2004 to 2006 the central government borrowed in the domestic market exclusively and only with tolar denominated securities with nominal fixed interest rates. The government relied on a system of primary dealers and system of market makers introduced in 2005 that helped to boost liquidity of central government securities. The introduction of market makers also contributed to enhance the accuracy of information about the cost of central government borrowing.

As part of the process of monetary integration, with the adoption of the euro in 2007, the infrastructure of domestic government debt market was further integrated to the

[5] The average weighted years to maturity of central government budget debt was 5.9 years as of 30.6.2007 comparing 5.2 years as of 31.12.2006.

EU market following the EMU targets on improvements of efficiency through harmonization process. In 2007 a new international structure of primary dealers was established which includes 3 resident and 6 non resident banks. Newly issued bonds now trade on major international trading platforms. [6] The issuing strategy was modified by increasing the minimum issuance size as well as by changing the method of issuance to broaden investor base and increase market integration of Slovenia to the Euro area as well as to assure appropriate level of liquidity and transparency into the price formation process. Within the central government debt management a regular buyback program strategy has been introduced. The purpose is to consolidate existing debt into fewer liquid benchmarks[7], to further support long run decrease of debt service cost, and to shape a debt portfolio structure that will further minimize exposure to market and macroeconomic risks. In March 2007 Slovenia issued its first EUR 1 bn benchmark government bond which successfully positioned Republic of Slovenia in the euro government bond market.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

4.1. Sensitivity analysis to changes in economic activity

The baseline scenario in Chapter 2 presents the central macroeconomic forecast, which is based on the realistic assumptions and is the most likely outcome. However, the outlook is subject to certain downside and upside risks.

A greater slowdown of external economic growth than projected in the baseline scenario could pose a potential risk to the baseline scenario forecasts. This would happen if the risks related to the financial crisis would materialize. In the event of lower economic growth in Slovenia's main trading partners by 0.5 p.p. in 2008, the real growth of Slovenian exports would be approximately 0.7 p.p. lower. Apart from that, the total real increase in gross fixed capital formation would also be 0.6 p.p. lower due to the slower real growth of private investment. Relatively smaller foreign demand would also dampen the growth of value added in manufacturing, which would reduce the growth of imports of intermediate goods. Consequently, the real growth of imports would slow down by 0.5 p.p. The total effect would result in 0.3 p.p. lower economic growth in 2008 relative to the baseline scenario.

[6] In 2007 the link between local CSD and two pan-European CSD's (Clearstream and Euroclear) was established.
[7] In 2007 buybacks were executed in the amount of EUR 1 billion, where EUR 0.7 were financed by proceeds of new EUR 1 billion benchmark issue.

4.2. Sensitivity of budgetary projections to different scenarios and assumptions

The sensitivity of budget projections to changes in variables affecting tax revenue is presented in Tables 4.1 and 4.2. The idea is to highlight the risk of macroeconomic scenario to revenue and budgetary projections. The effect of the change in real growth of average (gross) wage, employment, GDP, private and government consumption was assessed.

Six scenarios were made highlighting potential current risks to the macroeconomic (scenarios 1-5) and the effect of fiscal policy changes (scenario 6): i) lower real growth rate of average wages; ii) non increase in employment (keeping employment in the economy at the same level as in the previous year); iii) higher real growth of GDP in t-1; iv) a lower real growth of private consumption of households; v) higher inflation (current and past years) and; vi) lower real growth of government consumption.

Table 4.1. shows the impact on the budget balance of the changes in the mentioned macroeconomic variables channeled though different taxes considered independently. In general higher inflation and real wage growth increase tax revenue. In the case of personal income tax, in a scenario of lower inflation in current year than before, the effect of inflation in revenue is partial offset by the lagged adjustment of the tax brackets and higher claim of tax allowance in the current year. Changes in employment affect significantly social security contributions. The analysis indicate that changes in GDP per se are not directly reflected in the changes in tax revenue but the tax bases are better indicator of changes in economic circumstances. The scenario includes a reduction in government consumption by 1 percentage point for example a reduction from 3.2% to 2.2% in 2008. Such a change would reduce total government revenue by 0.03% channeled primarily through reduction of VAT revenue. The marginal effect is due to the relatively low weight of government consumption in GDP 19%.

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

Tax category	Macroeconomic base	Change in macroeconomic base	Change in general government balance in 2008 (% GDP)	Change in general government balance in 2009 (% GDP)
Personal Income Tax	Real growth in average gross wage	Higher by 1 percentage point	0.09	0.10
	Employment	Lower by 1 percentage point	-0.06	-0.06
	Inflation	Higher by 1 percentage point	0.09	0.10
	Last year's inflation	Higher by 1 percentage point	-0.04	-0.04
Social security contributions	Real growth in average gross wage	Lower by 1 percentage point	0.13	0.13
	Employment	Lower by 1 percentage point	-0.14	-0.14
	Last year's inflation	Higher by 1 percentage point	0.13	0.13
Corporate Income Tax	GDP growth in t-1	Higher by 1 percentage point	0.06	0.06
	Last year's inflation	Higher by 1 percentage point	0.06	0.06
Indirect Taxes	Real growth in private consumption	Lower by 1 percentage point	-0.10	-0.10
	Real growth in government consumption	Lower by 1 percentage point	-0.03	-0.03
	Inflation	Higher by 1 percentage point	0.11	0.11

Table 4.2. shows the combined effect of changes in the macroeconomic variables in the budget balance channelled though various taxes and the effect of reduction in government expenditure. The impact is most pronounced in the case of inflation, a 1 P.P. increase in inflation would lead to 0.35% higher revenue. The growth of real wages also affects significantly tax revenue 0.24%. The impact is also significant if the employment does not increase – the revenue is lower by 0.2% of GDP. The case of employment behaviour highlights the importance of enhancing labor market participation also on the grounds of improving public finances and its long-term sustainability. To have a complete picture of the effect of the various changes in the government balance it will be also needed to assess the impact on expenditures, for example, the effect of inflation on increasing social transfers. The sensitivity analysis also highlights the limited effect of a reduction in the real growth of government consumption. In particular a zero growth in real government consumption rate in 2008 would lead to only 0.09% of GDP decline in government VAT revenue due VAT in the same year and additional loss of tax revenue of 0.06% of GDP in the second year.

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

Macroeconomic base	Change in macroeconomic base	Tax category	Change in general government balance in 2008 (% GDP)	Change in general government balance in 2009 (% GDP)
Real growth in average gross wage	Higher by 1 percentage point	Personal Income Tax, Social Security Contributions, Payroll Tax	**-0.24**	**-0.24**
Employment	Lower by 1 percentage point	Personal Income Tax, Social Security Contributions	**-0.20**	**-0.20**
Inflation	Higher by 1 percentage point	All	**0.35**	**0.34**
Last year's inflation	Higher by 1 percentage point	Personal Income Tax, Corporate Income Tax	**0.15**	**0.16**
GDP growth in t-1	Higher by 1 percentage point	Corporate Income Tax	**-0.06**	**-0.05**
Real growth in private consumption	Lower by 1 percentage point	Indirect Taxes	**-0.10**	**-0.10**
Real growth in government consumption	Lower by 1 percentage point	Indirect Taxes	**-0.03**	**-0.03**

Source: MF RS.

4.3. Sensitivity analysis on the debt service

The outstanding central government debt is relatively insensitive to changes in inflation and exchange rate as the share of inflation-link instruments are pretty much insignificant now as a result of active debt management and will further diminished in year 2008. Similarly the share of debt in other currencies (USD, GBP, CHF) from 2008 forward will be very low (less then 1 % of whole central government debt).

The major influence on the cost of servicing of existing debt and repayment of existing credits and securities in future will have the change of interest rates of the ECB. However, the effect of interest rate increase on debt service should not be high in the short to medium term given the term structure of the debt primarily long term (average term to maturity 5.9 years at mid 2007). In the case of an interest rates increase of 100 basic points in year 2008, this would lead to increase of cost of new borrowing in the level of 0.004% in the year 2008 and 0.04% in the year 2009. If the real GDP growth were lower by 1 percentage point in 2008 and 2009 this would lead to an increase in the debt-to-GDP ratio of 0.2% in the year 2008 and 0.4% in the year 2009.

Table 4.3.: Sensitivity of interest payments and debt repayments of the general government

% GDP	2008		2009	
	Interest	Debt	Interest	Debt
Change in interest rates	0.00	0.00	0.04	0.00
Change in the GDP growth	0.01	0.20	0.02	0.39

Source: MF RS.

It is clear from above that the existing central government debt is a relatively stable macroeconomic aggregate that is not strongly influenced by changes in exchange rate and inflation as the shares of debt that are influenced by the exchange rate and inflation. The bulk of national debt is denominated in Euros, with other currencies representing only around 0.5% of the total central government debt. In terms of the structure of instruments, fixed-rate debt already represents around 98% of the total debt, while the proportion of instrument with variable interest rate would be around 2% of the total central government debt.

4.4. Comparison with the 2006 Stability Programme

The forecasts of GDP growth for 2007–2010 project higher growth rates in comparison with the Stability Programme 2006, particularly in 2007. This largely reflects the higher expected growth rates in gross fixed capital formation and exports based on the more favourable external assumptions and the accelerated growth of investment in the construction of motorway and railway infrastructure.

Table 4.4.: Divergence from previous update (December 2006)

% of GDP	2006	2007	2008	2009	2010
1. Real GDP growth					
Stability program (previous update)	4.7	4.3	4.2	4.1	4.1
Stability program (latest update)	5.7	5.8	4.6	4.1	4.5
Difference	1.0	1.5	0.4	0.0	0.4
2. General government net lending					
Stability program (previous update)	-1.6	-1.5	-1.6	-1.0	NA
Stability program (latest update)	-1.2	-0.6	-0.9	-0.6	0.0
Difference	-0.4	-0.9	-0.7	-0.4	
3. General government gross debt					
Stability program (previous update)	28.5	28.2	28.3	27.7	NA
Stability program (latest update)	27.1	25.6	24.7	23.8	22.5
Difference	-1.4	-2.6	-3.6	-3.9	

Source: IMAD, SORS, MF RS.

The general government deficit in 2006 was lower than presented in the SP 2006. Among the factors explaining the difference are the revision of the GDP figures by Statistical office and better realization as it was planned conservatibly. The estimation of the 2007 deficit reflects better realization in 2006, conservative planning and the effect of better economic environment. The fiscal stance and the approach followed in planning the budget are also reflected in the estimated for the period 2008-2010.

General government debt in 2006 was lower than planned reflecting the Statistical Office's revision of the GDP figures. Going forward the difference of the estimates reflect stronger fiscal consolidation than envisaged.

5. QUALITY OF PUBLIC FINANCES

Fiscal policy will continue underpinning the government Lisbon strategy goals. This implies continuing with the fiscal consolidation process in a program scenario of lower economic growth and by enhancing the quality of public finance of both revenues and expenditures. This policy should contribute to enhance growth potential.

In the area of expenditures the share in GDP will continue declining but not at expense of investment as the share in GDP will remain relatively high. Particular attention is giving to railway infrastructure.

The rationalization and re-orientation of expenditure structure towards growth enhancing priorities will continue, in particular in favor of R&D activities, education, active labor market policies and lifelong learning. Similarly, the absorption capacity of EU funds should be enhanced.

Improving the quality of public finances also involves ensuring a sustainable pay structure and motivated labor force in the public sector. To this end, in the next three year period wage differentials within the public sector will be corrected by using the funds that are being generated from the policy that is being followed (2004-2009) of public sector wage growth lagging inflation. Frontloading and gradually implementing the Law on Public Sector wages, which was previously foreseen only in the SP 2006 for 2010, will ensure that there are no large discrete increases in public expenditure and that the policy is implemented in a sustainable manner.

Envisaged improvements in the quality of public finance also include better public procurement procedures, the transfer of the provision of some public services to the private sector and its co-financing and the implementation of the legal and operating framework regulating public private partnership projects. To this end after the relevant law was adopted in November 2006, a unit in charge of PPP projects was established within the ministry of finance.

On the revenue side, the policy agenda envisages the full implementation by 2010 of the comprehensive tax reform initiated in 2005. Major changes have taken place already but further changes in the rates of corporate income tax and the elimination of payroll tax will be finalized by 2010. The comprehensive tax reform package should contribute to increase employment, savings and investment. Key changes include the 20% single tax rate on income from capital, the elimination of double taxation for corporations and streamlining tax corporate allowances in favor of R&D expenditure. As a result of the reform the tax system has become more stable and transparent, contributing to the competitiveness of the economy. The favourable impact will be seen gradually in the future.

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

5.1. General government revenues policy

A comprehensive tax reform is currently under implementation which will be reflected in the tax revenue dynamics during the program period. The overall impact of the reform in terms of loss of tax revenue was estimated in 2% of GDP. The share of total taxed in GDP is reduced from 24.6% in 2005 to 23.2% in 2010. Better economic performance and conservative planning of expenditures will allow financing the reform without rising VAT rates. The effect of the reform and in particular the gradual abolition of the payroll tax is visible in the reduction of taxed on production and import by 1.5& of GDP from 15.2% of GDP in 2006 to 13.7% of GDP in 2010 (Table 3.4.).

The key objective of the tax reform is to unburden the economy and improve conciliation for enhancing competitiveness. At the beginning of 2007 seven tax laws started to be implemented which complement the comprehensive tax reform initiated in 2005[8]. In that year two fundamental changes to the tax system were introduced: i) the split of the personal income tax into a dual tax system that taxes labor income at progressive tax rates while capital income at single 20% tax rate and; ii) the gradual phasing out of the so-called payroll tax, a progressive tax income on employers of high wage earners[9].

The reform measures in personal income tax reduced the tax burden as of 2007 by increasing the non-taxable allowance while at the same time lowering the progressivity of active income. This implied that taxpayers with in the highest income bracket increased their employability while enhancing the possibilities for technological companies to attract top staff. The reform also included simplifications in establishing the taxable base thereby increasing the incentives for taxpayers to pay taxes.

[8] Corporate income tax, VAT, Tax procedure, Real estate tax, Inheritance tax and tax on vessels.
[9] The tax revenue generated from this tax was about 1.8% GDP in 2005. In 2006 the tax rate was decreased by 20%. It was further decreased in 2007 by 40%, in 2008 by 70% while it will be completely abolished in 2009.

In the case of corporate income tax the reform followed the goals stipulated in the SRS underpinning increased competitiveness and higher growth. In 2007 a number of new provisions aiming at a more transparent and stable tax environment were enforced. They are eliminating the double taxation of income and enhancing legal certainty, whereby better investment opportunities are created and outflow of capital is discouraged to countries with lower capital taxation and lower fiscal transparency.

The CIT maintains a special tax relief for investment in R&D with the aim of contributing towards greater competitiveness of the economy. The relief is intended for investment in internal R&D activities of taxable persons as well as for acquisition of R&D services. The tax relief applies for both, the legal persons taxed according to the CIT and the natural persons (sole entrepreneurships) falling under the personal income tax regime. The tax relief for R&D was included in the reform already in 2006 as one of the measures under Lisbon reform programme. The preliminary data for 2006 indicates that the R&D relief is yielding results (see also section 2.4.).

The rates of corporate income tax are subject to gradual reduction from 25% in 2006 to 20% in 2010. The rate in 2007 is 23%; it will be 22% in 2008 and 21% in 2009.

The new Law on VAT takes full account of the existing VAT Directive, while at the same time increasing the clarity and certainty for taxpayers. In order to simplify the procedures for small taxpayers, the minimum threshold for taxable revenues was raised, tax warehouses were introduced allowing for a delayed tax liability, separate book-keeping was abolished, the upper threshold for the 3-month tax payers was substantially increased and the 6-month tax period was abolished. Change in the taxable turnover definition, used to determine the threshold for entrance to the VAT system, will result in a decrease of the number of persons liable to taxation and simplify the system for those, who mainly perform activities, exempted from VAT, without the right of input VAT deduction.

The existent rentals on use of building land will be replaced by a tax that will be applied to real estate not taxed under the VAT. The aim is to widen the tax base and the scope of tax allowances.

The system of property taxation has been upgraded with a new law on inheritance and gifts. It is extending the notion of taxable persons to the legal persons of private law (e.g. associations, funds, private institutions), while retaining exemptions for the first class heirs.

The law on nautical vessels replaced the previous system under the law on taxation of natural persons. The tax rate for nautical vessels increases in line with its length and engine strength and decreases in line with the age of vessel. The tax is not paid for vessels used exclusively for registered activities.

The tax reform package, implemented as of 1 January 2007 and totalling 7 laws also entails provisions on tax procedure. The new law simplifies the procedure and reduces unnecessary administration to a large extent, which will improve the efficiency of the tax administration and the tax system as such.

As of 2007, a new excise duty on electricity was introduced, while the excise duty on cigarettes was increased so as to achieve the minimum level foreseen by the acquis by 1 July 2007. This means that the excise duty reached 64 EUR per 1000 cigarettes and not less than 57% of the retail sales price of the most popular price category of cigarettes.

5.2. General government expenditure policy

The government policy will continue gradually reducing the share of government expenditure in GDP and reorienting its composition towards financing growth–oriented categories (e.g. railway infrastructure, R&D, higher education). Within the scope of this policy, according to the relevant legislation, the wage disparities within the public sector will be corrected. Efforts will be also devoted to increase the absorption capacity of EU funds which includes improving administrative capacity and increasing the number and quality of EU co-financed projects.

Key policy measures underpinning the reduction and re-orientation of expenditure towards development oriented priorities include: i) restrictive wage and employment policy in the public sector; ii) gradual reduction of intermediate consumption and; iii) unification of indexation of all social transfers, other than pensions, to the growth of consumer price index only. In addition the new information system on recipients of social transfers will ensure better monitoring and transparency of the overall system.

Despite the implementation of the Law to correct wage disparities the overall wage bill as percentage of GDP will continue declining gradually from the 2006 level of 11.4% to 10.6% in 2010 (Table 3.4.). The reasons are twofold. First, the annual increase in wages has been lower than productivity in the economy since 2002 (Table 2.4.). Despite the envisaged increase in wages due to primarily the correction of wage disparities in 2008 the trend will continue in the program period. This will be facilitated by the savings for correcting wage disparities. Second, employment in the general government sector should be reduced by 1% annually. The restrictive employment policy foresees additional employment in the public sector only in the judiciary system and in activities related to international commitments on security (army (NATO) and police (Schengen border)) and health care sectors (doctors). The average real wage growth of the wage bill will be 3.1% in the period 2008-2010.This figure is higher than the average during 2005-2007 (2.2%) but lower than the average during 2001-2004 (4.2%).

The second key policy area concerns the rationalization of government operating costs (purchase of goods and services) and improvement of public administration efficiency. The ratio of intermediate consumption in GDP will be reduced from 6.4% of GDP in 2006 to 6% in 2010 the lowest level in the whole decade. One important factor influencing this type of expenditure is that one-off type of expenditure associated with setting the Schengen border and EU related activities are to be terminated in 2008. Other measures under implementation or considered are: i) reallocation of expenditures from programs that are less effective and successful to more effective programs; ii) changing the criteria for eligibility for funds; iii) using public private partnerships projects (PPP); iv) some operational expenses associated to projects are growingly financed with EU Funds and; v) simplification of the budget preparation process enabling greater control over efficiency and effectiveness of expenditure.

The third key important area is the streamlining of the system of social transfers. In 2006 two important changes in legislation were introduced which are reflected in the reduction of social transfers other than in kind as percentage of GDP. The first concerns the criteria for eligibility of unemployment benefits and social assistance. In both cases access to benefits has been made more dependent on a claimant's readiness to accept employment that has been offered. The second change consists of the harmonization of indexation of all transfers to individuals, with the exception of pensions, to changes in consumer price. The later change is bringing significant savings up to 0.1% of GDP every year. Further progress in this area involves increasing the transparency and simplicity of the social transfers system. The upgrading the information systems and their integration expected to be fully operational in 2009 will contribute to this end. The overall share of expenditure in social transfers other than in kind in GDP will be reduced gradually by 0.7% from 2007 to 2010. In 2007 the reduction was significant of 0.5% of GDP. The average real growth rate in 2005-2007 was 2.4% lower than 3.1% in 2001-2004. In the period 2008-2010 the average real growth will be 2.8%.

Besides the policy measures mentioned above, the more favorable economic environment has also contributed to reduce the number of recipients of these kinds of social transfers. The number of registered unemployed has decreased by 6.6% from 2005 (91.900) to 2007 (85.800). Such a trend is expected to continue in the program period underpinned by relatively good economic environment and implementation of labor market policy. An important policy measure in this regard, is the new law on employment relationship, with additional elements of flexsecurity. The number of registered unemployed is expected to further decrease to 61.800 thousands in 2010 (13.4%) and the rate of registered unemployed to 6.6%. In the year 2006, the rate of registered unemployed was 9.4% in 2007 is estimated to be 7.7%. Also the ILO rate of unemployment declined from 6.5% in 2005 to 5% in 2007 and is expected to decrease to 4.6 by 2010. The share of transfers to unemployed in GDP will slightly decrease in percentage of GDP from 0.6% in 2007 to 0.5% in 2010.

Other areas where savings will be registered in the period 2007-2010 include social care allowances (0.2% of GDP and. pensions (0.4% of GDP). The trend decline in the share of pension expenditure in GDP should continue from 11.1% in 2003 to 10.5% in 2007 and 10% in 2010. This behavior is underpinned by the 1999 pension reform measures which result in average pension growth lagging behind the average wage growth by around 0.5 percentage points. From 1999 to 2007 the average replacement rate fell by 11.3 percentage point from 77.2% to 65.9% in 2007. The decrease in unemployment and the number of war veterans is also contributing to reduce total expenditure. The improvement of active labor market policy measures and the adopted Employment Relationship Act that contains important changes regarding flexicurity will contribute to this end. In the case of war veterans it is expected that the downward trend in the number of individuals in need to transfers will decline.

Transfers in kind will maintain its relative share in GDP (2.1%). This is primarily the result of regular measures shifting the use of generic rather than original medicines and the introduction of a reference price list that has contributed to stabilize expenditure in medicines. The relatively stability of the expenditure in GDP is due to the fact that price dynamics of new medicines are usually above inflation. However, on the other hand, the change in indexation of sick leave benefits to the consumer price growth in 2006 has contributed to reduce expenditure. The draft of a new law on Health Care Insurance System is still under preparation. The draft law foresees changes in sick leave benefit and shifting costs to the private sector which can render significant savings. In the mean time savings from the adopted measures will be devoted to new programs such as reducing waiting lists for some surgical operations. According to economic classification total expenditure on health will remain broadly stable over the program period and will amount to 6% GDP in 2010 while according to COFOG the share will decline by 0.6 P.P. from 2007 to 2010.

Important savings are recorded in the area of interest payments, due to the lower deficits, debt repayment (2005) and active debt management operations. The share of interest expenditure in GDP will decline from 1.4% in 2006 to 1.1% in 2010. The integration of local market to euro area market has allowed spreads similar to those of countries with similar ratings subject to size and liquidity of relative low size of Slovenian government debt.

The share of subsidies in GDP will remain constant around current level 1.7% of GDP. However, its composition is changing. Total amount of subsidies to agriculture will increase while the share of subsidies to agricultural sector financed with domestic sources will decline. The share of other subsidies (e.g. restructuring/closing enterprises and mines) in total subsidies will decline and the freed resources will be oriented to finance the increasing amount of subsidies devoted to meet horizontal objectives. The share of R&D activities (research. the creation of technological centers and parks) will increase. The amount devoted directly to R&D in GDP will increase from 0.67% in 2007, to 0.73% in 2008 and further to 0.81% in 2009. In addition the government provides tax allowance on R&D expenditure. Other subsidies that have been increased relate to ecological programs and to the program of gradual provision of health services by the private sector.

Within the framework of gradual reduction of expenditure and consistent with Slovenia's Lisbon Agenda other financing priority areas besides R&D and Nato commitments include education and training, employment (active labor market policy), entrepreneurship and competition and defense.

With regard to education is important to mention that while its share in GDP remains constant (Table 5.1.), in terms of total spending structure its relative importance has increased, particularly spending on tertiary education. The government plans to increase overall investment in tertiary education (public and private) to the target of 2% of GDP in 2010.

Resources to active labor market policy will increase throughout the programme period from 2006 to 2010. Particular attention will be given to life-long learning and training. Increasing labor participation and education level rate has very important implication for improving growth perspectives and alleviating the fiscal pressures arising from population aging.

Expenditure in defense is another item that has increased. Slovenia spent 1.4% of GDP in 2007. The level has increased from 1.1% in 2000 and will continue gradually increasing during the program period (Table 5.1.).

Slovenia needs to continue closing the development gap with respect to the EU average and the infrastructure still needs to be improved. The policy is to keep the relative share of gross fixed capital formation financed with domestic sources above 3% of GDP. Additional investment will be financed with EU funds. The dynamics of investment in the period 2007-2009 are significantly influenced by the railway infrastructure projects. In particular, the planned expenditure in 2008 amounts to 0.4% of GDP. The direct financing of railway's infrastructure is temporary as the government envisages the involvement of third party investors and the use of EU funds in the future.

Tabel 5.1.: Expenditure of General governmnet by function

% GDP	**COFOG code**	**2005**	**2010**
Total expenditure		46.0	41.3
1. General public services	1	6.5	5.6
2. Defense	2	1.3	1.5
3. Public order and safety	3	1.7	1.4
4. Economic affairs	4	4.3	3.6
5. Environmental protection	5	0.5	0.4
6. Housing and community amenities	6	0.3	0.2
7. Health	7	6.4	5.7
8. Recreation, culture and religion	8	1.1	1.0
9. Education	9	6.4	6.3
10. Social protection	10	17.4	15.5

Source: SORS, MF RS.

6. SUSTAINABILITY OF PUBLIC FINANCES

The EU has agreed a three–pronged approach to tackle the demographic challenge consisting of: i) fiscal consolidation and debt reduction; ii) increased employment and ii) pension and related reforms. Slovenia is addressing the challenge within this framework. The debt-to-GDP ratio is low (27.1%), and it is expected to decrease significantly by 4.6 P.P. until 2010. Employment has increased over the past years and in 2006 (66.6%) the employment rate was slightly above the EU 15 average. Employment rate of older workers has increased at a relatively high pace in the last six years (32.6% in 2006) but it still below EU-15 average. Labor participation rate is still increasing and there is room for improvement. The labor activity rate of individuals age 15-64 is estimated to be 71.3% in 2007. Among the factors affecting these developments is the current implementation of the pension reform measures enacted in 1999. However the reform measures by itself it will not ensure long-term sustainability of public finances, especially after 2030. Further measures will be needed as well as implementing the NRP measures for increasing employment, particularly of older people and promoting their remaining in activity (the active ageing strategy). In addition, measures to stimulate private pension savings are also under consideration.

This section presents updated baseline projections related to age related expenditure taking into account agreed assumptions in the ageing working group and recent budgetary developments. It also presents long term projections taking into account recent demographic developments during the period 2004-2006, particularly changes in fertility rate, with the aim to have a more accurate picture of the cost associate with the aging of the population. The recent demographic developments should be included in the next round of projections that is being prepared by EUROSTAT. In addition various simulations are presented to highlight the impact of policy changes in the overall cost of aging and particularly the large variability of the cost resulting from policy changes. This dimension is particularly important taking into account that projections of contingent liabilities should be incorporated in the countries' medium term objectives once agreement has been reached on the appropriate methodology. The last section indicates the strategy of the government in the field.

6.1. Baseline projections

Eurostat's baseline demographic projections for Slovenia are based on an adverse demographic profile that will continue worsening in the future. Accordingly the dependency ratio calculated as the ratio between the number of persons of non-working age and the number of persons of working age will increase from 21.7% in 2005 to 55.6% in the year 2050.

Updated projections of the baseline scenario concerning the fiscal impact of population aging takes into account Eurostat demographic projections including approved assumptions on labor participation rates by Slovenian demographers (Table 6.1); agreed assumptions in the age working group concerning the future evolution of capital-labor ratio thus on productivity and GDP growth rates; and recent budgetary development and projections until 2010.

Table 6.1: Projections of participation rates in given years

	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
15-19	8.1	8.1	7.6	7.6	7.4	7.7	8.0	8.0	7.9	7.8
20-24	43.8	42.0	40.3	39.2	39.4	39.6	40.8	41.4	41.3	40.8
25-29	78.2	74.3	72.9	71.5	70.7	71.1	71.4	72.5	73.0	72.8
30-34	91.1	91.4	89.9	89.4	88.8	88.5	88.7	88.9	89.4	89.6
35-39	92.0	94.0	94.2	93.6	93.2	92.7	92.5	92.7	92.9	93.3
40-44	88.4	92.2	93.2	93.6	93.2	92.8	92.1	91.9	92.1	92.4
45-49	84.7	88.8	91.5	92.4	92.7	92.4	92.1	91.6	91.4	91.6
50-54	72.5	74.9	78.0	83.1	84.1	85.4	84.9	84.7	84.3	84.2
55-59	41.4	51.2	52.5	61.0	64.5	69.1	69.9	69.2	69.3	69.0
60-64	13.5	25.8	32.4	30.0	35.1	35.8	38.6	38.9	38.3	38.4
65-69	7.6	9.2	16.9	16.4	16.1	16.2	16.0	16.4	16.3	16.0
15-69	**61.0**	**63.8**	**64.9**	**64.6**	**64.7**	**64.1**	**63.5**	**62.9**	**62.5**	**63.1**

Source: Eurostat in European Commission. 2005; IER 2006.

Table 6.2. presents the updated base line projections of age related expenditure. It indicates that from 2006 to 2050 pension expenditure will increase by 6.1% of GDP, health expenditure will increase by 2.7% of GDP and long term care by 0.8%. The total debt-to-GDP ratio would increase by 137% of GDP over the 22.5% debt-to-GDP ratio projected by 2010. The figures presented in Table 6.2 are slightly different than those presented in the previous update of the Stability Program due to its recalibration taking into account the realization estimates of the 2007 budget, the proposed budgets for 2008-2009 and projections for 2009. The figures are slightly lower than those presented in the SP 2006. What is also important to highlight is that the level of expenditure on GDP are lower than the SP 2006 due to revision of GDP figures.

Table 6.2.: Long-term sustainability of public finances. % of GDP

	2006	2007	2010	2020	2030	2040	2050
Total revenue	**42.6**	**42.1**	**41.3**	**42.6**	**42.9**	**42.7**	**42.2**
Pensions	10.5	10.2	10.1	11.2	13.1	15.3	16.6
Old-age	7.2	7.0	7.0	8.3	10.2	12.4	13.9
Disability	1.7	1.6	1.5	1.5	1.4	1.4	1.2
Family	1.4	1.3	1.3	1.3	1.3	1.4	1.3
State	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other	0.2	0.1	0.1	0.0	0.0	0.0	0.0
Healthcare	6.1	5.9	5.8	6.5	7.4	8.3	8.9
Long-term care	0.8	0.8	0.8	1.0	1.2	1.5	1.7
Education	5.5	5.2	4.8	4.5	4.8	4.9	5.1
Interest expenditure	1.2	1.1	0.9	0.6	1.0	2.9	6.8
Total expenditure	**43.4**	**42.4**	**41.2**	**42.2**	**45.8**	**51.5**	**58.6**
Assumptions							
Labour productivity growth	3.5	3.0	3.1	3.0	2.7	1.9	1.7
Real GDP growth	3.3	4.3	3.7	2.4	2.0	1.0	1.1
Participation rates males (aged 15-64)	74.2	74.9	76.4	77.9	77.0	75.4	76.4
Participation rates females (aged 15-64)	64.5	65.1	66.3	69.0	69.8	69.0	70.5
Total participation rates (aged 15-64)	69.5	70.1	71.5	73.6	73.5	72.3	73.5
Unemployment rate	5.7	5.5	5.5	5.4	5.4	5.4	5.4
Share of population aged 65 years and over (%)	15.7	15.9	16.5	20.6	25.3	28.6	31.2

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

6.2. Simulations

6.2.1. One off change in the demographic scenario

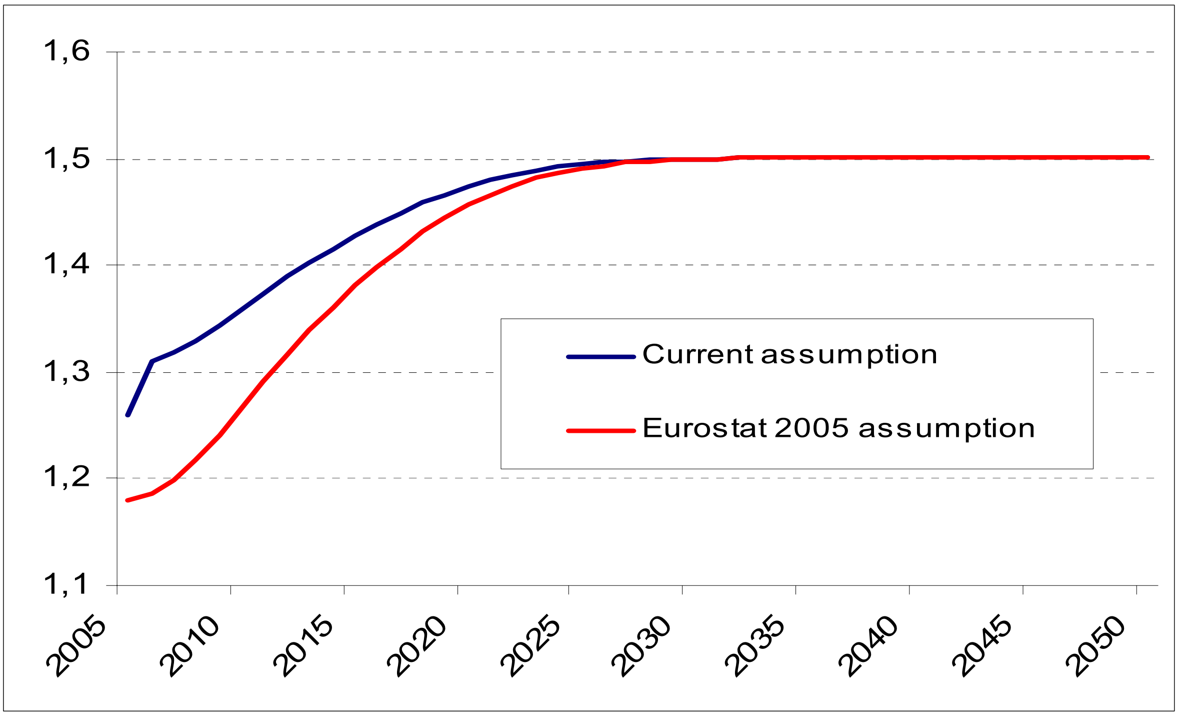
An alternative demographic scenario has been prepared based on current demographic developments (one-off increase in fertility rate 2004-2006). In particular in the 2005 demographic projections by Eurostat assumed an average fertility rate of one child per woman. In the meantime actual data until 2006 shows that during 2004-2006 the fertility rate has been higher; It was not around 1.18 child, as Euorstat assumed, but it was higher: 1.25 (in 2004), 1.26 (in 2005) and 1.31 (in 2006).

At this stage, we cannot conclude whether these higher rates are temporary and the long-term average may settle at 1.2 children per woman or they actually represent an increase in trend. The projections below assume that the fertility will continue increasing and will reach 1.5 children per woman as assumed by Eurostat in 2005. In so doing, the same slope of the growth curve is used and the same division of fertility by age groups is applied, but both on a higher level.

The final fertility rate of 1.5 children has not been changed as there are no grounds to do so. Even if the trend increase in fertility rates is taking place, this can only be due to the deferred fertility whereby fertility increases in older age groups. This is likely to level out as experienced by the other developed countries.

Future migration flows assumptions have not been changed since the 2005 and 2006 migration levels were close to those assumed by Eurostat. Nevertheless it should be pointed out that net migration in 2007 increased well above the baseline scenario projections. We have also not changed the future mortality rates and the starting size of population in 2004 was used rather than actual population in 2007.

Figure 6.1.: Total fertility rates according to the current assumption compared to Eurostat 2005 assumptions



The estimates of old age expenditure based on the new demographic scenario over the baseline scenario show a slight decline in total increase of the change in old age related expenditure (0.4 percentage points) and in the total increase in old age pension expenditure (0.3% percentage points). Although the change is small due to the fact that only information of three years was used, it points out to relative high sensitivity of the results of projections due to change in demographic scenario (Figure 6.2. and Table 6.4.).

6.2.2. Policy scenarios

Various policy scenarios were made on the baseline scenario and the new demographic scenario. The first type of scenario corresponds to increase in participation rate resulting from labor market and complementary policies. The second type of scenario corresponds to some changes in the parameters of the Pay-As-You-Go system.

In the scenario related to labor market a gradually increasing participation rate particularly of individuals aged 55 and above is assessed. This scenario takes into account envisaged systemic reform policies that would increase labor participation rates and reduce unemployment. These policies would result in similar participation rates for Slovenia in 2050 than those currently observed (2005) in the most advanced EU Countries. [10] The effect of increase in labor participation rate in the economy will feed into lower relative pension expenditure due to higher contributions received from a larger number of employees for a lower number of pensioners and at the same time by improving GDP growth rate which is the underlying figure used to assess the sustainability risk level. Figure 2 and Table 6.3 presents the simulation of the change in total old age and pension expenditure resulting from increasing labor participation rate. It indicates that the increase in pension expenditure increase will be mitigated up to the year 2030. From that year onwards the demographic change will result in disappearing surpluses and a gradual increase in the deficit due to pension financing up to a level of 7.6% of GDP in 2050. Under this scenario, the total old age and pension expenditure in the period 2006-2050 compared to the baseline scenario will be reduced by 2.4% of GDP and 1.6% respectively.

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Table 6.3: Long-term sustainability of public finances under increased activity level

	2006	2007	2010	2020	2030	2040	2050
Total revenue	**42.6**	**42.1**	**41.3**	**43.3**	**43.9**	**43.8**	**43.5**
Pensions	10.5	10.2	10.1	10.0	11.6	13.7	15.0
Old-age	7.2	7.0	7.0	7.2	8.8	10.9	12.4
Disability	1.7	1.6	1.5	1.4	1.3	1.3	1.2
Family	1.4	1.3	1.3	1.2	1.3	1.3	1.3
State	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other	0.2	0.1	0.1	0.0	0.0	0.0	0.0
Healthcare	6.1	5.9	5.8	6.2	7.0	7.8	8.4
Long-term care	0.8	0.8	0.8	0.9	1.1	1.4	1.6
Education	5.5	5.2	4.8	4.3	4.6	4.6	4.8
Interest expenditure	1.2	1.1	0.9	0.0	0.0	0.2	1.6
Total expenditure	**43.4**	**42.4**	**41.2**	**39.4**	**42.2**	**45.5**	**49.5**
Assumptions							
Labour productivity growth	3.5	3.0	3.1	3.0	2.7	1.9	1.7
Real GDP growth	3.3	4.3	4.2	2.7	1.8	1.1	1.1
Participation rates males (aged 15-64)	73.6	74.1	75.1	79.0	78.7	77.6	78.4
Participation rates females (aged 15-64)	65.5	66.5	69.0	75.4	76.0	75.1	76.3
Total participation rates (aged 15-64)	69.6	70.4	72.1	77.2	77.4	76.4	77.4
Unemployment rate	5.9	5.7	5.1	4.2	4.2	4.2	4.2
Share of population aged 65 years and over (%)	15.7	15.9	16.5	20.6	25.3	28.6	31.2

Source: IER, UMAR, MF RS.

The second type of scenarios corresponds to changes in the Pay-as-You-Go parameters as follows and combination of scenarios: i) Increase in the retirement age by one year; ii) change in pension indexation to 80% of wage. Currently the growth of the basic pension follows wage growth; however the increase on average pension is being downward corrected by an adjustment prescribed by law (art 151) which aims at equalizing the rights of pensioners retired in different periods. As a result the average replacement rate should fall until 2025 when the 1999 pension reform would be fully implemented.

Figure 6.2.: Sensitivity scenarios on change in old-age expenditure

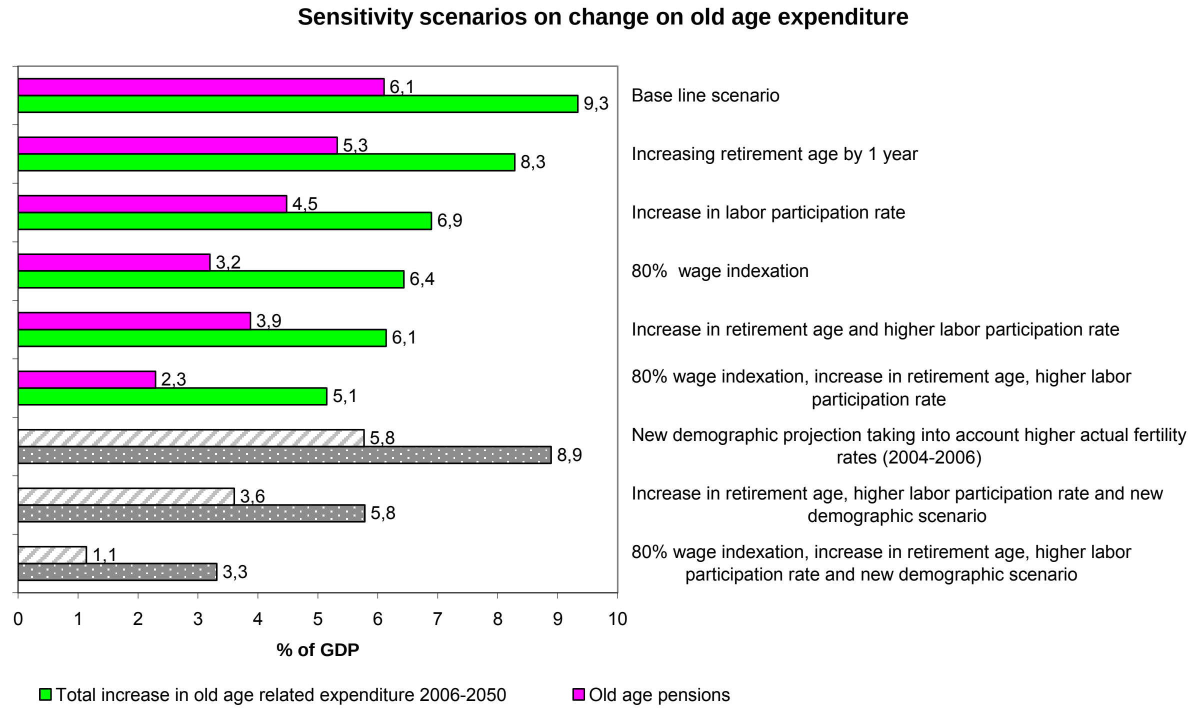

Figure 6.2 shows the effect of increasing retirement age by one year in the baseline scenario. It shows that this measure is relatively powerful in decreasing total accumulated old age and pension expenditures in the period 2007-2050 by 1 P.P. and 0.8% respectively. Change in indexation formula is by far the strongest measure. A change in the indexation formula to 80% of wages in the baseline scenario would reduce old age and pension accumulated expenditures in the period 2007-2050 by 2.9 P.P. respectively. A combination of increase in labor participation and in the retirement age by one year would produce similar result as the change in indexation. Old age and pension accumulated expenditures in the period 2007-2050 would be reduced by 3.1 P.P and 2.2 P.P. An increase in the participation rate to that currently in some members in the EU combined with the two changes in the parameters of the pay-as-you-go system would reduce old age and pension accumulated expenditures in the period 2007-2050 by 4.2 P.P. and 3.9 respectively. The debt-to-GDP ratio in this case would increase by 6.1% of GDP from 2007 to 2050.

Simulations performed based on the alternative demographic scenario provide similar but slightly stronger results.

The impact of the two scenarios on sustainability of public finance can be also assessed in light of the S1 and S2 indicators used by the EU Commission to estimate the fiscal effort (primary balance) necessary to keep the debt below 60% up to 2050 (S1) and to ensure that the intertemporal budget constraint is observed (S2). Table 6.4 shows the impact of policy measures in the various scenarios. It also include an estimate f the downward adjustment to pension growth resulting from the measure aiming at equalizing pension benefits among cohorts contemplated in the existing pension reform.

Table 6.4: S1 and S2 under increased different scenarios

	S1	S2
Base line scenario	1.6	5.5
No pension indexation adjustment (art 151)	3.3	7.5
Increasing retirement age by 1 year	0.1	3.8
Increase in labor participation rate	-1.3	2.0
80% wage indexation	0.2	3.3
Increase in retirement age and higher labor participation rate	-2.4	0.8
80% wage indexation, increase in retirement age, higher labor participation rate	-1.2	1.5
New demographic projection taking into account higher actual fertility rates (2004-2006)	1.5	5.2
Increase in retirement age, higher labor participation rate and new demographic scenario	-1.2	1.5
80% wage indexation, increase in retirement age, higher labor participation rate and new demographic scenario	-3.6	-1.2

Source: IER, MF RS

6.3. The government strategy

The government is implementing the three pronged strategy. The pension reform is being implemented until 2025; the fiscal stance is underpinning a faster debt-to-GDP reduction. Sustained implementation of government Lisbon Agenda in the area of labor participation will also contribute to dampen the increase in the relative cost of age related expenditure. But further measures tackling pension benefits directly need to be taken. This year an expert group has prepared a new draft version of amendments to the Pension and Disability Insurance Act. However, the proposal has not yet been discussed by the Government or the Economic and Social Council. On the other hand a new active ageing strategy is being drafted and is due to be finalised by the end of 2007. In addition the legislation concerning voluntary pension saving schemes is under revision to provide alternative products and increase private incentives to save for retirement.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. Budget formulation and deficit targeting

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

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

The budgetary framework allows for precise deficit targeting by means of budget execution procedure without the need to recourse to supplementary budget legislation. Under the scenario of changes in macroeconomic circumstances or occurrence of new commitments the government can determine the suspension of adoption of new commitments within the agreed limits of the Budget Execution Law. Furthermore, in the case of changing economic circumstances reflected in lower revenues than approved by parliament the government can reduce expenditures, and if the revenue short-fall is higher than a given threshold it can only carry-out expenditures up to a limit set by the Budget Execution Law (e.g. 2006).

7.2. Performance-based budgeting

Performance budgeting will be gradually introduced in the preparation and implementation of the budget. Currently the program objectives, targets and indicators are part of the budget document but are not yet used for determining budget allocations during the budget preparation. Similarly, budget priorities are not yet determined based on performance as the system of verification of indicators and compliance is still under development. In August 2007 a working group was established to review the system of indicators for the quality of public spending and monitor the achievement of the goals set by the budget users. The group's main tasks include: (i) revision of indicators for the quality of public spending and participation in the determination of budget users' objectives so as to ensure a connection between political priorities and the distribution of public funds; and (ii) monitoring the achievement of the set goals and the related results, thereby introducing programme-based budget planning.