THE REPUBLIC OF SLOVENIA

# STABILITY PROGRAMME

Ljubljana, December 2006

# CONTENTS

## FOREWORD

This is the first Stability Programme of Slovenia and first update of the fiscal developments according to targets set in the 2005 update of the Convergence Programme. According to Stability and Growth Pact a country joining the monetary union and within six months following a favorable Council's decision regarding the fulfilment of the necessary conditions for the adoption of the euro has to present a stability Program. These requirements are fulfilled with the present document.

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, and 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.

## 1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The macroeconomic policy mix allowed Slovenia to meet the relevant criteria for becoming the first new EU member after the 2004 EU enlargement in joining the Monetary Union as of January 2007.[1] On 11 July this year the convergence exchange rate was set at the same level as the central parity which reflects broad internal and external balances and sound competitive position of Slovenia. The overall policy framework delivered sustainable low rates of inflation.

The objective of economic policy is the creation of conditions for a faster and sustainable welfare increase in Slovenia above the average level of the enlarged EU. According to the Slovenia's Development Strategy (SDS), Slovenia should exceed the average level of the Em's economic development and increase employment in line with the Lisbon strategy goals by 2013. The SDS is comprehensive and pursues improvement of welfare and quality of living based on the principles of sustainability.

Fulfilling the government policy objectives depends upon the sustained implementation of coherent macroeconomic policy that maintains overall stability and competitiveness within the framework of the European Monetary Union and of government policies that enhance growth potential. Policy response to the fiscal challenge of population aging is an ongoing task. It is currently being met with the implementation of the pension reform measures and by maintaining low levels of government debt. Additional measures aiming at increasing labor participation of old age individuals and additional incentives for participation in individual pension insurance are being prepared.

The government is committed to maintaining macroeconomic stability in the euro area and enhance the response capacity of the economy to change in economic circumstances. In this regard and against a more favourable economic background fiscal policy will pursue fiscal consolidation while providing room for financing key infrastructure projects. Similarly important are the financing of the tax reform that is implemented during the program period and recent changes in the benefit system that will enhance resource allocation. The developmental restructuring of expenditure is an integral part of the government's broad development policy agenda to improve competitiveness.[2]

[1] In November 2003, the government and central bank jointly formulated the Programme for ERM II Entry and Adoption of the Euro. Soon after EU accession, Slovenia entered the ERM II, starting with June 28, 2004. A Joint action plan for introduction of the Euro entered into force on February 3, 2005, setting actual conversion preparations in motion. In March 2006 Slovenia requested from the European Commission and the ECB a Convergence Report on its progress in achieving the economic and monetary union. A positive assessment was delivered in May, and based on that the Council (ECOFIN) abrogated the Slovene derogation and fixed the irrevocable EUR/SIT exchange rate on 11 July 2006. Slovenia will adopt the euro on 1 January 2007 under a "big bang" scenario in which euro banknotes and coins will be introduced at the same time as the introduction of euro as the national currency with a dual circulation period of 14 days.

[2] See http://www.sigov.si/zmar/projekti/srs/StrategijarazvojaSlovenije.pdf
http://www.vlada.si/?lng=slo&vie=ctl&gr1=vbmOgl&id=2005100623424037

The wage setting mechanism and particularly the adopted wage policy that envisages wage growth lagging behind productivity growth will be also a key component of the strategy in the early years of participation in the monetary union. Implementation of policy aiming at increasing productivity will underpin competitiveness and resiliency of the economy. Growth potential will increase primarily as a result of the implementation of the National Reform Program's (NRP) specific policy measures in the areas of competition, knowledged-based economy, economic growth and employment. The implementation report of the Reform Programme for achieving the Lisbon Strategy goals submitted to EU Commission in October 2006 provides a comprehensive review of the Slovenian approach, policy objectives, measures and the policy progress made in advancing the reform agenda.[3]

Key areas where substantial progress has been made are reported in the NRP. It will improve the response capacity of the economy to changing circumstances in the monetary union. They include: tax reform and changes in the benefit system; labor market; knowledged-based economy; improving business environment and; government efficiency. Important progress has been made also in the area of sustainable development.

## 2. CURRENT ECONOMIC SITUATION AND OUTLOOK

### 2.1. World economy/technical assumptions

Assumptions about international economic developments in IMAD's autumn forecast (September 2006), which is used as the basis for macroeconomic projections in the Stability Programme, foresee buoyant economic growth in major trading partners in 2006 and a slowdown in 2007, while a slight rebound is expected again in 2008. The assumption regarding the average price of Brent crude in 2006 is USD 69/barrel, while in 2007 and in 2008 it is USD 73/barrel. The technical assumption on euro/USD rate is determined on the basis of developments in the period from April to September 2006. The interest rate assumption is the same as that from the common EU assumptions.

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

**Table 2.1.: Basic external assumptions**

| | 2006 | 2007 | 2008 |
|---|---|---|---|
| **EUR/USD exchange rate*** | 1.248 | 1.265 | 1.265 |
| **Nominal effective exchange rate (% change)** | 0.2 | 0.2 | 0.0 |
| **EUR exchange rate (average level)** | 239.64 | - | - |
| **World GDP growth (% change)** | 5.1 | 4.9 | - |
| **EU GDP growth (% change)** | 2.7 | 2.1 | 2.1 |
| **Growth in relevant export markets (% change)** | 10.3 | 8.5 | 8.9 |
| **World imports volumes – advanced economies **, growth in %** | 7.5 | 6.0 | - |
| **Oil prices (Brent, USD/barrel)** | 69.0 | 73.0 | 73.0 |

Source: IMAD, Autumn report 2006.
Notes: *A technical assumption based on average of the last 6-month period (April-September 2006)
**The assumption differs from the Guidelines on the format and content of Stability and Convergence Programmes as it also includes the EU countries.

The assumptions about international environment were taken from forecasts that were available up until mid-September 2006. These include the Consensus September forecasts, the September EC interim forecasts and the forecasts of the WIIW for Southern European countries. The IMF's September forecasts, which were released later, do not diverge from the figures that were used as assumptions. The macroeconomic forecast in the Stability Programme is therefore based on the data that were available by the middle of September and could not take into account the changed estimates and facts that emerged in the second half of September and October, which formed the basis of the European Commission's forecast released in November and were also used as the basis for the Common external assumptions. This led to divergence between both groups of assumptions. The EC's Common external assumptions project slightly higher economic growth in the EU in 2007 and 2008, mainly due to the smaller deceleration of GDP growth in Germany following the raising of VAT rates, and a slightly lower average oil price than assumed in the Stability Programme forecast as a result of the fall and stabilisation of these prices at a lower level in October. Based on the Common assumptions, the growth of exports and consequently of GDP in 2007 and 2008 would be somewhat higher while inflation could be slightly lower. These assumptions also suggest a minor deterioration in terms of trade in 2006 and their relatively more pronounced improvement in 2007.

## 2.2. Current economic situation and outlook

The autumn forecast of GDP growth for 2006 totals 4.7%, 0.7 of a percentage point more than in 2005. The Slovenian economy grew by 5% (y-o-y) in the first six months of 2006, supported by the favourable international economic developments and a strong growth of gross fixed capital formation. Economic growth will slow down somewhat in the second half of the year but will remain at a relatively high level. Supported by favourable economic developments in most trading partners, exports will grow by a real 9.9%. Given the booming growth of investment in the first half and the expected acceleration of investment in civil engineering in the second half of the year, the real growth of gross fixed capital formation is projected to total 8.6%. The forecast real growth of private consumption (3.3%) remains at a similar level as in 2005.

**Table 2.2.: Macroeconomic prospects**

| *Change in %* | **ESA Code** | **2005** | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|---|---|
| | | Level in SITmn* | | | | | |
| **1. Real GDP** | B 1 g | | 4.0 | 4.7 | 4.3 | 4.2 | 4.1 |
| **2. Nominal GDP** | B 1 g | 6,620,145 | 5.6 | 6.6 | 7.5 | 6.7 | 6.3 |
| **Components of real GDP** | | | | | | | |
| **3. Private consumption expenditure** | P3 | 3,636,387 | 3.4 | 3.3 | 3.6 | 3.6 | 3.4 |
| **4. Government consumption expenditure** | P3 | 1,295,422 | 2.2 | 2.8 | 2.5 | 2.8 | 2.5 |
| **5. Gross fixed capital formation** | P51 | 1,617,250 | 1.5 | 8.6 | 5.5 | 4.5 | 4.5 |
| **6. Changes in inventories and net acquisition of valuables (% of GDP)** | P52+ P53 | | 1.6 | 1.2 | 1.1 | 1.1 | 1.1 |
| **7. Exports of goods and services** | P6 | 4,276,117 | 10.5 | 9.9 | 8.3 | 8.5 | 8.2 |
| **8. Imports of goods and services** | P7 | 4,312,210 | 7.0 | 9.1 | 7.7 | 7.7 | 7.3 |
| **Contribution to real GDP growth (in percentage points)** | | | | | | | |
| **9. Final domestic demand** | | - | 2.6 | 4.5 | 3.8 | 3.6 | 3.4 |
| **10. Changes in inventories and net acquisition of valuables** | P52+ P53 | - | -0.6 | -0.4 | 0.0 | 0.0 | 0.0 |
| **11. External balance of goods and services** | B11 | - | 2.0 | 0.6 | 0.5 | 0.6 | 0.7 |
| * Revised national accounts data with FISIM being allocated | | | | | | | |

Source: SORS; IMAD, Autumn report 2006.

Economic growth is expected to slow in 2007 to 4.3 %. The anticipated economic slowdown in the international environment is expected to result in weaker growth of goods and services exports than in 2006 (8.3%). As imports of goods and services will rise by an estimated 7.7% in real terms, the contribution of external trade will remain positive (0.5 p.p.). In domestic demand, private consumption growth is expected to be higher (3.6%) given the projected positive effects of lower personal income tax rates which should be relatively stronger compared to the restrictive impact of higher interest rates. The forecast of investment (5.5%) foresees maintenance of the same pace of housing investment and continue motorway construction. The growth of investment in machinery and equipment will ease off by approximately 1 p.p. relative to 2006.

Real GDP growth in 2008 and 2009 is projected to remain slightly above 4 %. Assuming a rebound in the international environment, real export growth will be again somewhat stronger in 2008 and ease off slightly thereafter, stabilising at a high level. Compared with 2007, the growth of gross fixed capital formation will decelerate further in both years as the vigorous housing construction seen in the preceding years is expected to slow down due to a higher VAT rate on new housing. On the other hand, investment growth will come from the continued growth of civil engineering construction (based on plans of the national motorway construction company), higher funds from the EU and a further easing of the corporate tax burden through phasing out payroll tax and reducing corporate income tax. The growth of private consumption should remain at 3.6% in 2008 due to the positive employment prospects and purchases of durables and semi-durables that will follow increased housing purchases in the previous period. Household consumption is again expected to slow down slightly in 2009 to 3.4 %.

There is no expectation that growth in aggregate demand will outstrip growth in potential output over the program period, thus causing the economy to overheat. The chance of overheating is being additionally limited by the moderate growth in household income, a more-rapid-than-expected tightening of monetary policy in the euro area, and the strengthening of the supply side of the economy via increased investment and employment.

**Table 2.3.: Sectoral balances**

| *% GDP* | ESA Code | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|
| **1. Net lending/borrowing vis-à-vis the rest of the world** | B.9 | -1.9 | | | | |
| **of which:** | | | | | | |
| **- Balance on goods and services** | | -0,6 | -0,7 | 0,0 | 0,2 | 0,6 |
| **- Balance of primary incomes and transfers** | | -1,4 | -1,7 | -1,6 | -1,5 | -1,4 |
| **- Capital account** | | 0,1 | | | | |
| **2. Net lending/borrowing of the private sector** | B.9 | | | | | |
| **3. Net lending/borrowing of general government** | B.9 | -1,4 | -1,6 | -1,5 | -1,6 | -1,0 |
| **4. Statistical discrepancy** | | | | | | |

Source: SORS; IMAD, Autumn report 2006. MoF.

The current account deficit will gradually narrow in 2006-2009. In addition to the expected favourable flows in goods and services trade, where the surplus is projected to expand, this narrowing will be supported by the improved balance in current transfers resulting from the higher net acquisition of funds from the EU budget.

Employment growth is expected to be stronger in the period from 2006 to 2009 compared to 2005. In addition to the anticipated stronger economic growth, the forecast also reflects the expected effect of phasing out the payroll tax, the effects of changes to legislation regulating unemployment benefit and social assistance aimed at stimulating labor activity. The current flows suggest that the registered unemployment rate will decrease further in 2006-2009, while ILO unemployment will remain approximately at the achieved level, taking into account higher activity (mostly of the elderly) and the growth of population as foreseen in the SORS' projection. The projected real growth of gross wages per employee is 2.2 % in 2006, 2.5 % in 2007, while it is 3.0 and 3.2 % in 2008 and 2009, respectively. The growth of wages in the private sector will follow the dynamics of economic activity and be higher than in the public sector due to the effects of structural shifts in the private sector's employment, the anticipated increased hiring of highly qualified labour and restrictive wage policy in the public sector (Section 5).

**Table 2.4.: Labour market**

| | Level 2005 (000) | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|
| **1. Employment, persons *, growth in %** | 916.2 | 0.3 | 0.9 | 0.8 | 0.9 | 0.7 |
| **2. Unemployment rate by ILO definition (%)** | 67.0 | 6.5 | 6.4 | 6.4 | 6.4 | 6.3 |
| **3. Registered unemployment rate (%)** | 91.9 | 10.2 | 9.8 | 9.5 | 9.1 | 8.8 |
| **4. Labour productivity, growth in % **** | 30.1*** | 3.7 | 3.8 | 3.5 | 3.2 | 3.4 |
| **5. Compensation of employees, real growth in %** | | 3.4 | 3.2 | 3.4 | 3.9 | 4.0 |

Source: SORS; IMAD, Autumn report 2006.
Notes: * Occupied population, domestic concept national definition, ** Real GDP per person employed.
*** Level in 1000 EUR

Slovenia met the Maastricht criterion on inflation in November 2005. Since then the rate of inflation has been relatively stable, hovering close to the achieved level. In the first ten months of this year, consumer prices rose by 2 % while average inflation was 2.4% in October (HICP 2.5 %), which is similar to figures at the end of 2005 (2.5 %). The international environment has had a significant impact on the rises and volatility of consumer prices this year. The price rises of liquid fuels seen from January to August, which followed the dynamics of oil prices in international markets, were the main reason for the upward revisions to the spring forecasts of this year's average inflation from 2.1% to 2.7%. However, in September and October the prices of petroleum products fell to below the autumn forecast assumptions and their contribution to inflation, which totalled more than 50% in the first eight months of the year, also declined. If oil prices were to rebound by the end of the year to the level at the beginning of September, average inflation is likely to reach the forecast level of 2.7% this year; otherwise it may be 0.2 p.p. lower. The growth of prices that are not affected by external factors has been stable in 2006. In 2007 the slight upward effect of oil prices on inflation will remain. However, the average inflation forecast for 2007 will remain at 2.7% mostly as the result of the planned increases of various excise duties, linked partly to the changes in tax legislation that should enter into force next year (Section 5). This will contribute around 0.6 p.p. to inflation in 2007. In 2008 and 2009, average inflation is expected to decline to a level around 2.5% and 2.2%, respectively. The forecast is based on the expected lower inflationary impact of external factors and unchanged tax rates.[4] In order to sustain price stability and improve Slovenia's competitiveness, structural reforms will continue to be carried out, while Government will remain committed to counter-inflationary macroeconomic policies. The envisaged structural reforms with positive impact on price stability include above all the liberalisation and creation of competitive conditions in sectors where prices are still state-regulated or markets still monopolised (network industries), combined with measures that will boost the flexibility of the labour market.

**Table 2.5.: Price developments**

| *Change in %* | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| **1. GDP deflator** | 1.5 | 1.8 | 3.1 | 2.5 | 2.1 |
| **2. Private consumption deflator** | 2.2 | 2.6 | 2.6 | 2.4 | 2.2 |
| **3. HICP[1]** | 2.5 | 2.7 | 2.7 | 2.5 | 2.2 |
| **4. Public consumption deflator** | 3.2 | 3.0 | 3.7 | 3.7 | 3.7 |
| **5. Investment deflator** | 3.7 | 2.0 | 2.7 | 3.0 | 2.1 |
| **6. Export price deflator (goods and services)** | 2.9 | 4.3 | 2.6 | 1.2 | 1.2 |
| **7. Import price deflator (goods and services)** | 5.0 | 5.2 | 2.1 | 1.6 | 1.6 |

Source: SORS; IMAD, Autumn report 2006.

Notes: The growth of import and export price which significantly influence the GDP deflator takes into account on the assumptions of the growth of external prices (foreign domicile prices, oil prices, other commodities prices),

## 2.3. Medium-term scenario

Medium term scenario of economic trends in the Stability Programme is based on macroeconomic projections from the IMAD's autumn report, which are built on the current economic data, adopted national budgets for 2007 and 2008 and economic policy measures already implemented, in line with the Guidelines on the format and content of Stability and Convergence Programmes. Several structural reforms with expected positive impact on economic growth, especially in the areas of the network industries, privatisation, labour market and social security, are already in preparation, but are not yet included in the baseline scenario. The full implementation of the reforms envisaged in line with the Slovenia's Development Strategy (SDS) and Reform Programme for Achieving the Lisbon Strategy Goals (Reform Programme; see also 2.4), will raise potential GDP growth in line with the main developmental strategic goals. A tentative estimate can be made of the outcomes of carrying out the measures set out in the SDS and Reform Programme by comparing the projected economic development in 2009-2013 in case economic policy measures remain unchanged and in case the envisaged measures are optimally implemented

[4] The increase in both VAT rates in 2008, which remains as an laternative measure to compensate a potential tax revenue shortfall in that year, has not been included in the baseline inflation forecast. The final decision will be taken in the course of the 2007 budget implementation. If the VAT rates were raised from 8.5% to 9% and from 20% to 21%, the estimated effect of this raising on consumer price rises would total between 0.2 and 0.6 p.p., taking into account the different pass-through rates of the tax rise to final prices.

In the event that the SDS measures were optimally implemented economic development would follow the target economic development scenario for the period covered by the SDS (until 2013) presented in the Grounds for the Target Development Scenario of Slovenia's Development Strategy (IMAD, 2005). The target scenario is also broadly in line with alternative estimate of the reform results, based on an economic model being developed by the Institute for Economic Research. According to this scenario, the optimal implementation of the SDS measures would enable a breakthrough to a higher development level when the reforms had already begun to yield results, stimulating the faster growth of productivity and the economy's competitiveness. A period of accelerated economic growth, ending around 2010, would be followed by its relative slowdown and a period of its stabilisation at the approximate level of 5% which would represent the new level of potential GDP growth.

**Table 2.6.: Key macroeconomic variables under SDS scenario until 2013**

Real growth in % unless indicated otherwise

| | Medium-term scenario 2009–2013 | |
|---|---|---|
| | **Unchanged economic policy measures** | **Grounds for the Target Development Scenario of SDS** |
| **GDP** | **4.0** | 5.3 |
| Exports of goods and services | 8.0 | 9.1 |
| Imports of goods and services | 7.4 | 8.3 |
| Private consumption | 3.3 | 4.9 |
| Government consumption | 2.4 | 3.4 |
| Gross fixed capital formation | 4.8 | 5.1 |
| | | |
| **Employment**, growth in % | 0.7 | 1.1 |
| **Unemployment rate ILO**, in % | 6.4 | 3.7 |
| **Productivity**, growth in % | 3.3 | 4.1 |
| | | |
| **Inflation**, in % | 2.2 | 2.5 |

Source: IMAD projections

## 2.4. Growth implications of envisaged structural reforms

Structural reforms envisaged in the Reform Programme for Achieving the Lisbon Strategy Goals are firmly integrated within a comprehensive strategic development framework based on Slovenia’s Development Strategy, adopted in 2005. The implementation of the reforms will raise potential GDP growth and will be vital for achieving the main developmental goals of the Slovenia's Development Strategy. The reforms will also have a positive effect on the long-term sustainability of public finances.

The first year after launching the reform saw the introduction of several important changes to the tax system and the labour market that will stimulate people to accept work and enterprises to raise employment and invest in development. At the end of 2005, a law was adopted to phase out the payroll tax, which has a strong distortionary effect and particularly restricts the hiring of highly skilled professionals. The effect of this phased abolition will have a positive impact on the growth of private investment and employment. The introduction of a dual tax system in 2005 (i.e. the taxing of capital income (dividends, interest and capital gains) at a single 20% tax rate and labor income at progressive tax rates) which has been aimed at reducing the taxation of capital and preventing capital to flow abroad, will also have a positive effect.

In autumn 2006, the National Assembly adopted a package of seven new tax laws which, in addition to streamlining the tax system, provide for fewer personal income tax rates and a gradual reduction of the corporate income tax rate. The Government’s substantial reduction of the progressivity in personal income tax should enhance incentives for the activity of highly qualified labour. At the same time, gradual reducing of the corporate income tax rate from 25% to 20% and keeping the extensive tax relief for research and development should stimulate firms' investment in development. These measures are projected to result in 0.3 of a percentage point higher GDP growth in 2007, while their long-term effect will depend on the quality of private investment and the actual increase in employment.

The effects of the tax reform on employment will be backed by the legislative changes adopted this year that make eligibility for unemployment benefits and financial social assistance more conditional on a claimant’s readiness to accept employment that has been offered. Combined with the effects of the new law, that unifies indexation of all social transfers other than basic pensions to the growth of consume price index only and no longer to pay rises, this will create new incentives for less skilled people to enter activity. The regulatory changes also provide for lower growth of the minimum pay, which will reduce firms' costs of hiring these people. Measures aimed at increasing the employment of older people (the active ageing strategy) and encouraging them staying in activity, at least partly, for as long as possible, are being prepared along with additional incentives for individual pension insurance schemes. These measures will also contribute to an improved outlook for the long-term sustainability of public finances. Further efforts in this area planned for 2007 will focus on increasing the transparency and simplicity of the social transfers system, improving the active labour market policy measures and continuing the negotiations with the social partners on the Draft Employment Relationship Act that contains the Government's proposed changes regarding flexicurity.

Important progress has been made in enhancing the operation of financial market which is key to a successful participation in the euro area. This concerns primarily the recent approval of the Market in Financial Instruments Act. The aim is to enhance the development of the capital market, its effectiveness, quality, competitiveness and security by introducing a uniform set of rules. The Act also implements number of important European directives aiming at integration of European capital and financial services' market. In line with the “MIFID directive” the Act introduces adjustments to capital market infrastructure and sets rules of operation for financial market participants. In addition, in accordance with the “transparency directive” it solves the issue of transparency of ownership structures and true value of public companies. By implementing the “capital directives”, the Act introduces the standards of safe and prudent operation of investment companies. Other important developments concern the forthcoming changes to private pension legislation which should increase this type of savings.

The adopted measures will also have a positive effect on economic growth in the microeconomic field. New mortgage bonds and municipal bond act will have positive impact on the development of the mortgage banking and increase of the banks’ lending capacity. In the first year of implementing the reform the Government also made efforts to create a more supportive business environment for enterprises and a more user friendly and cheaper state. It adopted a programme for reducing the administrative burden and laid down the methodology for preparing the declaration on the removal of administrative obstacles and the participation of interested stakeholders that must be appended to any draft regulation. This is the first step towards making a comprehensive regulatory impact assessment of these regulations.

Further, progress was made in reducing court backlogs[5]. In network industries, competition increased particularly in telecommunications. During the next year, preparations must be made for a successful operation of the electricity market after the liberalisation of energy sales to households. Given Slovenia's development level, a boost in economic growth will also entail substantial investment in transport infrastructure, particularly railways, as well as investment in education and information infrastructure. Also in these areas Slovenia relies on backing from EU funds and a bigger role of public-private partnerships (Public Private Partnership Act was adopted in November 2006). Continuing the privatisation process and attracting more foreign direct investment remain the challenges for the oncoming year.

Relevant new measures were also introduced in the research and development field, which will also have a positive long-term effect on economic growth. In line with the adopted national programme, measures in progress include raising the number of researchers in the business sector and their mobility between the public and business sectors, increasing the share of expenditure on applied and developmental research, promoting the operation of knowledge mediators between research institutions and firms, and supporting the establishment of new higher education institutions. In the area of education, businesses and industry have benefited particularly from the reform of vocational colleges and secondary technical and vocational education.

The government has given pre-eminence of active labor market policy. The amount of resources allocated to this area in the 2007 and 2008 budgets has increased

[5] An inter-ministerial process of harmonisation of legislation is taking place, which will facilitate implementation of the elimination of court backlogs project, i.e. the Lukenda project, whose core objective is the elimination of court backlogs in courts by 2010.

considerably. In addition to increased employment, the long-term goals of active labor market policy target enhanced educational level of the active population and lower structural disparities (of long-term unemployment, unqualified unemployed, youth unemployment).

# 3. GENERAL GOVERNMENT BALANCE AND DEBT

## 3.1. Policy strategy

Fiscal policy will contribute to stability and resiliency of the Slovenian economy in the context of monetary union. Consistent with the government development goals, the quality of public finance will be further improved. At the same time, within fiscal policy targets, the government will contribute to fasten the process of income catching up to the level of more advanced EU members by devoting growing funds and providing income tax relief to R&D activities and partially financing projects that address the infrastructure deficit.

The strategy aims at reducing the headline deficit from a level of 1.6% of GDP in 2006 to 1% of GDP in 2009 and reaching the medium term objective by the end of the program period. Government revenue as percentage of GDP will decline by 3.3% and expenditure by 4% during the program period. The debt-to-GDP ratio will remain around the level reached in 2005 (28% of GDP) which has an important bearing in the long-term sustainability of public finances.

Against a more favourable economic environment, two key developments will influence significantly fiscal developments in the program period and consequently the pace of deficit reduction: the implementation of the tax reform that will enhance competitiveness of business environment and will contribute to retain and attract investment and; financing investment in railway infrastructure, a priority area that requires sizable investment, which was not envisaged in the last Convergence Programme.

The implementation of the comprehensive reform that has overhauled the tax system will contribute substantially to the reduction of government revenues estimated at 3.3% of GDP in the program period. The direct impact of tax reform will be a reduction of 2% of GDP while non tax revenue and social security contributions will reduce revenues by 1.3%. Revenue from social security contributions will decline as a result of wage growth lagging behind productivity growth.

The reduction of government revenue demands considerable effort on expenditure side to keep fiscal targets. On the other hand, the government approved investment projects in the area of railway infrastructure not previously envisaged and not included in previous fiscal projections. In particular, the government in accordance with the Initiative for Growth has decided to go ahead with the modernization and upgrading of 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. The timeliness of this decision and its importance should be looked at in the context of the effort at EU level to modernize and integrate communication's infrastructure. Slovenia's economy will not only greatly benefit from the project but also contribute to the broad EU endeavor.
Given the priority nature of the investments, tackling railway infrastructure needs can not be postponed. The financial requirement is sizable and a swift implementation of the projects requires additional resources to those of the government, which is constrained by the effort to reduce expenditure to finance the tax reform and meeting fiscal targets. That is why the government in the first stage, of a broad financing strategy that contemplates EU funds and in the future the engagement of private or third parties, has decided to partly finance the investment. It is relevant in this regard, the adoption of the Law on Public Private Partnership by the parliament in November this year which will be the framework regulating the future partnership or concession.

Notwithstanding the increase in expenditure due to co-financing of the railway infrastructure project, the general government expenditure will be reduced by 4% of GDP during the program period. At the same time the composition of expenditure will be re-structured towards growth oriented priorities while 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.

In the program period the comprehensive tax reform will be implemented. The initial reform measures already adopted at the end of 2005 have been complemented with a comprehensive package of measures recently adopted by the parliament in October 2006. Some policy measures started to be implemented already in 2006 and will continue to be implemented in the program period. 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. Tax policy will be accompanied by specific measures to increase the efficiency in the tax administration area.

For the program period of the next financial perspective (2007–2013) Slovenia aims at maintaining a budgetary position of net recipient of EU funds. The estimates of receipts from the EU budget and payments to the EU budget over the period of the next financial perspective are based on December 2005 European Council conclusions taking into account national program documents for drawing EU funds (Rural Development Program, National Strategic Reference Framework). The government estimates that during 2007-2011 the average revenue from the EU will be 1.56% of GDP while the expenditure to the EU budget will be 1.13% of GDP. Thus the net position of the general government budget vis-à-vis EU will amount on average to 0.43% of GDP during 2007-2011. These estimates do not take into account the flows from EU budget from subheading “Competitiveness for growth and employment” (i.e. 7th Research Framework Program, Ten, Galileo, Marco Polo) or subheading “Citizenship” (i.e. Culture, Youth, Media) that do not appear as revenue of the central government budget but will be paid directly to final recipients. As they are not negotiated in advance, it is not possible to estimate their amount by Member States.

### 3.2. Medium term policy objective

In the last Convergence Programme, the medium-term objective (MTO) for the cyclically-adjusted balance was set at **–1% GDP**. The MTO set is more demanding than the minimum benchmark identified by the Commission for Slovenia (1.9%). The MTO is to be reached over the program period. The policy strategy of reaching the MTO over the program period **remains valid**. In fact, had the government not implemented the comprehensive tax reform and committed to investing in railway infrastructure, the MTO would have been reached already in 2007.

Assesment of the adustment path towards the MTO and the MTO itself depend critically on the output gap measures. Estimates of Cyclically Adjusted Budget Balance (CABB) are subject to considerable uncertainties regarding estimates of potential output (and hence the output gap). In particular this has been recognized by Council Conclusions (11 May 2004) that for new EU members, due to the lack of sufficiently long time series when estimating potential output, both the production function (PF) and HP filter (HP-100) methods can be used in parallel.

A look at domestic economic trends in 2006 indicates that they are relatively favorable and that the economy is displaying a large degree of cyclical synchronisation with the euro area. GDP seems to be growing at about potential. Nevertheless, estimates of output gap using the two methods provide alternative indication for 2006 as to whether the gap has been closed yet; a negative output gap using HP filter and positive output gap with PF method. For the years ahead, under the scenario of no change in potential output growth, both methods provide an indication that the output gap is about to be closed. Nevertheless, output gap estimates with HP filter are lower than those with PF method, which also have bearing on the CABB estimates.

Notwithstanding the above mentioned caveats, the estimated cyclically adjusted balance using PF method is presented in Table 3.1. The CABB at the end of the period is about 1% of GDP. The fiscal stance remains broadly unchanged against a relatively more favorable economic background, which does not significantly influence tax revenue performance. The impact is estimated in higher tax revenue-to-GDP ratio on average of about 0.1% during 2006-2009. The adjustment path like in the case of the headline deficit is influenced by the temporary increase in investment in railway infrastructure. Notice in particular in Table 3.2. that the CABB without the effect of railway investment would have been lower exhibiting more clearly the underlying fiscal stance. It should also be pointed out that the tax reform will reduce government tax revenue as percentage of GDP in about 2% from 2006 to 2009.

**Table 3.1.: Cyclical developments**

| *% of GDP* | **ESA Code** | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|---|
| **1. Real GDP growth (%)** | | 4.0 | 4.7 | 4.3 | 4.2 | 4.1 |
| **2. Net lending of general government** | EDP B.9 | -1.4 | -1.6 | -1.5 | -1.6 | -1.0 |
| **3. Interest expenditure (incl. FISIM recorded as consumption)** | EDP D.41+FISIM | 1.8 | 1.7 | 1.4 | 1.3 | 1.3 |
| **4. Potential GDP growth (%)** | | 4.0 | 4.1 | 4.3 | 4.1 | 4.3 |
| **Contributions:** | | | | | | |
| **- labour** | | 0.7 | 0.5 | 0.4 | 0.1 | 0.1 |
| **- capital** | | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 |
| **- total factor productivity** | | 1.8 | 2.1 | 2.3 | 2.5 | 2.6 |
| **5. Output gap** | | -0.4 | 0.2 | 0.2 | 0.3 | 0.1 |
| **6. Cyclical budgetary component** | | -0.2 | 0.1 | 0.1 | 0.1 | 0.0 |
| **7. Cyclically adjusted balance (2-6)** | | -1.2 | -1.7 | -1.6 | -1.8 | -1.0 |
| **8. Cyclically adjusted primary balance (7-3)** | | 0.5 | 0.0 | -0.2 | -0.4 | 0.3 |

**Table 3.2.: The impact of railway investment on CABB**

| *% of GDP* | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|
| Cyclically adjusted balance | -1.2 | -1.7 | **-1.7** | **-1.8** | **-1.0** |
| Cyclically adjusted balance excluding railway's investment | -1.2 | -1.6 | **-1.3** | **-1.2** | **-0.8** |

The average potential growth of GDP during the program period is about 4.3% (production function method). Potential growth is explained primarily by total factor productivity (TFP) and capital. In particular TFP exhibits a growing trend since 2006 which contrast with the stable trend foreseen in the last Convergence Programme. In the case of capital and labor their contributions remain fairly constant.

## 3.3. Actual balances and implications

According to revised data the general government deficit in 2005 was 1.4% of GDP, lower than presented in previous update (1.7% of GDP). The main reason for deficit reduction according to the second estimate is significant increase in the accrual value of corporate income tax resulting also from changes in the relevant legislation approved in 2004 (taxation of unrealized losses or non recognized expenses from unrealized losses) in connection with new international accounting standards. The envisaged deficit for 2006 is 1.6% of GDP (Table 3.3.) broadly in line with the deficit figure presented in the previous update (1.7%). Budget execution for the first 10 months suggests that the targeted deficit is within reach.

The government balances in the period 2007-2009 include adopted budgets for the period 2007-2008 and projections for 2009. The Public Finance Law prescribes the adoption of budgets for 2 years on a rolling over basis. The development of the public finance in the program period will be deeply influenced by the comprehensive tax reform (2005-2006) which will contribute to the reduction of government revenue of 3.3% of GDP from 2006 (45.0%) to 2009 (41.7%) and, from the additional financing of railway infrastructure not previously included in projections. Notwithstanding, the additional financing requirement, the government expenditure will be reduced by 4% of GDP in the same period. As a result of these developments the general government deficit will linger about 1.6% of GDP in 2007 and 2008 and then will decline to 1% in 2009. As it is shown in Table 3.4 in absence of the railway financing the deficits as percentage of GDP in the period 2007 to 2009 will be 1.1%, 1.1% and 0.8% respectively. Such deficit figures are lowered than those presented in the last Convergence Program (See Table 4.4). These figures shown the adherence of the government to macroeconomic stability while, at the same time, within that framework to finance key infrastructure priorities.

The expenditure dynamics on the consolidation path will be also influenced particularly in the next two years by financial commitments related to NATO membership, EU presidency and finalizing Schengen border. The major consolidation effort will be placed on the rationalization of government consumption and system of social transfers.

**Table 3.1.: General government budgetary prospects**

| | ESA Code | 2005 Level | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|
| | | mio SIT | % of GDP | % of GDP | % of GDP | % of GDP | % of GDP |
| **Net lending (EDP B.9) by sub-sector** | | | | | | | |
| **1. General government** | S.13 | **-92.780** | -1.4 | -1.6 | -1.5 | -1.6 | -1.0 |
| **2. Central government** | S.1311 | **-149.098** | -2.3 | -1.5 | -1.6 | -1.8 | -1.1 |
| **3. State government** | S.1312 | **...** | | | | | |
| **4. Local government** | S.1313 | **3.287** | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 |
| **5. Social security funds** | S.1314 | **53.031** | 0.8 | -0.1 | 0.0 | 0.1 | 0.1 |
| **General government (S.13)** | | | | | | | |
| **6. Total revenue** | TR | **3.030.061** | 45.8 | 45.1 | 43.6 | 42.7 | 41.7 |
| **7. Total expenditure** | TE | **3.122.841** | 47.2 | 46.6 | 45.1 | 44.4 | 42.6 |
| **8. Net lending / borrowing** | EDP B.9 | **-92.780** | -1.4 | -1.6 | -1.5 | -1.6 | -1.0 |
| **9. Interest expenditure** | EDP D.41 | **117.238** | 1.8 | 1.7 | 1.4 | 1.3 | 1.3 |
| **10. Primary balance** | | **24.458** | 0.4 | 0.1 | -0.1 | -0.3 | 0.3 |
| **Selected components of revenue** | | | | | | | |
| **11. Indirect Taxes** | D.2 | **1.079.906** | 16.3 | 15.3 | 14.8 | 14.5 | 13.9 |
| **12. Direct Taxes** | D.5 | **613.387** | 9.3 | 9.8 | 9.5 | 9.2 | 9.2 |
| **13. Capital Taxes** | D.91 | **1.912** | 0.03 | 0.03 | 0.03 | 0.03 | 0.02 |
| **14. Social contributions** | D.61 | **980.620** | 14.8 | 14.7 | 14.4 | 14.3 | 14.3 |
| **15. Property Income** | D.4 | **92.778** | 1.4 | 1.3 | 1.3 | 1.1 | 1.0 |
| **16. Other revenues** | | **261.458** | 3.9 | 3.9 | 3.6 | 3.6 | 3.3 |
| **17.=6. Total Revenue** | TR | **3.030.061** | 45.8 | 45.1 | 43.6 | 42.7 | 41.7 |
| **p.m. Tax Burden (D.2+D.5+D.61+D.91)** | | **2.675.825** | 40.4 | 39.8 | 38.8 | 38.0 | 37.4 |
| **Selected components of expenditure** | | | | | | | |
| **18. Collective Consumption** | P.32 | **494.445** | 7.5 | 7.6 | 7.5 | 7.5 | 7.1 |
| **19. Social transfers in kind** | P.31 = D.63 | **967.436** | 14.6 | 14.6 | 14.4 | 14.3 | 13.7 |
| 19a. Social benefits in kind | D.631 | 472.710 | 7.1 | 7.2 | 6.9 | 6.8 | 6.7 |
| 19b. Transfers of individual non-market goods and services | D.632 | 494.726 | 7.5 | 7.4 | 7.5 | 7.5 | 7.0 |
| **20. Social transfers other than social benefits in kind** | D.62 | **1.071.513** | 16.2 | 16.0 | 15.5 | 15.2 | 15.0 |
| **21. Interest expenditure** | D.41 | **117.238** | 1.8 | 1.7 | 1.4 | 1.3 | 1.3 |
| **22. Subsidies** | D.3 | **92.818** | 1.4 | 1.4 | 1.3 | 1.5 | 1.4 |
| **23. Gross fixed capital formation** | P.51 | **221.547** | 3.3 | 3.4 | 3.2 | 2.7 | 2.5 |
| **24. Other expenditure** | | **157.884** | 2.4 | 2.1 | 1.8 | 1.8 | 1.7 |
| **25.=7. Total expenditure** | TE | **3.122.841** | 47.2 | 46.6 | 45.1 | 44.4 | 42.6 |

Source: MF RS.

**Table 3.4.: The impact of railway investment on net borrowing**

| *% of GDP* | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|
| Net Borrowing | -1.6 | -1.5 | -1.6 | -1.0 |
| Net borrowing without railway financing | -1.6 | -1.1 | -1.1 | -0.8 |

The central government deficit (state budget, extrabudgetary funds, agencies and other entities at the level of central government) in 2005 was 2.3% of GDP (Table 3.3). It was slightly lower than the figure reported in the last Convergence Programme (2.4%). The central government's deficit in 2006 is estimated to be 1.5% of GDP. During the next two years it is expected to increase as a result also of the investment expenditure in railways and then decline to 1.1% in 2009.

The two compulsory social security funds, the Pension and Disability Insurance Fund (Pension Fund) and Health Insurance Fund (Health Fund) will operate without deficits during the program period as required by Pension Fund Law in the case of the former and by the budget memorandum in the case of the latter. In 2005 the Funds registered a surplus of 0.8% of GDP. This year a negligible deficit is envisaged while in the three years ahead the funds will register marginal surpluses (Table 3.3.).

The overall consolidated budgets of local governments registered a balanced position in 2005 (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 debt was SIT 1.854 Bn (28.0% of GDP at the end of 2005). The largest share (98.9) of the total represents the central government debt. The shares on total debt of the State, social insurance funds and local communities were 89.3%, 0.22%, 1.8% respectively. In 2005 the state budget assumed the debt from social insurance funds (Health and pension fund) of about 0.7% of GDP and in the future they will not exhibit debt, as their budget position including transfers from the state budget will remain balanced. Local communities' budget on the other hand have their indebtedness capacity constrained by the Law on Municipalities financing which limits the total amount of borrowing in a given year to a maximum of 20% of realized revenues in previous year. The debt service (interest and principal) is also subject to a maximum of 5% of realized revenues in the previous year. The debt of local communities will remain constant as percentage of GDP at the same level as in 2005 (0.4%).

The general government debt-to-GDP ratio will be reduced by about 1% from the estimated level in 2006 (28.5% of GSP) until 2009 (27.7%). In 2005 the government repaid debt in the amount of SIT 80.9 billions (1.2% of GDP) using privatization receipts from the selling of a share in Nova Ljubljanska Banka in 2002. This transaction was reflected in the reduction of debt-to-GDP ratio in 2005 from a debt level of 28.7% of GDP in 2004.

In 2005 and 2006 the primary balance is in surplus and in the next two years the primary balance turns to deficit. In 2009 again there will be a surplus. Such a dynamic is also influenced by the financing of railways. Among the other components explaining the debt dynamics the effect of the interaction between the cost of debt and economic growth as captured by the “snowball effect” will contribute to reduce the debt-to-GDP. On the other hand, the stock and flow adjustment (SFA) will contribute to the growth of debt particularly in 2006. In the next three years its size on average (0.2%) will be lower than EU-15 weighted SFA average over the last decade (0.4%).

**Table 3.5.: General government debt developments**

| *% of GDP* | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|
| **1. Gross debt** | 28,0 | 28,5 | 28,2 | 28,3 | 27,7 |
| **2. Change in gross debt ratio** | -0,7 | 0,5 | -0,2 | 0,0 | -0,5 |
| **Contributions to change in gross debt ratio** | | | | | |
| **3. Primary balance** | -0,4 | -0,1 | 0,1 | 0,3 | -0,3 |
| **4. "Snowball effect"** | 0,3 | -0,1 | -0,6 | -0,5 | -0,4 |
| **5. Stock-flow adjustment** | -0,6 | 0,6 | 0,2 | 0,2 | 0,2 |
| **p.m. implicit interest rate on debt** | 6,5% | 6,3% | 5,3% | 5,0% | 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 by starting to issue long-term instruments and hiring loans, both with variable interest rates. The variable part of interest rates was still linked to inflation. Through the process of gradual transition from the use of inflation-indexed instruments to the use of nominal instruments of financing, the state began to reduce the sensitivity of its debt to inflation trends. In 2002, the central government for the first time on the domestic market issued long-term nominal three-year tolar bonds with a nominal, fixed interest rate. In 2003, the gradual transition towards the use of nominal instruments was completed with the issuing of the first five- and ten-year tolar bonds with nominal, fixed interest rates. The issuing of the first ten-year tolar nominal bonds with fixed interest rates enabled verification of compliance with the Maastricht long-term interest rate criterion. From 2004 onward the central government is borrowing in the domestic market exclusively, and only by issuing tolar denominated securities with nominal, fixed interest rates. At the second half of the year 2005 the system of primary dealers and system of market makers was introduced which helped to boost the 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 the infrastructure of domestic government debt market will be further integrated in the EU market following the EMU targets on improvements of efficiency through harmonization process.

# 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. The deteriorated conditions in the international environment relative to the baseline scenario assumptions present a potential risk to the realisation of macroeconomic forecasts, although this does not seem very likely. An alternative scenario assumes that economic growth in some, mostly old EU member states will average out at around 0.5 p.p. below the baseline scenario in 2007. For Slovenia, the realisation of these assumptions would translate into a lower rise in export demand, which would be mainly reflected in a lower real export growth rate (by about 0.7 p.p.) and partly in lower investment consumption (by about 0.6 p.p., largely due to the private sector's investment). The lower increase in orders would also slow down the growth of manufacturing's production volumes and, consequently, imports of intermediate goods. This would affect the volume of imports, which would grow at a slower pace than projected in the baseline scenario (0.5 p.p. lower). Were the mentioned assumptions to be realised, the real GDP growth rate would decrease by around 0.3 p.p. relative to the baseline scenario.

During the entire period of Slovenia's preparations for euro adoption, one of the potential risks related to the reduction of interest rates in the process of nominal convergence was the rapid acceleration of domestic (particularly private) consumption growth, which would lead to the overheating of the economy and increased inflationary pressures. In its reports published in the past two years, the IMAD has estimated that the probability of this risk being realised was low, given the structure of new loans (where housing loans in particular have been on the increase), the effect of restrictive incomes policy, and considering the results of several foreign studies analysing the correlation between domestic spending and interest rates[6]. With regard to private consumption the estimated dynamics in the last two years were accurate. Nevertheless, the risk of private consumption growing above the baseline scenario forecast cannot be entirely ruled out, particularly for 2007. Contrary to previous years, however, this acceleration is expected to mainly hinge on the changes in personal income tax legislation rather than the interest rates factor, which is actually expected to have the opposite effect. We have therefore reassessed the potential impact of increased aggregate demand on inflation[7]. The analysis shows that a 1% quarterly increase in GDP resulting from a net increase in demand above supply would raise inflation in the same quarter by 1.8 p.p. However, this dynamic response of inflation would ease off to 0.9 p.p. in the next quarter and become

[6] Also see Spring Report 2004, IMAD.

[7] The estimate was made using a bivariant model of cointegrated vector autoregression for inflation and gross domestic product whereby supply shocks are distinguished from demand shocks by applying long-term restrictions allowed by the cointegration analysis.

negligible in subsequent periods. At the annual level, the effect corresponds to a 0.6% rise in inflation. If the increase in demand by 1% of GDP were distributed evenly over the entire year (by 0.25% each quarter), the model's dynamic effects show a rise in inflation in Q1 by 0.45 p.p. This effect would intensify to 0.7 p.p. later on and ease off after about a year.

## 4.2. Sensitivity of budgetary projections to different scenarios and assumptions

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

Five scenarios were made: i) a 1 p.p. 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) lower real growth of GDP in t-1; iv) a lower real growth of private consumption of households and; v) a lower real growth of government consumption.

Table 4.1. shows the impact on the budget balance of the changes in the mentioned macroeconomic variables channelled though different taxes considered independently. As expected in all cases the impact is negative and particularly in the case of social security contributions and indirect taxes as these two categories each represent about one third of all tax revenues. The general government balance is relatively substantially influenced by a lower rate of growth in average wages.

**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 2007 (% BDP) | Change in general government balance in 2008 (% BDP) |
|---|---|---|---|---|---|
| **1** | Personal Income Tax | Real growth in average gross wage | Lower by 1 percentage point | **-0.1%** | **-0.1%** |
| | | Employment | Same as in year t–1 | **-0.06%** | **-0.06%** |
| **2** | Social security contributions | Real growth in average gross wage | Lower by 1 percentage point | **-0.14%** | **-0.14%** |
| | | Employment | Same as in year t–1 | **-0.14%** | **-0.14%** |
| **3** | Corporate Income Tax | GDP growth in t-1 | Lower by 1 percentage point | **-0.06%** | **-0.05%** |
| **4** | Payroll tax | Real growth in average gross wage | | **-0.02%** | **-0.01%** |
| | | Employment | Same as in year t–1 | **-0.01%** | **-0.01%** |
| **5** | Indirect Taxes | Real growth in private consumption | Lower by 1 percentage point | **-0.11%** | **-0.11%** |
| | | Real growth in government consumption | Lower by 1 percentage point | **-0.03%** | **-0.03%** |

Source: MF RS.

Table 4.2. shows the combined effect of changes in the macroeconomic variables in the budget balance channelled though various taxes. The impact is most pronounced in the case of real growth of average wages being lower by 1 p.p. It yields lower tax and social contributions revenue by 0.26% GDP in 2007 and 0.25% GDP in 2008. The impact is also significant if the employment does not increase – the revenue is lower by 0.21% GDP in 2007 and 0.20% GDP in 2008. The case of employment behaviour highlights the importance of active labor market policies towards increased employment also on the grounds of improving public finances and its long-term sustainability. In the case of wage dynamics the simulation underscores the tension between the positive impact of wages on tax revenues and the fiscal consolidation which is anchored in a restrictive wage policy.

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

| | Macroeconomic base | Change in macroeconomic base | Tax category | Change in general government balance in 2007 (% BDP) | Change in general government balance in 2008 (% BDP) |
|---|---|---|---|---|---|
| 1 | Real growth in average gross wage | Lower by 1 percentage point | Personal Income Tax, Social Security Contributions, Payroll Tax | **-0.26%** | **-0.25%** |
| 2 | Employment | Same as in year t–1 | Personal Income Tax, Social Security Contributions | **-0.21%** | **-0.20%** |
| 3 | GDP growth in t-1 | Lower by 1 percentage point | Corporate Income Tax | **-0.06%** | **-0.05%** |
| 4 | Real growth in private consumption | Lower by 1 percentage point | Indirect Taxes | **-0.11%** | **-0.11%** |
| 5 | 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 state debt is relatively insensitive to changes in inflation and exchange rate as the share of inflation-link instruments decreased in past years and will diminished in year 2007, and from fact that share of debt in other currencies (USD, GBP, CHF) from 2007 forward will be very low (0,5% 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 be the change of interest rates of the ECB. In the case where the interest rates of the ECB would increase in year 2007 by additional 100 basic points, this would lead to increase of cost of new borrowing in the level of 0.03% in the year 2007 and 0.06% in the year 2008. In the case when the growth of GDP would be lower in year 2007 and 2008 for 1% this would mean that share of central government debt in GDP would increase by 0.25%.

**Table 4.3.: Sensitivity of interest payments and debt repayments of the State**

| *% GDP* | 2007 | | 2008 | |
|---|---|---|---|---|
| | Interest | Debt | Interest | Debt |
| **Change in interest rates** | 0,03% | 0,00% | 0,06% | 0,00% |
| **Change in the GDP growth** | 0,01% | 0,25% | 0,01% | 0,25% |

**Source**: MF RS.

The simulation indicates that the existing central government debt is a relatively stable macroeconomic aggregate that is not strongly influenced by changes in exchange rate and inflation. The effect of interest on debt service is modest given the low level of debt and low borrowing requirements. The bulk of State debt is denominated in tolars and 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 debt.

## 4.4. Comparison with the 2005 Convergence Programme

The economic growth forecast for in 2006-2009 projects higher rates than anticipated in the Convergence Programme 2005 (December 2005). The GDP growth forecasts have been revised upwards by 0.7 p.p. for 2006, by 0.3 p.p. for 2007 and by 0.4 p.p for 2008. This revision is partly based on the higher projected real export growth due to stronger economic activity in the first half of 2006 and the improved forecasts for the international environment in the next two years. The upward revisions of forecasts for 2007 and 2008 also respond to the expected effect of changes of tax legislation on consumption growth (higher by 0.2 p.p in 2007-2008 than in 2005).

**Table 4.4.: Divergence from previous update (December 2005)**

| *% of GDP* | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|
| **1. Real GDP growth** | | | | | |
| Convergence program (previous update) | 3.9 | 4.0 | 4.0 | 3.8 | 3.8 |
| Stability program (latest update) | 4,0 | 4.7 | 4.3 | 4.2 | 4.1 |
| Difference | 0.1 | 0.7 | 0.3 | 0.4 | 0.3 |
| **2. General government net lending** | | | | | |
| Convergence program (previous update) | -1.7 | -1.7 | -1.4 | -1.0 | Na |
| Stability program (latest update) | -1.4 | -1.6 | -1.5 | -1.6 | -1.0 |
| Difference | 0.3 | 0.1 | -0.1 | -0.6 | Na |
| **3. General government gross debt** | | | | | |
| Convergence program (previous update) | 29.0 | 29.6 | 29.8 | 29.4 | Na |
| Stability program (latest update) | 28.0 | 28.5 | 28.2 | 28.3 | 27.7 |
| Difference | -1.0 | -1.1 | -1.6 | -0.9 | |

Source: IMAD, SORS, MF RS.

The general government deficit in 2005 was lower than presented in the Convergence Programme due to mainly a significant increase in the value of corporate income tax revenue resulting from the changes in the relevant legislation relevant in 2004 in connection of international accounting standards. The difference was about SIT 65 billion. In 2006 the estimated deficit is the same as previously envisaged in the Convergence Programme. For the years 2007-2008 the deficit has been reviewed slightly upwards. As mentioned already this is primarily due to the financing of the railways infrastructure project.

General government debt in 2005 was lower than the estimated debt in the last Convergence Program by 1% of GDP. The difference is explained by a lower deficit and Statistical Office's backward downward revision of the debt-to-GDP ratio. The debt to-GDP ratio will remain around 28% of GDP during the program period which is lower by about 1% of GDP compared to the figures presented in the last Convergence Programme.

## 5. QUALITY OF PUBLIC FINANCES

Fiscal policy will continue to underpin the government Lisbon strategy goals. This means maintaining fiscal discipline through adherence to the fiscal target that envisages the gradual reduction of the deficit in the program period and by enhancing the quality of public finances, both revenues and expenditures, that should contribute to improve growth potential.

The policy agenda includes the full implementation of the recently adopted comprehensive tax reform, some key measures of which already started to be implemented in 2005. On the expenditure side the government will continue to pursue the rationalization and re-orientation of expenditure structure towards growth enhancing priorities including increasing the absorption capacity of EU funds. Attention will be placed also in infrastructure priorities. Institutional effort will be devoted also to improve the assessment of the efficiency and quality utilization of resources used and their relation with the objectives pursued. 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. The relevant law was adopted in November this year.

The comprehensive tax reform package recently approved by the parliament, should contribute to increase employment, savings and investment. Also, as a result of the reform the tax system will be more stable and transparent, contributing to the competitiveness of the economy. Changes in personal income tax, particularly the 20% single tax rate on capital income, have profoundly modified incentives for individuals to save and invest. This is further enhanced with the elimination of double taxation for corporations. The impact will be seen gradually in the future.

The interaction of changes in personal income tax with tightening of criteria for eligibility of unemployment benefits and financial social assistance more conditional on a claimant's readiness to accept employment will increase labor participation of low income individuals. At the same time, incentives for employment of high educated individuals have improved with the gradual elimination of the so-called payroll tax and lowering of progressivity of labor income tax. Private expenditure in R&D is being encouraged with the introduction of tax allowance targeted to such activities. The recently adopted tax reform includes the simplification of tax procedure and reform of the operation of the tax administration towards a more efficient and friendlier tax administration is envisaged. The effect of the comprehensive tax reform has been incorporated in the revenue estimates presented in this program (Table 3.3.)

Key policy measures underpinning the reduction and re-orientation of expenditure towards development oriented priorities include: the tightening of criteria determining eligibility of social transfers; the recently adopted law that unifies indexation of all social transfers, other than pensions, to the growth of consume price index only; enhancing the information system on social transfers that will ensure better monitoring and transparency; the implementation of the ongoing restrictive wage and employment policies in the public sector.

Among the priorities to which growing resources will be allocated are: R&D activities, education, active labor market policies, lifelong learning and infrastructure.

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. Recently, in November 2006, the parliament approved seven tax laws 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.

The additional changes to personal income tax recently approved reduced tax brackets from five to three and simultaneously reduced progressivity and personal income tax burden for all taxpayers, particularly for those with the highest incomes. The system now taxes labor income at the rates 16%, 27% and 41% while capital income at 20%. The overall impact of the tax changes in terms of tax revenue will be a reduction of 0.5% of GDP in 2007.

In the case of corporate income tax the changes refer to the gradual reduction of the tax rate from 25% to 20% until 2010 and the abolition of the general investment tax allowance.[9] The tax relief on R&D expenditure is maintained both on research activities within the firm and for purchasing services and equipment for R&D.

[8] Corporate income tax, VAT, Tax procedure, Real estate tax, Inheritance tax and tax on vessels.
[9] In 2007 the tax rate will be 23%, 22% in 2008 and 21% in 2009.

Changes to the CIT are also systemic and aiming at ensuring a more transparent and stable tax environment. The aim is to enhance incentives for investment and to maintain capital in the country. The key change concerns the elimination of double taxation of income. The reform include the definition of the tax base, particularly the tax treatment of dividends and of profits in the case of shares sale, different treatment of reserves, as well as revenues resulting from valuation changes and expenditures on wages.

The impact of the reduction of the CIT rate on tax revenue is estimated in 0.5% of GDP over the period 2006 (3.2%) to 2009 (2.7%)

The gradual elimination of the payroll tax has important revenue consequences. The tax revenue generated from this tax was about 1.8% of GDP in 2005. In 2006 the tax rate was decreased by 20%. In the following years the tax rate will be reduced by 40% in 2007, by 70% in 2008 and it will be abolished completely in 2009 and no further revenue will be generated from this tax.

The VAT has been also changed. The new Law on VAT takes fully into consideration the 6th Directive. At the same time the law is much clearer and unambiguous 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 delaying of tax liability, separate tax bookkeeping was abolished, the upper threshold for the '3-month' tax payers was substantially increased and the 6-month tax period was abolished. Change of 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 impact of the changes on tax revenue is estimated to be negligible.

The Law on excise duties introduces, from the year 2007, excise duties on electricity and from the 1st of July 2007 increases duties on cigarettes to the levels equal to the minimal levels foreseen by the acquis, that is 64 euro per 1000 cigarettes and not less than 57% of the retail sales price of the most popular price category of cigarettes. The excise duties on alcohol and alcohol products will be also be increased according to the level of inflation rate since the last such increase in December 2001, that is 21,5%.

The change in tax rate will have only a minor impact on tax revenue from 3.3% of GDP in 2006 to 3.4% of GDP in 2009.

In the following years, further changes are foreseen in the field of indirect taxes (VAT, excise duties) as required by EU directives.

The new Law on inheritances and gifts tax will upgrade the system of property taxation by extending the notion of the 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 also reinforces the progressivity of tax rates for non related persons. Law on nautical vessels replaces the system of taxation previously set by the Law on taxation of physical persons. The tax rate for nautical vessels increases in line with its length and engine strength. The tax is not paid for vessels used exclusively for registered activities.

A very important dimension of the current tax reform is the simplification of the tax procedure. The new law on tax procedure to a large extent simplifies procedure and reduces unnecessary administration, both for tax payers and tax administration. As a result of the changes it is expected that the cost of implementing tax system laws will be reduced while the efficiency of the tax office will improve.

The tax reform will deliver a system that is more stable and transparent and which will contribute to enhance the competitiveness of the economy. The combined effect of the tax reform in total tax revenue-to-GDP ratio will be a reduction of 2% from 25.1% in 2006 to 23.1% in 2009. To offset the effect of tax changes in lowering tax revenue the 2008 adopted budget foresees an increase in the standard and reduced VAT rates from 20% to 21% and from 8.5% to 9% respectively. The actual implementation of such an increase is subject to the adoption of additional policy measures aiming at rationalization of public expenditure.

### 5.2. General government expenditure policy

The government policy will continue gradually reducing the share of government expenditure in GDP and reorient its composition towards financing growth–oriented categories (e.g. infrastructure, R&D, higher education). Within the scope of this policy financing investment in railway infrastructure will be a new priority in the next three years. 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.

The share of general government expenditures in GDP will be reduced by 2.3% between 2006 and 2009. The share of public investment in GDP (acquisition of assets and transfers) will remain above 4% of GDP and will average 4.3% during 2007-2009.

The policy measures aiming at rationalizing expenditure include the reduction of cost of public administration, enhancing its effectiveness and rationalizing social transfers. The policy measures concern primarily labor cost, social transfers and purchase of goods and services. The measures affecting these categories are captured in the dynamics of collective and individual consumption and social transfers (Table 3.3.).

The key policy underlying expenditure reduction and the cost of public administration is the reduction of labor cost. The overall wage policy will contribute to this end. The average wage growth in the economy will lag the productivity growth and wage growth in public sector will continue to be lower than in the private sector during 2007-2009. The Agreement on the Wage Policy in the Public Sector lays down that wages will rise by less than the projected inflation in 2007-2008, and the difference between the wage rise and inflation, including a part of the increase in productivity, will be used to eliminate the wage disparities in the public sector.[10] The Government will continue to apply a restrictive employment policy in the public sector. 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 wage bill in the public sector will decline by 0.8% of GDP over the program period. This will follow the ongoing trend that reduced this share in 0.4% of GDP from 2004 to 2006.

The other key policy area concerns the rationalization of government operating costs (purchase of goods and services) and improvement of public administration efficiency. Policy measure will contain the growth of expenditures on goods and services. The share of this expenditure in GDP will slightly reduce form 7.3% in 2006 to 6.9% in 2009. The level of expenditure in GDP was reduced in the last three years compared to previous years. The budget formulation process will be instrumental in enforcing agreed cost saving measures. 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) obtaining additional resources for infrastructure projects from non-public sources; iv) implementing the recently adopted legislation on public private partnerships (PPP); and v) simplification of the budget preparation process enabling greater control over efficiency and effectiveness of expenditure.

Some progress has been already made with the rationalization of some programs. These include the transport allowances, travel allowances and other expenses for

[10] Two measures underpin the envisaged wage bill behavior: i) The wage policy that ties wage increase in the general government sector only to expected inflation and within this scope earmarks savings in the wage bill to finance wage disproportions between different segments of the public sector and; ii) the policy of reducing employment in the general government sector by 1% annually and which has been already incorporated in the 2007-2008 budgets.

The implementation of the new Public Sector Salaries Act (2004) will be implemented in fulll by 2010. The law should be implemented in a fiscally neutral manner. The public sector wage agreement allows the government to save half of the yearly increase in the wage bill due to inflation to finance the implementation of the Act.

public employees. Similarly, some operational expenses associated to projects are growingly financed with EU Funds. At the institutional level the Law on Public Private Partnerships was approved this year in November which can further enhance efficiency of the State.

While effort is being place in reducing collective consumption, in the next two years there are important commitments to finance such as the EU presidency, Nato and finalizing the setting of the Schengen border.

Another key area underlying the reduction in expenditure is the undergoing changes in the system of social transfers. In 2006 two important changes in legislation will result in reducing the total amount as percent of GDP devoted to social transfers to individuals. 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 recent legislation past in November that foresees that all transfers to individuals, with the exception of pensions, will be indexed only to changes in consumer price. Up to now the increase of the various transfers was linked to different variables and the frequency of change during the year also varied. Savings due to the adopted measures is estimated to reduce transfers to individuals by 1% of GDP from 2006 to 2009. In 2006 the reduction in this item is estimated in 0.2% of GDP. Further efforts in this area planned for 2007 will focus on increasing the transparency and simplicity of the social transfers system. An important task in this regard is upgrading the information systems, including linkages among various data bases, to enable greater transparency and oversight of the systems of social transfers. Such a system is expected to be fully operational in 2009. In determining and assessing the granting of transfers the system will facilitate access to information not only to family income but also property. The operation of the system is expected to reduce significantly the amount devoted to particular social transfers.

Areas where significant savings will be registered in the period 2006-2009 include social care allowances (0.2% of GDP and, pensions (0.3% of GDP). The reduction of the ratio of pension expenditure in GDP continues the trend decline from 11.1% in 2003 to the estimated 10.7% in 2006. This behavior is underpinned by the 1999 pension reform measures which determine the lagging of average pension growth behind the average wage growth by around 0.5 due to changes in the accrual rate of pension benefits as well as to the gradual prolongation of retirement age.

The decrease in unemployment and the number of war veterans is also contributing to reduce total expenditure. The number of unemployed has decreased by 5.9% from 2003 (97.674) to 2005 (91.900). Such a trend is expected to continue in the program period underpinned by implementation of labor market policy. The number of registered unemployed will be reduced from 89.4 thousands to 81 thousands. The ILO rate of unemployment will remain around the current level. The share of transfers to unemployed in GDP will slightly decrease in percentage of GDP from 0.4% in 2006 to 0.3% in 2009.The improvement of active labor market policy measures and negotiations with the social partners on the Draft Employment Relationship Act that contains the Government's proposed 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.

The share of interest expenditure in GDP will decline from 1.7% in 2006 to 1.3% in 2009. This development is positively influenced by the debt repayment of about 1.2% of GDP in 2005 and active debt management operations that have resulted in significant savings. Active debt management will continue contributing to reduce debt service. While the integration of local market to euro area market will result in spreads similar to those of countries with EMU 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 1.4% of GDP. 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.

In the field of health, further measures are being introduced to contain expenditure. The draft of a new law on Health Care Insurance System is still under consideration by social partners. The draft law foresees changes in sick leave benefit and shifting costs to the private sector which can render significant savings. In the mean time the indexation of sick leave benefits has changed from wage growth to the price growth (CPI) Savings from the adopted measures will be devoted to new programs such as reducing waiting lists for some surgical operations. Additional measures relate to the use of generic rather than original medicines were adopted, and the introduction of a reference price list for medicines has contributed to stabilize expenditure in medicines. As a result of the measures it is expected that the cost in medicines will slightly decrease by 0.2% of GDP. Total expenditure on health will remain broadly stable over the program period and will amount to 6.2% GDP in 2009.

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

Within the framework of gradual reduction of expenditure its composition is changing towards financing Slovenia’s Lisbon Agenda expenditure priorities. As mentioned in Reform Program for Achieving the Lisbon Strategy Goals, SDS and 2005 update of the Convergence Programme, the government identified five priority areas of reform: financing priority areas include research and development, education and training, employment, entrepreneurship and competition. Table 5.1 provides a first assessment of the financial implications for the central government budget taking also into account EU funds for the period 2005-2008.

The largest increase of funds is devoted to the areas of entrepreneurship, innovation and implementation of active labor market policy. The amount of public funds for research and development coming from the central government budget is increasing. However, to reach agreed policy targets additional resources will have to be devoted in the coming years. In this regard it is also important to take into account the tax relief granted for research and development activities in the corporate income tax act as it can account as indirect financing from the central government budget.

**Tabela 5.1.: Overview of expenditure by development priority**

*v mio EUR*

| | 2005 | 2006 | 2007 | 2008 | TOTAL |
|---|---|---|---|---|---|
| **FIRST DEVELOPMENT PRIORITY** | 131.91 | 113.09 | 145.09 | 217.47 | 607.56 |
| -Entrepreneurship and competitiveness | 21.90 | 38.14 | 40.62 | 73.25 | 173.92 |
| -Transport Infrastructure[11] | 96.17 | 50.27 | 73.47 | 109.71 | 329.62 |
| **SECOND DEVELOPMENT PRIORITY**[12] | 525.46 | 588.44 | 621.07 | 651.32 | 2.386.29 |
| -Research and Development (public funding) | 179.74 | 225.88 | 244.44 | 255.36 | 905.42 |
| -Higher Education | 345.72 | 362.56 | 376.63 | 395.96 | 1.480.87 |
| **THIRD DEVELOPMENT PRIORITY** | 0.00 | 1.26 | 1.68 | 1.62 | 4.56 |
| **FOURTH DEVELOPMENT PRIORITY** | 63.63 | 90.31 | 77.53 | 100.58 | 332.05 |
| -Active employment policy | 60.80 | 86.19 | 73.52 | 96.48 | 316.98 |
| **FIFTH DEVELOPMENT PRIORITY** | 16.24 | 50.01 | 101.18 | 115.96 | 283.38 |
| **TOTAL** | 737.24 | 843.11 | 946.55 | 1.086.95 | 3.613.85 |
| | | | | | |
| **Growth Index** | 100.0 | 114.4 | 112.3 | 114.8 | |
| **Share of GDP** | 2.67 | 2.86 | 2.99 | 3.22 | |

Source of data: Ministry of Finance, line ministries, IMAD.

Slovenia currently invests 1.6% GDP for R&D, 60% of which is financed by the private sector and 40% by the public sector. Slovenia aims at increasing public funds for R&D to the level of 1% of GDP by 2010 and to encourage increase in private funds. The public sector R&D-related expenditure will increase over the program period as follows: euro 244.4 millions is budgeted for 2007 and euro 255.36 for 2008. Key instruments that expect to encourage private R&D spending include the tax relief on R&D activities and better and greater co-operation between the research sphere and business.

Education, particularly tertiary education is another important priority. The government plans to increase overall investment in tertiary education (public and private) to the target of 2% of GDP in 2010. Table 5.1 indicates that public investment on higher education will increase for about 14.5% from 2005 to 2008. Similarly resources to active labor market policy will increase substantially for about 58.2 % from 2005 to 2008. Particular attention will be given to life-long learning and training. Increasing labor participation and education level rate has very important

[11] The amount does not take into account resources needed to upgrade railway infrastructure
[12] Estimate from the Ministry of Higher Education.

implication for improving growth perspectives and alleviating the fiscal pressures arising from population aging.

Active labour market policy financing will increase substantially during the program period. It will amount to SIT 21.5 Bn. in 2007, SIT 25.934 Bn. in 2008 and SIT 26.9 Bn. in 2009, representing 22.3% increase in 2007, 47% in 2008 and 52.9% in 2009 against the 2004 outturn. In addition to increased employment, the long-term goals of active labor market policy target enhanced educational level of the active population and lower structural disparities (of long-term unemployment, unqualified unemployed, youth unemployment). It should lower the percentage of long-term unemployed to around 40%, the share of unemployed with no educational attainment to 25%, lower regional disparities in the labour market, and ensure that all young unemployed are included in educational programs. At the same time it should promote further development of social partnership.

Slovenia needs to continue closing the development gap with respect to the EU average and the infrastructure still needs to be improved. The policy is to keep the relative share of investment (acquisition of capital assets and transfers) on average around the current level of 4.3% of GDP. Additional investment will be financed with EU funds. The dynamics of investment during the next three years will be significantly influenced by the railway infrastructure projects (See Box 5.1.). It is envisaged that financing railway's investment as percentage of GDP will represent additional investment of 0.6% in 2007, 0.8% in 2008 and 0.5% in 2009.

## Box 5.1. The impact of the modernization of railway infrastructure

The modernization of railway infrastructure is part of the recently adopted Resolution on national development projects for the period 2007 – 2023. It advocates new investment in modernization and construction of railway infrastructure. It is an element in achieving sustainable development while improving the competitiveness, regional development, environmental, spatial and energy policy. The estimate amount of the project is about Euro 8.8 billions.

**Impact on competitiveness**
The program will result in bigger capacity, higher speed of railway services implying shorter travel time and lower costs of transport, more reliable modes of travel and greater travel safety. In addition, the program will assure harmonisation and interoperability of Slovene public railway system with that of the EU. This will impact positively the competitiveness in several respects: i) competitive advantage of railway against road travel; ii) competitive advantage of Slovene railway against the railway systems of Austria, Italy and Croatia in transit freight; iii) globally increased competitiveness since the economy making use of the railway will be more competitive.

**Impact on regional development**
The program will assure better access for certain regions to administrative centres and the capital while at the same time improving the connections between the regions. The current system of public railway infrastructure is technically and technologically outdated (single-track, outdated signaling and safety infrastructure, suboptimal capacity). This leaves a number of Slovene regions with poor connections to the main European transport networks, which would enable a better regional development.

**Impact on other policies**
The program has a number of synergies with environmental, spatial and energy policy. The energy efficiency of rail travel is significantly lower than in road travel (unit energy use is 3.5 times lower for passenger travel and 8.7 times lower for freight compared to road travel). Rail travel is more environmentally-friendly (specific emissions are 8.3 times lower for passenger travel and 30 times lower for freight compared to road travel). Moreover, the special usage in 2 to 3 times lower for railways compared to motorways for the same capacity level.

**Lisbon strategy framework**
Guideline 16 of the Lisbon strategy "Carry out investment projects on TEN-T corridors, upgrade lines and track facilities to allow greater speed and axle loads; renew existing lines" provides for a framework for financing railway infrastructure on TEN-T networks through Slovenia. Upgrading the existing rail tracks, constructing new lines and passenger centers will allow the Slovene railway network to reach the technical and operational level currently in place in the EU. The program of investing in railway infrastructure is thus in line with the Lisbon strategy goals.

# 6. SUSTAINABILITY OF PUBLIC FINANCES

Slovenia like the other EU member states is facing the challenge of population ageing and its adverse impact on public finances. In the recent Report on Long-term sustainability of Public Finances the EU Commission assessed Slovenia as a high risks country under a no-policy-change scenario. This is primarily the result of the adverse demographic profile in Slovenia and low employment rate of older workers. The sustainability challenge EU countries face is not related only to the need to reform pension systems but also to ensure an appropriate level of pensions within the same time horizon.

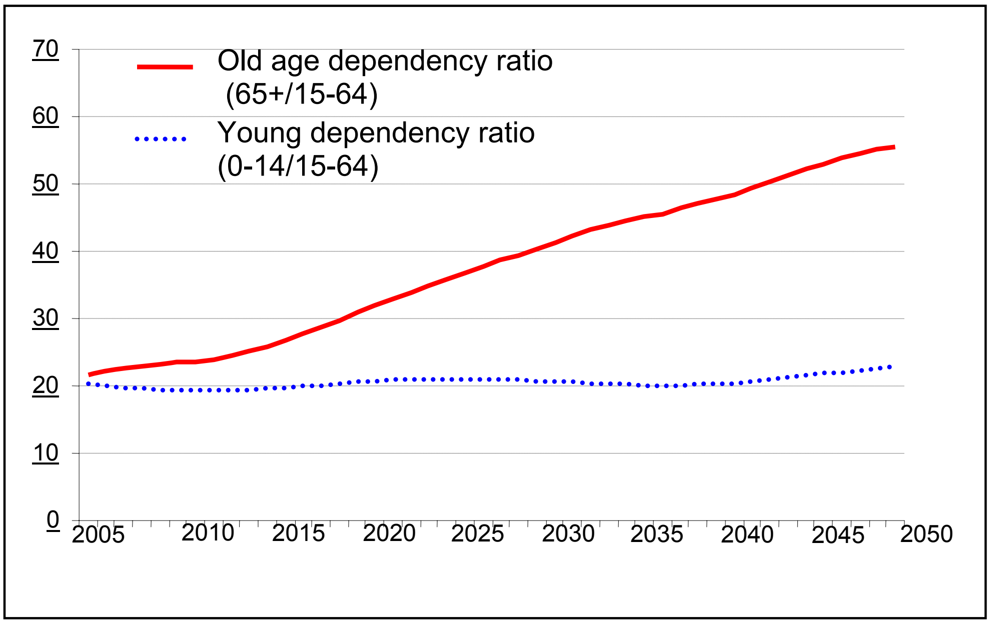
The EU has agreed a three–pronged approach to tackle the demographic challenge, and Slovenia is tackling the challenge within this framework. The debt-to-GDP ratio is low (28%) and will slightly decrease by the end of the program period. The first pension reform, enacted in 1999, is currently still under implementation, but by itself it will not ensure long-term sustainability of public finances. That is why, as indicated in the Report of Implementation on NRP, further measures for increasing employment, particularly of older people (the active ageing strategy), and promoting their staying in activity are being prepared. Similarly, measures to stimulate private pension savings are also under elaboration.

This section presents updated baseline projections related to age related expenditure taking into account agreed assumptions in the ageing working group. It also presents simulations on the likely impact of increasing labor participation rate resulting from policy measures in this field and illustrates the dampening effect of existing legislation on pension growth dynamics until its full implementation in 2025. The last section indicates the strategy of the government in the field.

## 6.1. Baseline projections

Eurostat's baseline demographic projections for Slovenia indicate that the existing adverse demographic profile in Slovenia, in which the number of old age individuals already exceeds the number of children, will continue worsening in the future. 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 (Figure 6.1).

**Diagram 6.1.: Demographic dependency ratios**




Source: Eurostat; own calculations.

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

**Tabela 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.

The updated projections on age related expenditure were estimated again based on an intergenerational accounting model which captures not only the impact of the demographic developments on age related expenditure but also the impact on revenues (i.e. lower tax base due reduction in labor force).

Table 6.2. presents the updated base line projections of age related expenditure based on agreed assumptions in the aging working group. It indicates that from 2006 to 2050 pension expenditure will increase by 7.3% of GDP, health expenditure will increase by 2.9% of GDP and long term care by 1.1%. The figures presented in 6.3 are slightly different than those presented in the last Convergence Programme. The reasons are twofold: i) the model was recalibrated taking into account the figures in the 2006 budget, the adopted budgets for 2007-2008 and projections for 2009 and; ii) the projections take into account the effects of new law on valorization of social transfers which determined that expenditure payments that are not age-related-pensions should be indexed to changes in the CPI index. In the previous estimation no-pension related expenditures of the Pension Fund were indexed to the growth of wages.

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

| | 2005 | 2010 | 2020 | 2030 | 2040 | 2050 |
|---|---|---|---|---|---|---|
| ***Total expenditures*** | 46.7 | | | | | |
| Of which: age-related expenditure | 18.8 | 17.5 | 19.5 | 22.5 | 25.8 | 27.9 |
| Pension expenditures | 10.9 | 10.4 | 11.6 | 13.6 | 15.8 | 17.2 |
| Healthcare | 6.3 | 6.2 | 6.8 | 7.6 | 8.4 | 8.9 |
| Long-term care | 0.8 | 0.9 | 1.1 | 1.3 | 1.6 | 1.8 |
| **Total revenues** | 44.9 | | | | | |
| *of which*: from pensions contributions | 9.9 | | | | | |
| **Assumptions (in %)** | | | | | | |
| Labour productivity growth | 3.5 | 3.1 | 3.0 | 2.7 | 1.9 | 1.7 |
| Real GDP growth | 4.0 | 3.7 | 2.4 | 2.0 | 1.0 | 1.1 |
| Participation rates males (aged 15-64) | 73.5 | 76.4 | 77.9 | 77.0 | 75.4 | 76.4 |
| Participation rates females (aged 15-64) | 63.9 | 66.3 | 69.0 | 69.8 | 69.0 | 70.5 |
| Total participation rates (aged 15-64) | 68.8 | 71.5 | 73.6 | 73.5 | 72.3 | 73.5 |
| Unemployment rate | 6.0 | 5.5 | 5.4 | 5.4 | 5.4 | 5.4 |
| Share of population aged 65 years and over (%) | 15.3 | 16.5 | 20.4 | 25.1 | 28.4 | 31.1 |

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

## 6.2. Simulations

An alternative scenario has been prepared which shows the potential positive impact of reducing the long-term sustainability risk by implementing policy measures aiming at gradually increasing participation rate and consequently the retirement level, particularly of individuals aged 55 and above. 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. [13] 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

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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.

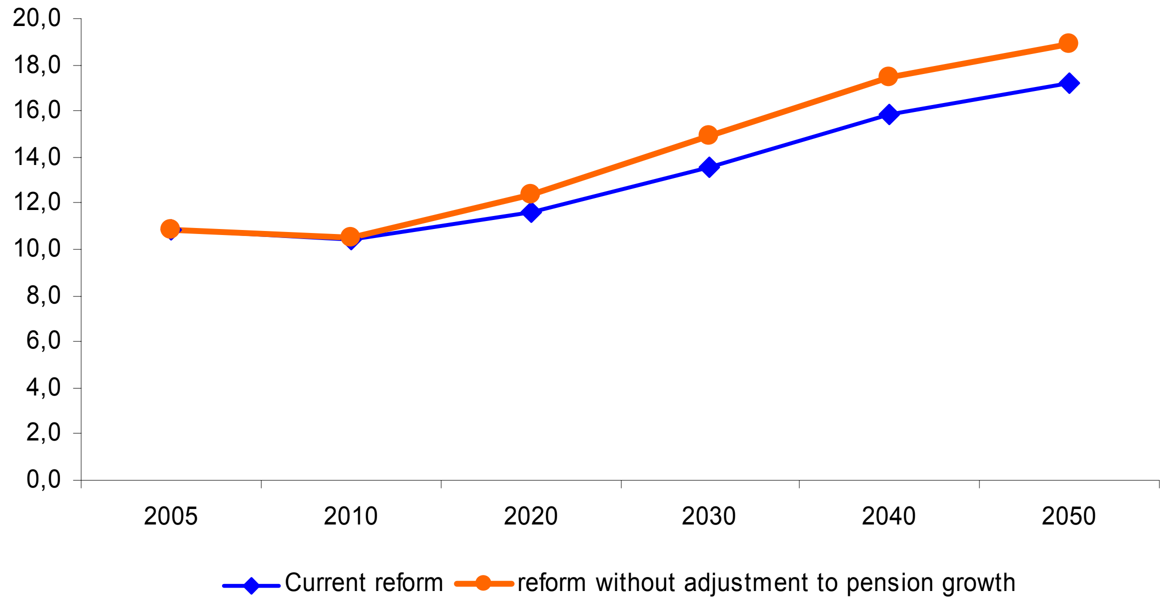
Table 6.3 presents the simulation of the change in pension expenditure resulting from increasing labor participation rate. It indicates that the increase in pension expenditure increase will be mitigated up to the year 2030, From that year onwards the demographic change will result in additional gradual increase in the deficit of pension financing up to a level of 3,1% in 2050,

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

| *% of GDP* | **2005** | **2010** | **2020** | **2030** | **2040** | **2050** |
|---|---|---|---|---|---|---|
| ***Total expenditures*** | 46.7 | | | | | |
| Of which: age-related expenditure | 18.8 | 17.4 | 17.6 | 20.3 | 23.4 | 25.5 |
| Pension expenditures | 10.9 | 10.3 | 10.2 | 11.9 | 14.0 | 15.4 |
| Healthcare | 6.3 | 6.2 | 6.4 | 7.2 | 7.9 | 8.4 |
| Long-term care | 0.8 | 0.9 | 1.0 | 1.2 | 1.5 | 1.7 |
| **Total revenues** | 44.9 | | | | | |
| *of which*: from pensions contributions | | | | | | |
| **Assumptions (in %)** | | | | | | |
| Labour productivity growth | 3.5 | 3.1 | 3.0 | 2.7 | 1.9 | 1.7 |
| Real GDP growth | 4.0 | 4.2 | 2.7 | 1.9 | 1.1 | 1.1 |
| Participation rates males (aged 15-64) | 73.5 | 75.1 | 79.0 | 78.7 | 77.6 | 78.4 |
| Participation rates females (aged 15-64) | 63.9 | 69.0 | 75.4 | 76.0 | 75.1 | 76.3 |
| Total participation rates (aged 15-64) | 68.8 | 72.1 | 77.2 | 77.4 | 76.4 | 77.4 |
| Unemployment rate | 6.0 | 5.1 | 4.2 | 4.2 | 4.2 | 4.2 |
| Share of population aged 65 years and over (%) | 15.3 | 16.5 | 20.4 | 25.1 | 28.4 | 31.1 |

Another simulation was made to illustrate the effect of the ongoing pension reform on average pension growth until 2025 when the reform will be fully implemented. While the growth of basic pension follows wage growth, the increase in 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. The effect of such adjustment on total pension expenditure can be seen from the simulation in Table 6.4. that shows what would be the total pension bill in absence of the adjustment to pension growth as prescribed by current legislation. Compared to base-line scenario pension expenditure-to-GDP ratio would be higher by 1.7% in 2050. Figure 6.2 shows the effect of the evolution of pension expenditure with and without the adjustment to pension growth made to ensure similar treatment among different cohorts of pensioners. The behavior of average pension growth has important policy implications when assessing the impact of policy measures aiming at improving productivity.

**Figure 6.2 Pension expenditure (% GDP)**




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 powerful impact of policy measures aiming at increasing participation rate as both indicators decline. It also indicate the importance of 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 indicators under increased different scenarios**

| | Baseline scenario | Increase activity rate | No pension indexation adjustment (art 151) |
|---|---|---|---|
| **S1** | 2.24 | -1.51 | 3.32 |
| **S2** | 6.14 | 1.62 | 7.55 |

## 6.3. The government strategy

Tackling the challenge of population aging is an ongoing process and requires an integrated approach. The implementation of the pension reform up to 2025 is a good step forward. Keeping a fiscal stance that will maintain debt at low level is equally relevant. The recently approved law on unifying indexation of social transfers to increases in consumer prices is an important step in this direction. Sustained implementation of government Lisbon Agenda will also contribute to dampen the increase in the relative cost of age related expenditure. But there is more to be done.

That is why the government has established a working group that is preparing measures aimed at increasing the employment particularly of older people. Such a policy can provide significant long-term savings and postpone the adverse effect on public finance.

In addition the legislation concerning voluntary pension saving schemes is under revision to provide alternative products and increase incentives to save. The new legislation should be enforced in 2007 and it should separately regulate voluntary pension insurance. Key policy changes that are currently under consideration concern: i) separation between saving and insurance periods; ii) enabling guaranteed returns on a voluntary basis; iii) separation between collective and individual pension products; iv) lifting participation restrictions to voluntary pension insurance; v) standardization of financial entities and products; vi) unification of supervision of legal entities; vii) investment policy; viii) universal requirement of custodian system; vii) re-organizing the areas of management fees and transfers among pension plans; viii) adjustment of existing pension plans and information of changes in the law,

# 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. During the program period the capacity for effective monitoring the budget implementation based on indicators will be developed and effectively used for budget preparation.