THE REPUBLIC OF SLOVENIA

CONVERGENCE PROGRAMME

Ljubljana, May 2004

CONTENTS

1. OBJECTIVES AND ASSUMPTIONS OF ECONOMIC POLICIES

1.1. Economic policy objectives

In the period leading to euro adoption, Slovenia's economic policy will aim at accelerating economic growth and employment, maintaining stable macroeconomic environment, reducing inflation, and increasing competitiveness and flexibility of the economy. The Government set out these objectives in the Programme for Effective Integration into the EU adopted in July 2003 and the Programme for Entering the ERM II and Introducing the Euro adopted together with the Bank of Slovenia in November 2003. The forthcoming entry into the ERM II and adoption of the euro will make fiscal and labour market policies play a key role in maintaining macroeconomic stability. Coupled with structural reforms, this policy will encourage economic growth and employment. The process of real convergence, which is based on raising the level of productivity, should not undermine price stability.

Slovenia already meets the Maastricht fiscal criteria, while other criteria will be met over the next two years. Therefore, the main goal of Slovenia's economic policy is to continue reducing inflation in a sustainable manner to a level corresponding to the Maastricht criteria set for the reference period before introducing the euro in 2007. While taking part in the ERM II, the Bank of Slovenia's policy will focus on maintaining stability of the tolar, the role of monetary policy in ensuring price stability will diminish, while the roles of fiscal and income policies will increase. The Government will continue supporting the efforts to reduce inflation mainly by carrying out the structural reforms, which will help establish effective competition in sectors where this still is inadequate.

Slovenia's membership in the EU and NATO, as well as the development priorities, are placing an upward pressure on the general government deficit. These integration processes are generating additional financial burden including co-financing of the funds received from the EU budget. For this reason, the government is enhancing the flexibility of public finances to improve the responsiveness of the fiscal stance to any asymmetric economic shocks. At the same time Slovenia, being a medium-developed member state, still needs to finance large investment projects, particularly in the field of infrastructure. It is therefore necessary to improve the adaptability of public finances to possible economic shocks, while the medium-term objective of balanced general government budget will be met gradually.

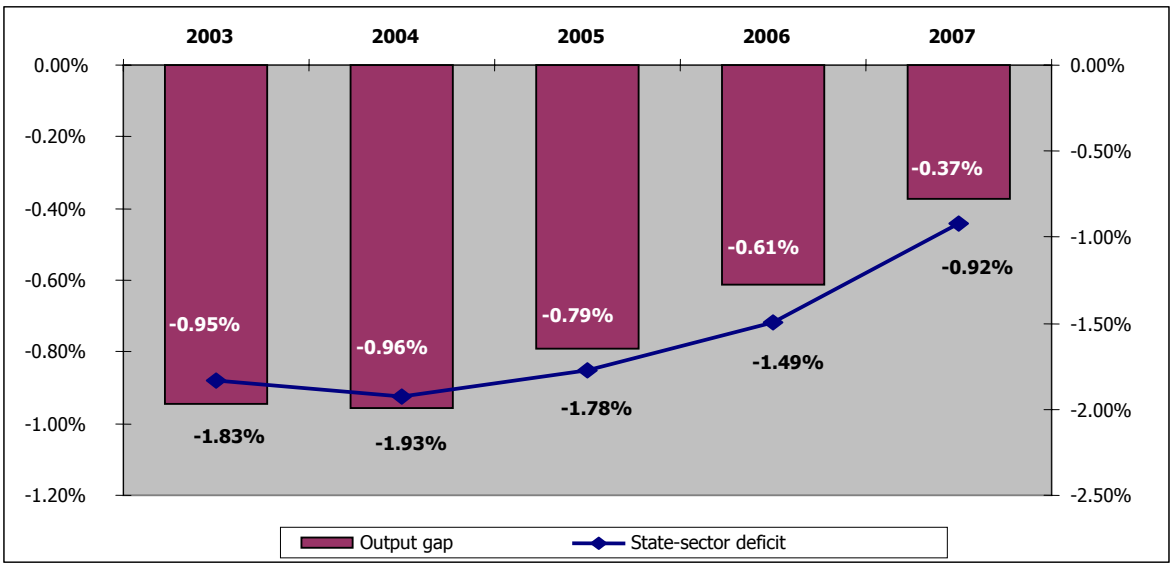
1.2. Fiscal policy

The objective of fiscal policy in the next medium-term period is to achieve a stable position close to a structural budget balance and to contribute to achieving the objectives of nominal and real convergence. The Government will attain the medium-term objective of achieving structural fiscal balance without increasing the general fiscal burden and gradually restructuring public-finance revenues and expenditures so as to contribute to the competitiveness of the economy and to economic growth. In line with this objective, the Government will pursue a policy of gradual reduction of the structural deficit while allowing a limited increase of cyclical deficit and hence o limited operation of fiscal stabilizers in less favourable economic environment.

Given the macroeconomic conditions expected in 2004 and 2005, the Government's objective is that the general government deficit will not exceed 1.93% of GDP in 2004 and 1.78% of GDP in 2005. Under this scenario, the general government deficit should fall to less than 1% of GDP by 2007. The Government will achieve this objective without changing the overall fiscal burden by gradually restructuring public-finance expenditure and revenues. The policy will be gear to improve the quality of public finances in order to spur competitiveness and growth of the economy.

Sustainability of public finances will require the maintenance of the relative size of the general government debt at no more than the current level.

Figure 1.1.: Output gap and general government deficit up to 2007 (ESA 95 methodology)



Source: MF RS

1.3. Monetary and exchange-rate policy

Slovenia intends to join ERM 2 by the end of 2004 at the latest, and to adopt the Euro at the beginning of 2007. The main objective of monetary policy remains ensuring price stability. Upon joining ERM 2, to achieve this objective, monetary and exchange-rate policy will focus on preserving exchange-rate stability within the framework of ERM 2.

The Bank of Slovenia manages monetary and exchange-rate policy in conditions where relatively high levels of nominal and real convergence have already been achieved. Coordination between the monetary and exchange-rate policy of the Bank of Slovenia, and Government economic policy has increased. The process of reducing inflation is balanced and sustainable in the long term, as indicated by the reduction of other price-growth indicators. Reducing inflation has not threatened external balance, and has not caused higher macroeconomic costs. Forecasts indicate that inflation will continue its gradual and sustained fall in the future, before settling at a level below 3% at the end of 2005, provided external shocks are manageable (e.g. prices of oil, other basic raw materials etc.).

In the run-up to joining ERM 2, the Bank of Slovenia will continue to operate a policy of managed float, which given the free international movement of capital, enables a certain degree of freedom in the management of monetary policy. The Bank of Slovenia influences demand for money through interest rates. Interest rates change in line with the necessary constraints on money supply with regard to estimated demand for money and depending on inflation trends and expectations. Under conditions of free movement of capital, it retains autonomy in setting interest rates through support of a managed float of tolar. Influence on the dynamics of exchange rates follows the principle of uncovered interest-rate parity, taking account of the premium for country risk. Such a policy enables sustained convergence of nominal interest rates and establishment of exchange-rate stability on joining ERM 2.

The objective of monetary policy after joining ERM 2 will be to create conditions that enable adoption of the Euro as soon as possible. Monetary and exchange-rate policy during participation in ERM 2 will focus on preserving the stability of the tolar within the limits laid down in the ERM 2. During participation in ERM 2, the role of monetary policy in ensuring price stability will be reduced, while the role of Government economic policy will be strengthened.

The Bank of Slovenia's interest rate policy will be subordinated to exchange-rate stability. Within the ERM 2 environment, the setting of nominal interest rates will primarily depend on the following elements: (i) reduction of risk premiums; (ii) the level of Eurozone interest rates; and (iii) inflationary pressures. Interest rates will therefore not always be at the level required to control domestic consumption and consequently inflationary pressures. The role of monetary policy in controlling domestic consumption will be supplemented by other economic policies, particularly fiscal and incomes policy, and by strengthened supervision.

1.4. Wage policy

The income policy aims at ensuring that wage growth lags behind labour productivity growth, thereby providing labour market flexibility and allowing more room for the wage policy to respond to potential shocks emerging in the period leading to euro adoption and beyond. The real gross wage per employee is expected to rise by 2% in 2004 (2.5% in the private and 0.5% in the public sector) and by 2.2% in 2005 (2.5% in the private and 1.2% in the public sector).

The social partners concluded a Social Agreement for 2003-2005 at the end of April 2003. They committed themselves to keep the real rise in the gross wage per employee behind labour productivity growth by at least one percentage point. This provided the basis for adopting the wages policy agreement for the public and private sectors.

The agreement for the private sector sets out nominal gross wage increase of 3.2% in 2004 and 2.7% in 2005. The most important element of the Agreement is that adjustment now involves a lump-sum amount of wage supplement rather than a percentage increase. This will make assure that: (i) the wages of all employees will rise by the same amount; (ii) this amount will be agreed at the level of sectoral collective agreements, which should encourage dialogue between the social partners at the level of activities; and (iii) all employees in the given activity will get the same adjustment supplement, which should improve wage distribution. The minimum adjustment amount agreed for 2004 is SIT 5,000 and SIT 5,100 for 2005. The adjustment mechanism also includes two safeguard clauses. If the actual rise in consumer prices excluding alcohol and tobacco is higher than anticipated, exceeding 3.6% in 2004 and 2.9% in 2005, this difference should be incorporated in the next wage

adjustment. If the actual inflation is lower than expected, the Government will propose amending the agreement. There is an additional safeguard clause if enterprises cannot pay the adjustment supplement for business reasons, in which case the employer and employees make an internal agreement at the level of the enterprise. While the Wages Policy Agreement sets the adjustment mechanism which takes price movements into account, the social partners may negotiate an additional rise at the level of activities on the basis of that activity's performance. However, they must follow the guideline of the Social Agreement that the gross wage per employee should lag behind labour productivity by one percentage point.

The wages policy for the public sector was agreed in July 2003 and will be applied in 2004-2005. The adjustment mechanism incorporates three elements – anticipated domestic inflation, anticipated inflation in the EU, and the anticipated rise in the EUR/SIT exchange rate – and they will carry a weight of 52%, 38% and 10% in 2004 and 52%, 48% and 0% in 2005. According to this agreement, public-sector wages should increase by 3.1% in 2004 and 3% in 2005 in nominal terms. When adopted, the agreement assumed that consumer prices would rise by 4.3% in 2004 and 4.0% in 2005. The agreement also lays down an additional adjustment in case of divergence in actual inflation from projections. If the inflation target is realised (Table 2.1.), public-sector wages, which are adjusted in accordance with this agreement, will be lowered in 2004 and 2005. The proposed adjustment mechanism will also help reduce pressure on the general government expenditure. This is especially true because half of the adjustment percentage should be used for the base wage and the other half for the elimination of wage imbalances seen after the entering into force of the new Public Sector Wage Act.

In the past, the biggest upward pressure on public-sector wages used to come from allowances negotiated in sectoral collective agreements. The Public Sector Wage Act, which was passed in June 2002, froze all public-sector collective agreements. As a result, wage growth in the public sector was moderate in 2002 and 2003. This was also due to the agreement reached between the social partners to replace part of last year's adjustment by a premium of collective supplementary pension insurance for public-sector employees. Before the Public Sector Wage Act begins to apply on 1 July 2004, the Government and the other social partners will have to agree on collective agreements that classify jobs into an appropriate pay scale without causing negative consequences for public finances. During the transition period, the Government is conducting a restrictive promotion and recruitment policy and aims to reduce the spread between the highest and lowest basic wage from 1:12.3 in 2002 to 01:10 in 2008.

An important element of wages policy is to reduce stratification. A rule that the minimum wage is raised in line with real GDP growth, in addition to the regular wage adjustment, has helped prevent wage dispersion at the lower end of wage distribution. This rule will continue to be applied in the future.

1.5. Structural policies

In the basic development documents[1] it has adopted, the Republic of Slovenia defined as the basic medium-term development objective balanced and coordinated economic, social, environmental, regional and spatial development.

[1] Economic development strategy has been published at http://www.gov.si/umar/projekti/sgrs/dokument.html, and the national development programme at http://www.gov.si/arr/9razno/1dr3.html

To achieve these objectives, the Government has already adopted a series of measures and activities to accelerate structural reforms that will increase efficiency, competitiveness and flexibility in the private and public sectors.

Measures of structural policy are and will continue to be geared primarily towards the following areas:

a) reinforcing competitiveness and scientific technological development, promoting entrepreneurship and eliminating administrative barriers (promoting private enterprise and private investment),
b) promoting investment contributing to creation of new employment opportunities in underdeveloped regions,
c) restructuring uncompetitive sectors (textile, leatherworking, steel and food industries) and state aids using a regional key,
d) increasing labour market flexibility with greater employment and wage flexibility alongside reinforcement of measures of the active employment policy and eliminating structural imbalances (reducing the proportion of long-term unemployment, the proportion of the unemployed without vocational education, and regional differences in unemployment, increasing the employment rate of older and highly qualified people),
e) increasing the competitiveness and cost-effectiveness of infrastructural and non-trade activities, particularly in the telecommunications, postal, transport and electricity sectors, either through effective regulation of natural monopolies or through privatisation and liberalisation while simultaneously establishing effective protection of competition and ensuring supply reliability,
f) tax reforms adopted will reduce labour burdens and will ensure more targeted incentives in the field of corporate taxation ,
g) functional and organisational renovation of public administration and renovation of human-resource management in public administration,
h) health reforms which, together with the implementation of measures to rationalise the health system (effects of centralisation of public procurement in health sector, effects of reference prices for medicines and other measures envisaged by reforms in the area of compulsory health insurance) and changes within the current system of additional health insurance, will enable the health care system to operate at a surplus in the years to come and to cover deficits from previous years by 2008,
i) implementation of the second part of the reforms adopted for the pensions system, which were enacted by the Pension and Disability Insurance Act, with the introduction of capital cover for additional pensions insurance financed by premiums of employees, employers or a combination of the two, in both the private and public sectors,
j) increasing the competitiveness and effectiveness of financial institutions through processes of restructuring, increasing capital adequacy or strength, internationalisation and diversification of financial services, and by establishing more effective oversight of the whole financial sector within the framework of a unified supervisory institution, or improving corporate culture.

2. ECONOMIC TRENDS AND FORECASTS OF MACROECONOMIC AGGREGATES

2.1. Economic growth

The forecasts of economic growth indicate that the recovery of economic activity in the main trading partners will continue in 2004 and 2005. The favourable trend is set to continue in 2005 and economic growth should accelerate to an average of 2.2% in the EU. The assumption of the average oil price in 2004 was based on trends in world markets, international institutions' forecasts and the technical assumption of unchanged euro/dollar exchange rate (1.22). The assumption of the fixed euro/dollar exchange rate (1.22) means that changes in the actual oil price may be subject to changes in the US dollar's exchange rate[2]. These projections of economic growth in the international environment, which are mainly based on Consensus forecasts (March 2004) and the IMAD's own estimates, are closely in line with the European Commission's spring forecasts[3], while minor differences can be seen in expectations for 2005: the IMAD's forecast of economic growth is slightly more conservative for the EU and slightly more optimistic for the USA. Differences are slightly wider in projections of the average oil price per barrel: the IMAD forecasts a lower price for both years, however, this should have little impact on the projections of macroeconomic aggregates[4].

Slovenia achieved modest economic growth in 2003 (2.3%). Economic growth was more affected by unfavourable conditions in the international economic environment than in the preceding two years, when growth (2.7% in 2001 and 3.4% in 2002) was equally below the average of the past medium-term period (4.3% in 1996-2000). Further, this reflects to some extent the slow pace of structural reforms, which hindered progress in competitiveness. The structure of gross domestic product growth changed as a consequence of increased contribution of domestic demand. Growth in private consumption picked up, while the increased household borrowing from banks, mainly in the form of long-term loans, suggests increased purchases of durable goods. Real growth in gross fixed capital formation gained momentum. The modest real export growth was primarily due to the slow economic recovery in EU members, Slovenia's most important trading partners. Unlike in 2002, exports to the countries of former Yugoslavia fell, with the exception of Croatia, while exports to Russia and CEFTA countries remained robust. On the other hand, the accelerated investment activity and increased private consumption

[2] Any further falls in the dollar's value in international foreign exchange markets may push the oil price up (expressed in dollars), however, this should not raise notably the costs for the Slovenian economy.

[3] European Commission: European Spring Forecast 2004 (April, 2004).

[4] After the IMAD has prepared its spring forecasts, the International Monetary Fund (IMF) and the European Commission (EC) released their economic growth forecasts for the international environment. They project a slightly higher average oil price (Brent crude) compared to the IMAD's assumption: around USD 30 per barrel according to the IMF and USD 31.1 according to the EC. The realisation of these estimates would not change significantly the IMAD's forecasts of macroeconomic aggregates for 2004. A rise of about USD 4 per barrel, resulting in the average oil price of USD 31.7 per barrel, would reduce the spring economic growth forecast by 0.2 of a percentage point at most, while inflation would be 0.1 to 0.2 of a percentage point higher. While estimating the impact on economic growth, we assumed that higher oil prices would dampen domestic consumption growth. At the same time, we estimate that the originally projected export growth is achievable in spite of the higher oil price because this projection is based on the same assumptions which underpin the latest IMF and EC forecasts, which already take the high oil price into account. In other words, the baseline scenario is slightly conservative in terms of export growth. Any rise in inflation caused by the higher oil price would not undermine the meeting of the Maastricht convergence criteria because this is a symmetrical shock, equally affecting prices in the euro zone. The impact of deteriorated terms of trade on the current account might widen the current account deficit by around EUR 100 million.

increased imports. These export-import flows reduced the current account surplus from EUR 330 million in 2002 (1.4% of GDP) to EUR 17 million in 2003 (0.1% of GDP).

Economic developments seen in the last quarter of 2003 largely reflect the rebound in economic activity in the international environment which, as expected, began in the second half of 2003. Hence, real gross domestic product growth strengthened year on year in the last quarter mainly due to the strong growth in exports (to the EU in particular) and the sustained high growth in exports to CEFTA countries and Russia.

In 2004 and 2005, economic growth is expected to strengthen further since export demand should increase due to the improved conditions in the international economic environment, while domestic spending should continue rising, especially investment. The economic growth forecast is 3.6% for 2004 and 3.7% for 2005. Real export growth is expected to strengthen in both years owing to the improved conditions in the international environment. Private consumption growth should be underpinned by the new cycle of buying durable goods. Private consumption will also be encouraged by the gradual improvement in labour market conditions and lower nominal interest rates in the money market, resulting from the convergence with the euro-zone countries and entry into the ERM2. Private consumption will also be influenced by funds released from the first national housing savings scheme. Some of these savings should turn into consumption either directly or indirectly through the purchase of dwellings or other durable and semi-durable goods. The robust growth in gross fixed capital formation should be maintained in both 2004 and 2005, government investment should gain momentum, fuelled by motorway construction and the setting-up of the Schengen border, housing investment should rise more, and corporate sector's investment should accelerate in line with the improved economic cycle.

In 2006-2009, economic growth is projected to increase to around 4%. On the assumption of relatively favourable conditions in the international environment, positive effects of EU membership on international trade, and anticipated improvement in competitiveness, export growth should be sustained at a relatively high level. The relatively strong rise in domestic consumption should continue, however, it is likely to slow down slightly compared to 2004 and 2005. Growth in investment activity is still expected to exceed growth in gross domestic product, while investment should focus more on productive private investment, thereby encouraging competitiveness of the Slovenian economy. Growth in housing construction should also be maintained. Private consumption should broadly keep up the current level of growth owing to the favourable developments in the labour market. The current account should be roughly balanced by the end of the given period after recording a moderate deficit of up to 0.5% of gross domestic product, assuming that export competitiveness will improve.

Table 2.1: Growth and associated factors

Percentages unless otherwise indicated	ESA Code	Year **2003**	Year **2004**	Year **2005**	Year **2006**	Year **2007**
1. GDP growth at constant market prices (14+15+16)	**B1g**	**2.3**	**3.6**	**3.7**	**3.8**	**3.9**
2. GDP level at current market prices (SIT mil.)	B g	5,670,640	6,085,100	6,501,700	6,918,000	7,361,000
3. GDP deflator		**5.1**	**3.6**	**3.0**	**2.5**	**2.4**
4. CPI change (annual average)		5.6	3.3	3.0	2.7	2.6
5. Employment growth *		**-0.2**	**0.4**	**0.6**	**0.6**	**0.7**
6. Labour productivity growth **		2.5	3.2	3.1	3.2	3.2
Sources of growth: percentage changes at constant prices						
7. Private consumption expenditure	**P3**	**3.1**	**3.5**	**3.4**	**3.3**	**3.3**
8. Government consumption expenditure	P3	2.8	3.0	2.6	2.9	2.8
9. Gross fixed capital formation	**P51**	**5.5**	**7.6**	**7.0**	**5.0**	**5.5**
10. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	1.2	1.3	1.3	1.4	1.4
11. Exports of goods and services	**P6**	**3.4**	**5.5**	**6.0**	**6.3**	**6.6**
12. Imports of goods and services	P7	6.3	6.8	6.6	6.2	6.3
Contribution to GDP growth						
13. Final domestic demand		**4.3**	**4.6**	**4.4**	**3.9**	**3.9**
14. Change in inventories and net acquisition of valuables	P52+ P53	0.9	0.1	0.1	0.2	0.0
15. External balance of goods and services	**B11**	**-2.0**	**-1.0**	**-0.7**	**-0.1**	**0.0**

Source: Statistical Office of the Republic of Slovenia (SORS), Bank of Slovenia; forecasts: Institute for Macroeconomic Analysis and development (IMAD).

Notes: * Forecasts of the Institute for Macroeconomic Analysis and development (IMAD).
** Employed population, domestic concept, according to national accounts definition.
*** Growth of GDP at market prices per person employed at constant prices.

2.2. Employment growth

The faltering economic growth has affected labour market performance. Employment fell in 2003 for the second year running mainly due to the slowing economic growth seen in the last three years. The unemployment rate rose from 6.4% in 2002 to 6.7% in 2003 according to the labour force survey. Real wage growth was behind the growth in labour productivity, while wage growth in the public sector was much lower than in the private sector. The gross wage per employee rose by 1.8% in real terms in 2003 and lagged behind labour productivity growth measured by GDP per employee by 0.7 of a percentage point. Wage growth was 0.7% in the public sector and 2.1% in the private sector, while value added per employee rose by 3.1% in the private sector.

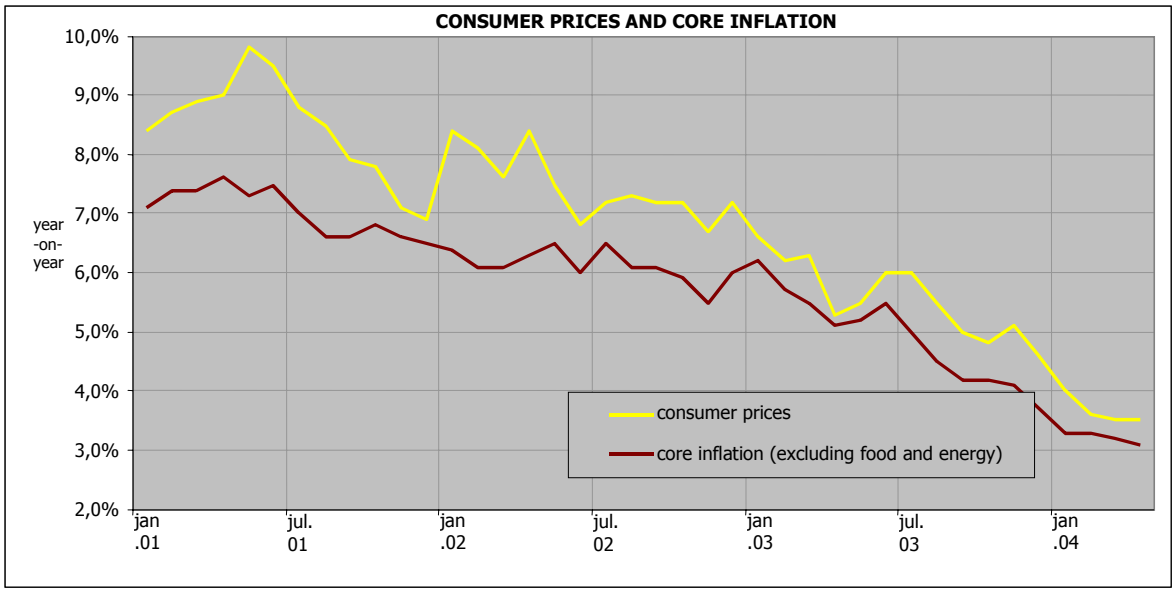
Labour market performance should improve in 2004 and 2005 in line with the rebound in economic activity. Employment, which contracted in the past two years, is expected to increase by 0.4% in 2004 and 0.6% in 2005, while both registered and survey unemployment rates are anticipated to fall, especially in 2005.

2.3. Inflation

The gradual fall in inflation, which began in 2001, was accelerated in 2003. Consumer prices rose by 4.6%, 2.6 percentage points less than in 2002 when annual inflation was 7.2%. This fall in inflation was chiefly due to more restrictive economic policies of the Bank of Slovenia and the Government and, more importantly, their improved co-ordination. This helped reduce inflation rapidly in the first quarter, and reduced inflationary expectations which, in turn, contributed to a further slowdown in prices. In early 2003, the Government released the upward pressure on prices caused by changes in administered prices and indirect taxes, while it buffered the impact of the volatility of liquid fuel prices by adjusting excise duties. In addition to the significant contribution of restrictive wage policy measures, the sustainable reduction of inflation was the result of structural changes, mainly the ongoing de-indexation process in the field of personal income (wages, transfers) and financial contracts.

Inflation is expected to decline further to an annual rate of 3.3% in 2004 and up to 2.9% in 2005. The slowdown in inflation will be the result of continued co-ordinated implementation of macroeconomic policy measures. Inflationary pressures from the domestic environment will also be reduced owing to last year's changes to indexation mechanisms. The wage adjustment agreements for the public and private sectors will ensure that wage growth does not create any inflationary pressures on the demand side in the upcoming two years. Inflationary expectations should also be anchored by the de-indexation introduced in the financial sector last year.

Graph 2.1: Consumer prices and core inflation



Provided that these economic policy measures are consistently implemented, any price rise above the EU average will primarily be due to faster productivity growth and the remaining structural imbalances. For a sustainable reduction of inflation in the long run, it will be necessary to complete the structural reforms, mainly in sectors where prices are regulated by the government and in the field of financial and labour markets.

Table 2.2: External assumptions

VARIABLE	Basic assumptions									COMMENTS
(annual growth rates in %	2003		2004		2005		2006		2007	
if not otherwise stated)		change*		change*		change*		change*		
Exchange rates										
Exchange rate vis-à-vis EUR	**233.7**	**1.2**	**238.7**	**4.8**	**239.8**	**5.5**	**239.8**	**5.5**	**239.8**	
USD / EUR **	1.13	0.08	1.23	0.18	1.22	0.17	1.22	0.17	1.22	
Nominal effective exchange rate	**-0.2**	**0.7**	**-0.8**	**0.2**	**-0.5**	**0.4**	**0.0**	**0.0**	**0.0**	
Real effective exchange rate	3.8	0.9	1.1	-0.9	0.9	-1.5	1.2	-0.9	1.1	
GDP (in real terms)										
World excluding EU [1]	**3.7**	**0.5**	**4.5**	**0.4**	**4.3**					**[1] World, including the EU**
USA	3.1	0.7	4.2	1.4	3.7					
Japan	**2.7**	**1.9**	**2.8**	**1.8**	**1.6**					
EU-15	0.8	-0.3	1.9	-0.3	2.2					
World trade (in real terms)										
County export markets	**4.5**	**0.0**	**6.4**	**-0,4**	**6.8**					
World imports [2]	5.6	0.2	8.3	1.7	7.8					[2] World imports of goods.
World prices										
World import prices (goods, in USD) [3]	**12.8**	**4.6**	**1.7**	**0.6**	**1.4**					**[3] World trade prices - manufactured goods.**
Oil prices (Brent - USD per barrel)	28.8	3.6%	27.7	10.8%	26.0					
Non-oil commodity prices (USD)	**9.8**	**0.4**	**11.3**	**9.0**	**-4.7**					

Notes: * Change vis-à-vis assumptions from PEP 2003.
** Taken from the IMAD Spring Report 2004, assuming that the USD/EUR exchange rate stays at the level 1.22.

3. GENERAL GOVERNMENT DEFICIT AND DEBT

3.1. Government revenues policy

Fiscal policy will be geared towards further restructuring of government revenues, particularly by relative reduction in the direct tax burden on labour and streamlining the tax reliefs in corporate income tax. Changes in the area of taxation will be accompanied by more efficient administration of public taxes. Total tax revenue should remain at roughly the same level as their current share of GDP.

New Personal Income Tax Act and the Corporate Income Tax Act were adopted this year, both of them will enter into force in the beginning of 2005. The Personal Income Tax Act reduces the burden on taxpayers with lower incomes without increasing the burden in higher tax brackets. The burden on individual types of income, determined on the basis of status, has been equalised. The law is based on equal tax treatment of taxpayers with approximately equal incomes. Clearer definition of the status of taxable incomes has expanded the base for charging social-security contributions, which will improve the balance sheet of the health-care system and reduce transfers from the state budget to the pension funds. The new Income Tax Act lays down five tax brackets, with rates ranging from 16% to 50%.

The Corporate Income Tax Act expands the tax base through a different definition of taxpayers and stipulation of detailed conditions for exemption of those engaged in not-for-profit activities. Tax incentives are more targeted and geared towards fostering competitiveness (withdrawal of general relief for investment in fixed assets and introduction of relief for assets intended for research and development). The new Act introduced more detailed arrangements for determining the tax base and tax treatment of transfer prices, interest among linked persons, taxation in the transfer of activities, exchange of capital shares, mergers and demergers. Equally, the circle of incomes taxed at source is expanded. The current tax rate is retained at the level of 25%, while a significant increase in the effective tax rate is expected. Increased revenues in this area should make up for reduced revenues from income tax.

The new Real Estate Tax Act, which will be adopted in 2005, will establish a new system of taxation of real estate to replace the existing system (compensation for the use of building land and property tax), based on completed and updated real-estate records. The new tax on individual real estate will not differ fundamentally from the current tax burden on such real estate, and so budget resources in this area will remain roughly the same.

As regards payroll taxes, given the lag of wage growth behind productivity growth, the Government will operate a policy of gradual reduction of taxation on salaries, thereby contributing to increased competitiveness of the economy.

Over the coming years, the Government does not envisage changes in the level of social-security contribution rates.

The Government is not planning significant changes in indirect taxes (primarily VAT and excise duty) in next years. Revisions to the VAT Act merely harmonised our VAT system with the EU system without significant fiscal consequences. The government will continue to adjust excise duties in accordance with the obligations accepted in pre-accession

negotiations. Excise duties defined in absolute amounts in accordance with the law will be defined before the start of each budget year, so they will be a stable source for the state budget and will preserve the real level of excise duty with regard to the tolar/Euro exchange rate.

3.2. Government expenditure policy

The Government's basic expenditure policy objective in the coming years is to improve its structure towards greater quality and to adjust its total to the targeted lower government deficits.

In previous years, public expenditure on administration, home affairs, justice, foreign affairs, social security and agriculture has grown faster than expenditure on development investments and other priority tasks. The state budget for 2004 already envisaged improvement in the structure of public expenditure, allocating more funds to promote economic development, reflected primarily in the increased share of investment expenditure in the state budget. In the year 2004 budget expenditures on investments have increased compared to 2003 by 32.7%. Such a large increase in government investments is a consequence of the restructuring of the budget due to the envisaged use of funds from EU structural funds. The 2004 general government budget secures part of the funding for increased expenditure on the common agricultural policy from the funds of the Ministry of Agriculture, rationalises the use of resources for national security, introduces the measures to rationalise the system of social transfers, introduces a new pay system in the public sector and reduces expenditure on goods and services. Most of these measures should contribute to the reduction of the structural deficit.

Government expenditure on salaries was up to 2002 the fastest growing part of public expenditure. Wage growth in the public sector began to ease in 2002, and this trend is continuing. In 2004, the new Public Sector Salaries Act will be implemented in a fiscally neutral manner. Collective Additional Pension Insurance for Public Servants Act was introduced. Additional employment in the public sector is restricted, as is the non-selective promotion of employees – the Government will link it to staff-restructuring programmes. A relative reduction in labour costs will be achieved by increasing employment flexibility in the public sector, increasing efficiency in performing tasks and reducing unnecessary costs. The Government will therefore prepare a centrally managed project for restructuring human resources in the state sector, and will adopt measures for the better operation of administration in the area of internal organisation and human-resource management.

Social transfers are increasingly oriented towards low-income groups of the population and effectively influence poverty reduction, since the targeting of resources has improved considerably in recent years. Slovenia's development objectives in this area are: reducing the dependency of the population on social transfers, ensuring social security through working activities, greater flexibility of the system of social transfers, and improving protection for the most socially vulnerable. To achieve the objectives set in this area, the Government will: (i) promote employment of recipients of social transfers and compensation for unemployment with the help of subsidies and other measures of employment policy, (ii) eliminate unjustified accumulation of benefits, (iii) upgrade information systems to enable greater transparency and oversight of the systems of social transfers, (iv) amend the mechanism for coordinating social transfers so as to complete the elimination of index-linking, which began in 2004. To ensure a sustainable public-finance

system of social security, the Government will again redefine the criteria for individual types of social benefits, and streamline them as required.

In addition to measures of tax policy, the Government will also implement measures to improve the structure of public expenditure by redirecting expenditure to promote economic development.

This is expected to be achieved through a combination of four measures:
- reallocating expenditures from programmes that are less effective and successful to more effective programmes,
- by changing the criteria for eligibility for funds,
- by reducing the rigidity of the method of coordinating statutory expenditures,
- by obtaining additional resources for infrastructure projects from non-public sources.

Based on analysis of the effectiveness and success of programmes, those programmes that do not provide satisfactory results will have to be abandoned.

In the area of investment in science and technological development, Slovenia still lags behind the EU countries. One of the objectives of the Lisbon strategy is to increase funds for research and development as a proportion of GDP. In the state budget, Slovenia increased funding for science and technological development from SIT 29.1 bn in 2001 to SIT 46.3 bn in 2005, representing a 60% increase in funding for science and technological development in 4 years, or an average annual increase of 12.5%. The state will retain expenditure for these purposes in future at the same real level. This will strengthen key factors that define the knowledge-based society and at the same time increase the competitiveness of the Slovenian economy, leading to real convergence.

Likewise, the area of education and training, particularly the term "knowledge-based society", is best linked to the basic objectives of the Lisbon strategy and the Bologna process. Education funding will be increased from SIT 218.2 bn in 2001 to SIT 301.7 bn in 2005, a total increase of 38% at an annual rate of 8.5%. This involves not just an increase in total expenditure in these areas, but also an appropriate reallocation among individual levels of education so as to maximise the long-term effects and results.

With regard to the ambitious general strategic plans of Slovenia within the EU, Slovenia will pursue the objective of maintaining and increasing the trend of the current high participation rate by young people in secondary and tertiary education. The education and training system will be developed and expanded so as to support national comparative advantages in the European and international context.

Funding from European structural funds and the cohesion fund, and for the implementation of the common agricultural policy, will increase steadily in the future. In order to draw on the available funds in the most effective manner, without pressure on the public-finance deficit, we will need to reduce financing of other measures in individual areas. Therefore, less funding will be made available for domestic-policy measures, while the funding for the implementation of common European policies will increase.

3.3. General government deficit

As in previous years, Slovenia will continue to maintain the general government deficit below 3% of GDP, in accordance with the policy of gradually reducing the structural deficit

and taking account of the sensitivity of the deficit to fluctuations in the economic cycle. This will assure greater responsiveness of fiscal policy to the economic cycle. The initial plan for faster reduction of the deficit, envisaged during preparation of the first Pre-Accession Economic Programme in 2001, has been moved back to 2007 due to deterioration of the economic environment and additional obligations linked to Slovenia's membership in the EU and NATO.

Table 3.1.: General government budgetary developments[5]

% of GDP	ESA code	2003	2004	2005	2006	2007
Net lending (B9) by sub-sectors						
1. General government	**S13**	**-1,83**	**-1,93**	**-1,78**	**-1,49**	**-0,92**
2. Central government	S1311	-1,63	-1,64	-1,82	-1,53	-1,01
	S1312	-	-	-	-	-
4. Local government	**S1313**	**-0,07**	**-0,05**	**-0,04**	**-0,04**	**-0,04**
5. Social security funds	S1314	-0,12	-0,23	0,09	0,09	0,12
General government (S13)						
6. Total receipts	**ESA**	**43,95**	**45,06**	**43,97**	**43,60**	**42,68**
7. Total expenditures	ESA	45,78	46,99	45,74	45,09	43,60
8. Budget balance	**B9**	**-1,83**	**-1,93**	**-1,78**	**-1,49**	**-0,92**
9. Net interest payments	D41	-1,58	-1,60	-1,42	-1,32	-1,27
10. Primary balance		**-0,26**	**-0,33**	**-0,36**	**-0,17**	**0,35**
Components of revenues						
11. Taxes	D2+D5	26,39	26,58	25,55	25,17	25,07
12. Social contributions	**D61**	**14,97**	**14,70**	**14,69**	**14,61**	**14,54**
13. Interest income		0,34	0,22	0,20	0,19	0,16
14. Other	**13. Other**	**2,59**	**3,78**	**3,73**	**3,82**	**3,07**
15. Total receipts	ESA	43,95	45,06	43,97	43,60	42,68
Components of expenditures						
16. Collective consumption	**P32**	**8,74**	**8,59**	**8,22**	**7,98**	**7,72**
17. Social transfers in kind	P31	-	-	-	-	-
18. Social transfer other than in kind	**D62**	**17,45**	**17,31**	**16,91**	**16,58**	**16,20**
19. Interest payments	D41	1,92	1,82	1,62	1,51	1,43
20. Subsidies	**D3**	**1,23**	**1,49**	**1,42**	**1,80**	**1,47**
21. Gross fixed capital formation	P51	2,60	3,26	3,01	2,95	2,84
22. Other	**21. Other**	**13,84**	**14,51**	**14,58**	**14,28**	**13,94**
23. Total expenditures	ESA	45,78	46,99	45,74	45,09	43,60

Source: MF RS

With the envisaged, relatively moderate government deficit in next years, fiscal policy will ensure macroeconomic stability, and compliance of the Maastricht fiscal criteria. Furthermore, in the process leading to euro adoption, it will contribute to offsetting the

[5] From 2004 onwards, the funds that Slovenia is expected to receive from the EU budget are shown as part of total revenues, and funds that Slovenia will be paying into the EU budget a are included in total expenditures. In 2007, estimated receipts from the EU budget corresponding to the new financial perspective are not included within total revenues.

macroeconomic shocks, thereby supporting the efforts of the Bank of Slovenia in the management of exchange-rate policy.

In 2003, the general government deficit amounted to 1.83% of GDP. The deficit is expected to increase in 2004 to 1.93% of GDP, while in 2005 it should be somewhat lower at 1.78% of GDP. In 2006 and 2007, the deficit is expected to continue to fall, reaching around 0.9% of GDP in 2007.

The central government deficit (according to national methodology) in 2003 was 1.21% of GDP. The deficit is expected to reach 1.5% of GDP in 2004 and 1.7% of GDP in 2007. With the implementation of the Government's fiscal policy defined in this document, the state budget deficit will be reduced in 2006 to around 1.5% of GDP and in 2007 to around 1% of GDP.

Implementation of the adopted fiscal policy will ensure that both compulsory social insurance funds (ZPIZ and ZZZS) will operate without deficits and will thus contribute to reduction of the overall general government deficit.

The Pensions and Disability Insurance Fund (ZPIZ), which ended the 2003 budget year without a deficit, will operate again in 2004 without a deficit, since the state budget will fully cover the difference between original revenues of ZPIZ and total expenditure for pensions and disability insurance. In the period 2005-2007, ZPIZ will even record a surplus in an amount that will enable gradual repayment of debt from previous years.

The Health Insurance Fund (ZZZS), through which compulsory health insurance is financed in Slovenia, recorded a deficit in year 2003 amounting to 0.2% of GDP. In 2004, under the adopted financial plan, the Fund will again end the year with a deficit amounting to 0.23% of GDP. In 2005 and subsequent years, through implementation of measures of the envisaged health reforms and rationalisation of the health system, the Fund will once again operate without a deficit. The debt incurred by ZZZS from past deficits up to 2004 – expected to amount to SIT 35 bn – will be taken on by the state budget.

Local governments have recorded deficits in recent years, but no more than 0.1% to 0.2% of GDP. In 2003, combined budgets of all 193 municipalities in Slovenia recorded a deficit of 0.05% of GDP. For the period 2004-2007, we expect that the deficit of the local governments will again not exceed 0.05% of GDP.

Other extrabudgetary public funds and agencies on the central government level[6] recorded a surplus in 2003 amounting to 0.05% of GDP. In the period from 2005 to 2007 deficits in the balance sheets of these extrabudgetary funds are not foreseen.

3.4. Structural and cyclical balance

In line with the estimates for GDP growth, it is expected that in future years the growth of potential GDP will also increase. Potential GDP growth (estimated using the production function method) is estimated to increase from 3.5% this year to 3.7% over the next four years. Despite the continued reduction in the contribution of total factor productivity, growth in potential GDP remains primarily a consequence of the latter and of the increased contribution of capital.

[6] 12 extrabudgetary public funds and 9 public agencies operate in Slovenia in 2004.

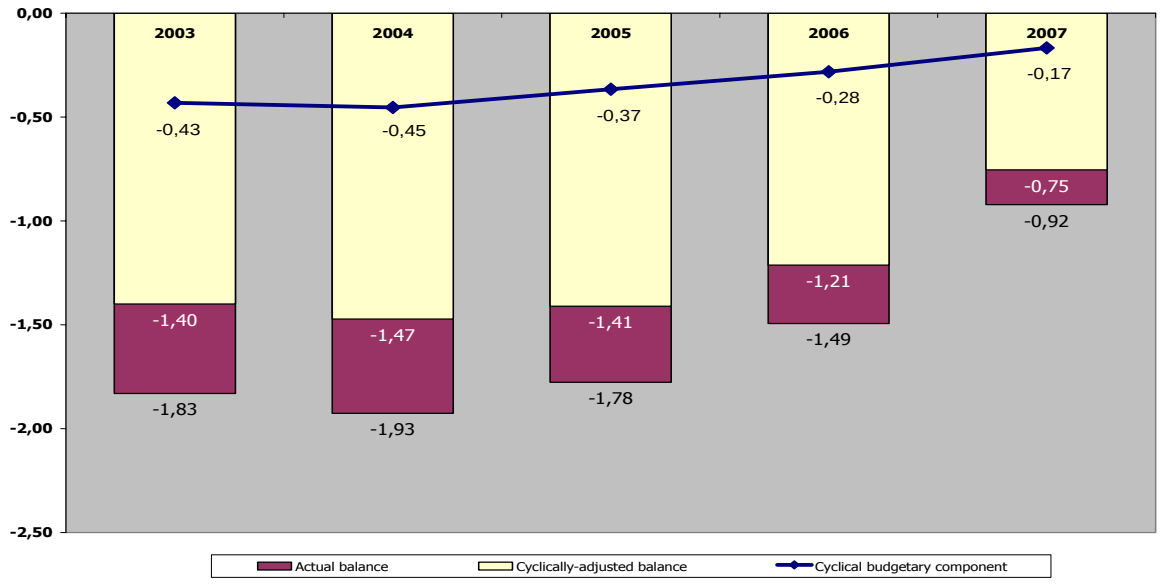
Table 3.2.: Cyclical developments

% of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP – real growth rate	**B1g**	**2.3**	**3.6**	**3.7**	**3.8**	**3.9**
2. Actual balance	B9	-1.83	-1.93	-1.78	-1.49	-0.92
3. Interest payments	**D41**	**1.92**	**1.82**	**1.62**	**1.51**	**1.43**
4. Potential GDP growth		3.66	3.51	3.62	3.61	3.68
5. Output gap		**-0.95**	**-0.96**	**-0.79**	**-0.61**	**-0.37**
6. Cyclical budgetary component		-0.52	-0.55	-0.44	-0.34	-0.20
7. Cyclical adjusted balance (2-6)		**-1.31**	**-1.38**	**-1.34**	**-1.15**	**-0.72**
8. Cyclical adjusted primary balance (7-3)		0.27	0.22	0.08	0.16	0.55

Source: MF RS

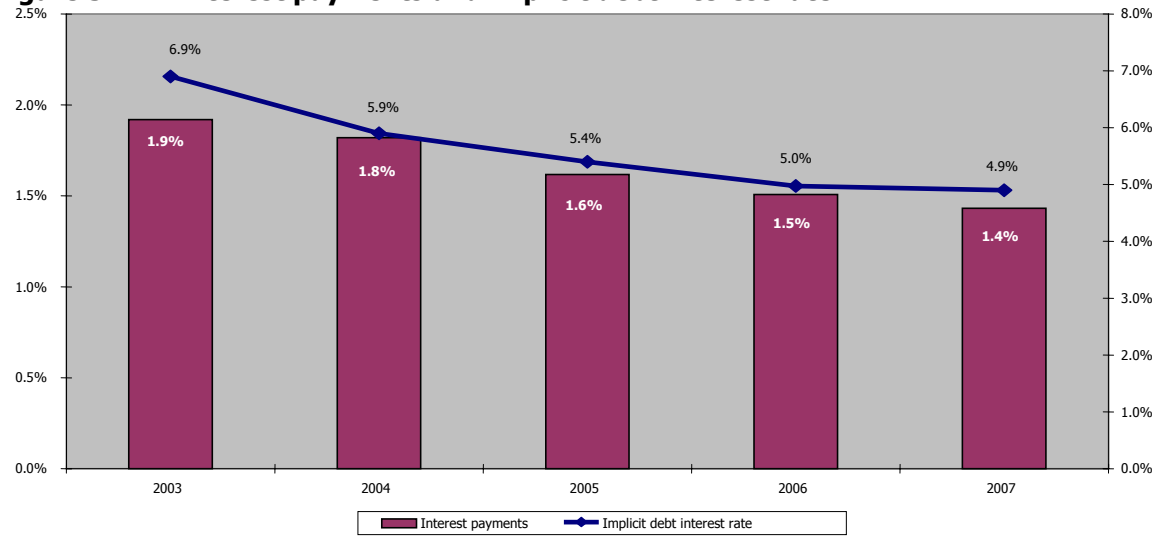
The gradual decrease in the general government deficit over the next four years will be partially a consequence of the gradual reduction in the cyclical deficit after 2005, but primarily of the completion of structural reforms linked to the fiscal sector. Measures on the part of public-finance revenues and expenditures described in the previous chapter will contribute to a reduction in the structural portion of the public-finance deficit by approximately 0.7 percentage points by the end of 2007. In addition, expenditure reduction will also be influenced by a more active policy of debt management. Thus interest payments will be reduced from 1.92% of GDP at the end of 2003 to 1.43% of GDP by the end of 2007.

Figure 3.1.: Actual and cyclicaly-adjusted balance of the state under ESA-95 methodology (all data expressed as % of GDP)



The cyclical component of public-finance revenues and expenditure is calculated using the methodology recommended by the European Commission and presented in appendix 2. It is based on the elasticity of public-finance revenues and expenditures to deviations in actual GDP from its potential value.

Figure 3.2.: Interest payments and implicit debt interest rate



3.5. General government debt

The outstanding amount of general government debt at the end of 2003 reached SIT 1,623.5 bn (28.6% of GDP). The largest share (more than 95%) of the total represents the central government debt. The shares of social insurance funds' debt and local communities' debt are 2,5% and 1%, respectively.

Due to the undeveloped and small financial market and high inflation, until 2000 the cental 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. In 2004 – and as expected in 2005 – the central government will borrow in the domestic market in the full amount of required financing, and only by issuing tolar securities with nominal, fixed interest rates.

General government debt is still expected to grow in 2004 and 2005, primarily due to the central government deficit. Furthermore, in 2005 the central government is expected to take over the debt of ZZZS. General government debt will gradually decline after 2005. This dynamics is explained mainly by reduction of central government deficit. Increased investment is expected in future years in public infrastructure, primarily in the area of railway infrastructure, but at the same time the debt of the Pensions and Disability Insurance Fund will be gradually reduced.

Table 3.3.: General government-debt developments

% of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		**28,6%**	**29,1%**	**29,5%**	**29,4%**	**28,4%**
Change in gross debt		**-0,2%**	**0,5%**	**0,4%**	**-0,1%**	**-1,0%**
Contributions to change in gross debt						
Primary balance		0,26%	0,33%	0,36%	0,17%	-0,35%
Interest payments	**D41**	**1,58%**	**1,60%**	**1,42%**	**1,32%**	**1,27%**
Nominal GDP growth	B1g	-0,58%	-1,41%	-1,45%	-1,43%	-1,50%
Other factors influencing the debt ratio		-1,45%	-0,02%	0,07%	-0,17%	-0,42%
p.m. Implicit interest rate on debt		**6,9%**	**5,9%**	**5,4%**	**5,0%**	**4,9%**

Source: MF RS.

The general government debt is relatively low compared to other EU member states. The repayment profile of central government debt is predominantly long-term and spread evenly over time. In addition, the bulk of the central government external debt is in Euros, while repayment of the bulk of principals will mainly fall due after Slovenia has already adopted the Euro.

4. ANALYSIS OF THE SENSITIVITY OF PUBLIC FINANCES TO CHANGES IN ECONOMIC ACTIVITIES AND COMPARISON WITH PEP 2003

4.1. Analysis of sensitivity to changes in economic activity

The Programme for Entering the ERM II lays down a set of measures to reduce inflation in a sustainable manner to the level required by the Maastricht criteria in 2005 and to stabilize the tolar's exchange rate without causing any deterioration in other macroeconomic indicators. During preparations for participation in the ERM II or during participation itself some risks may arise.

In addition to the macroeconomic baseline scenario for 2004, which is the most probable, three alternative scenarios were made, which reflect an estimated scope of the main risks to the fulfilment of forecasts. The first risk factor is the deterioration of Slovenian economy's competitiveness after joining the EU. This would lead to lower domestic production growth and higher unemployment. Unsatisfactiory adjustment of the economy to conditions in the EU could undermine the competitiveness of labour-intensive industries, resulting in lower production volumes and higher unemployment due to reduced exports and increased competition from imported products. The scenario assumes 4.4 percentage points lower export growth of labour-intensive industries compared to the baseline scenario. As a consequence, economic growth might be about 0.8 of a percentage point lower and the average number of unemployed about 6,000 higher in 2004. According to these assumptions, the general government deficit might increase by 0.21% of GDP.

The second risk factor is based on the assumption that decline in nominal interest rates after entering the ERM II will additionally increase domestic demand, thereby worsening trade balance and increasing inflation. The estimated impact is strong investment and it is slightly less evident in private consumption where any additional demand for bank loans is limited by restrictive wages policy and relatively high non-interest borrowing costs. A greater response of domestic demand to lower interest rates, which is less likely than foreseen in the baseline scenario, could further increase real growth in gross fixed capital formation by 4 percentage points and private consumption by 1.5 percentage points at most. If we take the related increase in imports into account, domestic demand could accelerate economic growth by about half of a percentage point and widen the current account deficit to about 1.5% of GDP. At the same time, increased domestic spending would slightly slow down the path of disinflation by 0.2 of a percentage point in both 2004 and 2005 compared to the baseline scenario. As a result of these factors, the general government deficit would decrease by 0.16% of GDP.

The third risk factor is the increase in average price of oil. Under assumptions of the increase of average oil price to 31,7 USD per barrel and unchanged retail prices of oil derivatives, the revenues resulting from the excise duties on motor oils would decrease by not more than 0,2% GDP. The resulting lower GDP growth would have the impact on rise of general government deficcit by 0,05% GDP. This means that the result of increased average oil price in 2004 is already taken into account in the safety margin and does not have a substantial impact on fiscal scenarios.

It is clear from the table below that the structural fiscal deficit in the period under observation throughout is lower (or equal in 2004) than the Maastricht criteria corrected for the safety limit.

Table 4.1.: General government deficit adjusted for safety margin

leto	Output gap	Sensitivity of balance to output gap	Measure of cyclicality	Upper limit of deficit (3%) reduced by safety margin	Structural deficit
2003	-0,95%	0,5466	2,73%	**-1,51%**	-1,40%
2004	-0,96%	0,5683	2,69%	**-1,47%**	-1,47%
2005	-0,79%	0,5557	2,65%	**-1,53%**	-1,41%
2006	-0,61%	0,5492	2,63%	**-1,56%**	-1,21%
2007	-0,37%	0,5301	2,62%	**-1,61%**	-0,75%

Source: MF RS

The outstanding general government debt is relatively insensitive to changes in inflation, exchange rate and the level of GDP. The cost of servicing existing debt and repayment of existing credits and securities[7] in 2004 is relatively insensitive to economic shocks.

Were the EUR/SIT exchange rate to increase in 2004 by SIT 30, and the USD/SIT exchange rate by SIT 45, this would increase interest by 0.08% of GDP, and repayment of principals by 0.15% of GDP. If inflation increased by 2.75 percentage points above the planned level in 2004, this would mean increased interest costs of 0.02% of GDP, and would therefore have negligible impact on the level of repayment of principals. The combined effects of deteriorating exchange rates (depreciation) and higher inflation would be 0.11% of GDP on interest and 0.14% of GDP on principals. If economic growth in 2004 was 2 percentage points lower, this would mean 0.03% of GDP higher interest costs and 0.06% of GDP greater repayment of principals.

Table 4.2.: Sensitivity of interest payments and debt repayments of the general government to changes in certain macroeconomic aggregates for two standard estimation errors

% GDP

	Interest	Principal
Change in exchange rates (EUR/SIT and USD/SIT)	0.08%	0.14%
Change in inflation	0.02%	0.00%
Change in exchange rates and inflation	0.11%	0.14%
Change in GDP	0.03%	0.06%

Source: MF RS.

It is clear from above that the existing central government debt is a relatively stable macroeconomic aggregate that is not strongly influenced by changes in exchange rate and inflation. This is primarily a consequence of the currency structure and the structure of debt instruments. The bulk of national debt is denominated in tolars and euros, with other currencies representing only around 1.6% of the total central government debt. In terms of the structure of instruments, fixed-rate debt already represents around 55% of the total

[7] We carried out simulations by deteriorating in the selected year individual macroeconomic aggregates by two standard estimation errors, covering 97.5% of all possible results in a normal distribution of possible results. We could conclude from this that we are dealing with a highly extreme negative value of the aggregate.

debt, while the proportion of index-linked debt (to inflation and/or exchange rates) has fallen to around 16% of the total central government debt.

4.2. Comparison with the updated Pre-accession Economic Programme (August 2003)

The estimated economic growth in 2003 and projections for 2004 are slightly lower than the PEP 2003 forecasts primarily as a result of different international environment assumptions. Namely, the economic recovery in Slovenia's main trading partners came later than anticipated. This mainly led to lower projections of real export growth rates. Furthermore, gross domestic product figures for 1995-2003 were revised last and this year, leading to some changes in projections, so the forecasts of the PEP 2003 and Convergence Programme 2004 are not fully comparable in terms of methodology.

Table 4.3.: Divergence from previous update

	ESA code	Year **2003**	Year **2004**	Year **2005**	Year **2006**	Year **2007**
1. GDP growth (constant prices)						
Previous update (2003) %		**3,1**	**3,9**	**4,0**	**4,4**	**n.p.**
Latest update (2004) %		2,3[1]	3,6	3,7	3,8	3,9
Difference, % points		**-0,8**	**-0,3**	**-0,3**	**-0,6**	**n.p.**
2. General government financial balance						
Previous update (2003) % of GDP		**-1,95**	**-1,64**	**-1,58**	**-1,30**	**n.p.**
Latest update (2004) % of GDP		-1,83	-1,93	-1,78	-1,49	-0,92
Difference, % points		**0,12**	**-0,29**	**-0,20**	**-0,19**	**n.p.**
3. Gross debt levels[2]						
Previous update (2003) % of GDP		**n.p.**	**n.p.**	**n.p.**	**n.p.**	**n.p.**
Latest update (2004) % of GDP		28,6%	29,1%	29,5%	29,4%	28,4%
Difference, % points						

[1] Debt figures from the PEP 2003 include central government debt acroding to the national methodology (based on GFS 1986 methodology). The only exception in the PEP 2003 is the figure on debt relative to GDP for 2002 (27.78%) which refers to general government.

5. STRUCTURAL POLICIES

Structural reforms that help improve the competitiveness and flexibility of the economy are playing a crucial role in Slovenia's effective integration into the EU. The policies of strengthening economic competitiveness and establishing the knowledge-based society will allow Slovenia to manage risks more effectively, take advantage of the benefits of integration into the new economic environment, and strengthen both economic and employment growth in the upcoming years. The approved budgets for 2004 and 2005 enable an increase in expenditure for purposes that mostly contribute to higher economic growth and better real convergence.

5.1. Fostering entrepreneurship and competitiveness

Slovenia has made significant progress in raising competitiveness over the last few years, and it aims to further step up this process by taking additional measures. Positive shifts have been seen in rising productivity and falling costs per unit of value added, while foreign market shares and inward and outward direct investment have increased.

The guidelines and measures introduced to bolster competitiveness are in line with the Lisbon Strategy. It is crucial to increase investment that will help reduce the productivity gap with the EU and encourage restructuring in favour of high value-added activities, to bolster the main growth factors, to accelerate structural reforms and reforms that will improve the efficiency of the institutional regulatory framework and public administration, and to create an environment conducive to entrepreneurship and innovation.

Measures to reinforce the main corporate competitiveness factors include:

- stimulate enterprises to make strategic investment;
- stimulate the development of services providing support to the internationalisation of enterprises;
- adjust legislation regulating export insurance and develop other facilities to support exports; and
- take systemic measures to encourage the development of tourism in line with the Strategy of Slovene Tourism in 2002-2006.

The Programme of Measures to Promote Entrepreneurship and Competitiveness 2002-2006 is an operational document, which aims to implement corporate sector's development policy and boost competitiveness by offering additional financial incentives to enterprises. Measures taken in the field of small and medium-sized enterprises plan to create a support environment and provide services through a network of small business promotion centres and the SME Development Fund. The One-Stop Shop[8] system is currently under construction and it will play a crucial role in reducing costs during the start-up and regular operations. A special project envisaged in the Government Programme for 2004 is to prepare a government decree and methodology for regulatory impact assessment (RIA).

[8] The One-Stop Shop aims to simplify and accelerate procedures necessary to set up a new small enterprise. It facilitates the procedure of entering a new enterprise into the register of companies or changing its legal status by providing a central contact office whose sole responsibility is to carry out procedures necessary to establish an enterprise. This will allow individuals to make all registration formalities at one place and in one office, using local registration points.

Measures to create a stimulating environment for business and entrepreneurship include:

- elimination of administrative barriers for establishing enterprises (amendments to systemic legislation, setting up an information system to facilitate company registration);
- amending the tax law regulating the collection of public levies with the aim of reducing the administrative burden on enterprises; and
- facilitate access to financing sources and develop the venture capital market for new corporate investment.

Similarly, the Single Programming Document[9] stresses the importance of encouraging the corporate sector and competitiveness. Measures under the first priority focus on bolstering competitiveness factors, corporate investment and entrepreneurship, and improving the availability and access to information, services and financing for small and medium-sized enterprises. Further goals are to improve know-how, co-operation and knowledge transfer between education and research institutions on one hand and the production sector on the other, and to encourage co-operation between enterprises in the European Research Area (the Sixth Framework Programme and Eureka).

5.2. Research, development and innovation

Expenditure on research and development (R&D) relative to GDP (1.57% in 2001, the latest available figure) puts Slovenia in the lead among new EU members and ahead of some EU-15 members. If the current dynamics of investing in R&D are maintained (2001 saw an increase of 0.1 of a percentage point over the year before), the objective of the Strategy for the Economic Development of Slovenia will be achieved (an increase in R&D expenditure to around 2% of GDP by 2006). Slovenia may therefore draw close to the Barcelona objective of 3% of GDP earmarked for R&D. The business sector represented 54.7% of total financing for R&D in 2001. The Government will provide incentives to increase the private sector's co-financing of R&D by making institutional changes to the organisation of R&D activity, adopting a more applied research-oriented National Research and Development Programme, and granting tax relief for investment in R&D in corporate income tax (already in place).

Two agencies have been set up in 2004, one in the field of research activity and one in the field of technological development. Their role is to carry out professional, research and executive tasks relating to the implementation of the new National Research and Development Programme, including the development of innovation infrastructure, systemic measures and institutions for knowledge transfer, and the stimulation of technological progress and economic growth.

Measures to strengthen R&D activity include:
- increase investment in the key areas of raising the level of technological advancement, using the existing technology networks;
- increase the share of applied research and target research programmes;
- encourage the schooling system to adapt to the needs of economic development by increasing financing, tuning education programmes to the needs of the economy, and by developing education infrastructure;

[9] See the Single Programming Document, Slovenia, 2003.

- increase the importance of the young researcher programme;
- encourage corporate investment in R&D by offering relief for R&D spending in the system of corporate income taxation; and
- facilitate the setting-up of centres of excellence, which will help concentrate know-how and equipment in areas of economic importance.

5.3. Labour market

In 2002 Slovenia's labour market was characterised by modest employment growth and a downward trend in unemployment which, however, came to a halt in 2003. Nevertheless, the unemployment rate according to the labour force survey (6.7%) was below the average of EU member states. The employment rate (63.4%) was slightly behind the EU-15 average and above the level of EU acceding countries. As far as age is concerned, youth employment (15-24 years of age) and employment of people aged over 50 was below the EU average. As regards the former, this was primarily due to the relatively high youth enrolment in secondary and tertiary education and a higher rate of youth unemployment compared to the EU average. As regards the latter, the low employment rate is still affected by early retirement in the early 1990s. The average retirement age is rising thanks to the pension reform, but it is still lower than in the EU on average. In addition, structural unemployment is characterised by large shares of long-term unemployed, first-time job-seekers, unskilled unemployed, and people with special needs. On the other hand, differences in unemployment between statistical regions began to narrow in 2003.

The new Employment Act, which entered into force on 1 January 2003, increased labour market flexibility. Another important step towards greater labour market flexibility is wage de-indexation (see Chapter 1.3.).

The National Programme of Labour Market and Employment Development 2000-2006 is an umbrella document in the field of the labour market. Drawing on this Programme and the European Employment Strategy, the Government adopts an active employment policy programme each year. The selection of target groups is made with a particular concern for unemployed women, while funding from active employment policy is primarily directed to regions with above-average unemployment.

Measures taken in the labour market include:

- measures to employ older unemployed workers aged over 55;
- measures to deal with the issue of unemployed people with a higher education; and
- employment subsidies, which are earmarked for the active resolution of unemployment problems and are intended for the long-term unemployed who are recipients of social benefits in cash. When a long-term unemployed person is hired, subsidies are provided to cover part of the wage.

Slovenia's pension reform was enacted in 1999 by passing the Pension and Disability Insurance Act. The main changes in the public pension system include a gradual increase in the exit age from the labour market to 63 for men and 61 for women, an increase in the reference period for calculating the pension base, the possibility of accumulating annual accrual rates after the pension qualifying period has been attained, additional rises and cuts in pensions for early or late retirement etc. The second part of the reform involves systemic changes: the reform has introduced the possibility of a second pillar voluntary pension insurance financed by premiums of employees, employers or both.

5.4. Education and training

Slovenia allocates a relatively high percentage of GDP for education and training, ranging between 5.5% and 5.7%. The education deficit of younger generations is falling as enrolment rates are rising to relatively high levels, while priorities remain the reduction of the number of drop-outs and improved balancing between the supply of education and training programmes and the needs of the economy. Another priority is to narrow the education deficit of adults.

The strategic and conceptual framework for education and training is laid down the White Paper on Education and Training adopted by the National Assembly in 1995. The White Paper has been upgraded by a number of documents, acts and implementing regulations which reflect the integration of Slovenia's education and training with the main EU policies in the field of human resource development, supporting the Lisbon Strategy, the knowledge-based society, economic competitiveness and knowledge excellence.

Efforts to reduce the education deficit of adults include greater enrolment of adults in various forms of lifelong learning, activities aimed at raising the education level and knowledge excellence, and encouragement of lifelong learning policy. The unemployed can enrol in training programmes to obtain formal education, take part in the national vocational qualifications assessment and awarding programme, mainly in areas recording a deficit of people with certain qualifications, and participate in training programmes which allow them to obtain additional skills.

Measures taken to support national education and training policy are:

- teacher training;
- upgrading and development of education and training programmes, including the post-graduate level;
- development and expansion of IT equipped local/regional lifelong learning centres, vocational guidance services for young people and adults, primarily for women and people with unfinished education; and
- expansion of a quality control model which is based on the principle of self-assessment, paying particular attention to institutions and training for vocational qualifications and adult learning.

5.5. Financial system

Structural reforms and measures in the financial system are being carried out in parallel with harmonisation with the acquis, while the main priorities include further restructuring, greater capital capacity, and competitiveness of financial institutions.

Financial institutions (banks, insurance companies and other financial intermediaries) continue to pursue the processes of internal restructuring and consolidation, internationalisation and diversification of services. These efforts include the reduction of costs and employment, and the improvement of financial institutions' capital adequacy and capacity, taking place through integration, privatisation and internationalisation. It is also important to diversify the supply of services, improve their quality, and obtain new skills in areas such as risk management and information and organisation technologies which

follow the latest international standards. This will allow entities to expand their financial services in terms of substance and spatial distribution and, in turn, increase competitiveness, improve financial services and reduce the cost of services for the user.

Following the trend of financial market integration in the EU, the development of Slovenia's financial market is likely to take the same direction, thereby enhancing business opportunities for all entities in the market and strengthening corporate culture. This will take place through the process of introducing new forms of organised trading, changes to the ownership structure (integration), and the principles of corporate functioning.

In view of the tendency for financial instruments, institutions and markets to integrate, leading to growing competition, steps will be taken to increase the transparency of operations of financial institutions and improve supervision in all segments of the financial sector by setting up a single and independent supervisory authority.

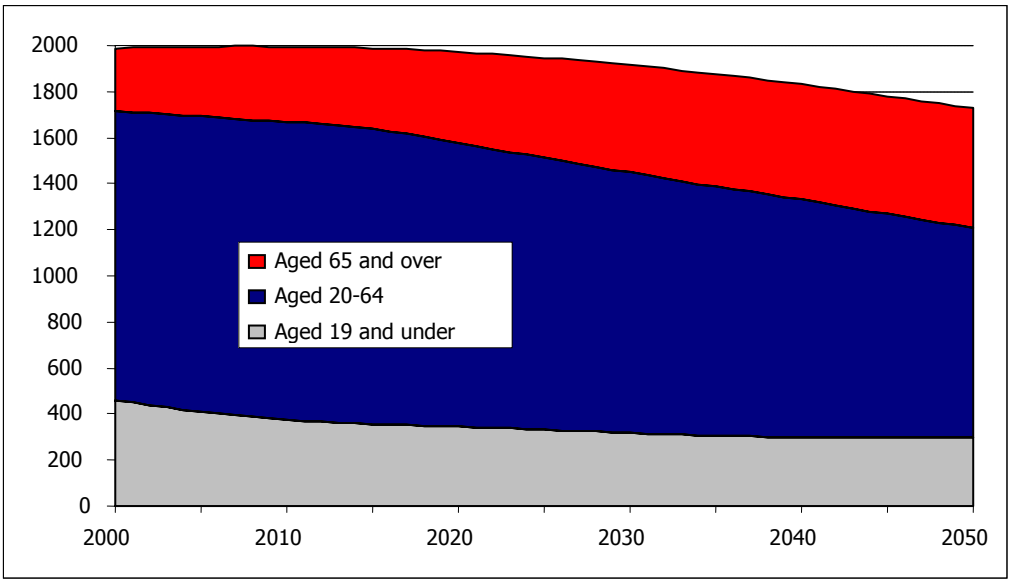
6. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES[10]

In the coming decades in Slovenia, the proportion of the population aged over 65 and aged over 80 will rise sharply compared to the working-age population. Faster ageing of the population will place strong pressure on public finances and will require appropriate action for the long-term sustainability of public finances.

Similar demographic processes and linked fiscal problems are occurring in other countries, but events in Slovenia are particularly marked. Life expectancy is shorter than in the most developed countries, and so it can in future be expected to increase significantly. At the same time, fertility levels are the lowest in Europe, having stuck at a value of around 1.2 children per woman.

Forecasts suggest that the population of Slovenia will fall by the middle of this century to around 1.72 million, representing a reduction of almost 270,000 people compared to 2003. The population structure will also change fundamentally, becoming in fiscal terms distinctly unfavourable. The population over 65 will increase from 295,000 (14.8%) in 2003 to 517,000 (29.9%) in 2050 (Figure 6.1). On the other hand, the population aged 20-64 will fall from approximately 63% in 2003 to less than 53% in 2050.

Figure 6.1.: Demographic changes – population by individual age groups [000s]



Source: Statistical Office of the Republic of Slovenia and Institute for Economic Research.

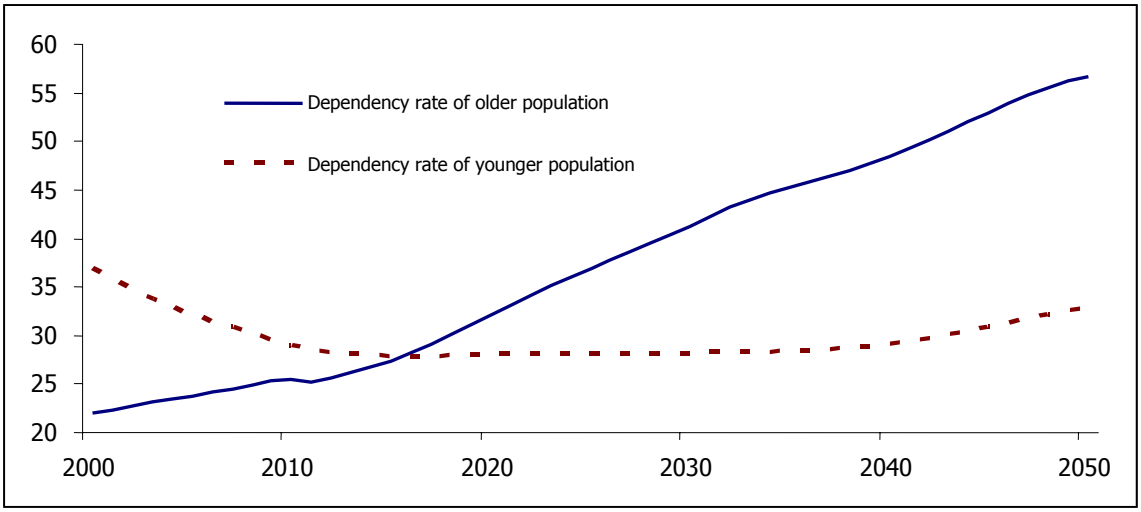
The dependency rate[11] of the younger population, measured as the ratio between the number of persons aged under 20 per 100 persons aged 20-64 will in the next decade fall from the current level of 34 to 28, and will stabilise at this level (Figure 6.2). It will

[10] Since Eurostat's demographic projections for Slovenia are still not available, the analysis used population forecasts prepared in spring 2004 by a working group of Slovenian demographic experts. Analyses of the impact of demographic projections on the long-term sustainability of public finances are in preparation, and so estimates will in future be supplemented or corrected.

[11] Normally the burden on the active population is expressed as the ratio between the number of people not of working age and the working-age population.

increase somewhat in the last decade of the projection period, since while the population under 20 will stabilise at around 300,000, the number of people aged 20-64 will continue to fall. A key problem will arise in the dependency rate for the older population, since the projection suggests that the number of people aged over 65 per 100 people aged 20-64 will increase considerably throughout – from 23 in 2003 to almost 57 in 2050. If there are no appropriate systemic changes, such marked growth would mean the fiscal position deteriorating very quickly, becoming unsustainable.

Figure 6.2.: Demographic rate of burden



Source: Statistical Office of the Republic of Slovenia and Institute for Economic Research.

The fiscal impacts of expected demographic changes[12] on both the expenditure (increased expenditure on pensions and health) and revenue (lower tax base as a consequence of reduced labour supply) sides. Realising the impending demographic changes, certain measures have already been adopted. The most important of these is the pension reform which was begun in 2000 and will mean that by the end of the transition period, men's retirement age will increase by around 2.5 years, and that of women by around 4.5 years.

The long-term sustainability of public finances will depend strongly on the employment rate. The unemployment rate under optimistic assumptions will fall from the current 6.7% to 2% in 2020, and will stabilise at this level. The target value for the activity rate in 2050 for the 15-64 age group is set at an ambitious 80%. In order to achieve this, the activity rates will have to be increased in all groups, particularly in groups with special difficulties in entering the labour market (young people and immigrants).

Demographic projections assume net immigration to Slovenia. If this is not the case, or if immigrants have difficulty integrating into the labour market, then the future fiscal situation could be less favourable. There is a particular danger that trends in the activity and unemployment rates could be less favourable.

[12] To analyse the effects of demographic changes on public finances, we attempted to allocate as many public-finance revenues and expenditures to representatives of individual age groups, and where possible also separately by sex. In the first stage, mostly on the basis of individual (survey) data, for individual categories we estimated the relative position of representatives of individual groups; then in the second stage we applied the structure to (actual) aggregate data. We allocated other revenues and expenditures (e.g. army, police, judiciary, ...) equally across all age groups, which means that trends for these aggregates will follow changes in population numbers. In the analysis, we also attempted to take account of certain key statutory and other changes made that will influence public-finance events in the future. We applied the projections of age- and sex-specific profiles so obtained to population projections (by age groups and sex).

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

	2005	2010	2020	2030	2040	2050
Total expenditure	42.8	42.0	41.4	42.3	44.5	47.3
Pensions	12.5	12.2	13.1	14.6	16.2	16.8
Healthcare	6.7	6.8	7.2	7.8	8.5	8.9
Interest payments	1.6	1.2	0.4	0.1	0.9	3.5
Total revenues	42.2	42.5	42.6	41.8	40.7	39.0
Of which: from pension (and disability) contributions	9.5	9.6	9.8	9.7	9.6	9.4
Assumptions						
Labour productivity growth	3.1	3.5	3.0	3.0	3.0	3.0
Real GDP growth	3.7	4.3	2.5	2.4	2.3	2.2
Activity rate males (aged 15-64)	71.3	73.8	76.8	78.8	80.9	84.6
Activity rate females (aged 15-64)	63.4	66.0	69.0	73.0	75.0	75.0
Total participation rates (aged 15-64)	67.4	70.0	73.0	76.0	78.0	80.0
Survey unemployment rate	6.3	3.6	2.0	2.0	2.0	2.0

In line with the estimated effects of pension reform and the optimistic assumptions regarding the activity and unemployment rates, the fiscal situation in the next two decades appears favourable. However, a budget deficit is expected to recur in 2029 and then accelerate, exceeding the EMU criterion of three percent in 2038. By 2050, it will thus reach around 8% of GDP. Expenditures on health and particularly pensions will increase substantially, since life expectancy is expected to continue to rise at the same time as numerically larger generations will retire.

To avoid this, further measures will be required at the start of the 30s.

Appendix 1: Methodology for calculating potential output

We calculated the potential output and the output gap using the production function (PF), which is the official EU method for preparing convergence programmes and the official method of the European Commission for assessing such programmes. The PF method is based on the Solow model of economic growth, more precisely on the equation for calculating growth (so-called growth accounting). We used the Cobb-Douglas production function,

$$Y = AK^{1-\alpha}L^{\alpha}, 0 < \alpha < 1$$

where A is technology, K capital, L labour and α the share of labour in income. In the logarithmic form of PF

$$y_t = tfp_t + \alpha l_t + (1-\alpha)k_t$$

tfp_t represents the total factor productivity, which in economic theory is known as the Solow residue and represents sources of growth not arising from the contributions of capital or labour. l_t and k_t are the logarithms of the stakes of labour and capital.

Capital stock was calculated using the perpetual inventory method. We first calculated capital stock (K_0) in the base year (2000) based on:

$$K_0 = \frac{(1-\alpha)y_0}{r_0 + \delta}$$

where $(1-\alpha)$ is the share of capital in income, y_0 is real GDP in the base year, r_0 is the real long-term interest rate on capital investment and δ is the depreciation rate (7.5%). We calculated capital stock in other years on the basis of:

$$K_{t+1} = \frac{I_{t+1} + K_t}{1+\delta}$$

where I_{t+1} are real gross fixed investments.

Potential employment level in the commercial sector was calculated as:

$$L = PR * NWA * (1 - NAWRU) - EG$$

where NWA is the population aged 15-65, PR is the trend participation rate, $NAWRU$ is the unemployment rate at which there is no pressure to increase wages (NAWRU= non-accelerating wage rate of unemployment) and EG is the number of employees in the public sector. NAWRU was calculated using a simplified method that accession states can use instead of the otherwise required method of unobserved components. We thus used the following form

$$NAWRU = U - \left(\frac{DU}{D^3 \log W} \right) * D^2 \log W ,$$

where U is the unemployment rate, DU the first differential of the unemployment rate and $D^2 \log W$ and $D^3 \log W$ are the second and third differentials of the logarithms of the level (total) of gross wages. It is clear from the method for calculating potential employment that we used data on the number of employees and the unemployment rate, and that at the time we did not follow the latest proposal of the European Commission, under which the share of labour should be calculated based on data on the actual number of hours worked.

Share of capital in income $(1-\alpha)$ is calculated as the share of operational gross surplus and gross mixed income in the total factor income. **The share of labour in income** (α) is calculated as the share of wages of employees in the total factor income. Total factor income is calculated as the difference between nominal GDP and net indirect taxes. The value α , which we used in the PF, is the average value of the share of labour in income over the period 1995-2002.

The time series **total factor productivity** tfp_t was calculated as the difference between the logarithmic values of actual production and other input data. The time series of residues was then smoothed using an HP filter (λ=100), resulting in the trend total factor productivity, tfp_t^*.

Potential output (in logarithmic form) for the private sector of the economy y_t^* was calculated by inserting into PF the logarithmic value of input date:

$$y_t^* = \alpha l_t + (1-\alpha)k_t + tfp_t^*$$

We took account of the recommendations of the European Commission and calculated the potential output separately for the private sector by excluding the added value of the public sector from the GDP data and using the share of labour adjusted for the number of employees in the public sector. We later added the contribution of the public sector in the form of public-sector added value to the estimated potential output of the private sector.

Sources of data and forecasts:

All input data used are real data with base year 2000.

- **GDP**: source (1995-2003): UMAR; forecasts (2004-2009): UMAR
- **Public-sector added value**: source (1995-2003): UMAR; forecasts (2004-2009): UMAR
- **Gross fixed investment:** source (1995-2003): UMAR; forecasts (2004-2009): UMAR
- **Real interest rates for long-term capital investments:** source (1993-2002): BS Bulletin assuming that they remain at the same level as in 2002
- **Population aged 15-64:** source (1995-2002): UMAR
- **Employment (ILO):** source (1995-2003): UMAR; forecasts (2004-2009): UMAR
- **Unemployment rate (ILO):** source (1995-2003): UMAR; forecasts (2004-2009): UMAR
- **Public sector employment:** source (1995-2002): SURS; (2003-2009): assumption 1% growth
- **Total gross wages:** source (1995-2003): UMAR; forecasts (2004-2009): UMAR

Appendix 2: Methodology for estimated structural fiscal aggregates

Economic cycles have a major impact on certain segments of public finances, and so a true picture of the fiscal situation of the state is provided by structural fiscal aggregates, from which the influence of the cyclical nature of the economy is excluded. Budget revenues and expenditures do not change in proportion to changes in GDP due to the progressive nature of certain taxes, the existence of restrictions on certain social transfers and changes to tax rates.

In calculating the fiscal structural balance we followed the guidelines of the European Commission. In the first stage we estimated the output gap, which is the difference between actual output and its potential value, and is thus an indicator of the deviation of economic conditions from the norm. We then calculated the elasticity of individual fiscal categories with regard to GDP and on the basis of both estimated the cyclical component of public-finance revenues and expenditure. In the final stage, we separated this component from the actual values of fiscal aggregates.

To **estimate potential output and the output gap** we used the production function method. The share of labour used to estimate potential output was adjusted to take account of human capital by multiplying the level of potential employment calculated on the basis of ***NAIRU/NAWRU*** by the quality of labour index. Due to a lack of data on stock of physical capital for Slovenia, we calculated this on the basis of estimated capital stock in the base year, estimated share of capital in income and data for gross fixed investment, applying a **10%** depreciation rate. The share of capital in income is calculated as the share of gross operational surplus and gross mixed income in the total factor incomes (GDP minus output and import taxes). Potential output was calculated separately for the private sector by excluding from input data the added value of the public sector and employees in the public sector. At the end, we added to the calculated potential output the contribution of the public sector in the form of added value. The estimated potential output and output gap ((Y-Y^*)/Y^*) were calculated on the basis of real data with base year 2000.

Revenue elasticity (ε_R) was calculated as a weighted average (with regard to their shares in total revenues) of the elasticity of five categories of revenues: income tax, corporation tax, social-security contributions, including payroll taxes, indirect taxes and all other revenues. Elasticity for individual groups of revenues was calculated using regression equations that show the dependence among the logarithms of each of the five groups of revenues and the logarithm of GDP. The cyclical component of revenues ($r_t^{(c)}$) is then calculated as the product of actual revenues (r_t), elasticity of revenues and the output gap:

$$r_t^{(c)} = r_t * \varepsilon_R * (Y - Y^*) / Y^*$$

The EU methodology further assumes that economic cycles only influence transfers to the unemployed, and not other categories of expenditure. Expenditures linked to unemployment are laid down in law, and so they increase "automatically" in the event of a slowdown in economic activity. The **elasticity of revenues** linked to unemployment (β) is calculated as the product of the elasticity of the unemployment rate with regard to GDP (an inverse Okun's coefficient) and the elasticity of transfers to the unemployed with regard to the unemployment rate. Both of these elasticities are calculated using dual-logarithmic regression models. The cyclical component of expenditures is calculated as the product of transfers to the unemployed, the elasticity of expenditures and the output gap.

$$e_t^{(c)} = e_t * \beta * (Y - Y^*) / Y^*$$

Thus the elasticity of revenue categories and the elasticity of transfers to the unemployed are calculated from nominal data appropriate to the national methodology for managing values for individual fiscal categories. Such elasticities were thus applied to revenue and expenditure data under the ESA 95 methodology.